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Cancellation of selected uses of strychnine

Although provisions of the Federal Fungicide, Insecticide, and Rodenticide Act (FIFRA) provide for the cancellation of the registration of uses of chemicals (7 U.S.C. § 136(d), 40 C.F.R. 1164), environmental groups successfully gained similar relief under the Endangered Species Act (16 U.S.C. §§ 1531-1543) in *Defenders of Wildlife v. Administrator, Environmental Protection Agency,* 882 S.2d 1294 (8th Cir. Aug. 16, 1989).

The litigation was brought by three environmental groups to prohibit the above-ground use of strychnine for meadow mice, prairie dogs, and ground squirrels. The environmental groups claimed that they were proceeding under the citizen suit provisions of the Endangered Species Act, 16 U.S.C. § 1540(g)(1), and brought suit against the Administrator of the U.S. Environmental Protection Agency (EPA) and the Secretary of the Interior.

On the issue of the exclusivity of the FIFRA statutory review procedure, the circuit court found that generally the FIFRA procedure was the exclusive means of cancelling a registration. Nevertheless, the citizen suit provision was acknowledged to be a viable option for enjoining any asserted violations of the Endangered Species Act. The environmentalists were permitted to seek injunctive relief under the Act, which could indirectly lead to the cancellation of pesticide registrations.

The environmentalists argued that the continued registration of strychnine was an illegal "taking" under the Endangered Species Act. The EPA countered with the argument that the takings were incidental to agency action, and so could qualify as an exception (16 U.S.C. § 1536(b)(4), (o)(2); 50 C.F.R. 402.14(g)(7),(i)). However, since there had not been any authorization by the Secretary of Interior, the court found that the facts supported the conclusion that the registrations constituted takings of endangered species. Thus, the injunction granted by the district court enjoining the EPA from continuing the strychnine registrations was upheld.

The circuit court noted the possibility whereby the EPA could secure a subsequent authorization to sanction the incidental takings. If compliance with the incidental taking provisions is shown, the EPA may be able to show that the injunction should be lifted.

— *Terence J. Centner*
Associate Professor, The University of Georgia

Retirement of Farm Credit stock in Chapter 12 bankruptcy

The issue of whether a debtor in a Chapter 12 bankruptcy proceeding may surrender or compel the retirement of his stock in a federal land bank association or a production credit association has resulted in inconsistent holdings by the courts addressing the issue. All of the reported bankruptcy court decisions, and at least one unreported decision, have permitted either the full or partial surrender of stock, although the first of those decisions to be reported was reversed by the district court. *In re Massengill,* 73 Bankr. 1008 (Bankr. E.D. N.C. 1987), *rev'd,* 100 Bankr. 276 (E.D. N.C. 1988); *In re Indreland,* 77 Bankr. 268 (Bankr. D. Mont. 1987); *In re Fields,* No. 3-87-01539 (Bankr. S.D. Ohio Dec. 30 1987); *In re Chaney,* 87 Bankr. 131 (Bankr. D. Mt. 1988); *In re Arthur,* 86 Bankr. 98 (Bankr. W.D. Mich. 1988); *In re Ivy,* 86 Bankr. 623 (Bankr. W.D. Mo. 1988); *In re Neff,* 89 Bankr. 672 (Bankr. S.D. (Ohio 1988) *modified,* 96 Bankr. 800 (Bankr. S.D. Ohio 1989); *In re Miller,* 98 Bankr. 311 (Bankr. N.D. Ohio 1989). *See also In re Greseth,* 78 Bankr. 936 (D. Minn. 1987) (affirming the bankruptcy court's approval of a partial surrender of stock). *But cf. In re Stedman,* 72 Bankr. 49 (Bankr. D. N.D. 1987) (declining to deduct the value of the debtors' federal land bank association stock from the debtors' indebtedness to the federal land bank in determining the debtors' eligibility for Chapter 12). In addition, in affirming an unreported bankruptcy decision, a district court has approved a Chapter 12 plan allowing the debtors to surrender their stock. *In re Cansler,* 99 Bankr. 758 (W.D. Ky. 1989).

However, not only has the first reported bankruptcy decision been reversed, the

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most recently reported decision on the issue reverses a bankruptcy court decision permitting the debtors' surrender of stock. *In re Shannon,* 100 Bankr. 913 (S.D. Ohio 1989), *appeal filed,* No. 89-3585 (6th Cir. June 19, 1989). Because that decision has been appealed to the Sixth Circuit, the first court of appeals decision on the issue should be forthcoming.

The issue is an important one for debtors who seek to reduce their obligations under Chapter 12 in an effort to achieve confirmable, workable plans. At the same time, it is important to Farm Credit System institutions seeking to avoid erosion of the capital provided by borrower stock. *See generally,* Harl, *Policy Considerations Related to Further Intervention in the Farm Credit System,* 2 J. Agric. Cooperation 57, 64-65 (1987) (noting that "A system of capital generated by farmer loans is simply too fragile to endure in times of extreme economic adversity.").

