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INSIDE

- In Depth: Income tax consequences of disaster payments and drought sales
- Groundwater contamination: pendent jurisdiction and sufficient evidence
- Crop insurance fraud: damage and penalty awards
- Tenth Circuit finds breeding livestock to be "tools of the trade"
- Ag Law Conference Calendar
- *Federal Register* in brief

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IN FUTURE ISSUES

- Grain elevator bankruptcy: statutory lien
- Milk-hormone labeling bills
- The problem of non-U.C.C. liens on agricultural collateral

Supreme Court holds that demand notes issued by ag cooperative are securities

The U.S. Supreme Court, in a 5-4 decision, held in *Reves v. Ernst & Young,* 110 S. Ct. 9 (Feb. 21, 1990), that demand notes issued by an agricultural cooperative constitute "securities" within the meaning of section 3(a)(10) of the Securities Exchange Act of 1934. The Court therefore reversed and remanded the case to the Eighth Circuit Court of Appeals for proceedings consistent with the opinion, which could reinstate a $6.1 million verdict against the cooperative's accountant for violations of federal antifraud provisions.

In order to raise money to support its general business operations, the Farmers' Cooperative of Arkansas and Oklahoma sold uncollateralized and uninsured promissory notes payable on demand by the holder. Offered to both co-op members and nonmembers and marketed as an "Investment Program," the notes paid a variable rate of interest exceeding that of local financial institutions. After the co-op filed for bankruptcy, holders of the notes sued approximately forty defendants, including the cooperative's directors, general manager, office manager/comptroller, attorneys, and accountants, alleging violations of Arkansas and federal securities law.

In 1986, the federal district court in Arkansas granted summary judgment to the plaintiffs against the cooperative's manager and directors for selling unregistered securities in violation of Arkansas law. *Robertson v. White,* 635 F. Supp. 851 (W.D. Ark. 1986). See 4 Agric. L. Update 1-2 (Dec. 1986) for a discussion of this case.

In 1987, the plaintiffs obtained judgment in the amounts of $1,750,000 against the cooperative's attorneys (reduced by remittitur to $982,000) and $6.1 million against the cooperative's accountants, following a jury verdict that the defendants had violated the antifraud provisions of both federal and state securities law. Only the cooperative's accountant, Arthur Young & Company (predecessor to Ernst & Young), appealed the decision.

A panel of the Eighth Circuit, in *Arthur Young & Co. v. Reves,* 856 F.2d 52 (8th Cir. 1988), reversed, applying the test for a security devised by the U.S. Supreme Court in *SEC v. W.J. Howey, Co.,* 328 U.S. 293, 66 S. Ct. 1100, 90 L. Ed. 1244 (1946). See 6 Agric. L. Update 1 (Jan. 1989) for a discussion of this stage of the case.

(Continued on next page)

Supreme Court upholds "Rails to Trails"

The U.S. Supreme Court upheld the constitutionality of the federal "rails-to-trails" statute in an unanimous opinion issued in *Preseault v. Interstate Commerce Commission,* 110 S. Ct. 914 (Feb. 21, 1990). The Court, however, left open the issue of whether the federal statute can suspend reversion under state law of property rights, such as easements.

The statute, a 1983 amendment to the National Trails System Act, provides for conversion of unused railroad rights-of-way to recreational trails. Pub. L. No. 98-11, 208, (codified at 16 U.S.C. § 1247(d)). A railroad wishing to discontinue operations along a route may enter into an agreement allowing state agencies, local agencies, or private interests to manage the right-of-way as a recreational trail. The Interstate Commerce Commission (ICC) must approve the agreement and may impose terms and conditions on the agreement.

The recreational use is an interim use subject to restoration or reconstruction for railroad use. The statute declares that the interim recreational use shall not be treated, for purposes of any law or rule of law, as an abandonment of the right-of-way. Therefore, the statute authorizes the ICC to approve the change from rail use to trail use without regard to reversionary property interests under state law.

The Preseaults claim a reversionary interest in a railroad right-of-way adjacent to their land. The state of Vermont acquired the right-of-way in 1962 and then leased it to Vermont Railway, Inc. More than a decade ago, Vermont Railway stopped using the route and removed all railway equipment from the portion of

(Continued on page 3)

The U.S. Supreme Court rejected the Eighth Circuit's adoption of the *Howey* test as the appropriate measure of whether a promissory note is a security. Although the Court indicated that the *Howey* test is still to be applied when the instrument in issue is an investment contract, the Court concluded that applying that test to every type of security listed in the federal securities acts would "make the Acts' enumeration of many types of instruments superfluous." 1990 Lexis 1051, 16, citing *Landreth Timber Co. v. Landreth,* 471 U.S. 681, 692 (1985). Instead, the Supreme Court adopted the Second Circuit's "family resemblance" test as the appropriate standard.

