Agricultural Law Update

VOLUME 14, NUMBER 7, WHOLE NUMBER 164 MAY 1997

Official publication of the American Agricultural Law Association

INSIDE

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

- Why production flexibility contracts?

USDA scolded for failure to meet deadline for ruling on administrative cases

In a sharply worded rebuke, Judge Harold H. Greene of the U.S. District Court for the District of Columbia, on March 6, 1997, chastised USDA and the Director of the National Appeals Division (NAD) for not ruling on appeals in a timely manner.

The case, *Passarell v. Glickman*, Civil Action No. 95-2122 (D.D.C.), involved a review by the court as to whether rulings by NAD Hearing Officers, which are appealed to the Director of NAD, need to be decided within thirty business days, as Congress requires by statute.

In the *Passarell* administrative case, the hearing officer issued a final ruling on April 19, 1995 denying the farmers certain disaster payments. The farmers requested a review by the Director of NAD. By statute, 7 U.S.C. § 6998(b), the Director must issue a final determination, or remand the case, within thirty business days, but in this case failed to do so.

Plaintiffs, through counsel, then filed a lawsuit for a declaratory and summary judgment and an order requiring USDA to pay plaintiffs their disaster payments.

The court, reviewing the actions of the Director of NAD, pursuant to the Administrative Procedures Act, 5 U.S.C. § 706, focussed on the statute's requirement that the Director "shall" rule within the thirty-business-days deadline. USDA had argued that the thirty-day deadline was merely "aspirational, not mandatory."

With a caustic yet funny analogy and choice of words, Judge Greene rejected the USDA's argument:

> Congress clearly ordered the Director of NAD to issue its ruling in 30 days; Congress left no room for the agency to exercise its discretion in the matter. By contrast, the government's construction of the term would render the mandatory 'shall' meaningless.
>
> In his celebrated work *Nineteen Eighty-Four*, George Orwell prophesied that the Ministry of Truth of the future government of Oceania would completely alter the meaning of language to achieve desired results; *e.g.*, by decreeing that War is Peace; Freedom is Slavery; Ignorance is Strength. Orwell did not anticipate that the current Department of Agriculture of the United States would add to that list the equally nonsensical construction that 'shall' is an 'aspirational' 'may.' The government's construction ignores the numerous precedents in which courts have construed the meaning of the word 'shall' in this context as being mandatory.

Continued on page 2

Tax-exempt financing—first-time farmers

Responding to a significant loss of young farmers, the North Dakota Legislature recently passed, and the Governor signed, Senate Bill No. 2398, establishing a first-time farmer finance program, allowing the state to utilize tax-exempt financing provisions in the internal revenue code. The first-time farmer program was proposed by North Dakota Agricultural Commissioner Roger Johnson during his successful campaign for office last fall. The stated goal of the legislation is "to encourage first-time farmers to enter into and remain in the livelihood of agriculture and to provide first-time farmers a source of financing at favorable rates and terms generally not available to them."

As a general rule, gross income for federal income tax purposes does not include interest on any state or local bond. 26 U.S.C. section 103(a). *See generally, South Carolina v. Baker*, 108 S. Ct. 1355 (1988)(Congress has always exempted state bond interest from taxation). Historically, bonds could be issued on a tax-exempt basis even if the proceeds were to be used completely for private purposes. A private activity bond is one in which the bond proceeds are used to benefit private purposes as opposed to governmental purposes. Congress has gradually restricted the use of private activity bonds and now withholds the federal subsidy from any unqualified private activity bond. 26 U.S.C. section 103(b)(1). A private activity bond will be qualified, and thus

Continued on page 2

The Court concludes that defendant's actions of construing the thirty-day time limit as aspiration is not only arbitrary and capricious) but also a violation of 7 U.S.C. § 6998. (Footnotes and citations omitted.)

The court granted plaintiffs' motion for summary judment (finding USDA's refusal to make a timely ruling arbitrary and capricious) but refused to award plaintiffs the disaster money asked for. As to the latter, he ordered USDA to hold a new hearing *and* issue a new ruling within thirty days and to file directly with the court.

Lawyers or farmer wanting a copy of the decision can contact the author directly at 202-331-7050.

—Alexander J. Pires, Jr., Conlon, Frantz, Phelan & Pires, Washington, D.C.

Agricultural Law Update

VOL 14, NO 7, WHOLE NO. 164 May 1997

AALA Editor .. . . . .Linda Grim McCormick
Rt 2, Box 292A, 2816 C.R. 163
Alvin, TX 77511
Phone/FAX: (281) 388-0155
E-mail hcxh52a@prodigy.com

Contributing Editors Drew L Kershen, University of Oklahoma, Norman, OK. Neil E Harl, Iowa State University, Ames, IA, Paul A Meints, Bloomington, IL; Alexander J. Pires, Jr., Conlon, Frantz, Phelan & Pires, Washington, DC, Scott D. Wegner, Beauclair & Cook, Bismarck, ND; Linda Grim McCormick, Alvin, TX.