In essence, the resolution of the issue turns on whether various provision in the Bankruptcy Code, including 11 U.S.C. section 1222(b)(8)(1986) permitting plans to provide for "the distribution of all or any part of the property of the estate among those having an interest in such property" and section 1225(a)(5)(C) which recognizes the surrender of property securing a claim to the holder of the secured claim is a proper way for a plan to treat a secured claim, prevail over specific provisions of the Farm Credit Act granting exclusive discretion to retire borrower stock to the Farm Credit System institution that issued the stock. 12 U.S.C.A. § 2154a(c)(1)(I) (West Supp. 1989) (a former statute granting the sole discretion to the institution, 12 U.S.C. §2034 (1984), was deleted by the Agricultural Credit Act of 1987). *See also* 53 Fed. Reg. 40033, 40046-48 (1988) (to be codified at 12 C.F.R. Part 615, Subpart J) (final regulations concerning the retirement of borrower stock).

The courts that have allowed confirmation of Chapter 12 plans providing for the debtor's surrender of stock have essentially found that the "emergency" nature of Chapter 12 "should not be frustrated by the Farm Credit Act of 1971." *In re Massengill,* 73 Bankr. at 1012. On the other hand, the courts that have disallowed the debtor's surrender of stock have invoked various canons of statutory construction to give precedence to the specific language of the Farm Credit Act's limitations on stock retirement over the general language of the Bankruptcy Code. *E.g., In re Shannon,* 100 Bankr. at 920 ("the Court concludes that . . . the general intention of Congress to aid farmers is no substitute for evidence of a specific intention of Congress to permit Chapter 12 debtors to surrender their stock pursuant to a bankruptcy plan.").

The stock surrender issue is important not only to Farm Credit System borrowers in Chapter 12 bankruptcies, but also to other patrons of agricultural cooperatives in bankruptcy. Last year, the Fourth Circuit held that a Chapter 11 plan may authorize the debtor to release a portion of the debtor's patronage certificates to a cooperative in satisfaction of the cooperative's secured claim. *In re FCX, Inc.,* 853 F.2d 1149 (4th Cir. 1988) *cert. denied sub nom. Universal Cooperatives, Inc. v. FCX, Inc.,* 109 S. Ct. 1118 (1989). *See* Centner, Bankruptcy Empowering Statute May Alter Rights in Cooperative Patronage Certificates, 6 *Agric. L. Update* 3 (March, 1989).

Unlike the state chartered cooperative that issued the certificates at issue in *FCX,* Farm Credit System institutions have been granted the sole discretion to retire borrowers' stock by a federal statute. Thus, a distinction can be made between the rights of members to surrender patronage certificates in a state chartered cooperative and the rights of member-borrowers to surrender stock in federally chartered Farm Credit System institutions. However, the rights of each were perceived to be sufficiently analogous by the Fourth Circuit in *In re FCX, Inc.* to warrant an approving discussion of a related portion of the bankruptcy court decision in *In re Massengill.* 853 F.2d at 1158. (After holding that a Chapter 11 plan could override the nonbankruptcy agreement between the cooperative and the debtor embodied in the cooperative's bylaws, the Fourth Circuit agreed with the bankruptcy court in *Massengill* that the valuation of the certificates (or stock) should be at face value.) (Although the district court decision reversing the bankruptcy court in *Massengill* was issued on May 26, 1988, for unapparent reasons, it was not published until August 1, 1989. *In re FCX* was decided on August 11, 1988, but the opinion does not reference the district court's opinion in *Massengill.*).

– *Christopher R. Kelley,*
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WIFE case reversed

In a lower court opinion, 682 F. Supp. 599 (D.D.C. 1988), the plaintiffs, Women Involved in Farm Economics, won a ruling that the USDA's regulation treating husbands and wives as one person for purposes of payment limitation (7 C.F.R. § 795.11 (1988)) was violative of both the Administrative Procedures Act and the Fifth Amendment. *See* 5 *Agric. L. Update* 1-2 (May 1988) for a discussion of the district court's decision.

Women Involved in Farm Economics (WIFE) v. USDA, 876 F.2d 994 (D.C. Cir. 1989) has reversed the district court ruling, holding that the payment limitation rule for treatment of husband and wife as one is reasonable and not unconstitutional.

The appeals court affirmed that heightened scrutiny of the husband-wife rule was inappropriate because the rule does not "interfere directly or substantially with the right to marry." The court then cited the Tenth Circuit's ruling in *Martin v. Bergland,* 639 F.2d 647 (10th Cir. 1981) that the financial interdependence of husbands and wives constitutes a rational basis for the rule. The court rejected the district court's view that such rationale was only pretextual.

The appeals court said there were two problems with the district court's analysis. First, it used a standard of review more like heightened scrutiny that the rational-basis test. Second, the appeals

(Continued on page 3)

Recent bankruptcy decisions

Recent Chapter 12 bankruptcy litigation has produced interesting caselaw in several areas. The courts have addressed the newly arising issue of the modification of a Chapter 12 plan. The debtor's right to dismiss his pending bankruptcy has also produced new caselaw. This article summarizes developments in these two areas.

Modification of confirmed plans. In recent Chapter 12 bankruptcy litigation, the courts dealt with plan modification. Although there have not been very many cases generated on this topic, two recent bankruptcy decisions are of particular interest.

In the case of *In the Matter of Craven,* 97 Bankr. 549 (Bankr. W.D. Mo. 1989), the court was asked to approve a modification of a confirmed Chapter 12 plan. The debtors sought modification to extend a loan term by one year, from a twenty-year term to a twenty-one–year term. The creditor affected by the modification objected, arguing that the plan was infeasible. The court approved the requested modification, finding that the debtors were unable to comply with the confirmed plan solely because of the severe drought affecting their farming operation. In addressing some of the creditor's feasibility arguments, the court held that preconfirmation evidence on feasibility is barred by res judicata.

