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Pilot Wetlands Reserve Program

The ASCS has published final rules for a pilot Wetlands Reserve Program (WRP). 7 C.F.R. pt. 703. 57 Fed. Reg. 23908 (June 4, 1992). Under the WRP, the ASCS purchases wetlands conservation easements on eligible land from agricultural producers. For fiscal year 1992, the WRP is limited to nine states: California, Iowa, Louisiana, Minnesota, Mississippi, Missouri, New York, North Carolina, and Wisconsin. 7 C.F.R. § 703.1. The ASCS determined that these states provide eligible acres necessary to enroll approximately 50,000 acres and allow an evaluation of the WRP implementation procedures. The 1990 Farm Bill requires that the USDA Secretary, to the extent practicable, attempt to enroll one million acres in the WRP by the end of 1995. 16 U.S.C.A. § 3837(b). The legislation provides that the easements may be permanent, for thirty years, or for the maximum period allowed under state law. 16 U.S.C.A. § 3837a(e), but also requires that the Secretary give priority to permanent conservation easements. 16 U.S.C.A. § 3837c(d). The ASCS announced it is accepting only permanent easements in the pilot program. 57 Fed. Reg. 23908, 23912.

Under the rules, cropland eligible for the WRP includes farmed wetlands or prior converted cropland that has potential for successful restoration as high value wetlands in light of the costs of restoration. The cropland must also have been annually planted, or considered planted, to an agricultural commodity in at least one of the five crop years from 1986 through 1990 and must be suitable for planting to an agricultural commodity at the time of enrollment in the WRP. Land suitable for planting to an agricultural commodity is also eligible if it is wetland restored under a Conservation Reserve Program (CRP) contract or a federal or state wetland restoration program without an easement of at least thirty years, if such land was planted to an agricultural commodity two of the five crop years from 1981 through 1985. Other eligible lands include: non-cropland adjacent to the wetlands whose inclusion will significantly contribute to the restoration of the wetlands; riparian areas linking wetlands which are protected by an easement or other conservation agreement; and lands adjacent to restored wetlands which will contribute to the

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U.S. District Court vacates $1,700,000 penalty against farm family

In a recent decision entitled *Roy and Renee Vandervelde v. Yeutter*, 789 F. Supp. 24 (April 15, 1992), the U.S. District Court for the District of Columbia vacated a determination of the Deputy Administrator for State and County Operations (DASCO), which had penalized them $1,700,000 (the largest penalty ever in the history of the Dairy Termination Program (DTP)). The court remanded the case to DASCO for a new hearing, with a provision that plaintiffs may appeal any decision of DASCO to the new National Appeals Division of USDA.

Plaintiffs previously owned and operated one of the largest dairy farms in Oregon. They entered into a contract with USDA to participate in the DTP, and sold their dairy herd (1,224 head) for slaughter. Subsequently, USDA found that plaintiffs had breached their contract, and DASCO denied them payments due under the contract, which totalled approximately $1,700,000.

The district court found that the administrative hearings "were not conducted in the manner deemed most likely to obtain the facts." The court noted that the record was replete with hearsay, and that DASCO's decision was based entirely on a report prepared by a single OIG investigator, who drafted the written statements of the witnesses he interviewed. Plaintiffs had requested that some of these witnesses be made available for interviews or depositions, but plaintiffs' repeated requests were denied. The court found evidence of intimidation of the witnesses and "an aura of community vendetta" emanating from the record. The court also commented on the "possible disproportionality between the plaintiffs' alleged offense and the $1,700,000 sanction."

—Alexander Pires, counsel for the Vanderveldes, Conlon, Frantz, Phelan, Knapp & Pires, Washington, D.C.

Qualifying gross income requirement in '88 Disaster Assistance Act

A federal district court has construed the eligibility requirements of the Disaster Assistance Act of 1988, 7 U.S.C. § 1421, and the regulations promulgated under it, 7 C.F.R. pt. 1477, as precluding the addition of the gross revenues of a wholly-owned nonfarm corporation to the producer's individual gross revenues when making the initial eligibility determination that the producer did not have annual gross income in excess of $ 2 million. *Hanson v. Madigan*, 788 F. Supp. 403, 1992 WL 59078 (W.D. Wis. 1992). The court declined to defer to the ASCS's contrary interpretation of the statute and regulations. It also declined to follow a similar case reaching the opposite result, *Vculek v. Yeutter*, 754 F. Supp. 154 (D.N.D. 1990), *aff'd sub nom.*, *Vculek v. Madigan*, 950 F.2d 727 (8th Cir. 1991). *Id.*, 1992 WL 59078 *6.

The Disaster Assistance Act of 1988 limited eligibility to "persons" whose "qualifying gross revenues" did not exceed $ 2 million annually. If the majority of a person's annual income was derived from farming in the preceding year, only that income was to be considered in determining "qualifying gross income." Otherwise, income from all sources was to be considered. *Id.*, 1992 WL 59078 at *3 (citations omitted).

