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FmHA response to latest Coleman *decision*

On June 2, 1987, after finding that FmHA Form 1924-26 was unconstitutional, Judge Bruce Van Sickle, in *Coleman v. Lyng,* 663 F.Supp. 1315 (D.N.D. 1987), enjoined FmHA's further use of the deficient form. (For an outline of the *Coleman* decision, see October 1987 issue of *Agricultural Law Update.*) In response to the injunction, FmHA halted processing of loan-servicing options chosen by a farmer-borrower on the basis of Form 1924-26. This position was relaxed somewhat with the issuance of three letters to local FmHA offices, which authorized local FmHA officials to handle some requests, as long as the national FmHA office first supplied its permission. The agency directives contained in these letters were superseded, however, by those contained in a subsequent letter.

In a letter sent to all county FmHA offices on September 1, 1987, FmHA established a method for dealing with loan-servicing solicitations received from farmers who had used the flawed Form 1924-26. Under the procedure, FmHA will not process any applications for debt settlement, loan servicing, voluntary liquidations, etc., unless the farmer first signs a waiver form.

According to the Farmer's Legal Action Group, Inc. (FLAG), the attorneys for the farmers in the *Coleman* litigation, the farmer, when he or she signs the waiver form, relinquishes "all rights to have his/her loan accounts reprocessed according to the revised procedures ordered by the *Coleman* court." Farmer's Legal Action Report, Vol. 2, No. 5, at 4 (September/October 1987). FLAG is also concerned that the waiver form does not contain a full explanation of waived rights.

As a result of these and other perceived deficiencies in the waiver form, FLAG has moved the *Coleman* court to appoint a special magistrate to scrutinize the requests for services made by individual borrowers.

– *Michael Thompson*

Technical Corrections Bill may not pass this year

The 1987 Technical Corrections Bill was incorporated into the Budget Reconciliation Act of 1987 (H.R. 3545) and passed by the House of Representatives on October 26, 1987. Included in that bill are several modifications to the 1986 Tax Reform Act that clear up technical problems as well as make some substantive changes.

As part of the budget negotiations, Rep. Rostenkowski, Chairman of the House Ways and Means Committee, has stated that all the revenue losing provisions in H.R. 3545 will be dropped in conference if the Senate passes a bill without any revenue losing provisions. Such an action would remove many provisions that affect farmers.

Provisions that would apparently be dropped include section 10361 of H.R. 3545, which would exempt raised livestock from the rule that requires capitalization of preproductive expenses. Section 10361 would have relieved owners of dairy and beef herds from the 1986 Act rule that requires them to add the cost of raising replacement heifers to the basis of those heifers rather than claiming the costs as a deduction in the year the cost is incurred. *See* Beard, *The Uniform Capitalization Rules and Cattle Held for Breeding and Dairy Purposes*, 5 Agric. L. Update 4-6 (Nov. 1987). The cost of raising plants that have a preproduction period of more than two years would not be affected by section 10361 and therefore would still be subject to the 1986 Act if the new provision were enacted.

Another provision that would apparently be dropped allows taxpayers another depreciation option for personal property. H.R. 3545 section 10202(a)(11). The new option would have allowed personal property to be depreciated over the alternative MACRS life at the 150% declining balance rate. Since that is the rate specified for the alternative minimum tax (AMT), the new rate would allow taxpayers another option for matching the depreciation rate used for the alternative minimum tax

(continued on next page)

with the rate used for regular tax purposes. Under the 1986 Act, taxpayers could match regular tax depreciation and AMT depreciation by using alternative MACRS for regular tax purposes since the Act requires taxpayers to use straight-line depreciation for personal property for AMT purposes if a straight-line method is used for regular tax purposes. IRC § 56(a)(1)(A).

If the Budget Reconciliation Act of 1987 is enacted without the technical correction provisions, it is likely that the technical correction provisions will be introduced again early next year so that they can become law before the end of the next tax filing season. Since the IRS supports changes such as exempting raised livestock from the capitalization of preproduction cost rules, it appears that most of the technical corrections will eventually become law.

– Philip E. Harris

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Discharge of indebtedness income – changes in the rules for solvent farmers

Prior to the Tax Reform Act of 1986 (TRA), IRC section 108 provided three exceptions under which discharge of indebtedness income would not have to be recognized. TRA 1986 replaced the third exception (if the indebtedness discharged was qualified business indebtedness (IRC § 108(a)(1)(C)) with one more narrowly drawn in terms of availability. New subsection (g) provides that "the discharge by a qualified person of qualified farm indebtedness of a taxpayer who is not insolvent at the time of the discharge shall be treated in the same manner as if the discharge had occurred when the taxpayer was insolvent." Tax attributes have to be reduced, but the available attributes generally are the same as those with respect to the insolvency and bankruptcy exceptions rather than being limited to depreciable basis as under the old exception.

