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Solicitation of articles: All AALA members are invited to submit articles to the Update. Please include copies of decisions and legislation with the article. To avoid duplication of effort, please notify the Editor of your proposed article.

IN FUTURE ISSUES

- American Jobs Creation Act of 2004

New conditional waiver program in California's Central Coast to regulate waste discharge for irrigated lands

In a landmark agreement reached between agricultural and environmental organizations, California's Central Coast Regional Water Quality Control Board ("Control Board") adopted new conditional waiver of waste discharge requirements for irrigated lands. Through the new conditional waiver program, water quality from irrigated return flow and agricultural storm water runoff will be regulated and monitored. Over twenty agricultural and environmental organizations, many with competing interests, helped develop the new water quality requirements. Other conditional waiver programs in California have not been as successful in incorporating the competing interests of agriculture and environment.[1] This article briefly discusses the formation of Central Coast's conditional waiver program.

California Water Code § 13260 requires persons who discharge or propose to discharge waste that could affect the State's water quality to file a report of water discharge (ROWD) to a Regional Water Quality Control Board (Regional Board). The Regional Board will then either issue a National Pollutant Discharge Elimination System (NPDES) permit (if the discharge is from a point source) or a Water Discharge Requirement (WDR) based on the information submitted in the ROWD. California Water Code § 13269 authorizes a Regional Board to issue waivers of WDRs for a specific discharge as long as it is conditional and in the public interest. A Regional Board is also authorized to waive the requirement to file a ROWD.

Since 1983, irrigation return flows and storm water runoff from agricultural lands in the Central Coast have been exempted from the NPDES system and WDRs. In 1999, California Water Code § 13269 was amended "causing all waivers to Water Discharge Requirements that existed prior to January 1, 2000 to expire on January 1, 2003."[2] Regional Boards were authorized to renew the existing waivers by a hearing or to adopt new waivers. Waivers for irrigated return water and for non-point source storm water discharges thus expired and needed to be reinstated.

The Control Board has jurisdiction over California's coastal region from Santa Barbara County to Santa Cruz County.[3] There are 600,000 acres of irrigated cropland and over 2500 farming operations in this jurisdiction. The majority of these operations have less than 50 acres, and less than 8% of the total farming operations in the region have more than 2000 acres. Prior to the adoption of the new conditional waiver, several agricultural industries led efforts in the region to proactively address water quality issues. The

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Reporting income under "ledger" contracts

Although ledger contracts for marketing hogs have been around for nearly a decade,[1] audit activity has picked up in recent months with taxpayers questioned as to how income under the contracts was reported during the period of extremely low live hog prices in 1998-99 when hog prices dropped to as low as eight cents per pound.

Ledger contracts were developed as a risk-sharing arrangement between a producer and a livestock packer under which the parties agreed that the packer would pay a specified amount per pound of live hogs (such as 38 cents per pound) regardless of the actual cash price. If the specified price was less than the market price, a balance would build up on the packer's ledger in favor of the producer. When the cash price was less than the specified price, the producer would still receive the specified price and the ledger balance on the packer's books would be reduced accordingly. If the specified price was set at or near the long-term average price for live hogs, the ledger balance would fluctuate as the market price oscillates above and below the long-term average price. With such a contract in hand, a producer, especially a marginal producer financially, would be more likely to obtain necessary funding for production facilities.

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Control Board decided to develop a conditional waiver that could build upon the already existing voluntary programs.

In order to assist in the development of the waiver program, the Control Board formed an Agricultural Advisory Panel (Panel) which included members of over twenty agricultural and environmental organizations. The purpose of the Panel was "to assist staff in developing recommendations to the Regional Board for a replacement to the expired waivers that will be protective of water quality, the viability of Central Coast agriculture, and comply with state law."[4] The Panel met for a year and a half in facilitated discussion sessions. They explored concerns about fertilizers and pesticides in the streams and the costs of a conditional waiver program on agriculture producers. The Panel only made recommendations to the Control Board that were developed by consensus in the discussion sessions. The Control Board adopted a conditional waiver program that incorporated those recommendations.

The conditional waiver program provides both a waiver for WDRs and a waiver to file a ROWD. It applies "to all irrigated lands used for producing commercial crops, including, but not limited to, land planted to row, vineyard, field and tree crops, commercial nurseries, nursery stock productions and greenhouse operations with soil floors that are not currently operating under Waste Discharge Requirements." [5] Discharges regulated include "surface discharges, ... discharges to groundwater and storm water runoff flowing from irrigated lands."6 A discharger is "the owner and/or operator of irrigated cropland on or from which waste is discharged that affects or could affect the quality."[7]

In order to comply with the program, a farmer will have to submit a Notice of Intent, complete fifteen hours of farm water quality training within three years of the waiver's adoption, and develop a farm water quality management plan. The farm water quality management plan must address irrigation management, nutrient management, pesticide management, and erosion control. The farmer is required to implement management practices identified in the plan, perform water quality monitoring and submit periodic progress reports. Both the owner and the operator of the farm will be held responsible for complying with waiver conditions and requirements.

The waivers are categorized by a tiered structure, with a Tier 1 waiver valid for five years and Tier 2 valid for one year. Farmers could apply for Tier 1 if they have completed fifteen hours of farm water quality training and have completed and begun implementing the farm water quality plan. Farmers under a Tier 1 waiver will only have to submit an updated management practice checklist at the mid-point of the five year waiver cycle.

Tier 2 waivers are for farmers that cannot meet the Tier 1 requirements by December 1, 2004. Tier 2 waivers are renewable for up to three years. Farmers with Tier 2 waivers are required to submit an annual report that includes proof of progress toward meeting education requirements, as well as a checklist of management practices that are currently being implemented.