In addition to limiting eligibility based on a person's "qualifying gross revenues," the statute directed the Secretary to define the term "person" to conform to the extent possible to the payment limitation definition of that term. The dispositive issue in the case was whether the statute treated "person" determinations for payment limitations purposes distinctly and differently from initial eligibility determinations.

Answering that question affirmatively, the court accepted the plaintiffs' argument that the statute contemplated differing treatment of a producer's income from non-farm sources when determining eligibility and the payment limit. It adopted the plaintiffs' contention that, when less than the majority of the producer's income in 1987 was derived from farming, both the statute and regulations permitted the adding together of the producer's income from farm and non-farm sources for payment limitation purposes, but not for eligibility purposes. *Id.*, 1992 WL 59078 at *4-5.

Notably, the court observed that the 1989 Disaster Act expressly required that "annual gross revenues should be determined for eligibility purposes in the same manner as for payment limitation purposes." *Id.*, 1992 WL 59078 at *5 n.3.

— Christopher R. Kelley, Of Counsel, Arent, Fox, Kintner, Plotkin & Kahn, Washington, D.C.

Farm stored grain quality dispute

The U.S. Claims Court has upheld an ASCS decision to order delivery of a Wisconsin producer's collateral securing a Farm Storage Grain Reserve note and security agreement. *Gratz v. United States*, 25 Cl. Ct. 411 (1992). In doing so, the court rejected a host of constitutional and other challenges to the ASCS's actions.

Between January, 1982, and December, 1987, James and Therese Gratz stored corn under thirteen grain reserve nonrecourse loan contracts. Under the agreements, the Gratzs were responsible for any loss in the stored corn's quality and quantity. *See* 7 C.F.R. §§ 1421.15.

In 1987, the ASCS inspected several of the storage sites and found weevil infestations and other quality shortcomings. Nevertheless, the inspectors rated only two of the sites as "questionable," and the others as "satisfactory."

For several months after the inspections, the ASCS made numerous demands for the Gratzs to take various actions regarding the stored grain. During this time, the ASCS also reinspected the grain and, despite the discovery of continuing quality shortcomings, "inexplicably gave 'satisfactory' ratings to all but one contract and upgraded one from 'questionable' to 'satisfactory.'"

Later, after the ASCS had decided to call all of the existing loans for continuing quality problems and other reasons, the grain was inspected for a third time. That inspection "only rated one contract as questionable." Finally, in January, 1988, the county ASCS committee demanded delivery of the stored corn "due to unauthorized disposition, corn quality, passed due maturity dates, and lack of storage agreements."

Ultimately, that county committee's decision to call the loans was affirmed on appeal hy the ASCS state committee and the ASCS Deputy Administrator for State and County Operations (DASCO). DASCO, however, "restored any loan which 'was not called due to deteriorating condition.'"

Before the Claims Court, the Gratzs raised a host of issues, including the claim that the Farm Storage Loan worksheet Form 677-1 used by the county committee did not use the same grade terminology as required by Federal Grain Inspection Service (FGIS) standards. Although the Claims Court acknowledged that the grain storage regulations required the use of the FGIS standards in making grain quality determinations and that "it was unclear whether the ASCS inspectors used FGIS criteria in assessing plaintiffs' corn," the court concluded that the county committee had "acted on the totality of those inspections, looking beyond the 'satisfactory' rating." Accordingly, it held that the ASCS bad acted rationally, notwithstanding the "satisfactory" ratings for most of the contracts. *Id.* at 419 (citing *Frank's Livestock & Poultry Farm v. United States*, 17 Cl. Ct. 601, 606 (1989), *aff'd*, 905 F.2d 1515 (Fed. Cir. 1990) for the proposition that "questions as to grain quality . . . are peculiarly within the expertise of [the ASCS]").

The court also rejected the Gratzs' contention that they were entitled to an appeal hearing before the ASCS called their loans and demanded delivery of the grain, holding that the post-demand administrative appeal process under 7 C.F.R. pt. 780 satisfied the Gratzs' due process rights. Finally, the court held the ASCS's actions did not constitute a "taking" under the due process clause because the government was acting in a proprietary capacity, not as a sovereign, under the loan program.

— Christopher R. Kelley

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restoration. This final category of adjacent land may not be more than an average of 100 feet wide nor more than twice the size of the restored wetland, unless the ASCS Deputy Administrator of State and County Operations determines that a larger adjacent area is necessary to meet the objects of the WRP. An additional blanket provision allows inclusion of other wetlands that would not otherwise be eligible, if those wetlands significantly add to the values and functions of the eligible land included in the WRP. 7 C.F.R. § 703.7.

Land under CRP contract is eligible for inclusion in the WRP if the land meets the other criteria for inclusion and the land is likely to return to agricultural production after expiration of the contract. 7 C.F.R. § 703.7(d)(3). If the ASCS agrees to the transfer of land from the CRP to the WRP, the CRP contract will be terminated or otherwise modified subject to mutually agreed upon terms and conditions. Transfers from the CRP to the WRP, however, will only be available after the second WRP signup period if the landowner agrees to refund all CRP payments made since the close of the second available WRP signup period. 7 C.F.R. § 703.9.