Interpretation questions immediately arose. The new exception literally applies only if the farmer is solvent at the time of the discharge. There is no provision that it should be applied after application of the insolvency exception (IRC § 108(a)(1)(B)). Moreover, although tax attributes of the debtor have to be reduced, there is no provision that income has to be recognized to the extent the debt discharged exceeds available tax attributes.

Under this interpretation, a farmer who was only slightly insolvent at the time of discharge could be at a disadvantage as compared with a farmer who is solvent. *Example:* Farmer A and Farmer B each have $50,000 in debt cancelled. Assume Farmer A is insolvent by only $1,000 immediately before the discharge, and Farmer B is solvent by $1,000. Under a literal interpretation of the new provisions, A would have to recognize $49,000 of income with respect to the discharge (the insolvency exception being limited to the amount of A's insolvency, $1,000), while B may not have to recognize any (the solvency exception potentially applying to the entire amount discharged).

However, the "Blue Book" indicates that the amount of income excluded under the new solvency exception cannot exceed the amount of available tax attributes. Staff of Joint Comm. on Taxation, General Explantion of the Tax Reform Act of 1986, at 194.

The 1987 Technical Corrections Act (TCA) would adopt this approach, and would also clarify the availability of this exception to insolvent farmers. The TCA would rewrite the farm solvency exception to bring it much closer to the "qualified business indebtedness" exception of prior law. As rewritten, the exception would be for the discharge of "qualified farm indebtedness." TCA § 104(a)(1). The changes would make it clear that if qualified farm indebtedness is discharged when the farmer is insolvent, the insolvency exception can be applied first, with the qualified farm indebtedness exception then being applied if the farmer has been rendered solvent by the discharge. TCA § 104(a)(2). However, the changes would specifically provide that the qualified farm indebtedness exception would *not* apply to the extent the amount otherwise excludible exceeds available tax attributes. TCA § 104(a)(3).

For the present solvency exception to apply, the discharge must be by a "qualified person" – generally unrelated commercial lenders. IRC § 108(g)(3); 46(c)(8)(D)(iv). The TCA would include as qualified persons lenders that are federal, state, or local governmental agencies. TCA § 104(a)(4).

To constitute "qualified farm indebtedness" under the present exception, it must have been incurred "directly in connection with the operation by the taxpayer of the trade or business of farming," and at least fifty percent of the taxpayer's average annual gross receipts for the three years preceding the year of discharge must be "attributable to the trade or business of farming." IRC § 108(g)(2).

The TCA clarifies the gross receipts tests by providing that at least fifty percent of the taxpayer's aggregate gross receipts from all sources for the three-year period prior to the year of discharge must be attributable to the trade or business of farming. TCA § 104(a)(4). In other words, all of the taxpayer's gross receipts from farming for the three-year period would be added together and divided by the aggregate of all of the taxpayer's gross receipts from all sources for the same period.

Solvent farmers who have debt discharged will find the new exception, as rewritten by the TCA, more limiting than the TRA 1986 version in that the amount excluded by the exception will be limited by available tax attributes. On the other hand, the TCA changes make it clear that an insolvent farmer who is rendered solvent by the discharge may have both the insolvency exception and the qualified farm indebtedness exception available to exclude income.

– Lonnie Beard

Stray voltage litigation

Stray voltage, or neutral-to-earth voltage, is a problem of increasing concern to dairy farmers and their lawyers. The term "stray voltage" denotes not a single problem, but a variety of electrical phenomena with many associated variables.

For the purpose of this discussion, stray voltage can be divided into two classes – "systemic" and "negligent." "Systemic" stray voltage exists not as a result of any negligence, but as an inherent part of modern electric power grids. In order to make electricity available to customers, utilities must install transformers that reduce the available current from the thousands of volts carried in primary distribution lines to the 110 or 220 volt standards employed in houses and farms. The excess current then travels back along neutral wires that are grounded at intervals. For a good description of stray voltage, see Gustafson, *Stray Voltage: Detection and Diagnostic Procedures*, National Rural Electric Coop. Ass'n (1983). Due to varying electrical resistance, "whenever there is a current in a neutral system, a voltage will exist between it and the earth." *Kohli v. Public Utilities Comm'n of Ohio*, 18 Ohio St. 3d 12, 12, 479 N.E.2d 840, 841 (1985). That voltage is he stray, albeit predictable, voltage of concern to dairy farmers. In a dairy cow "bridges the gap" between the grounded conductor (neutral) and the true earth, the voltage will force enough current through the cow's body to cause serious problems. Gustafson, *supra*, at 3.