In order to ensure the effectiveness of a waiver program, California Water Code § 13629 requires the Regional Board to develop a monitoring system. The Control Board adopted a monitoring system that gives farmers the option of performing individual monitoring or participating in a Cooperative Monitoring Program. Individual monitoring will likely be the more expensive option, with costs varying based on the type of discharge and higher for farms that "discharge tailwater directly to surface water."[8]

The Cooperative Monitoring Program would allow individual farmers to pool resources and conduct group monitoring at a lower cost than individual monitoring. The Regional Board will select 50 fixed sites along main stems of rivers and tributaries where water quality problems attributable to agriculture have been identified. A farmer interested in signing up for the Program must elect the Cooperative Monitoring Program option in the submitted Notice of Intent. Twenty-three agricultural organizations in the Central Coast have agreed to implement the Cooperative Monitoring Program. It is estimated that it will cost up to one million dollars annually and will be initially funded by settlement and grant funds.[9] Costs to participate will be based on the size of the farming operation and type of discharge and "will be set by a cost allocation subcommittee established by the agricultural industry."[10] In the first few years, costs to farmers should be minimal and should remain lower than the cost for individual monitoring. More information about this program can be found at: http://www.swrcb.ca.gov/rwqcb3/AGWaivers/Index.htm.

—Amy Lowenthal, AgLaw Center

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*NCALRI is a federally-funded research institution located at the University of Arkansas School of Law Web site: http://www.nationalagalawcenter.org/ * Phone: (479) 575-7646 * Email: NCALRI@uark.edu*

[1] On February 26, 2004, a number of environmental and fishing groups sued the Central Valley Regional Water Board for failure to regulate agricultural runoff through its conditional waiver program. For more information see http://www.cleanfarmscleanwater.org/.

[2] California Regional Water Board: Central Coast Region, *Staff Report for July 8, 2004, available at* http://www.swrcb.ca.gov/rwqcb3/AGWaivers/Index.htm.

[3] David Beck, *Mercury News*, July 9, 2004, *available at* http://www.mercurynews.com/mld/mercurynews/news/9120559.htm?1c.

[4] California Regional Water Board: Central Coast Region, *supra* note 2.

[5] California Regional Water Board: Central Coast Region, *Frequently Asked Questions About The New Conditional Waiver For Irrigated Agriculture, available at* http://www.swrcb.ca.gov/rwqcb3/AGWaivers/Index.htm.

[6] *Id.*

[7] *Id.*

[8] *Id.*

[9] David Beck, *Mercury News*, July 9, 2004, available at http://www.mercurynews.com/mld/mercurynews/news/9120559.htm?1c.

[10] California Regional Water Board: Central Coast Region, *supra* note 5.

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Agricultural Law Update is published by the American Agricultural Law Association, Publication office: County Line Printing, Inc., 6292 NE 14th St. ***The next issue of the Update will contain a more complete review of this year's annual conference in Des Moines, IA, but I thought I would announce here the recipients of this year's awards. Awards Committee chair, Don Uchtmann presented the Distinguished service award to Orville W. Bloethe for his more than seven decades of service to agricultural clients and to the legal profession through his writings and seminars. Don also presented the Professional Scholarship Award to Drew L. Kershen and the Student Scholarship award to Nicholas***

25th Annual Agricultural Law Symposium in Des Moines

The 25th Annual Agricultural Law Symposium in Des Moines may be history, but I am sure that all who attended will continue to carry new insights and information with them throughout the next year. President Bill Bridgforth assembled an excellent faculty of speakers at the historic but technologically modern (wireless broadband internet connections) Hotel Fort Des Moines in downtown Des Moines. The annual agricultural law update sessions were expanded to 30 minutes each and everyone agreed the extra time was well spent and still left the audience and speakers with more information in the written materials.

I received many comments praising the food this year and I can only credit the fine chefs at the Hotel Fort Des Moines, who clearly know how to please a hungry crowd. The luncheon in honor of Dr. Neil E. Harl featured all Iowa food products with a huge tender pork chop at the center and a fine Iowa "brown Betty" cobbler as the *piece de resistance* for dessert. Orville Bloethe of Victor, Iowa presented a touching review of Neil Harl's accomplishments in agricultural law and President Bridgforth presented Neil with a plaque featuring a likeness of Neil etched in a magnesium plate.

The association was very fortunate this year to have many sponsors who generously provided funds for several aspects of the conference. As it has in many past conferences, the Farm Foundation provided a scholarship fund to allow students to attend the conference at a greatly reduced rate. Ramsay Bridgforth, Harrelson and Starling LLP of Pine Bluff, AR sponsored the Friday morning breakfast. The Des Moines law firm of Brown, Winick, Graves, Gross, Baskerville and Schoenebaum, P.L.C sponsored a portion of the Friday morning snack break and Lawler & Swanson, P.L.C., of Parkersburg, IA sponsored a portion of the Friday afternoon break. The attendees were entertained in the hotel's historic Grand Ballroom to a reception sponsored by the Des Moines law firm of Beving, Swanson & Forrest, P. C.. Finally, but not least, Pioneer Seeds provided a grant to the AALA conference in support of the educational activities. Many, many thanks to all our sponsors who demonstrated their generous support of the AALA goals and purposes.

Past-President Susan Schneider performed her last official duties as President for 2004 by presiding over the annual business meeting. The members approved a motion to amend the bylaws to add a new membership dues category of "new professional" at $60 per year. The category will be available to new members during the first three years after their graduation from law school or college. Susan also announced the appointment of Robert P. Achenbach, Jr. as permanent executive director. Robert reported that the association can expect a budget surplus this year, even with additional costs associated with the transition of the executive director office to Eugene, OR. Following her report, Susan received a standing ovation from all of those present for her outstanding contributions to the AALA during her presidency.