The following land, even if it meets general criteria for WRP eligibility, is ineligible for the WRP: wetlands whose conversion was commenced after December 23, 1985 — i.e., wetland whose conversion constitutes a Swampbuster violation; land that contains timber stands or trees established under a CRP contract; lands owned or acquired by a federal agency; or land already subject to a deed restriction that prohibits the production of agricultural commodities or the alternation of existing wetland hydrology. 7 C.F.R. § 703.8. Also, if a landowner has restored a converted wetland to mitigate the effects of a Swampbuster violation, thereby avoiding Swampbuster penalties, the restored wetland is not eligible for inclusion in the CRP. 7 C.F.R. § 703.79(a)(2)(iii). To enter the WRP program, a landowner must file a statement of intent to participate in the WRP with the local county ASCS committee during announced signup periods. The first signup period ran in Iowa from June 1 to June 26 and in the other pilot program states from June 15 to June 26.

The landowner completes the application for participation by obtaining a Wetlands Reserve Plan of Operations (WRPO) from the USDA Conservation Service and the U.S. Fish and Wildlife Service, which must be approved by the ASCS. The landowner then submits to the ASCS a bid for easement payments. Bids must be submitted no later than ninety days after the close of the announced signup period unless the ASCS agrees to a later date. 7 C.F.R. § 703.11.

The WRPO is essentially a conservation management plan for the restoration and maintenance of the wetlands. It provides for specific wetland restoration measures and may include provisions for weed and pest control, management of specific compatible uses such as hunting and fishing, periodic haying and grazing, and managed timber production.

The Soil Conservation Service and the U.S. Fish and Wildlife Service develop the WRPO in cooperation with the landowner. Before the landowner submits the WRPO, it must be signed by the Soil Conservation Service, the Fish and Wildlife Service, the conservation district in which the land is located, and the landowner. 7 C.F.R. § 703.15.

The ASCS will consider easement bids in light of various regulatory criteria. The ASCS may not accept a bid in excess of the value of the agricultural land adjusted for soil costs, landowner restoration costs, and other factors. In general, the ASCS will rank the bids based on the environmental benefits per dollar of government expenditures on wetland restoration and easement purchase. 7 C.F.R. § 703.10.

Landowners whose bids are accepted must comply with numerous obligations. Primarily the landowner must grant a conservation easement to the ASCS and restore and maintain the land subject to the easement in accord with the WRPO and an easement contract between the ASCS and the landowner. The landowner must create and record a deed restriction for the land which grants ASCS easement rights superior to all other rights, except as authorized by the ASCS. In addition, the landowner must agree to a permanent retirement of the aggregate total of crop acreage bases and allotment and mandatory quota history on the farm or ranch to the extent that the crop acreage bases are not supported by the cropping pattern on the farm with the WRP land excluded. Management of land outside the easement area is also affected in that the landowner must refrain from activities on the farm area that will either cause excessive sediment and other pollutants to enter the easement area or that will alter the flow of surface or subsurface waters, except as provided in the WRPO. 7 C.F.R. § 703.12.

The ASCS in turn will pay the landowner according to the terms of the easement contract. ASCS payments shall be made in cash. For permanent easements, ASCS may make a lump sum payment to the landowner. ASCS, however, may not pay more than ten percent of the total purchase price of the easement per year until completion of any agreed upon restoration of the wetlands. ASCS must also agree in the WRPO or the easement contract to share the costs of rehabilitating the WRP wetlands. For permanent easements, ASCS shall pay not less than seventy-five percent of the actual restoration costs as determined by the ASCS. For easements which are not permanent, the ASCS shall pay between fifty and seventy-five percent of the costs. 7 C.F.R. § 703.13.

Note that in some states, other entities may pay the remaining costs, thereby relieving the landowner of any restoration costs. For example, in Minnesota, the state Department of Natural Resources, the U.S. Fish and Wildlife Service, and three conservation groups — Ducks Unlimited, Pheasants Forever, and the Minnesota Waterfowl Association — plan to raise $1 million dollars to cover landowners' expenses for WRP wetlands restoration. Schara, *Bogged Down Again — Some Wetlands To Be Restored*, Star Tribune June 21, 1992 at p. 12c.

If a landowner violates the terms and conditions of the easement contract, the WRPO, or the recorded WRP easement, the easement shall remain in force and the ASCS may require the landowner to fully restore the easement area in accord with the terms and conditions of the easement contract and the WRPO. The ASCS may also require the owner who received the payments to refund all the payments with interest. The ASCS, or any other entity assigned responsibility by the ASCS to compel compliance, may initiate a civil law action or any other authorized action to compel compliance at the property owner's expense. 7 C.F.R. § 703.19. Note that all owners of WRP land agree that each person on the easement contract with the ASCS, or each person who is subject to the easement, shall be jointly and severally liable for compliance and for any refunds or payment adjustments that may be required for failure to comply with the WRPO, the easement contract, or any provisions of the landowners' obligations provided for in the regulations. 7 C.F.R. § 703.12(a)(16).