The Supreme Court began with the definition of a security in the Securities Exchange Act of 1934. Section 3(a)(10) of the Act states that, "[t]he term 'security' means any note. . . ." Because of this inclusion, the "family resemblance" approach presumes that any note with a term of more than nine months is a "security."

The "family resemblance" approach identifies a list of notes that are obviously not securities. 1990 U.S. Lexis 1051, 16. The issuer is permitted to rebut the presumption that a note is a security if it can show that the note in question bears a strong family resemblance to an item on the list, or convinces the court to add a new instrument to the list.

The Supreme Court identified four factors that were considered in labeling those items nonsecurities. The first factor was the motivation for the sale. If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments, and the buyer is interested primarily in the profit the note is expected to generate, the note is likely to be a security. If, on the other hand, the note is utilized to facilitate the purchase of a minor asset or consumer good, to correct the seller's cash-flow difficulties, or for some other commercial or consumer purpose, the note is less likely to be a security.

The second consideration was the plan of distribution. The Court stated that it would examine the instrument to determine whether it was one in which there was common trading for speculation or investment.

The third factor was the reasonable expectation of the investing public. The Court indicated that a note may be held to be a security because of public expectations even though an economic analysis of the transaction might suggest otherwise.

The final factor was whether another regulatory scheme existed that significantly reduced the risk of the instrument, thereby rendering the application of the Securities Acts unnecessary.

Applying the family resemblance approach to the facts in Reves, the Court had little difficulty in concluding that the notes in issue were securities. First, the Court stated that the co-op had sold the notes in an effort to raise capital for its general business operations, and purchasers had bought them in order to earn a profit in the form of interest. The Supreme Court rejected the position of the Eighth Circuit that interest on the notes in issue could not be construed as "profit." The Court emphasized that "by 'profit' in the context of notes, we mean 'a valuable return on an investment,' which undoubtedly includes interest." The Court recognized that "profit" had been defined more restrictively in applying the *Howey* test to investment contracts, but refused to apply that restrictive definition to the determination of whether an instrument was a "note" within the definition of the federal securities acts.

Second, the Court acknowledged that the co-op had offered the notes over an extended period of time to its 23,000 members, as well as to nonmembers, and that more than 1,600 people held notes at the time the co-op filed for bankruptcy. Although the notes were not traded on an exchange, the Court found that the offer and sale to that broad segment of the public sufficiently established the requisite "common trading."

Third, the Court noted that the notes were advertised as "investments," and that there were no countervailing factors leading reasonable persons to question that characterization.

Fourth, the Court found no risk-reducing factor to suggest that the instruments were not in fact securities. Pointing out that the notes were uncollateralized and uninsured, the Court expressed its concern that the notes in issue would escape federal regulation entirely were the Securities Acts not to apply.

The remaining issue was whether the notes in *Reves* fell within an exemption in the 1934 Act for "any note . . . which has a maturity at the time of issuance of not exceeding nine months." 15 U.S.C. 78c(a)(10). Although the notes in issue were demand notes and thus immediately mature for state purposes, four justices concluded that the maturity of the notes was a question of federal law. Since demand could be made for payment either before or after the nine-months limit, the plurality opinion stated that it was plausible that the maturity of a demand note could be regarded as being in excess of nine months. The plurality stated that, given this ambiguity, the exclusion must be interpreted in accordance with its purpose. In light of Congress' broader purpose of ensuring that investments be regulated to prevent fraud and abuse, the four justices interpreted the exception not to cover the demand notes in issue.

Justice Stevens in a concurring opinion agreed that the notes in issue were securities, but disagreed as to why they fell outside the nine-months exemption. He concluded that the exemption should not be read literally, but should apply only to the types of commercial paper indicated by the legislative history of the 1933 Act – that is, to short-term, high quality instruments issued to fund current operations and sold only to highly sophisticated investors.

The four dissenting justices concurred that the notes in issue were "securities," but concluded that the instruments were exempted by the nine-months exclusion. Asserting that the notes were immediately due because payable on demand, the dissenters concluded that the notes therefore fell within the nine-months exemption.

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the right-of-way claimed by the Preseaults.

After unsuccessful state court actions to claim their reversionary rights, the Preseaults petitioned the ICC for a certificate of abandonment of the right-of-way. The state of Vermont intervened, claiming title in fee simple to the right-of-way and arguing in the alternative that, even if Vermont's interest were an easement, the land could not revert while it was being used for a public purpose. The state of Vermont and Vermont Railway petitioned the ICC to approve discontinuance of the rail use and transfer of the right-of-way to the City of Burlington for interim use as a recreational trail under the rails-to-trails statute. The ICC gave its approval. Instead of issuing a certificate of abandonment, the ICC issued the railroad company a Certificate of Interim Trail Use.