"Negligent" stray voltage exposes dairy cattle to similar risks, but the dangerous electrical condition is created by faulty wiring, and/or improper grounding in either the distribution system or in farm equipment such as milking machines.

Whatever its genesis, stray voltage of as little as one volt can seriously affect a cow's milk production. The principal concern is that stray voltage often precipitates an increase in mastitis, a common udder infection that makes milk unmarketable, and in its most virulent form can require the slaughter of affected cattle.

Stray voltage litigation is of recent origin. Plaintiff dairy farmers have been successful in reaching juries on the issue of strict liability for "systemic" stray voltage in some jurisdictions. *Otte v. Dayton Power & Light Co.*, No. 86 CA22 (Ohio App., April 23, 1987) (Westlaw, Allstates Database); *Public Service Indiana, Inc. v. Nichols*, 494 N.E.2d 349 (Ind. App. 1986). However, a study of the cases reveals a mixing of strict liability and negligence issues. Liability has not yet been imposed where a distribution system, not negligently constructed or maintained, has inherently exposed the plaintiff's cow to harm.

There have been substantial recoveries where defendant utilities or equipment manufacturers have been found to be negligent in installing or maintaining either electric lines or farm equipment. Critical to all "negligent" stray voltage litigation has been the issue of defendant's knowledge, either constructive or actual, of potential risks posed to dairying by stray voltage. Plaintiffs that have proven such knowledge have fared well. *Schriner v. Pa. Power & Light Co.*, 348 Pa. Super. 177, 501 A.2d 1129 (1985) (remanded for trial on strict liability and negligence issues); *Potomac Edison Co. v. Burdette*, 70 Md. App. 566, 521 A.2d 1276 (1987) (remanded on issue of negligent installation of milk parlor); *Public Service Indiana, Inc. v. Nichols*, *supra*, ($340,000 award against electric company for negligent line maintenance upheld); *Hoover's Dairy, Inc. v. Mid-America Dairymen Inc.*, 700 S.W.2d 426 (Miss. 1985) (affirmed $234,000 in actual damages against defendant for negligent installation of milking machines, reversed $1,000,000 in punitive damages); *Babson Bros. Co. v. Tipstar Corp.*, 446 N.E.2d 11 (Ind. App. 1983) (affirmed $580,000 in damages against defendant for negligent installation of milking machines).

Proof of whether defendants knew or should have known of stray voltage risks, via obviousness, publication or general knowledge, has been a decisive issue in those cases where plaintiffs did not recover. *Kohli Public Utilities Comm'n of Ohio*, *supra*; *Wells v. French Broad Elec. Membership Corp.*, 68 N.C. App. 410, 315 S.E.2d 316 (1984); *West Penn Power Co. v. Pa. Pub. Util. Comm'n.*, 478 A.2d 947 (Pa. Cmwlth 1984).

– *Mark Childress*

Federal Register *in brief*

The following is a selection of items that have been published in the *Federal Register* in the last few weeks.

1. FCIC; Combined Crop Insurance Regulations; Proposed rule. 52 Fed. Reg. 41728.
2. FCA; Organization; Director Compensation; Proposed rule. Written comments due Jan. 8, 1987. 52 Fed. Reg. 43081.
3. FCA; Regulatory Accounting Practices – Temporary Regulations; Loan Policies and Operations – Loss-Sharing Agreements; Final rule. 52 Fed. Reg. 43733; Correction published at 52 Fed. Reg. 44969.
4. FCA; Borrower Rights; Final rule. 52 Fed. Reg. 45161.
5. INS; IRCA; Control of Employment of Aliens; Interim rule with request for comments; Comments due Jan. 8, 1988. Interim rule effective Nov. 9, 1987. 52 Fed. Reg. 43050.
6. INS; IRCA; Adjustment of Status for Certain Aliens; Interim rule with request for comments. Effective date Nov. 17, 1987 52 Fed. Reg. 43843.
7. APHIS; Animal Damage Control Program; EIS; Notice. Written comments due Jan. 20, 1988. "APHIS intends to prepare a new EIS for the federal/cooperative Animal Damage Control program." 52 Fed. Reg. 43778.
8. APHIS; Animals Destroyed Because of Brucellosis; Notice of reopening and extension of comment period. Comments due Dec. 28, 1987. 52 Fed. Reg. 45200.
9. FmHA; Implementation of Provisions of the Supplemental Appropriations Act (Pub. L. 100-71), Dated Jul. 11, 1987. 52 Fed. Reg. 43766.
10. FmHA; Account Servicing Policies; Proposed rule. Comments due Dec. 21, 1987. "Proposes to amend its regulations to eliminate the necessity for borrowers to attempt voluntary debt adjustment prior to being considered for deferral." 52 Fed. Reg. 44607.
11. FmHA; Appeal Procedure; Hearing/Review Officer Designations; Final rule. Effective date Dec. 2, 1987. 52 Fed. Reg. 45806.
12. CCC; Grains and Similarly Handled Commodities; Loan and Purchase Programs; Proposed rule. 52 Fed. Reg. 44989.
13. CCC; Commodity Certificates; Acceptance after Expiration Date; Notice. Dated Nov. 30, 1987. "Original holders of generic commodity certificates with expiration dates that have passed may present such certificates for cash. . . ." 52 Fed. Reg. 45473.
14. Department of Justice; Rules of Practice and Procedure for Administrative Hearings Before Administrative Law Judges in Cases Involving Allegations of Unlawful Employment of Aliens and Unfair Immigration-Related Employment Practices; Interim rule with request for comments. Comments due Dec. 24, 1987. Effective date Nov. 24, 1987. 52 Fed. Reg. 44972.
15. ASCS; Commodity Certificates, In Kind Payments, and Other Forms of Payment; Issuance and Exchange; Interim rule. Effective date Dec. 1, 1987. Comments due Dec. 31, 1987. "7 CFR 770.4(g)(1) is amended to provide that other commodities . . . may be obtained from CCC inventory in exchange for 'commodity specific' certificates." 52 Fed Reg. 45606.