Responsibility for the long-term survival of the WRP ultimately rests with the Congress. Fiscal year 1993 funding legislation, as approved but not yet introduced by the House Appropriations Committee, contains no funding for the WRP. The Committee reported that it is deferring additional funding until the results of the pilot program can be analyzed. *House Panel Approves Higher Funding for Some USDA Programs But Cuts Others*, Daily Report for Executives (BNA) (June 26, 1992).

— *Martha L. Noble*
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Private timber management: federal income taxes, capital expenditures and management expenses

By John S. Harbison

In the United States, excluding Alaska, there are approximately 483 million acres of timberland. This is forested land that is currently producing or capable of producing marketable timber. More than seventy percent of this acreage is in private hands. Some privately owned timberland is held in relatively large tracts by forest industries that also operate wood processing plants, but most is held in relatively small parcels by non-industrial owners. Indeed, 97 million acres, or twenty percent of the total, is held by farmers. Another 179 million acres, or thirty-seven percent of the total, is held by individuals and companies classified as "other private persons."[1] Many of these non-industrial owners may make timber sales infrequently during their lifetimes. However, even those not in the regular business of selling timber should attend to the tax consequences of owning timberland.

This article introduces the principal tax problems associated with the management and disposition of privately owned timber. The federal income tax treatment of capital expenditures and management costs are matters of consequence to taxpayers who (a) occasionally sell a portion of their standing timber or (b) periodically make improvements to their property by reforestation, precommercial thinning, or other means.

This article also offers an introduction to timber accounting for federal income tax purposes. Federal and state taxation is a complex topic. The taxpayer wishing a more complete explanation of federal taxation should consult *Forest Owner's Guide to Timber Investments, the Federal Income Tax, and Tax Record Keeping,* United States Department of Agriculture, Forest Service Agriculture Handbook No. 681.

What are the basic tax rules for different timber-related costs?

A stand of timber held for investment or business may be thought of as an agricultural crop with two unique features. The first is the relatively long period between planting and maturity. The second is that trees in the stand, especially if owned by a farmer or other non-industrial owner, may have uneven ages. Over time, portions of the stand may be cut and reforested. The taxpayer may construct logging roads and firebreaks, pay for the advice of consulting foresters, conduct prescribed burning or thinning to encourage growth, fight insects and fungi, and undertake many other activities associated with the ownership of timber.

Under the federal income tax code, the costs attributable to these activities are either (a) capital expenditures, (b) reforestation expenses [a special type of capital expenditure], or (c) ordinary management expenses. The distinctions between these costs are significant with respect to the methods by which they can be recovered by the taxpayer.

All capital expenditures may be capitalized and recovered either (a) incrementally in subsequent tax years or (b) as a whole when the timber is sold or abandoned.[2] Reforestation expenses may be recovered incrementally and also qualified for an investment tax credit.[3] Some ordinary management expenses, those deemed to be carrying costs, may be capitalized and recovered incrementally. Alternatively, carrying costs and all other management expenses may be deducted from current income.[4] Each of these basic concepts is discussed in the sections that follow.

What are capital expenditures?

Capital expenditures are the costs of making improvements to property that have useful lives beyond the tax year.[5] For example, capital expenditures might include expenses for the construction of firebreaks, timber roads, and buildings related to the timber operation. Capital expenditures also include the costs of purchasing machinery and equipment. Even though non-industrial timber owners may make capital expenditures infrequently, the tax consequences may be significant. Basically, a capital expenditure can be either periodically depreciated or recovered one time on the disposition of the timber, depending on the nature of the improvement.

When can a capital expenditure be recovered incrementally?

A capital improvement can be recovered incrementally, or depreciated, if it has a determinably useful life during which it will lose value from normal wear and tear or exhaustion.[6] If a capital expenditure is depreciable, it is assigned a recovery period by the tax code. For example, a light general purpose truck used in a timber business has a recovery period of five years.[7] The cost of the truck can be recovered by taking appropriate deductions from gross income over this five-year period. Depreciation schedules for different types of capital expenditure are tax accounting measures worked out on tax forms supplied by the Internal Revenue Service.

How is a non-depreciable capital expenditure recovered?

Essentially, the taxable income from a sale of timber is the difference between the proceeds of the sale and the timber's adjusted basis. Whenever an expenditure is capitalized, the basis is increased by the amount of the expenditure. By increasing the basis, and consequently decreasing the difference between proceeds and adjusted basis, capitalized expenditures can reduce the amount of taxable income from a sale.

Assume, for example, that the original basis of the timber is $50,000. After acquiring the timber, the owner makes a capital improvement costing $10,000. The original basis is adjusted and becomes $60,000. If the timber is then sold for $80,000, the taxable income is the difference between the proceeds of sale and the adjusted basis, or $20,000. This is, of course, a highly simplified example. However, it demonstrates that capital expenditures can be recovered even if not depreciated.