The annual AALA award ceremony was held during the Friday lunch and Awards Committee chair, Don Uchtmann presented the Distinguished service award to Orville Bloethe for his six decades of service to agricultural clients and to the legal profession through his writings and seminars. Don presented the Professional Scholarship Award to Drew Kershen for his articles "Of Straying Crops and Patent Rights," 43 *Washburn Law Journal* 575 (2004) and "Legal Liability Issues in Agricultural Biotechnology," 44 *Crop Science* 456 (2004). Don also presented the Student Scholarship award to Nicholas White for his Note, "Industry-Based Solutions to Industry-Specific Pollution: Finding Sustainable Solutions to Pollution From Livestock Waste," 15 *Colo. J. Int'l Envtl. L. & Pol'y* 153 (Winter 2004).

Also at the luncheon, Maureen Kelly Moseman, chair of the Membership Committee, presented the new 2005 membership recruitment program. Members who recruit nonmembers to become new members and/or to attend the annual conference in Kansas City in 2005 will receive chances in a drawing to be held at the Kansas City conference. First prize is a cash prize equal to the registration fee for the conference ($345 in 2004). Consolation prizes will also be awarded and all successful recruiters will be recognized. Please contact the Executive Director for an information packet, sample letter and membership brochures that can be used to contact your colleagues and students about AALA membership. The same items can be downloaded from the AALA web site. Look for the Membership Recruitment Program link on the AALA home page. The membership committee grew the AALA membership by over 25 percent in 2004 to over 680 members. The goal is 800 in 2005.

A major factor in increasing the AALA membership in 2005 will be a well-attended conference in Kansas City, October 7 & 8 in 2005. We encourage all our Kansas and Missouri members to make suggestions for potential speakers/ topics and sponsors for the conference. President-elect Don Uchtmann will be planning the 2005 program. He welcomes your ideas and may be reached at uchtmann@ucic.edu or (217) 333-1829. We will be making connections with the Missouri and Kansas Bars to spread the word that the most comprehensive and professional conference on agricultural law is coming to their neighborhood. We also welcome all suggestions for what I can do to help make the conference more enjoyable for all attendees and their guests.

Members who did not have a chance to attend the 2004 conference may still obtain a CD of the conference written materials for $25.00. The CD features an interactive table of contents with click-through titles which take you automatically to the beginning of each paper. The CD also includes an archive of several years of past issues of the Agricultural Law Update. Request your CD by e-mail, RobertA@aglaw-assn.org, with your mailing address and I will mail it to you with an invoice.

—*Robert P. Achenbach, Jr., AALA Executive Director*

Ledger contracts/Cont. from page 1

The extended downturn in live hog prices in 1998-99 produced large, sustained negative balances in the ledger account.2 Among the obvious questions raised by such large negative balances were-(1) what is the packer's position relative to the producer's lender; (2) how is the ledger account handled on the producer's balance sheet; (3) what are the consequences if the packer (or producer) declares bankruptcy, terminates the business or is sold; and (4) how does the producer report payments in the face of a large sustained negative balance in the ledger account?

In this article, the principal focus is on how a producer reports payments for live hogs during a period of large, sustained negative balances.

Income tax treatment of payments for live hogs

The income tax aspects relate to two distinct reporting problems—(1) how payments for live hogs should be reported and (2) how payments at the end of a contract are to be reported.

First, it should be noted that amounts actually paid for live hogs should be reported as income as the payments are received.[3] As the Internal Revenue Code clearly states, "Except as otherwise provided ... gross income means all income from whatever source derived, including (but not limited to) ... gross income derived from business ...."[4]

Example 1:

A taxpayer has a ledger contract with a packing plant that sets the specified contract price at 38 cents per pound of live hogs. The taxpayer delivers 400 hogs weighing 100,000 pounds at a time when the market price is 43 cents per pound. The taxpayer is paid 100,000 x $.38 = $38,000 and the ledger account balance is credited with 100,000 x ($.43 - .38) = $5,000. The

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Tax-exempt financing and agriculture

By Scott D. Wegner

In 1913, the first income tax law following adoption of the Sixteenth Amendment excluded from income interest received by the holders of government issued bonds, and that exemption continues. Thus, gross income for federal income tax purposes does not include interest on any state or local bond.[1] The principal advantage of tax-exempt bond financing is the lower interest cost in comparison to the interest cost on conventional debt.[2] Because investors who buy tax-exempt bonds do not pay federal or state income tax on interest payments received on the bonds, investors are willing to accept a lower interest rate, generally 2.00% to 3.00% below conventional rates.

This difference in interest rates can amount to a substantial savings. For example, a $5,000,000 project financed over 10 years at a conventional fixed rate of 8.00% versus at a tax-exempt fixed rate of 5.50% would realize a savings of $650,000 over the life of the loan.[3] It is estimated that the U.S. municipal bond market will cost the federal government $33 billion in lost revenue in fiscal year 2005.[4] Given budget deficits, some members of Congress are less than sympathetic to tax-exempt bond financing. This has led to a great deal of regulation aimed at curbing use of tax-exempt financing.[5]

Typically, bonds are issued by a state or political subdivision to finance facilities and infrastructure necessary to carry out primary governmental functions, such as schools, courthouses, correctional facilities, and the providing of water, sewer, and streets. Bonds issued for such public purposes are known as governmental bonds. However, a state or political subdivision can also issue certain types of bonds for private rather than for public purposes. These bonds are known as private activity bonds. In certain circumstances, private activity bonds may be issued to finance farming operations and facilities commonly used in agri-business. Although not common, some states may issue governmental bonds to aid agri-business. However, in those instances, the government may need to be involved as an owner of the facility. Tax increment bonds are one example of governmental bonds that might be issued to further agri-business.[6] In certain situations *taxable* bonds are issued to promote agriculture. A recent example is the issue of taxable bonds by the Louisiana Agricultural Finance Authority to build a sugar mill.[7]