– *Linda Grim McCormick*

The impact of the passive activity rules on agricultural investments

by Steven B. Kutscheid

The Tax Reform Act (TRA) of 1986 made sweeping changes to the taxation of most industries, including the agricultural industry. New section 469 of the Internal Revenue Code limits the use of passive activity losses and credits by individuals, estates, trusts, closely held corporations, and personal service corporations to the extent such losses exceed income from passive activities. These new "passive activity" rules will have a significant impact on past and future agricultural investment. Constraints placed on the ability to deduct passive losses may severely limit the flow of new money into the agricultural sector of the economy.

Prior to the recent decline in farm values, many high income investors purchased farm property for investment. The investment typically generated substantial losses, primarily resulting from interest and depreciation deductions. These losses, under prior law, could be offset against income from other activities. However, these losses will not likely be deductible under new section 469 of the IRC. Congress under the TRA of 1986 has sought to rid the agricultural industry of tax shelter capital. Congress indicated that it feels tax preferences are harmful to the farming industry. This message is clear in the Senate Finance Committee report, which states:

> For example, in the case of farming, credits and favorable deductions have often encouraged investments by wealthy individuals whose principal or only interest in farming is to receive an investment return, largely in the form of tax benefits to offset tax on positive sources of income. Since such investors may not need a positive cash return from farming in order to profit from their investments, they have a substantial competitive advantage in relation to active farmers who commonly are not in a position to use excess tax benefits to shelter unrelated income. This has subsequently contributed to the serious economic difficulties presently being experienced by many active farmers. S. Rep. No. 313, 99th Cong., 2d Sess. 715-16.

Whether these new rules benefit or hurt farming is at this point unknown. However, in order to understand the impact of these new passive loss rules, the farmer must be able to learn a new and complex set of rules. This article explains these rules and discusses what impact they have on the agricultural industry.

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Defining "passive income and loss"

The TRA of 1986 divides income and expenses into three categories. First, "portfolio income" includes interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business. It also includes gains and losses from the disposition of property producing these types of income, such as stocks and bonds, or other property "held for investment." IRC § 469(e)(1). Second, "active income" generally includes all wages, salaries, fees for services and income from a business in which the individual "materially participates." IRC § 469(e)(2). Third, "passive income," or loss, is from a trade of business in which the taxpayer does *not* "materially participate," and from any rental activity even if he materially participates in such rental activity. IRC § 469(e)(1) and (2).

Material participation

In order to have income or loss characterized as income or loss from an active trade or business, the taxpayer must "materially participate." "Material participation" is defined in IRC section 469(h) as involvement in the operation of the activity on a regular, continuous and substantial basis. The test applies to each individual owner or investor for each taxable year. A limited partner is conclusively presumed to be passive, except to the extent provided by the regulations. IRC § 469(h)(2). Until regulations are issued, the following guidance on application of the material participation test to taxpayers (other than limited partners) is based on the Senate Finance Committee report (pages 730-735). Factors considered under the Committee Report are: (1) whether the activity is the taxpayer's principal trade or business; (2) the amount of knowledge and experience the taxpayer has in the business; (3) whether the taxpayer devotes considerable time to the activity; and (4) how regularly the taxpayer is present where the principal business operations are conducted.