When a capital expenditure is depreciated, the adjusted basis is decreased by the amount of the deduction. If, in our example, the expenditure were depreciable over a five-year period at $2,000 per year, the original $60,000 adjusted basis after the expenditure would be steadily reduced as the deductions were taken. If the timber were sold during the fourth year after the expenditure, the taxable income would be the difference between the sale price ($80,000) and the new adjusted basis ($60,000 less $2,000 multiplied by 3 tax years), or $26,000. Again, this is a very simplified example, but it shows the distinction between a one-time and an incremental recovery of a capital expenditure.

What is the property's initial basis and how is it adjusted?

Adjusted basis reflects the capitalized costs in a property like timberland that have not yet been recovered.

The initial basis of a property depends

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on the method by which it is acquired. For example, if timber is acquired by purchase, the original basis is the purchase price.[8] If it is acquired by inheritance, the basis is the fair market value of the property on the date of the decedent's death.[9] If it is acquired by gift, the basis is usually the donor's adjusted basis in the property at the time of the donation.[10] Other less common forms of acquisition require various substituted basis calculations.

As expenditures are capitalized, the initial basis is adjusted upward to reflect these costs. As capitalized expenditures are recovered by depreciation, the adjusted basis is reduced. The adjusted basis is also reduced as parcels of timber from the property are sold. This accounting device is called a depletion allowance.[11]

How does the timber owner record adjustments to basis?

The timberland owner should establish a system of accounts to allocate the initial basis and any subsequent adjustments to the land and the timber. The timber account should include subaccounts for (a) merchantable timber, (b) naturally seeded immature timber, and (c) planted immature timber. The timber in each of these subaccounts should be identified by its quantity and dollar basis. The quantity of merchantable timber should be shown in cords or thousands of board feet. The quantity of immature timber can be shown in acres.[12]

Determining the initial and adjusted basis for timber subaccounts requires competent timber appraisals. Because immature timber becomes merchantable with time, unless it is destroyed, the subaccounts must be periodically reconciled with the forest's current age structure. Assume, for example, that the initial cost basis allocates $20,000 for merchantable timber and $5,000 for immature timber. According to an appraisal made five years after acquisition of the property, however, half the acreage identified in the immature timber subaccount is merchantable. The timber owner should adjust the subaccounts by increasing the merchantable timber basis to $22,500 and decreasing the immature timber basis to $2,500.

Second, assume that the timber owner sells some of the merchantable timber and then replants. Depletion would reduce the basis allocated to the merchantable timber subaccount. The basis of the planted immature timber subaccount would be increased by the amount of the capitalized reforestation cost. It is important to keep separate accounts for planted and naturally-seeded immature timber because special depreciation rules apply to reforestation costs.

How are reforestation expenses recovered?

The federal income tax code contains two special provisions for the recovery of reforestation expenses. These provisions are intended to encourage replanting by non-industrial owners. First, reforestation expenses up to $10,000 per year may be depreciated over seven years.[13] Second, the tax code provides a one-time investment tax credit for ten percent of the reforestation cost, provided the credit does not exceed $10,000.[14] Qualifying expenses include the costs of site preparation, seedlings, labor and tools.[15]

The allowed depreciation and the tax credit are integrated by the $10,000 cap. If a timber owner has reforestation expenses of $15,000 in the tax year, he can allocate and recover the cost as follows: The taxpayer can (a) take a $1,000 reforestation tax credit in the year the cost is incurred, (b) depreciate $10,000 of the reforestation cost over the first seven taxable years after the cost is incurred, and (c) recover the remaining $5,000, which is also capitalized, when the timber is sold. The last $5,000 can be recovered because capitalization increases the property's adjusted basis.

What is an ordinary management expense?

So far we have been dealing with capital expenditures. As we have seen, these costs are capitalized and recovered in a variety of ways, but essentially they are recovered incrementally after the expenditure or at one time when the timher is sold. We now turn to the recovery of ordinary management expenses. Ordinary management costs are divided into two categories: carrying charges and operating expenses.

Carrying charges include property taxes, mortgage interest payments, insurance premiums and analogous expenses. These expenses may be capitalized and recaptured when the timber is sold. Alternatively, they can he recovered, at least in part through deductions from current income.[16]

Operating expenses, on the other hand, can *only* be deducted from current income. Operating expenses include:

fees paid to consulting foresters; travel expenses directly related to the income potential of the property; the costs of silvicultural activities such as prescribed burning and precommercial thinning; the expenses of fire, insect and disease protection; the costs of tools having a short useful life; salaries for hired labor; and professional fees.[17]

What management costs can be deducted?

The federal income tax code permits the deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."[18] The code also permits the deduction of ordinary and necessary expenses incurred in "the management, conservation or maintenance of property held for the production of income."[19] In other words, ordinary and necessary expenses are deductible with respect both to timber held in a regular business and timber held for investment. The first question is whether the timher is held for the production of income. The second is whether an expense is, in fact, ordinary and necessary.