The Preseaults sought review of the ICC's action in the Second Circuit Court of Appeals. 853 F.2d 145 (1988). The Preseaults conceded that the ICC acted within its authority under the rails-to-trails statute but contended that the law is not a valid exercise of Commerce Clause power because it does not serve a rational, legal purpose. They also claimed that the statute is unconstitutional on its face under the Fifth Amendment because it effects a taking of property interests, established by state law, without just compensation.

The Second Circuit found that the statute serves two legitimate congressional goals under the Commerce Clause: (1) preserving rail corridors for future use; and (2) permitting public recreational use of trails. The court ruled that the rails-to-trails provision is a reasonable means of achieving those purposes. Accordingly, the court held that the statute is within congressional Commerce Clause power.

As to the Taking Clause issue, the circuit court ruled that state property law, where it concerns railroad rights-of-way, operates subject to the ICC's plenary authority to regulate railroad abandonments. Until the ICC issues a certificate of abandonment, a railroad right-of-way remains subject to the ICC's jurisdiction, and state law may not cause a reverter of the property. The federal statute, rather than state law, determines the property interest. Reasoning that the property interest in the right-of-way could not revert, the court held that the change from rail to trial use did not constitute a taking.

The U.S. Supreme Court affirmed the Second Circuit's ruling on the Commerce Clause issue, applying the traditional rational basis standard of review to the challenge. The Preseaults argued that the purpose of rail corridor preservation was mere sham because conversion to trail use is approved only after the ICC has determined that the rail use is not necessary for the foreseeable future. They also contended that Congress could achieve the purpose of rail corridor preservation through a mandatory program administered by the ICC. The Supreme Court ruled that even if it agreed that the rail corridor preservation purpose was not a legitimate exercise of congressional Commerce clause power, the rails-to-trails scheme is reasonably adapted to the second purpose of encouraging the development of additional recreation trails. A law does not need to serve more than one purpose.

The Supreme Court also ruled that the rails-to-trails statute is not unconstitutional on its face under the Takings Clause. The Court found that if a taking has occurred, the Preseaults have a remedy for it under the Tucker Act. The Court did not agree with the Preseaults' argument that language in the rails-to-trails statute and its legislative history indicated a congressional intent to foreclose the Tucker Act remedy.

The Court's majority opinion did not expressly approve of or disapprove of the Second Circuit's ruling that state law may not cause reverter of a railroad right-of-way until the ICC has issued a certificate of abandonment. Instead, the Court held that the taking claim is premature until the Preseaults avail themselves of the compensation process provided by the Tucker Act.

Justice O'Connor, in a concurring opinion joined by Justices Scalia and Kennedy, adamantly disagreed with the Second Circuit's ruling on the takings claim. The concurrence declared that: (1) the Preseaults' property interest in the right-of-way is determined by state law, without reference to the ICC's recent actions; (2) although ICC actions may preempt the operation and effect of certain state laws, ICC actions do not displace state law as the traditional source of real property interests; and (3) ICC action under the rails-to-trails statute cannot act to suspend or defer the vesting of property rights that would otherwise vest under state law.

The final determination of the effect of the rails-to-trails statute on state law property interests is significant to many states and private landowners. Each year, railroads propose to abandon about 3,000 miles of rail corridor. Much of this land is held under easements granted by neighboring landowners. Many states are eager to establish trails in discontinued rail corridors. For example, Iowa, which ranks forty-ninth in the nation in the amount of public land, is using the rails-to-trails statute to augment its public recreational land. As of August, 1989, Iowa had six rail trails with a total length of approximately 170 miles.

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Groundwater contamination: pendent jurisdiction and sufficient evidence

The use of pesticides and hazardous substances in agriculture entails risks of groundwater contamination. While these issues generally involve questions of state law, defendants may end up in federal court by reason of pendent jurisdiction under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), since federal courts have exclusive jurisdiction over CERCLA. 42 U.S.C. § 9613(b).

In *Mateer v. U.S. Aluminum Co.*, No. 88-21147 (E.D. Pa. June 2, 1989) (available on 1989 W.L. 60442), the court found that pendent jurisdiction enabled it to hear complementary state negligence, trespass, nuisance, and strict liability claims. Even when one of multiple defendants received summary judgment on the CERCLA claim, pendent jurisdiction meant that the federal court could retain jurisdiction over complementary state claims against that defendant.

The court also examined the evidence of the duration and level of plaintiffs' exposure to hazardous substances. Plaintiffs' evidence was found to lack allegations of present symptoms of any disorders related to their consumption of contaminated drinking water. In the absence of a minimal showing of a significant potential health risk, plaintiffs' claims for personal injury, medical damages, medical monitoring, emotional distress, and apprehension of future injury were dismissed.

The court found that plaintiffs' evidence was sufficient to support a cause of action under CERCLA and state liability theories.