To meet the material participation standard, a taxpayer must participate in the activity through the taxable year and must take an active part in the important operational matters of the business. If a taxpayer utilized a farm manager, the material participation standard may be difficult to meet. The Senate Finance Committee Report (page 734) states:

> The fact a taxpayer has little or no knowledge or experience regarding the business is highly significant in determining whether such taxpayer's participation in management is likely to amount to material participation. However, even if a taxpayer has knowledge and experience, if he merely approves management decisions recommended by a paid advisor the taxpayer's role is not substantial (and accordingly, he has not materially participated), since decisions could have been made without his involvement.

Furthermore, where the taxpayer utilizes employees or contract services to perform daily functions in running the business, the activities of such agents are not attributed to the taxpayer

The Senate Finance Committee Report states that the "material participation" standard is based on standards apppearing under IRC section 1402(a) (relating to self-employment tax) and IRC section 2032A (relating to special use valuation). However, precedents under these IRC sections are not controlling in regard to the passive loss rules. However, it is helpful to understand these provisions for planning purposes.

Treasury regulations under IRC sections 1402(a) and 2032A state that an owner materially participates when he:

1. Periodically consults with the tenant as to the production of commodities;
2. Periodically inspects the production activities on the land; and
3. Furnishes a substantial proportion of the machinery, implements and livestock used in the production of commodities, or assumes financial responsibility for a substantial part of the expenses involved in the production of commodities. See Treas. Regs. §§ 1.1402(a)-4(b)(3) and 20.2032A-3(e)(2).

Rental activities

Congress did not rely exclusively on the material participation requirement, which is prone to disputed interpretations, in order to curb the flow of money into what it considers to be a tax shelter.

It attacked real estate leasing more directly by defining all rental activites as passive activities, whether or not the taxpayer materially participates. Since a rental activity is treated as a passive activity under the new law, a cash rent lease will be treated as a passive activity.

Congress defined a rental activity to include any activity where payments are principally for the use of tangible property. IRC § 469(j)(8). Where substantial services are performed, the activity is not considered a rental activity. Consequently, a crop-share lease may be characterized as either farming or rental activity. Assuming a crop-share lease were to be determined or deemed to be a farming activity, the material participation test would be applied and if the owner materially participated, the activity would not be deemed one of a passive nature.

In a crop-share lease arrangement, it is difficult to meet material participation factors set forth under the regulations for IRC sections 1402(a) and 2032A. Generally, it is difficult to establish that an owner furnishes a substantial proportion of the machinery, implements and livestock used in the production of the commodity since the tenant often provides all machinery and implements, except perhaps irrigation equipment. Accordingly, an owner must show material participation by his assumption of financial responsibility for a substantial part of the expenses involved in the production of commodities and by periodically consulting with the tenant and inspecting the activities.

A current case shows this difficulty. In *Margels v. United States*, 632 F. Supp. 1555 (S.D. Iowa 1986), the court held that a landlord under a crop-share lease did not meet the material participation standard. There, a conservator, acting on behalf of a disabled farmer, leased tillable farmland on a crop-share basis. In determining that the material participation standard had not been met, the court stated:

> No agent of the conservator lived on the farm. No agent of the conservator did any physical work on the farm. The conservator did not furnish any part of the machinery and implements used in the production activities. The conservator did participate with the tenant in management decisions but the frequency of consultation was low – one session each winter for 1½ – 2 hours and a one-hour session about once a month often by phone. Mr. Lage made a two-hour inspection of the farm about once each quarter, not just to inspect crops but also to inspect for general maintenance matters such as fence and tile repair needs. The conservator and tenant shared fertilizer, pesticide, herbicide, and seed costs. The conservator exclusively made decisions relating to marketing the landlord's share of the crops and relating to long-term management matters and capital improvements, such as a drainage tile project in 1979.

The court viewed the conservator's participation to be no greater than that of a landlord in a "typical crop-share lease agreement" and stated that such activity was not enough to constitute material participation. The court pointed out that a crop-share arrangement does not necessarily lead to a finding of no material participation by a landlord. However, for there to be material participation, there must be significant participating acts by the landlord.

The new tax laws require that crop-share lease arrangements be structured in a manner that will support a material participation argument. Under "aggregation rules" put into the act, each farm generally will constitute a separate activity. Accordingly, material participation will need to be established for each farm. Taxpayers must be careful to document actual operations under the crop-share lease in their effort to support material participation by the owner. I think it can be safely assumed that the Internal Revenue Service may disallow losses under any crop-share lease. However, in order to plausibly argue against such a decision, a crop-share lease should contain the following factors:

1. The owner, where possible, should live on the farm.
2. Each lease should provide that the owner will furnish a substantial portion of the machinery and implements used in the production activities.
3. The lease should provide that the owner will determine what fertilizer, insecticide, pesticide, herbicide, chemicals for weed control, and seed for crop production will be used on the property.
4. Each lease should provide that the owner will determine crop and rotation patterns, the location on the real estate where such crops will be grown, and the variety and type of each specific crop that will be planted.
5. Under each lease the owner should determine what government programs, if any, in which to enter.
6. Each lease should provide that the owner will decide soil and water conservation practices, scheduling of repairs, use of storage facilities, and changes in tillage practices.
7. The owner should be aware of the adverse effect of a farm management agreement and consider restructuring any management agreement as a consulting agreement with reduced responsibilities on the part of the consultant.
8. The owner should consult frequently with the tenant as to the production of commodities, and record the length and frequency of such consultations in a log book.
9. The owner must frequently inspect the farm and record the length and frequently of the consultations in a log book.