A trustee in bankruptcy moved to modify debtors' confirmed plan in the case of *In re Pearson,* 96 Bankr. 990 (Bankr. D. S.D. 1989). This motion was based on the non-fraudulent undervaluation of an asset by the debtors. The court held that while the trustee did have standing to request the modification, and although the asset was clearly and substantially undervalued, modification would not be allowed. It discussed the purpose of modification and found that it is appropriate only in response to unforeseen difficulties and circumstances that could not be anticipated at or before confirmation of the original plan. Because either the trustee or the affected creditors could have caught the error in valuation before confirmation, modification was inappropriate.

The right to dismiss a bankruptcy. Concerning a debtor's absolute right to dismiss a pending Chapter 12 bankruptcy, the court in *In re Graven,* 101 Bankr. 109 (Bankr. W.D. Mo. 1989), limited this right when fraud on the part of the debtor has been found. Because of the fraudulent activities of the debtor, the court denied the motion to dismiss the case, and instead granted the creditor's motion to convert the case to a Chapter 7 proceeding. Basing its decision on Chapter 13 caselaw, the court argued that "if fraud can invalidate an order of dismissal under section 1307(b), fraud can allow a court to convert a Chapter 12 to a Chapter 7 when the public good requires it." 101 Bankr. 113. Admitting that its view is a minority position, the court, incensed by the debtor's fraud, stated that it would refuse to reward a debtor who abuses the legal process. The court did note, however, that the "honest Chapter 12 debtor" continues to have the "unfettered right to dismiss at any time." *Id.*

In another attempt to limit the right of a Chapter 12 debtor to dismiss a pending case, the court in *In re Tyndall,* 97 Bankr. 266 (Bankr. E.D. N.C. 1989) held that dismissal could be delayed to allow for the liquidation of collateral as provided for in the confirmed plan. The debtors in this case had previously been granted an extension in making their payments under the plan and in exchange had agreed to the addition of a default clause in the plan. Pursuant to this clause, the trustee was authorized to liquidate the collateral after a period of default. The court refused to allow immediate dismissal on these facts, and instead ordered dismissal to occur after time was allowed for the liquidation.

In summary, the debtor may not have the absolute right to dismiss his case as stated in the Chapter 12 statute. It appears that at least some courts are willing to modify and limit this right to meet individual fact situations.

– Susan A. Schneider,
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WIFE CASE REVERSED / CONTINUED FROM PAGE 2

court disagreed that "impermissible stereotyping is here lurking behind the facade of a sex-neutral explanation," as the district court had ruled. The appeals court disagreed with the plaintiffs' allegation that treatment of a husband and wife as a unit in a modern setting is inevitably malign, citing other similar premises such as in the Internal Revenue Code, and failed to see such a policy as demeaning either to women or to the institution of marriage.

WIFE has noted its intention to appeal the case to the United States Supreme Court. Representative Marlenee (R. Mont.) has introduced legislation, "The Farm Spouse Fairness and Equity Act of 1989," which would provide the relief sought by WIFE.

– Neil D. Hamilton,
Director, Agricultural Law Center,
Drake University School of Law

AG LAW CONFERENCE CALENDAR

1989 American Agricultural Law Association Tenth Annual Conference and Annual Meeting

November 3-4, 1989, Hotel Nikko, San Francisco, CA.

Refer to insert in the August issue of Update for program information.

1989 ABA National Agricultural Bankers Conference

Nov. 12-15, 1989, St. Louis Marriott Pavilion Hotel, St. Louis, MO.

Topics include: Farmer Mac's current status, avoiding environmental liabilities, and the 1990 Farm Bill.

Sponsored by American Bankers Association; Agricultural Bankers Division.

For more information, call 202-663-5274.

Penn State Income Tax Institutes

Nov. 13-14, Uniontown;
Nov. 14-15, Monroeville;
Nov. 15-16, Beaver Falls;
Nov. 16-17, Butler;
Nov. 20-21, Gettysburg;
Nov. 21-22, Harrisburg;
Nov. 29-30, Wilkes-Barre;
Nov. 30-Dec. 1, Allentown;
Dec. 4- 5, State College;
Dec. 11-12, Edinboro;
Dec. 12-13, DuBois;
Dec. 13-14, Johnstown;
Dec. 14-15, Danville;
Dec. 18-19, Souderton;
Dec. 19-20, W. Chester.

Topics include: Reporting passive losses; TAMRA review; pensions.

Sponsored by Penn State University Department of Agricultural Economics.

For more information, call 814-865-7656.

1990 Agribusiness Tax Strategies

Dec. 12, 1989, Live on the Continuing Legal Education Satellite Network.

Topics include: Estate planning strategies; § 2032A; tax options for troubled farmers; complying with new reporting requirements.

Sponsored by Continuing Legal Education Satellite Network and others.

For more information, call 1-800-669-1625.

Income tax consequences of debt reductions under the Agricultural

by Philip E. Harris

The Agricultural Credit Act of 1987[1] created some new rules for reducing the farmer's obligation to repay Farmers Home Administration (FmHA) debts. The rules require the farm borrower to transfer one or more rights to the FmHA at the time of the debt reduction. Three of the rights that are transferred in some workouts are: 1) a Shared Appreciation Agreement; 2) a Recapture Agreement; and 3) a conservation easement. The tax consequences of the debt reduction and the transfer of these rights are discussed in this article.