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Private activity bonds

A private activity bond is one in which the bond proceeds are used to benefit private purposes as opposed to governmental purposes.[8] In the 1820s and 1830s, municipal bonds were issued that today might be characterized as private activity bonds, such as for railroads, banks, canals and turnpikes. During the panic of 1837, the states defaulted on most of these bonds.[9] In 1936, Mississippi enacted the Balance Agriculture with Industry program allowing the state or local government to borrow at tax-exempt interest rates and use the proceeds of the borrowing to benefit private business.[10] Such private activity bond financing was and is still known as conduit financing. In a conduit financing, the governmental entity acts merely as a conduit through which the tax-exempt bond proceeds flow.[11] The repayment on such conduit financing is limited to the revenues generated by the particular project (together with any guarantees or other moneys available to the business). The government's credit is never pledged.[12]

Other states followed Mississippi, and by the 1960s, the effort to promote private industrial development through governmentally issued tax-exempt bonds grew nationwide. In the Revenue and Expenditure Control Act of 1968, Congress added Section 103(b) to the Internal Revenue Code of 1954. Section 103(b) introduced the term "Industrial Development Bond" or "IDB" to describe a bond the proceeds of which were used in any trade or business other than by a governmental unit or a 501(c)(3) entity.[13] The 1968 legislation marked the first successful attempt by the federal government to limit the scope of the exemption for interest earned on bonds.[14]

Congress has gradually restricted use of private activity bonds and now withholds the "federal subsidy" from any private activity bond that is not a qualified bond.[15] A private activity bond will be qualified, and thus tax-exempt, if the proceeds from such bond are used for any one of seven "good" private uses identified by Congress.[16] Thus the 1968 legislation was the first to sort out good and bad uses of tax-exempt bonds and define public purpose. In addition to falling into an approved category, private activity bonds must still comply with several other regulations.[17]

One particular regulation deserves special attention. Congress seeks to control revenue loss by limiting the volume of private activity bonds that can be issued in a calendar year. Known as "volume cap," each state is allotted a certain dollar volume of private activity bonds based upon population.[18] Introduced in 1984, volume cap complicates considerably the issuance of private activity bonds.[19] Demand for volume cap often exceeds supply. For example, a state may use a large amount of their private activity volume for qualified mortgage bonds and qualified student loan bonds, leaving little or no volume left for other types of private activity bonds, such as "aggie" bonds, discussed below. State law generally establishes the method and priority for allocating volume cap between various private activity bonding programs.

While Congress defines the circumstances under which the interest on bonds is excludable from income for federal income tax purposes, state law provides the circumstances under which a state or political subdivision can validly issue tax-exempt bonds.[20] Both federal law and state law are needed for tax-exempt bonding to work. For example, state legislatures, eager to promote the ag economy, might authorize the issuance of bonds that, if issued, would actually not be exempt from federal income tax because they do not fit into a congressionally authorized private activity bond category.[21]

Aggie bonds

A type of private activity bond, known as "aggie bonds," are available to help first-time farmers acquire land, farm improvements, machinery, and livestock.[22] According to the National Council of State Agricultural Finance Programs, some 18 states have active aggie bond programs with the first aggie bond issued in 1980.[23] In the lexicon of the Internal Revenue Code, aggie bonds are characterized as qualified small issue bonds under Section 144.[24] The issuance process works as follows: given an eligible farmer, the state bond agency, such as the North Dakota Farm Finance Agency or the Illinois Farm Development Authority, sells a bond to a bank. The agency uses the loan money from the bank to lend to the farmer. The agency then assigns the farmer's note back to the bank. Working as a true conduit situation, the agency is then out of the picture, and repayment, including risk of default, is entirely between the farmer and the bank. The interest rate is lower than a conventional loan since the interest paid by the farmer is exempt from federal income tax. In the case of a contract for deed, the bond issued by the state agency is assigned to the seller.

Several restrictions apply. First, the amount of each bond is limited to $250,000.[25] Second, the first-time farmer must be the principal user of such farmland and must materially and substantially participate in the operation of the farm.[26] Third, the farmer cannot have had any direct or indirect ownership interest in substantial farmland, unless the previously owned farmland was disposed of while the farmer was insolvent. Substantial farmland means any par-

cel of land, unless it is smaller than thirty percent of the median size of a farm in the particular county where the land is located and the fair market value of the land at any time while held by the individual does not exceed $125,000. Further, the purchase of used farm machinery from the bond proceeds is limited to $62,500.[27] Beginning in 1996, farmland may be acquired from a related person, provided 1) the purchase price is fair market value and, 2) following the acquisition, the related person does not have a financial interest in the farming operation.[28] So, a contract for deed arrangement between father and son is eligible for tax-exempt financing. Attempts to address the restrictive features of aggie bonds, such as the $250,000 limit and the need for volume cap, are ongoing.[29] One area of uncertainty is whether anyone other than an individual may participate. While the statute uses the word "individual" there is an argument that the acquired farmland can be held in partnership, trust, or corporate form.

Beyond the federal requirements, states may impose additional eligibility tests. For example, North Dakota law adds a residency requirement, restricts any purchase of land to the purchase of North Dakota farmland, and establishes an applicant's maximum net worth at $200,000.[30] Additional criteria may be set administratively, such as age, education, and expertise requirements and the minimum dollar amount for which a bond will be issued.