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Income tax consequences of disaster payments and drought sales

by Philip E. Harris

The droughts of 1988 and 1989 raised a number of income tax issues. Many of those issues were resolved in Notice 89-55, 1989-20 I.R.B. 134. However, some issues remain unresolved. The issues raised by the droughts include the treatment of disaster payments received under the Disaster Assistance Act of 1988 and the Disaster Assistance Act of 1989 and the treatment of gain from livestock that was sold because of the drought. This article discusses some of the unresolved issues.

Disaster payments and crop insurance

Generally, farmers who use the cash method of accounting must report payments as income in the year they are received. I.R.C. section 451(d) creates an exception to that rule for some crop insurance and disaster payments. The exception allows a farmer to elect to report a payment received in the year the crop was destroyed as income in the following year. It does not allow the taxpayer to accelerate reporting the payment if the payment is received the year after a loss.

The purpose of this election is to allow farmers to continue their established pattern of reporting income and deductions. If a farmer has a pattern of selling a crop the year after it is raised, reporting an insurance or disaster payment in the year the crop is destroyed would upset the pattern and cause the farmer's income to be pushed into a higher bracket in the year the payment was received. For example, assume Seth normally sells his corn crop in the year after it is raised. In 1989 his crop was destroyed by a hail storm and he received a payment from his crop insurance in 1989. If he was not allowed to report the insurance payment as 1990 income, he would have to report both the sale of his 1988 crop and the insurance payment in 1989. That doubling-up of income is likely to push him into a higher tax bracket for 1989.

Requirements

Several requirements must be met in order to qualify for the election.

Cash-basis taxpayer. One requirement is that the taxpayer must be using the cash receipts and disbursements method of accounting. I.R.C. § 451(d).

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Crop insurance or disaster payment. A second requirement of I.R.C. section 451(d) is that the payment must be crop insurance proceeds or a disaster payment under the Agricultural Act of 1949, as amended, or under title II of the Disaster Assistance Act of 1988. I.R.C. § 451(d). Noticeably absent from the above list are payments under the Disaster Assistance Act of 1989. Legislation has been proposed to amend I.R.C. section 451(d) to include payments under the Disaster Assistance Act of 1989, but none has been passed at the time of this writing. However, on February 9, 1990), the Department of Treasury issued Temp. Reg. section 1.451-6T, which makes *all* federal crop disaster payments (including those under the 1989 Disaster Assistance Act) eligible for I.R.C. section 451(d) treatment.

In Notice 89-55, 1989-20 I.R.B. 134, May 15, 1989, the I.R.S. stated that a payment received by the taxpayer from an insurance company does not qualify as crop insurance if the taxpayer does not suffer a crop loss. Therefore, payments from "rain insurance" policies do not qualify for this provision. Under these policies, the insured receives a payment based on the amount of rainfall at a designated location. The payment has nothing to do with the insured's crop production.

Normal business practice. A third requirement is that a taxpayer must be able to show that under the taxpayer's normal business practice the income from the crop for which the payment is received, would have been reported in a year following the year the crop was damaged or destroyed. I.R.C. § 451(d). It is important to note how narrowly this provision is written.

The provision does not allow a taxpayer to report a disaster or insurance payment in the year before the payment is received. For example, assume a farmer has a normal business practice of selling crops in the year they are harvested. The 1988 crop was reduced by the drought and the farmer applied for a payment under the Disaster Assistance Act of 1988 and received that payment in 1989. This provision does not allow the farmer to elect to report that payment as 1988 income even though the crop that was lost would have been sold in 1988.

The provision also *does not* allow a taxpayer to postpone an insurance or disaster payment beyond the year after the crop was destroyed. Treas. Reg. section 1.451-6(a) states, "[I]f the taxpayer receives such insurance proceeds in the taxable year following the year of destruction or damage, then he shall include such proceeds in gross income for the taxable year of receipt without having to make an election under section 451(d)." For example, assume a farmer has a normal business practice of selling crops the year after they are harvested. The 1988 crop was reduced by drought and the farmer applied for a payment under the Disaster Assistance Act of 1988 and received that payment in 1989. This provision does not allow the farmer to postpone reporting that income until 1990.

Election. The taxpayer must make the election to postpone reporting the insurance or disaster payment by attaching a statement to the tax return for the year the payment was received or on an amended return for that year. Treas. Reg. § 1.451-6(b)(1). The statement must include:

1. The name and address of the taxpayer.
2. A declaration that the taxpayer is making an election under section 451(d).
3. Identification of the specific crop or crops destroyed or damaged.
4. A declaration that under the taxpayer's normal business practice the income derived from the crops that were destroyed or damaged would have been included in his gross income for a taxable year following the taxable year of such destruction or damage.
5. The cause of destruction or damage of crops and the date or dates on which such destruction or damage occurred.
6. The total amount of payments received from insurance carriers, itemized with respect to each specific crop and with respect to the date each payment was received.
7. The name(s) of the insurance carrier or carriers from whom payments were received.