Provisions of the Agricultural Credit Act of 1987

The Agricultural Credit Act of 1987 requires the FmHA to restructure a borrower's debt rather than to foreclose if the restructuring will cost the lender less than foreclosing.[2] The debt restructuring may include the write-off of principal and accrued interest on the loan as well as extending the repayment period and reducing the interest rate on the remaining debt.

The Act allows borrowers to terminate their obligation to the FmHA by paying the FmHA an amount equal to the "net recovery value".[3] The net recovery value is the current appraised value of the collateral for the loan minus all administrative, attorney, management, and resale costs that FmHA would expect to incur if it were to foreclose and liquidate.[4] This option is available only if the net recovery value is equal to or less than the "value of the restructured loan" – which is simply the value of the payments the borrower would make on the restructured loan, discounted to take into account the fact that the payments would be made over several years.[5]

As a condition of terminating the borrower's obligations under the loan, the borrower must agree to allow the FmHA to recapture some of the loan amount that was not paid as a result of the buy-out agreement.[6] The recapture occurs if the borrower sells or conveys the property that was collateral for the loan within two years of the buy-out agreement and receives more for the transfer than was paid in the buy-out agreement. The amount that can be recaptured is all or part of the difference between: 1) the amount the borrower paid for the buy-out; and 2) the fair market value of the property securing the loan as of the date the buy-out agreement was signed.

The Shared Appreciation Agreement is required for all debt reductions involving real estate as collateral. If the borrower transfers the property or ceases farming within four years of the write-down, the borrower must pay the FmHA seventy-five percent of the appreciation in value of the collateral. If the borrower does not transfer the property or cease farming within four years, the borrower must pay the FmHA fifty percent of the appreciation in value of the collateral on the earlier of two dates: 1) at the end of the agreement, which must be no more than ten years after the write-down; or 2) at the time the borrower transfers the property or ceases farming. The total amount recoverable under the Shared Appreciation Agreement is limited to the amount of debt written down.

Another option for borrowers who are not eligible for the primary loan programs is to grant a conservation easement in exchange for a debt write-down. The conservation easement restricts the borrower's right to farm the property for a period of fifty years.

Income Tax Consequences of Reducing Debt

When a borrower's obligation to repay a debt is reduced, there may be income tax consequences depending upon the reason for the debt reduction and the status of the borrower at the time of the debt reduction.

In many transactions, debt is reduced because the borrower "paid" off part or all of the debt by transferring something of value to the lender. If the debt is reduced because the borrower transferred something of value to the lender, such as an interest in property, then the borrower is treated as if the lender bought the property interest with cash and the borrower then used the cash to pay off the debt.[7] There are no tax consequences to paying off the debt but there may be tax consequences from the transfer of the property interest.

If the lender receives no consideration for part or all of the debt reduction, the reduction is treated as either a gift or a discharge of indebtedness. If it is a gift, the amount of the reduction is not treated as income to the borrower.[8] If the reduction is discharge of indebtedness, it is treated as income to the borrower[9] unless one of the following exceptions applies:

1. payment of the debt would have allowed the borrower to claim a deduction;[10]
2. the borrower was in bankruptcy at the time of the debt reduction;[11]
3. the borrower was insolvent at the time the debt was reduced;[12]
4. the debt discharged was qualified farm indebtedness;[13] or
5. the debt was between the original seller and original buyer under a seller financed transaction.[14]

The borrower is required to reduce his or her tax attributes to account for the discharged debt that does not have to be reported as income because of the bankruptcy, insolvency or solvent farmer exceptions.[15] Net operating losses, capital loss carryovers, and basis are reduced one dollar for each dollar of discharged debt.[16] General business credits and foreign tax credits are reduced 33⅓ cents for each dollar of discharged debt.[17]

If the borrower is under the bankruptcy or insolvency exception and runs out of tax attributes before all the discharged debt is accounted for, the remaining discharged debt is not income. Furthermore, in the instance of bankruptcy or insolvency, unless the borrower makes the election to reduce basis in depreciable property first,[18] basis in the borrower's assets does not have to be reduced below the debt that remains after the principal has been written off.[19]

Tax Consequences of Debt Reduced With Conservation Easement

If the value of the conservation easement transferred by the borrower equals the amount of debt reduction, then there is no discharge of indebtedness and the only tax consequences to the borrower result from the transfer of the conservation easement.

Since the borrower has received a benefit from the transfer, the borrower is treated as if he or she sold the conservation easement for an amount equal to the debt reduction. Neither the courts nor the I.R.S. has ruled on the character of income from such a sale, but it is very much like the sale of a right-of-way or other easement. Therefore, it is likely that the amount received from the sale of the conservation easement (the amount of the debt reduction) will first reduce basis in the land subject to the easement and then be treated as gain from the sale of the land to the extent the amount received exceeds the basis in the land.[20]

Philip E. Harris is an Associate Professor of Agricultural Economics and Law at the University of Wisconsin-Madison. He is past president of the AALA.

Tax Consequences of Debt Reduced With a Recapture Agreement or Shared Appreciation Agreement

There are three potential arguments for the treatment of debt reduction in exchange for a Recapture Agreement or a Shared Appreciation Agreement.