Because of the potential inability to use losses under a typical crop-share lease arrangement, a prospective investor in agricultural property must be aware of possible limitations on passive losses.

However, even if a taxpayer does not materially participate in the crop-share lease, there is a potential exception which may permit him to deduct losses. Under the new rules, there is a special rule allowing a natural person (not a corporation) who *actively participates* in certain rental real estate activities to use up to $25,000 of net passive losses annually from all such activities against active or portfolio income. IRC § 469(i). The active participation test cannot be met by a limited partner. IRC § 469(i)(6)(c). A general partner or investor in a crop-share lease may satisfy this requirement if he has at least a ten percent interest in the activity and participates in a significant and bona fide sense, such as making management decisions or arranging for others to provide for services. See Senate Report, page 737. A person is not considered to actively participate if he or she owns less than ten percent of the activity, because without a significant ownership interest, this participation is likely to be for the benefit of others rather than one's ownership. However, ownership of ten percent or more of the activity will not auto-

(continued on next page)

matically qualify the taxpayer for the $25,000 exception. Again, all relevant facts or circumstances will be considered in determining active participation. This active participation standard is intended to be less stringent than the material participation standard as set forth above. See Senate Report, page 737.

Because the special $25,000 loss allowance was designed to aid only persons with "moderate income who manage their properties," it is phased out for taxpayers with adjusted gross income between $100,000 and $150,000 (without reduction for passive losses). See Senate Report, pages 736 and 737.

The $25,000 allowance is applied by first netting the qualifying rental real estate activities. If a net loss results, net passive income from other activities is then applied against it. Any remaining loss is eligible for the $25,000 allowance. Any loss remaining after application of the $25,000 allowance is subject to the passive loss provisions. The $25,000 allowance is reduced by 50 percent of the taxpayer's adjusted gross income (AGI) between $100,000 and $150,000 ($50,000 and $75,000 for a married taxpayer filing separately). Consequently, married taxpayers filing jointly with AGI of $150,000 or more, will receive no benefit from this provision. For these purposes, AGI is determined without reference to Individual Retirement Account deductions, taxable Social Security benefits, and passive activity losses.

Dispositions of interests in passive activities

Unused losses generated in a passive activity are allowed in full upon a taxable disposition of the taxpayer's entire interest in the activity. Gain realized upon such a disposition is generally treated as passive income and is first offset by suspended losses from that activity. Any excess passive income may be used to offset suspended losses from other passive activities. IRC §. 469(g). Since the purpose of the disposition rule is to allow real economic losses of the taxpayer to be deducted, credits, which are not related to the measurement of such loss, are not specifically allowable by reason of a disposition.

Where a taxpayer disposes of less than his entire interest or disposes of his entire interest in a non-taxable transaction, suspended losses are generally not allowed because "the issue of ultimate economic gain or loss on his investment remains unresolved." Senate Report, pages 725-726. However, where a taxpayer is a limited partner in a partnership involved in more than one separate activity, it is not necessary that he dispose of his entire partnership interest in order to trigger suspended losses. Limited partners are treated as having made a taxable disposition triggering suspended losses when the partnership disposes of one or more of its separate activities in a fully taxable transaction. In addition, an installment sale of a taxpayer's entire interest in a passive activity constitutes a fully taxable disposition for purposes of triggering suspended losses. These losse are triggered according to the same ratio that the gain recognized during the year bears to the total gain on the sale.

Regulating authority to classify income as non-passive

Additionally, section 469(k)(3) authorizes treasury to prescribe regulations requiring net income or gain from a passive activity to be treated as non-passive (presumably portfolio) income. These "anti-abuse" regulations are intended to prevent taxpayers from structuring income-producing activities (including those which do not bear significant expenses) in ways designed to produce passive income that may be offset by unrelated passive losses. Senate Report, p. 730. The Conference Report identifies the following examples where the exercise of this regulatory authority may be appropriate: (1) ground rents that produce income without significant expenses; (2) related party leases or subleases, with respect to property used in a business activity, that have the effect of reducing active business income and creating passive income; and (3) activities previously generating active business losses that the taxpayer intentionally seeks to treat as passive at a time when they generate net income with the purpose of circumventing the rule. H.R. Rep. No. 841, 99th Cong., 2d Sess., II-147.