Once made, the election is binding for the taxable year for which it is made unless the district director consents to a revocation of the election. Treas. Reg. § 1.451-6(b)(2).

Ambiguities

Two ambiguities arise under I.R.C. section 451(d) when crop insurance and/or

disaster payments are received for two different crops and the crops are normally sold in different years.

Fifty percent of all crops? One ambiguity is whether the producer must show that more than fifty percent of the crops would have been sold in a year after the crops were damaged or destroyed. In Rev. Rul. 74-145, 1974-1 C.B. 113, the I.R.S. implies that a producer must show that he or she normally sells more than fifty percent of *all* crops in the year following the year of harvest, in order to make the election to postpone reporting income. However, Notice 89-55, *supra,* I.R.C. section 451(d) and Treas. Reg. section 1.451-6 have no such requirement. Notice 89-55 and I.R.C. section 451(d) merely state that insurance proceeds and disaster payments can be postponed "if the taxpayer establishes that, under its normal business practice, income from the crops would have been reported in the year following the year of destruction or damage."

The difference between the two positions can be illustrated with the following example. Assume Rachel normally sells her soybean crop at the time of harvest and normally sells her corn crop in the year following harvest. Under the implied requirement of Rev. Rul. 74-145, Rachel would be allowed to make an election to postpone insurance proceeds received for her corn crop only if her corn sales were more than fifty percent of the total sales. Notice 89-55 and I.R.C. section 451(d) seem to allow Rachel to make the election as to payments received for her corn crop regardless of the ratio of corn sales to total sales.

A strong policy argument can be made that the implied requirement of Rev. Rul. 74-145 is overly restrictive since the purpose of the provision is to allow the producer to continue an established pattern of marketing crops.

All proceeds? The second ambiguity is whether an election under I.R.C. section 451(d) applies to insurance proceeds and disaster payments received for crops that would *not* have been sold in the year after the damage or destruction. Rev. Rul. 74-145 seems to say that Rachel (from the previous example) must treat the payments received for the soybeans and for the corn in the same manner. However, it could be argued that the language of I.R.C. section 451(d) does not allow Rachel to postpone reporting the payment received on soybeans since she normally sells that crop in the year it is harvested. Notice 89-55 sheds no light on this issue since it uses the language of the code but does not specifically overrule Rev. Rul. 74-145. Treas. Reg. section 1.451-6(a)(2) includes the additional requirement that the election apply to "all such proceeds unless such portion is attributable to a crop or crops [that] represent a [separate] trade or business." It can be argued that "all such proceeds" refers to proceeds that are eligible for the I.R.C. section 451(d) election. Therefore, Rachel would be allowed to postpone only the payments received for her corn crop.

This is an important issue for some taxpayers because they may want to report part of the insurance and disaster payments in the year they were received. For example, assume Rachel (from the previous example) sold her 1988 corn crop in 1989. In 1989 her soybean and her corn crop were destroyed by a hail storm and she received insurance proceeds for both crops in 1989. To maintain her pattern of reporting income from the soybeans in the year of harvest and the income from corn in the year after harvest, she must be allowed to report the insurance payment on the soybeans in 1989 and the insurance payment on the corn in 1990. Again, a strong policy argument can be made to overrule Rev. Rul. 74-145 since the purpose of I.R.C. section 451(d) is to allow the taxpayer to continue the normal business pattern of reporting income.

Drought sales of livestock

If a farmer sells livestock because of a shortage of water, grazing, or other consequences of a drought, the recognition of the proceeds from the sale may be postponed. There are two different tax treatments, both of which apply only to drought sales in excess of normal business practice. The first treatment applies to draft, breeding or dairy animals that will be replaced within a two-year period. The second applies to all livestock.

Election to postpone gain by purchasing replacement animals

If livestock (other than poultry) held for any length of time for draft, breeding, or dairy (no sporting) purposes are sold because of drought conditions, the gain realized on the sale does not have to be recognized if the proceeds are used to purchase replacement livestock within two years of the end of the tax year of the sale. Notice that there is no required holding period for this provision as there is for I.R.C. section 1231. The new livestock must be used for the same purpose as the livestock that was sold. Therefore, dairy cows must be replaced with dairy cows. The taxpayer must show that the drought caused the sale of more livestock than would have been sold without the drought conditions. For example, if the farmer normally sells one-fifth of the herd each year, only the sales in excess of one-fifth will qualify for this provision. There is no requirement that the drought conditions cause an area to be declared a disaster area by the federal government.

The farmer has a basis in the replacement livestock equal to the basis in the livestock sold plus any amount invested in the replacement livestock that exceeds the proceeds from the sale.