Transfer of an Interest in Property. One argument is that the borrower has transferred an interest in his or her property to the lender. The interest transferred is the right to share in the increase in the value of the property. The transfer of the interest could be treated like the transfer of an easement described above. That is, the basis in the property subject to the agreement would be reduced by the amount of the debt reduction. If the debt reduction exceeded the basis in the property, the excess would be treated as gain from the transfer of the property.

True Debt. The second argument is that the parties have replaced the original debt obligation with a new debt obligation – the obligation to pay under the Recapture Agreement or the Shared Appreciation Agreement. Under this argument, there is discharge of indebtedness at the time of the workout to the extent the original debt is not replaced by the new debt. If part or all of the new debt does not have to be paid under the agreement, the amount that is not paid is discharge of indebtedness at the end of the agreement.

Example 1: Matthew Horton entered into a buy-out agreement with FmHA under which he paid $125,000 and the FmHA terminated his obligation to pay his $150,000 farm loan. A condition of the agreement was that if Matthew sold the farm within two years of the buy-out agreement, he would have to pay the FmHA the lesser of: 1) the excess of the amount he received for the farm over the $125,000 he paid under the agreement; or 2) $15,000 – the difference between the $140,000 fair market value of the farm on the date of the buy-out agreement and the $125,000 that he paid under the buy-out agreement.

On the date of the buy-out agreement, Matthew has $10,000 of discharge of indebtedness since the maximum recapture is $15,000 of the $25,000 difference between the amount owed on the original loan and the amount he paid for the buy-out. Two years from the date of the buy-out agreement, Matthew has $15,000 discharge of indebtedness if he has not sold or conveyed the farm in the meantime. If he did sell or convey the farm within the two-year period, his discharge of indebtedness on the date of sale would be $15,000 reduced by the amount recaptured by the FmHA.

Contingent liability. The third argument is that the borrower's obligation under the Recapture Agreement or Shared Appreciation Agreement is so contingent that it should be ignored for income tax purposes. Under this argument, the borrower has discharge of indebtedness at the time of workout equal to the full debt reduction.

Example 2: Assume the same facts as in Example 1. If Matthew's potential obligation to repay the $15,000 is treated as a contingent liability, then he has $25,000 of discharge of indebtedness at the time he entered into the buy-out agreement. If he is required to repay part of the discharge, he should receive a tax benefit from the repayment in the form of a deduction or an increase in basis.

Which Argument is Best for the Taxpayer?

The argument that is best for the taxpayer depends upon his or her status at the time of the workout. If the taxpayer is in bankruptcy or is insolvent at the time of the workout and has no tax attributes that will be reduced under I.R.C. section 108, then the contingent liability argument is best for the taxpayer since it removes all the income tax consequences from the debt reduction without any cost to the taxpayer. By contrast, the true debt argument may require the taxpayer to recognize discharge of indebtedness income if he or she is solvent, not in bankruptcy, and not a qualified farmer at the end of the Recapture Agreement or Shared Appreciation Agreement. Even if one of the exceptions applies, the taxpayer may lose tax attributes that were acquired between the date of the workout and the termination of the agreement. Under the property interest argument, the taxpayer would at least lose basis and may have to recognize gain.

If the taxpayer's status would require him or her to lose tax attributes or recognize discharge of indebtedness income at the time of the workout, then the contingent liability argument is likely to be the worst for the taxpayer. By comparison, the true debt argument allows the taxpayer to postpone the consequences of discharge of indebtedness. To the extent recognition of income is postponed, the taxpayer has an interest-free loan from the I.R.S. If attribute reduction is postponed, the taxpayer may be able to use the attributes to reduce tax liability during the term of the agreement and thereby avoid paying the price for not recognizing discharge of indebtedness.

If the taxpayer has enough basis in the property to absorb the full debt reduction and plans to make use of the I.R.C. section 1014(a) date-of-death basis adjustment, then the property interest argument is best for the taxpayer since it removes all the income tax consequences from the debt reduction without any cost to the taxpayer.

Which Argument is Likely to Prevail?

In a letter to the Farmers Home Administration,[21] Peter Scott, Acting Chief Counsel of the Internal Revenue Service, takes the position that argument three is correct. The letter states "Because the SAA [Shared Appreciation Agreement] is fundamentally different from the old debt and is so contingent that it is impossible to estimate whether and when any amount will be paid under the SAA, the SAA is not an indebtedness substituted for the amount of the FmHA debt written down."

Having treated the debt write-down as income at the time of the workout, the I.R.S. must then deal with the consequences of a repayment of the debt that has been treated as discharged. In his letter to the FmHA, Mr. Scott states that the taxpayer is permitted an adjustment that reverses the tax treatment accorded under I.R.C. section 108 if part or all of the debt write-down is repaid.

Example 3: Assume that Matthew in Example 2 had the following tax consequences at the time of the workout.

1. NOLs were reduced by $16,000 and basis was reduced by $4,000 under the insolvency rules;
2. another $3,000 of discharged debt was not recognized under the insolvency rules but no attribute reduction was required; and
3. the remaining $2,000 of discharged debt was recognized as income.

The I.R.S. would reverse those tax consequences for the $15,000 that is repaid by allowing Matthew to claim the following:

(Continued on next page)

1. a deduction against ordinary income for the first $2,000 that was repaid;
2. no adjustment for the next $3,000 that was repaid since there was no tax consequences to that discharge of indebtedness; and
3. a $4,000 increase in basis and a $6,000 addition to NOL carryovers for the remaining $10,000 that was repaid.