The property does not have to generate annual income. Instead, management expenses must merely be related to the production of expected income from the property.[20] Although timher held hy farmers and other small owners may generate income very infrequently, it would qualify as income-producing property if the owner demonstrates an intention to take profits as timber matures and becomes merchantable. The taxpayer in incurring the expenses must have a profit-seeking motivation.[21]

In addition, the taxpayer has the burden of showing that the expenses are ordinary and necessary.

How much of a management cost is deductible?

Under the tax code's passive loss rules,[22] the extent to which a cost is deductible depends on (a) the nature of the taxpayer's interest in the timber, (b) the degree of the taxpayer's participation in the timber operation, and (c) the nature of the expenditure. The passive loss rules apply to expenses related to business property owned by individuals, estates, trusts, personal service corporations, and closely held C corporations. To simplify rather complicated matters, this discussion is confined to individuals who own non-industrial timber.

If the timber is held as part of a husiness in which the taxpayer materially participates, all operating and carrying costs are fully deductible against income from any source. Treasury regulations

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set forth several tests for determining whether the taxpayer does materially participate.[23] Essentially, these tests seek to ensure that the taxpayer's participation in the business is regular, continuous and substantial.

If the timber is held as part of a business in which the taxpayer does *not* materially participate, expenses can only be deducted from income derived from "passive" activities. According to the tax code, passive activities are taken in connection with businesses in which the taxpayer does not materially participate.[24] In short, deductions related to a business in which the taxpayer does not materially participate can only be taken against income derived from businesses in which the taxpayer does not materially participate. However, if passive deductions exceed passive income, the deductions can be carried forward to future tax years in which passive income is earned.[25]

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[1] K. Waddell, D. Oswald & D. Powell, Forest Statistics of the United States, 1987 21 (1989).

[2] I.R.C. § 263 (1988).

[3] I.R.C. §§ 48, 194 (1988).

[4] I.R.C. §§ 162, 212 (1988).

[5] I.R.C. § 263(a)(1988).

[6] I.R.C. § 168 (1988).

[7] I.R.C. § 168(e)(3)(B)(i)(1988).

[8] I.R.C. §1012 (1988).

[9] I.R.C. § 1014 (1988).

[10] I.R.C. § 1015 (1988).

[11] Depletion allowances are discussed in related Producer Bulletin No. 10, NCALRI.

[12] For a more complete description of this accounting system, including examples, see W. Hoover, W. Siegel, G. Myles & H. Haney, Forest Owner's Guide to Timber Investments, The Federal Income Tax, and Tax Recordkeeping 12-13 (1989).

[13] I.R.C. § 194 (1988).

[14] I.R.C. § 48(a)(1)(F)(1988).

[15] I.R.C. § 194(c)(3)(A)(1988).

[16] I.R.C. § 189 (1988).

[17] W. Hoover, W. Siegel, G. Myles & H. Haney, *supra* note 12, at 19.

[18] I.R.C. § 162(a)(1988).

[19] I.R.C. §212 (1988).

[20] *Caruso v. U.S.*, 236 F. Supp. 88 (D.N.J. 1964).

[21] *Zell v. Commissioner*, 763 F.2d 1139 (10th Cir. 1985).

[22] I.R.C. § 469(1988).

[23] Temp. Treas. Reg. §1.469-5T (1991).

[24] I.R.C. § 469(c)(1) (1988).

[25] I.R.C. §469(f)(1988).

CERCLA liability of prior owners

Agribusiness firms with storage tanks located at facilities should take note of a recent court of appeals decision hailed as resolving liability issues under the federal Comprehensive Environmental Response, Compensation and Liability Act (CERCLA). Prior owners of property are responsible for cleanup costs under CERCLA regardless of whether the prior owners knew about or actively participated in the disposal of hazardous substances, according to a May 29, 1992 decision by the United State Court of Appeals for the Fourth Circuit. *Nurad, Inc. v. Hooper & Sons Co.*, 1992 WL 113360.

The ruling came in a case where the present owner sought reimbursement for cleanup costs against all the prior owners (including the shareholders and directors of the company that owned the property at the time of contamination) of the facility from the time of installation of the underground storage tanks forward. Under CERCLA, a person who incurs cleanup costs is entitled to recover from anyone who qualifies as a "responsible person" under the statute.

The court found that the term "disposal" used in the statute was not limited to "active human conduct." Rather, the court said that CERCLA is a "strict liability" statute and that liability is not dependent upon "culpability or responsibility for the contamination." The court also ruled that a plaintiff seeking to recover cleanup costs from a prior owner is not required to meet the "onerous burden of pinpointing at what precise point a leakage may have begun." Thus, leakage of the underground storage tanks on the property was "presumed" to have been "the result of a gradual and progressive course of environmental contamination" that included all of the prior owners of the property involved in the case.