Conclusion

A long term effect of the TRA of 1986 on farming is yet to be seen. Although many of the changes specific to agriculture are aimed at ridding the industry of tax shelter capital, the provisions will affect many bona fide farmers. Investors and their advisors must now carefully analyze the economic benefits to be derived from an investment in agricultural property as the tax benefits associated with such an investment may no longer be available. Accordingly, the flow of new money into the agricultural sector may be limited.

Past and present crop-share lease arrangements must now be carefully analyzed and structured. All existing crop-share lease arrangements should be restructured and revised in an effort to meet the new material participation requirements.

– Steven B. Kutscheid

Seller liability for cancellation of principal

The Installment Sales Revision Act of 1980 added new language to the Internal Revenue Code saddling sellers who cancel or forgive principal on an installment contract with income tax liability on the cancelled or forgiven amounts. The amount of tax liability is determined by whether the seller and buyer were unrelated (in which case the gain was measured by the difference between the seller's basis in the obligation and the fair market value of the contract) or related (in which case the face value of the obligation was treated as its fair market value). The intended target for the 1980 provision was sellers who would forgive principal payments periodically as a way to transfer wealth to the purchaser.

Since the onset of financial woes in agriculture and the advent of loan restructuring, the question has been whether the language calling for income tax liability for sellers cancelling or forgiving principal applied where sellers would forgive principal in an effort to help financially troubled purchasers or property. The statute has not been clear on that point but the language has seemed broad enough to cover forgiveness or cancellation of principal in conjunction with debt restructuring.

In Internal Revenue Service has now issued Ltr. Rul. 8739405, June 30, 1987, holding that the seller in that situation has no income to recognize. The ruling cites 1955 and 1968 rulings as controlling, both of which were governed by pre-1980 law. The 1987 ruling fails to mention the 1980 amendment. For that reason, the letter ruling outcome seems highly suspect. The ruling will serve, however, to add confusion to an already murky area. Clarification by the Internal Revenue Service is now badly needed.

– Neil E. Harl

Patronage-sourced coop earnings

Recent litigation further delineates the requirements for patronage-sourced earnings. *Certified Growers of California, Ltd. v. Commissioner*, 88 T.C. 238 (1987); *Washington-Oregon Shippers Coop. v. Commissioner*, 52 T.C.M. 1406 (CCH 1987). *See* 3 *Agric. L. Update* 8 (January 1986).

In *Certified Growers of California*, the tax court found that the temporary investment of borrowed funds was patronage-sourced.

On the other hand, in *Washington-Oregon Shippers Coop.*, it was determined that the interest income from a T-bill, certificate of deposit, and savings account did not constitute patronage-sourced income under subchapter T. For a more extensive discussion of earlier litigation of this issue, see Centner, *Qualifying Earnings for Deduction under Subchapter T*, 9 J. Agric. Tax'n and Law 143, 149-51 (1987).

– Terence J. Centner

STATE ROUNDUP

MINNESOTA. *Most favored lender rates.* Most favored lender rates apply to agricultural loans under Minnesota law. The Minnesota Court of Appeals, in *Dahl v. Lanesboro State Bank*, 399 N.W.2d 621 (1987), rejected farmers' argument that the Minnesota usury provisions regulating interest on agricultural loans control over other provisions granting most favored lender banks the right to charge up to 21.75% interest.

The court rejected the farmers' contention that the Lanesboro State Bank is not granted most favored lender status under 12 U.S.C. section 1831. Lanesboro is a state-chartered, federally insured bank. Such banks are granted most favored lender status under a recent Minnesota case, *First Bank East v. Bobeldyk*, 391 N.W.2d 17 (Minn. Ct. App. 1986), *pet. for rev. denied* (Minn. Sept. 24, 1986). Lanesboro therefore was entitled to charge the highest rate allowable for the same class or type of loan. Since the bank competes for agricultural loans with industrial loan and thrift lenders who are allowed to charge 21.75%, Lanesboro may also charge up to 21.75% on such loans.

The farmers next argued that most favored lender rates do not apply to agricultural loans. They argued that the language in the Minnesota agricultural loan usury provisions establish that the most favored lender doctrine was not meant to apply to agricultural loans. Specifically they argued that the language in Minnesota Statute section 334.011 stating that the section applies "[n]otwithstanding the provisions of any law to the contrary" establishes that this lower agricultural loan usury limitation controls over Minnesota's most favored lender statutory provisions.

The court rejects this argument, relying upon the wording of section 53.04 subd. 3a(a), which states that 21.75% interest may be charged "in lieu of" Chapter 334 rates by most favored lenders. The court further points out that section 334 was passed in 1976 and last amended in 1981, whereas section 53.04 was passed in 1981 and subsequently amended in 1982, 1983, 1984, and 1985.