The I.R.S. cites two types of cases to support its position. One type is illustrated by *Zappo v. Commissioner*.[22] In that case, the taxpayer and his creditor entered into an agreement that moved the taxpayer from a position of being primarily responsible for some debt to a position of a guarantor of the debt if a third party (who remained primarily liable) did not pay the debt. The court stated, "the guarantee agreement was too contingent on a primary obligation to be treated as a true debt."[23] The Recapture Agreements and Shared Appreciation Agreements are distinguishable since there is no third party that is primarily responsible for paying the debt and the borrower is more than a guarantor of the debt.

The other type of case relied upon by the I.R.S. are cases in which the taxpayer purchased an item for a price that was contingent.[24] In those cases, the contingent obligation is not recognized as part of the basis until the payment is actually made.

The basis cases are not on point and therefore do not support the contingent liability argument. In those cases, the taxpayer owed nothing before the transaction began. The courts determined that the contingent obligation should not be recognized to *change* the status quo. In the case of FmHA workouts, the taxpayer owes the money before the transaction begins and the question is whether the Shared Appreciation Agreement or the Recapture Agreement should be recognized to *continue* the status quo.

A better statement of the issue is whether there is any possibility that the borrower will pay on the debt. If so, the tax consequences for both the borrower and the creditor should be held in abeyance until it can be determined whether or not a payment is likely to be forthcoming. This statement of the issue and the true debt argument is supported by several cases.

In *Brountas v. Commissioner*,[25] the court faced the issue of when a taxpayer must report discharge of indebtedness income. The court stated:

> we believe the moment it becomes clear the 'loan' will never have to be paid, the 'loan' must be viewed as having been discharged. For this purpose, the test must be the practical one of worthlessness of the debt – the point at which a creditor could deduct a bad debt is not when it is absolutely impossible that it could be repaid, but when only an incorrigible optimist would expect repayment ... Likewise here ...[26].

That case did not deal with a refinancing and therefore is not on point with respect to the replacement of a fixed obligation with a contingent obligation. However, the court did determine the time of discharge to be the drilling of the last dry hole – that is, the time when all practical chances of paying the debt were extinguished. In the case of an FmHA workout, the analogous point of no practical likelihood of repayment occurs when the Shared Appreciation Agreement or Recapture Agreement terminates.[27]

In *Federation Bank & Trust Company v. Commissioner*,[28] the court addressed an issue very similar to the one presented by the FmHA workouts. The issue in that case was the timing of discharge of indebtedness income to a bank that had a reduction in its deposit liability. In 1932, depositors waived a portion of their deposits in exchange for a right (as participants in a trust) to proceeds from a liquidation of assets. The proceeds from the liquidation were to be first applied to a fixed sum to be retained by the bank, then to interest on that fixed sum, and then to the depositors. In 1942, the depositors received a payment that was about twenty percent of the deposits they had waived. In 1945, an additional amount was paid to settle a class action suit brought by the depositors for an accounting of the 1942 settlement. The issue for the court was whether the discharge of indebtedness income arose in 1945. The court concluded:

> We feel that the purchase in 1942 of an assignment and release of the right, title, and interest of the depositors in the designated assets determined the final amount, if any, of the indebtedness forgiven. This purchase, and the order of the court approving the purchase, terminated all rights the holders had under the trust agreement and participation certificates except for an accounting.

The facts of *Federal Bank and Trust Co.* are similar to the shared appreciation agreements in that the creditor has exchanged a fixed obligation for a right to share in the value of an asset if the value exceeds a stated amount. The court determined the timing of the discharge of indebtedness income by looking at when all rights to receive payments from the asset were terminated. In the case of Shared Appreciation Agreements and Recapture Agreements, that is at the termination of the agreement.

The contingent liability argument is very much like the "cash equivalent" argument that the I.R.S. presented to support recognizing discharge of indebtedness income when corporations retired debt with shares of stock. That argument was rejected by the courts.[29] In 1984, Congress statutorily adopted the cash equivalent argument for the retirement of corporate debt with corporate stock by adding I.R.C. section 108(e)(10). The cash equivalent argument has not been statutorily adopted for debt replaced with a new obligation. Therefore, the courts are likely to reject the contingent liability argument of the I.R.S.

The property interest argument – that the debt reduction was the purchase price of an interest in the collateral – is not as strong as the true debt argument. Since the lender had a security interest in the collateral before the workout and has a security interest in the collateral after the workout, the transaction is more like a refinancing than a purchase of a property interest.

Conclusion

Taxpayers can use the uncertainty of the tax consequences of debt reduction under the Agricultural Credit Act of 1987 to their advantage. If the contingent liability argument is best for a particular taxpayer's situation, that position can be taken on the tax return and is not likely to be challenged since it is the stated position of the I.R.S. If the true debt argument is best for a taxpayer's situation, that position can be taken on a tax return without fear of under-reporting penalties since there is case law to support that position. If the I.R.S. challenges the true debt argument, this author believes there is enough authority to prevail on that argument in court. The property interest argument is the weakest of the three arguments and is not likely to survive a challenge by the I.R.S.