Manufacturing bonds

Another type of qualified small issue bond authorized by Internal Revenue Code Section 144 is a manufacturing bond. Section 144 defines "qualified small issue bonds" as bonds issued in the aggregate face amount of $1 million or less, with at least 95 percent of the net proceeds being used to acquire, construct, or improve land or depreciable property.[31] Under certain circumstances, the $1 million limitation may be increased to $10 million. The Internal Revenue Code also restricts the aggregate principal amount of qualified small issue bonds that may be outstanding nationwide for a particular beneficiary to $40 million.[32]

Qualified small issue bonds may be issued to construct a manufacturing facility.[33] Manufacturing facility is defined as any facility that is used in the manufacturing or production of tangible personal property (including processing resulting in a change in the condition of such property) and facilities that are directly related and ancillary to a manufacturing facility.[34] Use of the $10 million option is severely limited by a capital expenditure rule.[35] Capital expenditures paid or incurred during the six-year period surrounding the bond issue (i.e. three years forward and three years back) for a particular facility are limited to $10,000,000. So, if a particular project is the beneficiary of $8 million in tax-exempt bonds, the corporation is limited to $2 million in capital expenditures for the project in the six-year period. The capital expenditure limit put in place in 1968 was last increased in 1978. Very recently, Congress authorized an increase in overall capital expenditures to $20,000,000. However, the effective date for the increase to $20,000,000 is not until 2009.[36] If properly structured, it is possible to use lease transactions for equipment in order to avoid breaching the capital expenditure limitation.

The question for agri-business is whether the proceeds of the bonds for a particular project are used to provide a "manufacturing facility" within the meaning of Section 144. For example, the IRS has concluded that financing the cost of acquiring a facility for the breeding, growing, harvesting, packaging and limited processing of fish is not manufacturing and does not qualify for tax-exempt financing under Section 144, unless an individual could qualify as a first-time farmer under the aggie bond provisions.[37] More recently, the IRS ruled that bond proceeds used to construct greenhouses and cold storage buildings for the raising of garden plants were not used for a qualified purpose.[38] Specifically, the IRS determined that while the growing process may require a high degree of technology and automation, it is not "manufacturing". In another case, a corporation was engaged in processing and packaging of freshly harvested vegetables. By transforming the property into a product ready for consumption, the corporation was engaged in manufacturing.[39] Another example involved private activity bonds issued for an egg processing facility in Kentucky. A subsequent IRS audit found that the processing plant did not qualify as a manufacturing facility.[40] In another situation the IRS stated that a cheese curing facility was manufacturing and eligible for tax-exempt financing.[41] The subject of another ruling was a potential bond issue to finance modifications to a steel hulled vessel to be used in processing raw scallops while at sea. The IRS concluded that the process to be financed would transform ocean harvested scallops into a processed product ready for commercial consumption and use and so was manufacturing.[42] Traditional agricultural activities such as cultivation of soil and feeding, growing, and harvesting livestock and crops do not constitute manufacturing. However, the processing of agricultural products does constitute manufacturing.[43]

An example of tax-exempt financing for manufacturing related to agriculture is the 2001 bond issue in North Dakota for a strawboard plant. There, local farmers contracted to provide wheat straw to the plant which used the straw to manufacture molded cabinet doors.[44] North Dakota also has specific legislation authorizing the state to issue qualified small issue bonds and to loan the bond proceeds to persons establishing meatpacking plants.[45] Under federal law, a meatpacking plant would be considered to be a manufacturing facility, and tax-exempt bonds could be issued to finance it. However, no bonds have been issued in North Dakota for such plants because such bonds are hard to market because such a plant would be considered a startup entity. A startup entity is not able to demonstrate a financial track record. Second, the capital expenditure limit of $10 million may be unworkable. Nevertheless, other agriculture related industries could benefit from qualified small issue bonds. The capital expenditure limit however, may inhibit the use. For example, several ethanol plants are being considered for North Dakota. But with a construction cost of around $80 million, the capital expenditure limit prevents tax-exempt financing as an option unless it is built by the government and governmental bonds are issued.[46]

Exempt facility bonds

Congress does allow the issuance of private activity bonds, in the form of qualified exempt facility bonds, for solid waste environmental facilities. Exempt facility bonds are any bonds issued as part of an issue 95 percent or more of the proceeds of which are to be used to provide certain facilities, including solid waste disposal facilities.[47] A large range of agricultural activities falls into this category, such as waste disposal facilities for hog farms.[48] Waste disposal assets used in connection with a concentrated dairy farm operation have also been financed with exempt facility bonds. Another example of the use of exempt facility bonds are those that were issued for American Crystal Sugar Company by Traill County, North Dakota. The bond proceeds were used to acquire and install equipment including a pulp drier furnace grate assembly, a pulp pellet mill, and tailings recovery equipment all which is equipment used in connection with solid waste disposal.[49]

Conclusion

Albeit limited in scope, tax-exempt financing for agricultural purposes can result in significant interest savings and should always be considered as a financing option.[50]

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[1] 26 U.S.C. §103(a). *See South Carolina v. Baker*, 108 S.Ct. 1355 (1988) (although Congress has always exempted state bond interest from taxation, it can, if it wishes, subject interest on state and local bonds to federal income taxation; the tax-exempt status of bonds is not constitutionally protected). Proponents were initially concerned with the language of the 16th Amendment which states that Congress shall have the power to collect taxes on incomes, "*from whatever source derived*." U.S. Const. amend. XVI. *See generally*, National Association Of Bond Lawyers, Fundamentals Of Municipal Bond Law (2004).

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[2] Although the term bond is generally used to describe tax-exempt financing, any type of debt instrument with an identifiable interest component can be tax-exempt. Accordingly, notes, contracts for deed, and leases can all be tax-exempt financing instruments.