The election to defer the recognition of gain by reducing the basis of the replacement livestock is made by not reporting the deferred gain on the tax return and by attaching a statement to the tax return showing all the details of the involuntary conversion including:

1. Evidence of existence of the drought conditions that forced the sale or exchange of the livestock.
2. A computation of the amount of gain realized on the sale or exchange.
3. The number and kind of livestock sold or exchanged.
4. The number of livestock of each kind that would have been sold or exchanged under the usual business practice in the absence of the drought.

Election to defer income to subsequent tax year

If any livestock are sold because of drought conditions, the taxpayer may be eligible for another exception to the general rule that the sale proceeds must be reported in the year they are received. This election applies to all livestock. This exception allows the taxpayer to postpone reporting the income by one year. To qualify, the taxpayer must show that the livestock would normally have been sold in a subsequent year. Furthermore, a drought that caused an area to be declared a disaster area must have caused the sale of livestock. It is not necessary that the livestock be raised or sold in the declared disaster area. The sale can take place before or after an area is declared a disaster area as long as the same disaster caused the sale.

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The amount of income that can be postponed is computed as follows. Assume that because of drought conditions, Grace sold 750 head of sheep in 1988 instead of the 500 she normally would have sold. She received $75,000 for the 750 head sold. She can postpone reporting the sale of only 250 sheep. That amount is calculated by dividing the sale proceeds by the 750 sheep sold and multiplying the result by the 250 for which she can postpone the proceeds. Therefore, $75,000/750 × 250 = $25,000 can be reported in 1989 rather than in 1988.

The election must be made by the due date of the return (including extensions) for the tax year in which the drought sale occurred. The election is made by attaching a statement to the return that includes the following information:

1. A declaration that the taxpayer is making an election under section 451(e).
2. Evidence of the existence of the drought conditions that forced the early sale or exchange of the livestock and the date, if known, on which an area was designated as eligible for assistance by the federal government as a result of the drought conditions.
3. A statement explaining the relationship of the designated drought area to the taxpayer's early sale or exchange of the livestock.
4. The total number of animals sold in each of the three preceding years.
5. The number of animals that would have been sold in the taxable year had the taxpayer followed his or her normal business practice in the absence of drought.
6. The total number of animals sold and the number sold on account of drought during the taxable year.
7. A computation, pursuant to Reg. Section 1.451-7(e) (the computation shown above), of the amount of income to be deferred for each such classification.

Notice 89-55, *supra*, explains the application of these rules to sales made in 1988 as a result of the drought. The Notice points out that the declaration of eligibility for assistance that is required under I.R.C. section 451(e) can be made by "the President or by an agency or department of the federal government. Determinations by the Department of Agriculture, such as the Farmer's Home Administration or the Agricultural Stabilization and Conservation Service, are sufficient designations."

Neither this Notice nor any other I.R.S. announcement lists the areas that were declared eligible for assistance in 1988. It could be argued that any area in which producers were allowed to graze set-aside acres or CRP land qualifies for purposes of I.R.C. section 451(e).

An ambiguity that is not addressed in the Notice is whether the sale of livestock has to occur in the same year as the disaster. Many producers were forced to sell part of their producing herds in the spring of 1989 because of a feed shortage caused by the drought of 1988. Can the proceeds from those 1989 sales be reported in 1990 under I.R.C. section 451(e)? The literal language of the code seems to say that it could.

Crop insurance fraud: damage and penalty awards

In a recent civil action under the False Claims Act, 31 U.S.C.A. §§ 3729-3733 (West 1988), the jury found that Betty Kelsoe and Jeffery Kelsoe had submitted fraudulent claims to the Federal Crop Insurance Corporation. Ralph Kelsoe was found to be a co-conspirator. *Kelsoe v. Federal Crop Insurance Corporation,* 724 F. Supp. 448 (E.D. Tex. 1988).

Using the statutory provisions in place at the time the case was commenced, the jury found that FCIC was damaged to the extent of $2,019.00 by the two claims submitted by Betty, and to the extent of $21,200.00 by the six claims submitted by Jeffery. It was anticipated that the government would be entitled to double damages plus civil penalties of $2,000.00 per violation. Liability was not initially assessed against Ralph.

In 1986, while the case was pending, Congress amended the False Claims Act to provide for treble damages and for civil penalties of no less than $5,000.00 and no more than $10,000.00 for each violation. Pub. L. No. 99-562, 100 Stat. 3153 (1986). The district court found nothing in the legislative history or in the language of the amended statute to indicate whether the new provisions were to be applied retroactively. Accordingly, the court pursued the analysis set forth in *Bradley v. School Board of the City of Richmond,* 416 U.S. 696, 94 S. Ct. 2006, 40 L.Ed.2d 476 (1974).