The court acknowledged that allowing these higher interest rates to be charged upon agricultural loans may be burdensome to farmers in today's economic situation, but stated that it is the legislature's role to except agricultural loans from most favored lender rates.

– Gerald Torres

SOUTH DAKOTA. *Effective date of 1985 Farm Credit Amendments.* A farm mortgage was made to defendants Jensen in 1975 by the Federal Land Bank. Defendants failed to make annual payments due in 1984, 1985, and 1986; in April of 1986, the Bank instituted mortgage foreclosure proceedings in South Dakota state court. Defendants answered with affirmative defenses based on the Farm Credit Amendments of 1985. Specifically, defendants asserted that the Bank failed to provide them a copy of its policy of forbearance as required by section 301(b) of the 1985 Act (12 U.S.C. § 2199(b)(Supp. 1987)) nor did the defendants receive any written communication from the Bank notifying them that their "non-accruing" loan had been reviewed in accord with section 307 (uncodified).

The trial court granted Bank's motion for summary judgment on these issues and the South Dakota Supreme Court affirmed. *Federal Land Bank of Omaha v. Jensen, 415 N.W.2d 155 (1987)*, #15615, #15622 – a – REM (S.D., Nov. 4, 1987).

While it was undisputed that the Bank had never furnished borrowers a copy of any forbearance policy nor notified them of a loan review, regulations implementing the new legislation were not issued until November, 1986. In the interim, the 1985 Act specifically provided in section 4.02(d) (uncodified) that "[a]ll regulations... and policy directives issued or approved by the [FCA]... shall be continuing and remain valid until superseded, modified, or replaced...." On the basis of this language, the court held that the prior FCA regulations and procedures, with which the Bank had complied, were in effect.

– John H. Davidson

FLORIDA. *"Melaleuca leaves of wrath."* The plaintiff in *Gallo v. Heller*, 512 So.2d 215 (1987) sought injunctive relief and damages from her neighbors, who had allegedly allowed the branches and roots of their ficus and melaleuca trees to encroach on plaintiff's property. This intrusion purportedly damaged plaintiff's roof and house, cracked her sidewalk, and so shaded her vegetation that it died. In addition, the melaleuca leaves dropping onto plaintiff's property caused her Afghan hound to suffer a severe allergic reaction.

The trial court dismissed, and the court of appeal affired, stating that Florida law does not allow damages to persons outside of a property for a nuisance resulting from trees and natural vegetation growing on the property. The adjoining landowner, however, may trim at her expense any vegetation that encroaches onto her property.

– Sid Ansbacher

SOUTH DAKOTA. *Trustee's fees on direct payments.* In the case of *In re Erickson Partnership,* 77 Bankr. 738 (Bankr. D.S.D. 1987), debtors, operators of a farming and hog raising business, filed a Chapter 12 plan of reorganization that provided for direct debtor payments to two creditors.

The first creditor, First Federal Savings and Loan Association (First Federal), was fully secured. When the debtors filed for relief under Chapter 12, they were not in default on their payments to First Federal. Moreover, the debtors had kept current on their payments to First Federal throughout the reorganization. Thus, debtors' plan of direct payments did not modify First Federal's claims.

The second creditor, Metropolitan Life Insurance Company (Metropolitan), was undersecured. The debtors were in default on their obligation to Metropolitan at the time of the filing of their bankruptcy petition. Consequently, the parties entered into a stipulation whereby Metropolitan would be paid the amount equal to the value of the secured property over a ten-year period. Also set forth in the stipulation were procedures and remedies for Metropolitan if the debtors ceased to conform to the agreement. This stipulation was incorporated in the plan of reorganization. Here, the debtors' tender of direct payment modified Metropolitan's rights in that Metropolitan would not receive its entire debt, only the value of its collateral.

The Trustee opposed confirmation of the debtors' plan of reorganization, arguing that it did not provide for payment of the Trustee's ten percent fee on all disbursements.

The debtors contended that they had complied with the fee requirements of 28 U.S.C. section 586(e) since 11 U.S.C. section 1226(c) permitted the debtors to make direct payments, as part of their plan or reorganization, to First Federal and Metropolitan; and, 28 U.S.C. section 586(e)(2) limited the Trustee's remuneration to payments directly to creditors. This right was limited, however, depending on whether the creditor's claim had been modified in the plan of reorganization. Here, the debtors were allowed to make direct payments to First Federal and Metropolitan, and the Trustee was not allowed to impose a fee on such payments.

– Michael B. Thompson

Address Correction Requested

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AMERICAN AGRICULTURAL LAW ASSOCIATION NEWS

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