[3] A portion of the savings is offset by legal fees, including bond counsel and other costs associated with issuing and selling the bonds. However, conventional financing comes with its own costs.

[4] Craig Ferris, *Tax Exemption on Muni Interest Will Cost $33B in 2005*, The Bond Buyer, Feb. 3, 2004.

[5] *See generally*, Joan Pryde, *The Ongoing Battle: Almost 70 Years Of Assaults on Tax-Exempt Municipals*, The Bond Buyer, (Centennial Edition, 1991). Nicholas Boyle, *Federal Exemption for Municipals Under Attack; Flawed Idea Would Enslave States*, The Bond Buyer, June 8, 1992. Most recently, the Congressional Budget Office released a report suggesting that state and local government financing could be more efficiently achieved through a federal tax credit rather than traditional tax-exempt bonds. Congressional Budget Office, Tax-Credit Bonds and the Federal Cost of Financing Public Expenditures (July 8, 2004). *Contra* The Bond Market Association, CBO Tax-Credit Bonds v. Tax-Exempt Municipal Bond Market (September 2004) (proposal to replace the municipal market is fundamentally flawed).

[6] *See, e.g.*, *City of Guymon v. Butler*, 92 P.3d 80 (Okla. 2004) ($4.5 million in tax increment bonds to assist in construction of a pork processing facility upheld).

[7] $45,000,000 Louisiana Agricultural Finance Authority, Variable Rate Demand Revenue Bonds (Lacassine Syrup Mill Project) Series 2004 (Official Statement dated Feb. 27, 2004, available at munios.com). "The proceeds of the Series 2004 Bonds are being made available to the Authority to (i) finance the cost to acquire, construct and equip a syrup mill for refining sugar cane to the syrup stage and other related facilities to be located in Lacassine, Louisiana." The bonds are payable in part from slot machine revenues subject to annual appropriation by the legislature. The Authority will own the mill until the bonds are retired at which time it will be turned over to a cooperative.

[8] A bond issue is considered a private activity bond if more than 10% of its proceeds are used for private purposes and if more than 10% of the debt service is paid from private sources. 26 U.S.C. §141.

[9] Note, *The Limited Tax-Exempt Status of Interest on Industrial Development Bonds under Subsection 103(c) of the Internal Revenue Code*, 85 Harv. L. Rev. 1649 (1972). The situation grew worse following the civil war: "During the years following the war, many municipalities, especially some of the western states and territories, became careless and extravagant in the issue of bonds for all sorts of authorized, and occasionally unauthorized purposes. They were frequently voted with little or no restriction, in aid of all sorts of railroad schemes, in many cases for railroads never built, and in some cases apparently never intended to be built." Undated remarks on the role of bond lawyers, *quoting*, Charles Fairman, History Of The Supreme Court Of The United States, Volume VI, Reconstruction And Reunion, 1864-88 (1971).

[10] *See* Stephen V. Ward, Selling Places: The Marketing And Promotion Of Towns And Cities 1850-2000 (New York: Routledge 1998), at 159-160. *See also,* Anderson & Wassmer, Bidding For Business (Kalamazoo: W.E. Upjohn Institute for Employment Research 2000), at 5.

[11] For example, the North Dakota conduit financing act, the Municipal Industrial Development Act, provides that bonds are issued by a city or county which then loans the bond proceeds to the owner of a project to be financed. N.D. Cent. Code chapter 40-57 (Supp. 2003). The Act states that the conduit bonds "shall not be payable from nor charged upon any funds other than the revenue pledged to the payment thereof, nor shall the municipality issuing the same be subject to any liability thereon. No holder or holders of any such bonds shall ever have the right to compel any exercise of the taxing power of the municipality to pay any such bonds or the interest thereon, nor to enforce payment thereon against any property of the municipality except those projects, or portions thereof, mortgaged or otherwise encumbered under the provisions and for the purpose of this chapter." N.D. Cent. Code §40-57-15.

[12] Since the backing on private activity bonds is limited to revenues of the particular project, the interest rate is tied to the credit worthiness of the conduit borrower. Some state statutes allow for the governmental entity issuing conduit bonds to actually provide backing to the bonds in the form of a general tax levy. However, governmental backing of private activity conduit bonds is rare and of questionable constitutionality in light of prohibitions against any governmental assistance to individuals or corporations. *See* N.D. Cent. Code §40-57-19 (1983) (city or county may issue general obligation bonds upon 2/3 vote of the electors to aid in constructing a private activity project). *But see* N.D. Const. Art. X, §18 ("neither the state nor any political subdivision thereof shall otherwise loan or give its credit or make donations to or in aid of any individual, association or corporation"). It is believed that Section 40-57-19 has been used just once since enacted in 1961.

[13] Revenue and Expenditure Control Act of 1968, Pub. L. No. 90-364, 82 Stat. 251 (codified in scattered sections of 26 U.S.C.). Sometimes, the term Industrial Revenue Bond or IRB is used to describe conduit financing.

[14] *See generally*, Dennis Zimmerman, The Private Use Of Tax-Exempt Bonds (Washington: The Urban Institute 1991). *See also*, Price And Magnatta, ABCs Of Industial Development Bonds (Philadelphia: Packard Press 1989). In addition to concern about IDBs, Congress was also concerned with arbitrage bonds, the practice, abused by some, of issuing tax-exempt bonds and investing the proceeds in higher yielding investments just for the positive spread, or arbitrage.

[15] 26 U.S.C. §103(b)(1).