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1. Pub. L. No. 100-233, 101 Stat. 1568 (1988).
2. 7 U.S.C. § 2001(b)(4)(1985), *as amended by* the Agricultural Credit Act of 1987, Pub. L. No. 100-233, 101 Stat. 1568 (1988).
3. 7 U.S.C. § 2001(c)(5)(1985), *as amended by* the Agricultural Credit Act of 1987, Pub. L. No. 100-233, 101 Stat. 1568 (1988).
4. *Id.* § 2001(c)(2).
5. *Id.* § 2001(c)(3).
6. *Id.* § 2001(c)(6).
7. *Danenberg v. Commissioner*, 73 T.C. 370 (1979).
8. I.R.C. § 102(a) (1988).
9. I.R.C. § 61(a)(12) (1988).
10. I.R.C. § 108(e)(2) (1988).
11. I.R.C. § 108(a)(1)(A) (1988).

(Continued on next page)

12. I.R.C. § 108(a)(1)(B) (1988).
13. I.R.C. § 108(a)(1)(C) (1988).
14. I.R.C. § 108(e)(5) (1988).
15. I.R.C. § 108(b) (1988).
16. I.R.C. § 108(b)(3)(A) (1988).
17. I.R.C. § 108(b)(3)(B) (1988).
18. I.R.C. § 108(b)(5) (1988).
19. I.R.C. § 1017(b)(2) (1988).
20. *Conway v. U.S.*, 31 AFTR 2d 73-1028 (D.C. Ky. 1973); Rev. Rul. 73-161, 1973-1 C.B. 366.
21. The letter is addressed to Mr. Chet Bailey, Farmer Program Division, Farmers Home Administration, 5019 South Building, Washington, D.C. 20250 and is dated May 22, 1989.
22. 81 T.C. 77 (1983).
23. *Id.* at 88.
24. *See Brannen v. Commissioner*, 722 F.2d 695 (11th Cir. 1984).
25. 74 T.C. 1062 (1980), supplemental opinion to 73 T.C. 491 (1979), *vacated and remanded on other grounds* 692 F.2d 152 (1st Cir. 1982), *aff'd in part and rev'd in part on other grounds sub nom.*
26. *Id.* at 1074.
27. *See also Cozzi v. Commissioner*, 88 T.C. 435 (1987) and *CRC Corp. v. Commissioner*, 693 F.2d 281 (3d Cir. 1982).
28. 27 T.C. 960 (1957).
29. *Commissioner v. Motor Mart Trust*, 156 F.2d 122 (1st Cir. 1946); *Commissioner v Capento Securities Corporation*, 140 F.2d 382 (1st Cir. 1944). *But see Claridge Apartments Co. v. Commissioner*, 138 F.2d 962 (7th Cir. 1943).

Circuits split over implied cause of action

In a long awaited decision, the Eighth Circuit has held that Farm Credit System borrowers have an implied cause of action under the Agricultural Credit Act of 1987. *Zajac v. Federal Land Bank of St. Paul*, No. 88-5353 (8th Cir. Oct. 5, 1989)(1989 U.S. App. LEXIS 15193).

The right is a limited one, however, confined to injunctive relief directed at insuring FCS compliance with the specific procedural rules in the Act. The court expressly disclaimed any willingness to allow borrowers to obtain judicial review of the merits of FCS loan restructuring decisions.

The Eighth Circuit's decision conflicts with the Ninth Circuit's decision in *Harper v. Federal Land Bank of Spokane*, 878 F.2d 1172 (9th Cir. 1989), discussed in the August issue of the *Agricultural Law Update*.

– *Christopher R. Kelley, NCALRI*

Editor's note: A discussion of the *Zajac* case will appear in next month's Update.

STATE ROUNDUP

FLORIDA. *Perpetual, nonparticipating oil, mineral and gas royalty interest constitutes present, vested realty interest.*

Conway Land, Inc. v. Terry, 542 So.2d 362 (1989) concerned the City of Orlando's condemnation of real property subject to deed reservations covering "one-half of any and all royalties that may be paid or obtained from the lands . . . on account of any oil, mineral, minerals, or gas which may be taken from said real property. . . ." *Id.* at 363. The Florida Supreme Court considered whether successors in interest to the reserving party were entitled to any portion of the condemnation award.

The trial court had entered summary judgment against these successors in interest, citing the deed reservations' mention of a specific oil, mineral, and gas lease between the deed grantor, inter alia, and a third-party lessee. The trial court held that the reservation applied solely to this long-since expired lease. The district court of appeal reversed, stating that the reservation was not limited to that lease and that the reservation vested the grantor with a present interest in real property to unsevered oil, gas, and minerals.

The supreme court affirmed the appellate court's holding, stating that the reservation language encompassed "existing or any future oil, mineral and gas leases on the property," *Id.* at 364, and therefore constituted a vested interest in the parcel.

The supreme court noted that the successors to the reserving party held a "nonparticipating royalty interest," which is:

> [A]n interest in the gross production of oil, gas, and other minerals carved out of the mineral fee estate as a free royalty, which does not carry with it the right to participate in the execution of, the bonus payable for, or the delay rentals to accrue under oil, gas or mineral leases executed by the owner of the mineral fee estate.

Wells v. Berry, 434 So.2d 982, 984-85 (Fla. Dist. Ct. App. 2d 1983). The delay rentals to be paid by any lessee were specifically excluded from the reservation by the express language of the deed.