—*David C. Barrett, Jr., National Grain and Feed Association, Washington, D.C.*

AG LAW CONFERENCE CALENDAR

Wetlands Regulation Conference
September 9-10, 1992, Hyatt Regency Atlanta, Ga; November 12-13, 1992, Sheraton Carlton Hotel, Washington, D.C.
Topics include: who are the players in the 404 Permit Process; your options if the Corps of Engineers refuses to issue a permit; solutions where wetlands are present, mitigation.
Sponsored by: Executive Enterprises, Inc.
For more information, call 1-800-831-8333.

Land Use Institute
August 19-21, 1992, Sheraton Palace Hotel, San Francisco.
Topics include: update on planning and land use regulatory decisions, the taking issue and eminent domain decisions; wetlands regulations; endangered species.
Sponsored by ALI-ABA.
For more information, call 1-800-CLE-NEWS.

Fundamentals of Bankruptcy Law
July 6-10, Stanford Law School, Palo Alto, CA.
Topics include: basic areas of bankruptcy liquidation and rehabilitation.
Sponsored by ALI-ABA.
For more information, call 1-800-CLE-NEWS.

Eighth Annual Farm, Ranch, and Agri-Business Bankruptcy Institute
October 8-11, 1992, Lubbock Plaza Hotel, Lubbock, TX.
Sponsored by: West Texas Bankruptcy Bar Association, Texas Tech University School of Law, Association of Chapter 12 Trustees
For more information, call Robert Jones, 1-806-762-5281

47th Annual Soil and Water Conservation Society Conference
August 9-12, 1992, Baltimore, MD
For more information, call 1-515-289-2331

Ag Law Summer Institute
Drake University Agricultural Law Center, Des Moines, Iowa
July 6-9, International Agricultural Transactions; July 13-16, Wetland Protection Law and Agriculture
Sponsored by Drake Law School Agricultural Law Center
For more information, call 1-515-271-2947.

Federal Register *in brief*

The following matters were published in the *Federal Register* during the month of May, 1992.

1. FCA; Assessment and apportionment of administrative expenses; proposed rule. 57 Fed. Reg. 19405.

2. FCS; Nondiscrimination in lending; eligibility and scope of financing; effective date: 5/27/92. 57 Fed. Reg. 22157.

3. FmHA; Providing assistance to beginning farmers or ranchers; interim rule. 57 Fed. Reg. 19520.

4. FmHA; Holding period for suitable inventory farm property in accordance with provisions of the Food, Agriculture, Conservation and Trade Act of 1990; interim rule. 57 Fed. Reg. 19526.

5. USDA; Recordkeeping requirements for certified applicators of federally restricted use pesticides; proposed rule; comments due 8/10/92. 57 Fed. Reg. 20380.

6 IRS; Limitation on passive activity losses and credits; definition of activity. 57 Fed. Reg. 20802. Correction 57 Fed. Reg. 21152.

7. IRS; Small business corporations; one class of stock requirement; final rule. 57 Fed. Reg. 22646.

—*Linda Grim McCormick*

VIRGINIA. *Durable powers and voidable transfers.* Olive Case, a Virginia resident, executed a durable power of attorney appointing her son, Robert, as her attorney in fact. Her son was authorised to "lease, sell, grant, convey, assign, transfer, mortgage and set over to any person... and for such consideration as he may deem advantageous, any and all of my property..." and "to accept and receive any and all consideration payable to me on account of any such sale, lease, conveyance, transfer or assignment...." In addition, the power of attorney conferred the following general power: "to do, execute and perform all and every other act or acts, thing or things as fully and to all intents and purposes as I myself might or could do if acting personally, it being my intention by this instrument to give my attorney hereby appointed, full and complete power to handle any of my business or to deal with any and all of my property of every kind and description, real, personal or mixed, wheresoever located and howsoever held, in his full and absolute discretion."

During Olive's life, she joined with her husband, Carlton, in making gifts to their children. In such cases, Olive joined in the conveyances to release her dower interest under Virginia law and filed gift tax returns that elected split gift treatment of the gifts. After Olive became ill, Robert joined in the gifts made by Carlton in order to transfer Olive's dower interest. After Carlton died in 1982, Robert embarked on a gift giving program by transferring Olive's assets to various donees, including himself.

In 1989 Olive died and a federal estate tax return was filed. The return did not include any gifts made by Robert in 1982 and 1983 as attorney in fact for Olive. The IRS took the position that nowhere in the documents appointing Robert was there specific reference to authority to make gifts on Olive's behalf. Therefore, in the absence of a specific grant of authority, Robert's transfers as attorney in fact were voidable transfers that constitute revocable transfers that are includible in Olive's gross estate under I.R.C. section 2038(a)(1).

Virginia case law had not previously addressed the issue of whether an unrestricted power to make gifts can be found in a formally drawn, comprehensive, durable power of attorney that does not expressly grant it.

Virginia decisions traditionally construe powers of attorney narrowly in terms of their conferral, limiting an agent's authority to the strict letter of his or her instructions. Such considerations may become more important when dealing with durable powers of attorney. The special quality of the durable power — that it survives incapacity — removes the most critical basis for assuming that the principal retains the ability to protect herself.