[16] 26 U.S.C. §141(e). The seven "good" uses are: qualified mortgage bonds, 26 U.S.C. §143; qualified veterans' mortgage bonds, 26 U.S.C. §143; qualified 501(c)(3) bonds, 26 U.S.C. §145; exempt facility bonds, 26 U.S.C. §142; qualified small issue bonds, 26 U.S.C. §144(a); qualified student loan bonds, 26 U.S.C. §144(b); and qualified redevelopment bonds, 26 U.S.C. §144(c).

[17] Requirements generally applicable to all private activity bonds are found in 26 U.S.C. §§141-150, including: public approval requirement, IRS information return requirement, volume cap limit, arbitrage yield restrictions and rebate requirements, costs of issuance limited to 2% of the amount of bonds and bond maturity may not exceed 120% of the economic life of the project. Also, the interest on IDBs is treated as an item of tax preference for purposes of the alternative minimum tax. *See generally*, Jeremy Spector, *The Alternative Minimum Tax and Its Impact on Tax-Exempt Obligations*, Tax Notes (May 27, 2002). Further, IDBs cannot be bank-qualified bonds. 26 U.S.C. §265(b)(3). *See generally*, Office of Tax Exempt Bonds, Internal Revenue Service, Tax-Exempt Private Activity Bonds (IRS Publication 4078).

[18] The ceiling for all issuers in a state is the greater of $233,795,000 or $80 multiplied by the state's population. 26 U.S.C. §146. Rev. Proc. 2003-85.

[19] Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (codified in scattered sections of 26 U.S.C.).

[20] State law issues range from procedural requirements such as voting by the electorate to constitutional questions such as debt limits.

[21] *See* 1999 N.D. Laws 559 (Livestock Production Loan Program) ("Based upon consultations with bond counsel, it appears the proposed bonds are neither saleable nor tax-exempt. First, they will not find buyers since the full faith and credit of North Dakota is not behind them. These are solely revenue bonds. Investors will be looking for collateral and standing similar as a commercial bank, yet facing additional administrative costs involved with the government bonding. Second, the bonds will be used to finance private activity and are therefore not tax exempt. Such an exemption is usually a major attraction for investors." Governor's veto message). In some situations, industrial development bonds are issued on a taxable basis. In other words, the interest paid on such bonds may be exempt from state income tax but would be included in gross income for federal income tax purposes. One reason to issue taxable IDBs is for the benefit of a property or sales tax exemption offered by the state. A second reason is if the project cannot get a volume cap allocation. *See generally*, Jim Watts, *New Mexico County OKs $16B of Self-Funded IRBs by Intel*, The Bond Buyer, Sept. 20, 2004. *See also*, *Board of Directors of the Industrial Development Board of the City of New Orleans v. All Taxpayers*, 848 So.2d 740 (La. App. 4th Cir. 2003) (upholding taxable IDB to finance the construction of a Wal Mart super center).

[22] *See generally*, Rochelle Williams, *States Using "Aggie" Bonds to Cultivate New Farmers*, The Bond Buyer, Jan. 3, 2003.

[23] The states are Alabama, Arkansas, Colorado, Idaho, Illinois, Indiana, Iowa, Kansas, Minnesota, Missouri, Montana, Nebraska, North Carolina, North Dakota, Oklahoma, Pennsylvania, South Dakota, and Wisconsin. Early use of aggie bonds involved lenders pooling large numbers of loans and then issuing bonds to cover the pooled amount. The first such bonds issued in North Dakota where the $18,000,000 Industrial Commission of North Dakota, Agricultural Revenue Bonds, Series 1983A. Today aggie bonds are issued on an individual basis, one bond for each first-time farmer. *E.g.*, $138,013 North Dakota Farm Finance Agency, Agricultural Development Revenue Bond, Project No. 2-20 (1998).

[24] 26 U.S.C. §144(a)(12)(B)(ii).

[25] 26 U.S.C. §147(c)(2)(A).

[26] 26 U.S.C. §147(c)(2)(B)(ii).

[27] 26 U.S.C. §147(c)(2)(F).

[28] 26 U.S.C. §147(c)(2)(G). Small Business Job Protection Act of 1996, Pub. L. No. 104-88, 110 Stat. 1755.

[29] *See* Tax Empowerment and Relief for Farmers and Fishermen, S. 665, 108th Cong., 1st Sess. § 5 (2003).

[30] N.D. Cent. Code §54-17-34.2 (2001).

[31] 26 U.S.C. §144(a)(1). Today qualified small issue bonds are only authorized for manufacturing facilities

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and farm operations. 26 U.S.C. §144(a)(12)(B).

[32] 26 U.S.C. §144(a)(10)(A).

[33] 26 U.S.C. §144(a)(12)(B)(i).

[34] 26 U.S.C. §144(a)(12)(C).

[35] As a further limiting factor, the straight-line method of depreciation must be used for assets purchased with tax-exempt bond proceeds. 26 U.S.C. §168(g).

[36] American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418, §340.

[37] Priv. Ltr. Rul. 8819026 (Feb. 10, 1988).

[38] Field Service Advice TL-N-4814-99. See also, Tech. Advise Mem. 200122004 (Feb. 7, 2001) ("It would be inconsistent with congressional intent to permit land or property used on a farm for farming purposes that does not meet the first-time farmer requirements to be financed as a manufacturing facility.")

[39] Field Advise Mem. 200010012 (Mar. 10, 2000).

[40] *See* Amy Resnick, *Todd County, Ky., Settles With IRS After Bond Audit*, The Bond Buyer, Mar. 5, 1999.

[41] Tech. Advise Mem. 200025004

[42] Priv. Ltr. Rul. 9014014 (Dec. 27, 1989).

[43] *See* Andrew Bing, *Small Issue Bonds for Manufacturing Facilities*, Tax Notes (Dec. 26, 1988).