Bradley sets forth a three-part test to determine whether applying a new law to a pending case will result in manifest injustice. As to the first test, *Kelsoe* concluded that this was not a mere private case, but one involving great national concern. As to the second element, *Kelsoe* concluded that no substantive rights were affected by retroactive application – that the statutory changes did not go to the question of liability, but only to the matter of remedies. As to the final factor, *Kelsoe* concluded that there was no indication that the Kelsoes would have altered their conduct had the more severe provisions been known to them. Indeed, the Kelsoes did not make such an argument.

Kelsoe also rejected the argument that the question of retroactive application should receive narrow construction on the theory that the amended provision is "drastically penal" in nature. The court embraced an earlier FCA decision where it was suggested that the chief purpose of the False Claims Act is to provide complete restitution to the government.

The court therefore concluded that the amended penalty provisions could be applied in the instant case. Accordingly, Betty was assessed $6,147.00 in treble damages and $21,000.00 in civil penalties (two false claims plus one for conspiracy). Jeffery was assessed $63,600.00 in treble damages and $49,000.00 in civil penalties (six false claims plus one conspiracy claim). Ralph was held to be jointly liable as a co-conspirator in both instances.

It can be anticipated that USDA will soon stop using the False Claims Act, except in extraordinary cases. In 1986, Congress enacted the Program Fraud Civil Remedies Act, Pub. L. No. 99-509, 100 Stat. 1934 (codified at 31 U.S.C. section 3801-3812). Designed to provide the option of administrative remedies for false claims and statements "knowingly" made, the Act seeks to enhance the government's ability to proceed where the costs of litigation would make it uneconomical to sue under the False Claims Act.

Recently, USDA proposed regulations to implement the Program Fraud Civil Remedies Act. 55 Fed. Reg. 636 (1990) (to be codified at 7 C.F.R. §§ 1.301-1.346) (proposed Jan. 5, 1990). It is contemplated that in administrative proceedings liability may be established, assessments levied in lieu of damages at twice the amount of the claim, and civil penalties imposed of not more than $5,000 per claim. Initial decisions will be made by a USDA Administrative Law Judge, with provision for timely appeal to the USDA Judicial Officer. The administrative scheme is designed to provide due process, but with limited judicial review. There is a jurisdictional limit of $150,000.00 as to any claim or group of related claims. Where the limit is exceeded, the government will need to proceed under the False Claims Act.

– *Donald B. Pedersen,*
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Tenth Circuit finds breeding livestock to be "tools of the trade"

In a recent Chapter 7 bankruptcy case, *In re Heape,* 886 F.2d 280 (10th Cir. 1989), the farmer/debtors claimed that their cattle held for breeding purposes were exempt under the Kansas personal property exemption statute. Kan. Stat. Ann. § 60-2304 (1983). The statute exempts certain specified items of personal property "regularly and reasonably necessary in carrying on the person's profession, trade, business, or occupation." Because the statute specifically refers to "breeding stock," and the debtors' claim was within the statutory $5,000.00 valuation limit, no challenge was made to the exemption claim itself.

However, objection was made when the debtors moved to avoid the lien of the creditor who held a security interest in the livestock. The debtors asserted that the livestock were "tools of the trade" under the protection of section 522(f)(2)(B) of the bankruptcy code, which the creditor denied. Both the bankruptcy court and the district court held for the creditor, but the Tenth Circuit Court of Appeals reversed and remanded, holding that under the facts presented, the livestock were clearly the tools of the debtors' trade.

In reaching its decision, the court was guided by its conclusion as to the purpose of the lien avoidance power under section 522(f)(2)(B): to allow the debtor to retain such tools or implements as are necessary to enable the debtor to make a fresh start after bankruptcy.

With this intent in mind, the court analyzed judicial interpretation of the phrase "tools of the trade." It found a Michigan bankruptcy decision, *In re Walkington,* 42 Bankr. 67 (Bankr. W.D. Mich. 1984), to be most persuasive. There the court emphasized the "common sense" and "case by case" approach, which focuses on "the necessity of an item to the individual debtor's particular business or employment." *Heape,* 886 F.2d at 283, quoting *Walkington,* 42 Bankr. at 71-2.

The court also cited *In re LaFond,* 791 F.2d 623 (8th Cir. 1986), *Middleton v. Farmers State Bank,* 41 Bankr. 953 (D. Minn. 1984), and *In re Liming,* 797 F.2d 895 (10th Cir. 1986), cases supporting the expansion of the tools of the trade concept to include large items of farm equipment. The court found that tools of the trade must be interpreted in view of the particular debtor's business. Even items that are not "tools" in the conventional sense, but are necessary for maintaining the trade of farming, can be "tools of the trade" for purposes of section 522(f)(2)(B).