The court also considered whether the royalty interest was intended to reserve only an interest in personal property so that the successors would not derive any real property condemnation rights. The appellants relied on *Miller v. Carr*, 1137 Fla. 114, 188 So. 103 (1939), where the Florida Supreme Court had held that royalties in oil that had been severed from the ground constituted personal realty. Conversely, royalties in the oil remaining in the ground constituted real estate rights. The *Conway* court held that *Miller* supported a determination in the instant case that the successors' royalty interests in the unsevered oil, gas, and minerals constituted real property interests.

The *Conway* court finally considered whether the reservation violated the rule against perpetuities. Citing *Hanson v. Ware*, 224 Ark. 430, 274 S.W.2d 359 (1955), the court held that the deed reservation did not violate the rule against perpetuities because it created a current, vested real property interest. The court stated: "The fact that production is uncertain and may never occur does not defeat the interest." 542 So.2d at 365.

– *Sidney F. Ansbacher*
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FLORIDA. *Special tax assessment held invalid as applied to agricultural zoned land.* In *Lee County v. Zemel*, 545 So.2d 344 (Fla. DCA2 1989), the Florida Second District Court of Appeal reviewed a trial court's holding of a special tax assessment as being invalid as applied to an agriculturally zoned parcel adjoining an area to be benefitted by the assessment. Lee County created a municipal service taxing or benefit unit in an unincorporated area of Lee County, Florida. This taxing unit was to finance improvement of roads within a low income mobile home subdivision. Zemel's agriculturally zoned property lies to the north and west of the subdivision, and is separated from the subdivision by a dike and canal.

The appellate court upheld the trial court decision. The trial court found that the agricultural property was not within the improvement area nor was that property specially benefitted by that improvement area, as directed by salient statutes. Therefore, the court upheld the decision that the assessment was invalid as applied.

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ADDRESS
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AMERICAN AGRICULTURAL LAW ASSOCIATION NEWS

Tenth Annual Meeting and Education Conference of the AALA – Nov. 3-4, 1989

Hotel Nikko, San Francisco, CA – Topics and Speakers

Annual review of agricultural law–Stephen R. Silen; Uniform Commercial Code update–Larry M. Hultquist; ASCS payment limitations developments–Neil D. Hamilton; Agricultural tax developments–Philip E. Harris; Agricultural biotechnology–Paul E. Stern; New regimes in farmland ownership–Nels J. Ackerson; New directions in farmland preservation–Edward Thompson, Jr.; Progress in the Congress toward the 1990 Farm Bill–Charles (Chuck) Culver, III; Agricultural policy alternatives for the 1990s–Dr. Gordon C. Rausser; International agricultural trade–Trading on the Pacific Rim–Donald L. Uchtmann; The U.S. view–Julian B. Heron, Jr.; The Japanese view–Tatsuro Katsuyama; The Australian view–John Sault; Agricultural export promotion: the role of USDA Foreign Agricultural Service–Ann Veneman; The state view–Arthur C. Schuenemann; Transactional issues–James R.C. Salisbury; Agricultural labor law–John C. Becker; Outlook for agricultural labor in the 1990s–Dr. Phillip Martin; MSPA/FLSA issues–Marc Linder; OSHA/EPA issues–Charles N. Carnes; Immigration reform–Roxana C. Bacon; Agricultural labor management relations–William A. Quinlan; Marketing of fruits, vegetables, and tree nuts–Walter J. Armbruster; Introduction and overview–Dr. Kirby Moulton; Introduction to the Perishable Agricultural Commodities Act/ Sanctions under PACA–Donald J. Campbell; PACA reparation proceedings/the statutory trust–J.W. (Jake) Looney; Reducing liability risks for commission merchants and produce dealers–Patricia Rynn; Marketing orders–Dr. Leon Garoyan; Impact of California and EPA pesticide monitoring, FDA regulations, and USDA labeling requirements–Herbert L. Cohen; Trademark law for specialty fruits and vegetables–Terence J. Centner; U.S.-Mexico trade in fruits, vegetables and tree nuts–James F. Smith; Farm finance and credit issues–Patricia A. Conover; FmHA–Current issues in loan servicing and appeals–M. Joyce Lancaster; Farm Credit System: Current restructuring issues–James T. Massey; Chapters 11 and 12: Issues with plan formulation and administration–Randy Rogers; Farmer Mac: Structure and implications–Henry D. Edelman; Panel on farm equipment financing–Thomas A. Lawler, Kari Schmidt, Paul H. Berens, Wayne M. Jensen, Robert Schulz, Stephan R. Silen; Presidential address–Phillip L. Kunkel; Managing agricultural soil and water resources–Donald D. MacIntyre; Competition for scarce water resources/implementation of the Reclamation Reform Act Amendment of 1982–Kenneth J. Fransen; Non-point source pollution–George A. Gould; California's Proposition 65–Craig Thompson; Hazardous and toxic substances on agricultural lands–Norman W. Thorson; Low input agriculture–Malcolm H. Fleming; Agricultural cooperatives–James. B. Dean; The National Bank for Cooperatives: Structure and directions–W.M. Harding; Alternatives to mergers and consolidations–Randon W. Wilson; Equity redemption–Dr. David G. Barton; Status of cooperatives when farmer-members experience financial distress–John D. Copeland; Minority shareholder rights and director liability–James R. Baarda; Cooperative tax developments–Donald W. Butwill.