State Roundup

Of the four principal purposes for asset transfer — sale, lease, mortgage, and gift — all but gift are expresslyauthorized in specific terms in Olive's power of attorney.

In regard to the general grant of authority described above, the language refers to transfer for such consideration as the attorney-in-fact deems advantageous and the attorney's investment of those proceeds after the transfer. In combination, these two provisions suggest most strongly that the only asset transfer power intended to be conferred by the specific and general powers were transfers for value.

Therefore, in the absence of a specific grant of authority to an attorney-in-fact to make gifts of the principal's property, such gifts are voidable transfers, which are included in the principal's gross estate as revocable transfers.

— John C. Becker, Penn State

FLORIDA. *Legislature passes bill outlawing local prohibitions against solar collectors.* Florida Legislature amended section 163.04, Florida Statutes, to prohibit local ordinances from prohibiting the installation of solar collectors, clotheslines or other energy devices based on renewable resources. The statute had previously prohibited such ordinances except in building codes. The building code exemption has been deleted. Moreover, the statute's previous prohibition against plats or subdivision plans and such prohibitions has been clarified to forbid any deed restriction covenant or similar binding agreement to deny a property owner the right to install solar collectors or other energy devises based upon renewable resources for residential dwellings not exceeding three stories in height. Further, a property owner now may not be prohibited from installing solar collectors on the roof with an orientation to the south or within 45 degrees east or west of due south. The bill took effect on October 1, 1992.

— Sidney F. Ansbacher, Brant, Moore, Sapp, Macdonald & Wells, Jacksonville, FL

FLORIDA. *Florida Mitigation Banking Task Force recommends that state further utilize mitigation credit banking.* The Florida Environmental Regulation Commission (ERC) created a mitigation banking task force to consider the future use of mitigation banking in state wetlands regulation. Mitigation banking is defined as wetland restoration, creation, enhancement, or preservation undertaken to compensate for wetland losses from future development activities.

On March 27, 1992, the task force issued recommendations to the ERC approving mitigation banking and making suggestions for its future use in the state.

The task force listed several items to be considered in determining how much banking was necessary to compensate for dredge and fill impacts. Primarily, the task force sought to ensure that clear standards be set to measure the adequacy of mitigation.

The task force determined that mitigation banking would be appropriate only in very limited circumstances, and generally would be utilized only where other, more standard mitigation possibilities were unlikely to work or impossible to utilize.

In practice, mitigation banking will allow potential developers to create wetlands preferably of a like type to wetlands that may subsequently be impacted by their proposed dredge and fill activities, and preferably within the same water basin as those impacted areas.

The task force did not issue any recommendations on calculations of mitigation credits. Nonetheless, the task force recommended that mitigation credits be based on numerical scales in order to allow for easier determination. Moreover, the task force recommended that the Florida Department of Environmental Regulation prepare formal written agreement forms to allow a permit applicant to formally determine the mitigation banking criteria for a specific site. Still to be determined is whether mitigation banking will be proposed as a formal rule or agency policy; nonetheless, the recommendations to the ERC, which issues formal environmental rules for the state, supports further flexibility in the permitting process.

— Sidney F. Ansbacher

Foreclosed FmHA borrower farming inventory land without lease, ASCS payments eligibility

A federal district court has held that, under Mississippi law, a landlord-tenant relationship existed as a matter of law between a farmer and the FmHA, when, in the absence of a lease, the FmHA knowingly allowed the farmer to remain on the FmHA inventory land. The farmer had sought the court's determination that he had the right to possess the land in order to satisfy a federal farm program requirement that he had a right to possess the land. *Johnson v. U.S.*, No. CD88-158-S-O, 1992 WL 77499 (N.D. Miss. Apr. 15, 1992).

—Christopher R. Kelley, Of Counsel, Arent, Fox, Kintner, Plotkin & Kahn, Washington, D.C.

Agricultural Law Update

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AMERICAN AGRICULTURAL LAW ASSOCIATION NEWS

1992 AALA Conference Activities

For members planning to attend the 1992 Conference, September 25-26th, consider attending these three special features. On Thursday afternoon (September 24, 1992), two voluntary tours are scheduled; on Saturday evening, several members will lead groups to area restaurants for Dutch-Treat Dinners.

Chicago Mercantile Exchange (CME) - 2: 15 P.M., Thursday
Interested conference attendees will meet at 2:15 P.M. in the CME's visitors gallery on the 4th Floor of the South Tower (30 S. Wacher Dr.). Attendees will be able to view the trading and see the last pit close.

Chicago Brewing Co. - 4:00 P.M., Thursday
Attendees are invited to tour the Chicago Brewing Co., located at 1830 N. Besly Court at 4:00 P.M. Those attending the CME tour will walk to the Madison Street train station and purchase a ticket to Clybourne.

Dutch Treat Dinners- 7:00 P.M., Saturday
There will be sign-up lists at the registration desk enabling attendees to join a group for an evening of socializing and dinner at selected favorite restaurants.