Applying this to the facts in *Heape,* the court noted that "[b]reeding stock to the livestock farmer is the functional equivalent of the crop farmer's tractor – a means of producing physically distinct agricultural products. That breeding stock is composed of live animals does not change its essential function in the hands of the farmer." *Heape,* 886 F.2d at 283.

It should be noted that the same result may not be reached in other circuits. The *Heape* opinion notes the contrary decision in the Seventh Circuit. *In re Patterson,* 825 F.2d 1140 (7th Cir. 1987) (livestock are capital assets, not tools of the trade). Moreover, debtors confronted with less clear exemption statutes may fight the tools of the trade battle in the context of an objection to their claimed livestock exemption. In any case, however, *Heape* is clearly good news for debtors seeking a broad interpretation of their lien avoidance powers for tools of the trade.

– Susan A. Schneider,
Graduate Fellow,
National Center for Agricultural Law Research and Information

Federal Register *in brief*

The following is a selection of matters that have been published in the *Federal Register* from February 3 to February 28, 1990:

1. IRS; Withholding of tax on nonresident aliens, notice of proposed rulemaking; comments due 4/6/90. 55 Fed. Reg. 3750.

2. IRS; Limitations on passive activity losses; amendments of temporary regulations. "Concern[s] the treatment of losses resulting from recent natural disasters by providing that the limitations do not apply to certain casualty and theft losses. 55 Fed. Reg. 6980.

3. FCIC; Common crop insurance regulations (single policy); proposed rule. "FCIC proposes to issue a new part 499 in chapter IV of the title 7 of CFR effective for . . . 1991 and succeeding crop years to contain one common set of crop insurance regulations and a common policy of insurance. . . . 55 Fed. Reg. 4382.

4. Department of the Interior; BLM; National Environmental Policy Act; revised implementing procedures. 55 Fed. Reg. 4719.

5. EPA; Notification to Secretary of Agriculture of a proposed regulation on criteria for classifying pesticides for restricted use due to groundwater concerns. 55 Fed. Reg. 5861.

– Linda Grim McCormick

AG LAW CONFERENCE CALENDAR

Third Annual Symposium on Agricultural and Agribusiness Credit
April 26-27, 1990, Swiss Grand Hotel, Chicago, Illinois.
Topics include: agricultural production contracts; water law and ag finance; new realities in dealing with Eastern European economies.
Sponsored by ABA & ABA.
For more information, contact David Lander, 314-342-1618.

Sixth Annual Seminar on Bankruptcy Law and Rules
April 5-7, 1990, Marriott Marquis Hotel, Atlanta, GA.
Topics include: Insider preferences, indirect preferences, and the role of § 550; non-consensual retention of property subject to liens.
Sponsored by the Southeastern Bankruptcy Law Institute.
For more information, call 404-457-5951.

Farm Foreclosure Defense
April 6, 1990, Indiana Convention Center & Hoosier Dome, Indianapolis, IN.
Topics include: FmHA debt restructuring process; FmHA and FCS damage theories and attorneys fees; bankruptcy and tax issues.
Sponsored by Farm Counseling Project; Legal Services Organization of Indiana; Farmers' Legal Action Group; Indiana Legal Services Support Center.
For more information, call 317-637-3276.

Criminal Enforcement of Environmental Laws
April 19-20, 1990, the Mayflower Hotel, Washington, D.C.
Topics include: Environmental crimes in EPA's overall enforcement strategy; the search warrant, the grand jury subpoena, and the investigation.
Sponsored by ALI-ABA.
For more information, call 1-800-CLE-NEWS.

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AMERICAN AGRICULTURAL LAW ASSOCIATION NEWS

Seventh Annual Writing Competition. The AALA is sponsoring its seventh annual Student Writing Competition. This year, the AALA will award two cash prizes in the amount of $500 and $250. Papers must be submitted by June 30, 1990, to Ann Stevens, University of Wyoming College of Law. Box 3035, University Station, Laramie, WY 82071. For further information, contact Ann Stevens at 307-766-2182.

AALA Distinguished Service Award. The AALA invites nominations for the Distinguished Service Award. The award is designed to recognize distinguished contributions to agricultural law in practice, research, teaching, extension, administration, or business.

Any AALA member may nominate another member for selection by submitting the name to the chair of the Awards Committee. Any member making a nomination should submit biographical information of no more than four pages in support of the nominee. The nominee must be a current member of the AALA and must have been a member for at least the preceding three years. Nominations should be sent to Ann Stevens, University of Wyoming College of Law, Box 3035, University Station, Laramie, WY 82071.

Nominating Committee. The nominating committee invites the general membership of the AALA to become more directly involved in the process of selecting members for the Board of Directors. Any member may offer his own name or suggest the name of another member for nomination to the Board. Please contact Phil Kunkel, 1010 W. St. Germain, Suite 600, St. Cloud, MN 56301 for further information.