[44] The City of Lisbon, North Dakota issued $5 million in Municipal Industrial Development Revenue Bonds (qualified small issue manufacturing bonds) to help finance the $10 million Harvest Board plant. Nine area farmers contracted to deliver wheat straw to the plant. However, the plant subsequently failed. *See Strawboard plant receives eviction notice*, Bismarck Tribune, Nov. 14, 2003, at 8C.

[45] 2001 N.D. Laws 80 (Meatpacking Plant Bonds), N.D. Cent. Code Chapter 4-43 (Supp. 2003). *See generally*, Blake Nicholson, *State's ranchers excited about meatpacking bonds*, Bismarck Tribune, May 1, 2001, at 2C.

[46] *See* James MacPherson, *Proposed ethanol plant gets loan guarantee*, Bismarck Tribune, Oct. 2, 2004.

[47] 26 U.S.C. §142(a). Exempt facilities are identified as airports, docks and wharves, mass commuting facilities, facilities for the furnishing of water, sewage facilities, solid waste disposal facilities, qualified residential rental projects, facilities for the local furnishing of electric energy or gas, local district heating or cooling facilities, qualified hazardous waste facilities, high-speed intercity rail facilities, environmental enhancements of hydro-electric generating facilities and qualified public educational facilities.

[48] *See generally*, Darrell Preston, *Colorado Authority to Vote on Hog Farm Issue*, The Bond Buyer, May 14, 1996.

[49] $3,580,000 Traill County, North Dakota, Solid Waste Disposal Revenue Bonds (American Crystal Company Project) Series 1999 (Official Statement, September 9, 1999, at 9).

[50]

Tax-Exempt Private Activity Bonds	Taxable IDB	Tax-Exempt Government Bonds	Taxable Government Bonds
Aggie Bonds	Property and Sales Tax Exemption	Revenue or Appropriation Bonds (government ownership)	Louisiana Sugar Mill
Manufacturing Bonds	No need for volume cap	Tax Increment Bonds	
Exempt Facility Bonds	Self-Funded Option	General Obligation Bonds to Back IDBs	

Ledger contracts/cont. from page 3

taxpayer reports ordinary income of $38,000.

If the market price for hogs is below the specified contract price when the live hogs are delivered, the producer is paid the contract price (38 cents per pound in this example) and the difference between the specified contract price and the market price is subtracted from the ledger account.

Example 2:

The taxpayer in Example 1 delivered 100,000 pounds of live hogs when the market price is 35 cents per pound. The taxpayer is paid 100,000 x $.38 = $38,000 and 100,000 x ($.38 - .35) = $3,000 is subtracted from the ledger account. The taxpayer would report ordinary income of $38,000.

Inasmuch as taxpayers do not have the right to collect a positive balance in the multi-year ledger account or have the duty to pay a negative balance in the ledger account until the end of the contract, the taxpayer is neither required nor allowed to report the ledger account balances until the end of the contract.

The income tax consequences of the ledger contract are essentially the same whether the producer uses the cash method of accounting or the accrual method of accounting. The duty to report a positive ledger account balance or a negative ledger balance does not arise until the end of the contract and is dependent upon the market price for live hogs until the end of the contract. Therefore, the economic performance rules do not allow (or require) an accrual basis taxpayer to recognize a loss or a gain until the taxable year in which the contract ends.[5]

At the end of the contract, positive balances paid to the producer are reportable as ordinary income; negative balances reduce income by the amount of the payment and should be reported as a negative amount on Schedule F.

Are payments in excess of market price a loan?

The argument has been made that payments in excess of the market price for live hogs could be treated as loans. That would appear to be possible only if the amount in question is a bona fide loan. The authority which has emerged in recent decades for the taxation of advances on commodity sales sold with deferred payment provides useful guidance on when a payment is a bona fide loan.[6] Of course, a practice of reporting amounts by which the specified price exceeds the market price should involve reporting the excess of the market price as income over the specified price in years in which that is the case.

Fundamentally, however, treating the amounts as loans is only possible where it can be established that the amounts are bona fide loans. That is difficult to establish, if not impossible, when the contract does not characterize the amounts as loans as has generally been the case with ledger contracts for hogs.

—Neil E. Harl, Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University

[1] See Harl, Neil E. and John Lawrence, "Long-term Marketing Contracts with Packers: A Journey Through the Downside," 35 Iowa Pork Producer No. 9 (Sept. 1998). See also Harl, Neil E., "Hog Contract Losses," Ag Decision Maker, Iowa State University Extension Service, February, 1999.

[2] See Harl and Lawrence, note 1 supra.

[3] I.R.C. § 61(a).

[4] I.R.C. § 61(a)(2). See Treas. Reg. § 1.61-1(a): "Gross income includes income realized in any form, whether in money, property or services."

[5] Rev. Rul. 72-34, 1972-1 C.B. 132. See *United States v. General Dynamics Corp.,* 481 U.S. 239 (1987) (accrual method taxpayer; "all-events" test). See also I.R.C. § 461(h).

[6] *Fleming v. Comm'r*, T.C. Memo. 1966-251 (receipt of advances against indefinite future payments did not have to be reported in year of receipt where advances were intended to be loans); *Rutland v. Comm'r*, T.C. Memo. 1977-8. Compare Rev. Rul. 69-358, 1969-1 C.B. 139 (amounts received under fruit purchase contracts includible in income upon receipt regardless of whether sale price fixed at time contract signed, at time fruit picked or at time fruit delivered; sellers on accrual accounting include partial payments in income in year received and remainder in income in year price determined when price not determined until fruit picked or fruit delivered); Rev. Rul. 69-359, 1969-1 C.B. 140 (part of price (determined at time of delivery) received at harvest and remainder when fruit resold by purchaser; amount received at harvest represented part of sale price not loan and is reportable that year as income).

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