For AALA membership information, contact William P Babione. Office of the Executive Director, Robert A. Leflar Law Center, University of Arkansas, Fayetteville, AR 72701.

Agricultural Law Update is published by the American Agricultural Law Association, Publication office. Maynard Printing, Inc , 219 New York Ave , Des Moines, IA 50313 All rights reserved First class postage paid at Des Moines, IA 50313.

Latters and editorial contributions are welcome and should be directed to Linda Grim McCormick, Editor, Rt 2, Box 292A, 2816 C.R. 163, Alvin, TX 77511.

FIRST TIME FARMERS/Cont. from page 1

tax-exempt, if the proceeds from such bond are used for any one of seven "good" private uses, such as mortgage bonds for single family housing, 501(c)(3) bonds for charitable organizations, and bonds issued to make student loans. 26 U.S.C. § 141(e). In addition to falling into an approved category, private activity bonds must still comply with several other regulations, including the holding of a public hearing. 26 U.S.C. §§ 141-150.

Since 1980, over $450 million in tax-exempt bonds have been used by an estimated 5,250 first-time farmers to acquire land, farm improvements, machinery, and livestock to be used for farming purposes. Approximately seventeen states issue these private activity bonds, also known as "Aggie Bonds." As private activity bonds, the first-time farmer bonds must fit in a "good" use category to be tax-exempt. The "good" use is found in the small issue bond provisions, which generally grant qualified private activity bond status if the issue is for $1,000,000 or less and the proceeds are used to acquire land. 26 U.S.C. § 144(a).

Not surprisingly, the Internal Revenue Code places several qualifications on first-time farmer bonds. First, the amount of the bond, and the resulting loan, is limited to $250,000. Second, the individual must be the principal user of such land and must materially and substantially participate in the operation of the farm. 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 parcel of land which is thirty percent or larger of the median size of a farm in the particular county where the land is located, or if the fair market value of the land at any time while held by the individual exceeds $125,000. Also, the purchase of used farm machinery from the bond proceeds is limited to $62,500. Finally, recent amendments to the Internal Revenue Code now permit bond proceeds to be used for land acquisition from a related person, subject to certain conditions. 26 U.S.C. § 147(c)(2). Thus, a contract for deed arrangement between father and son is eligible for tax-exempt financing.

Beyond the federal requirements, states, of course, can impose additional eligibility tests. For example, the North Dakota legislation adds a residency requirement, restricts any purchase of land to North Dakota farmland, and establishes an applicant's maximum net worth at $200,000. Additional criteria may be established administratively, such as education and expertise requirements, maximum and minimum ages of first-time farmers, and the minimum dollar amount for which a bond will be issued.

In practice, a local lender negotiates the loan and security agreements with the farmer. An application and a request for a bond issue then goes to the particular state agency. If all state and federal requirements are met, the state agency issues the bond, with the local lender purchasing the bond and the proceeds are then loaned to the farmer. Since tax-exempt bonds carry lower interest rates than conventional loans, the bond proceeds can be loaned to the first-time farmer at lower rates. A first-time farmer bond is in the nature of a revenue bond, meaning that the principal and interest on the bond can only be paid from farm-generated revenue. Accordingly, if the farmer defaults, the lender's sole remedy is against the farmer. Unlike a general obligation bond, the state is not in any way obligated to pay the bondholder.

—Scott D. Wegner, LL.M. in Agricultural Law, Beauclair & Cook, Bismarck, ND

Federal Register *in brief*

The following is a selection of items that were published in the *Federal Register* from March 12 to April 11, 1997. [Unfortunately, the April 9, #67 issue was missing from the stacks.]

1. FSA; FAIRA 96; Implementation; direct and guaranteed loan-making provisions; correction. 62 Fed. Reg. 11953.
2. IRS; Estate and gift tax marital deduction; correction; effective date 2/18/97. 62 Fed. Reg. 12542.
3. APHIS; Importation of fruits and vegetables; proposed rule; comments due 5/27/97. 62 Fed. REg. 14037.
4. Foreign Agricultural Service; Notice of FY 1997 Emerging Markets Program and solicitation of proposals. 62 Fed. Reg. 14113.
5. Agricultural Marketing Service; Amendments to PACA; final rule; effective date 4/30/97. 62 Fed. Reg. 15083.
6. PSA; Clear title—protection for purchasers of farm products; statewide central filing systems; final rule; effective date 10/22/96. 62 Fed. Reg. 15363.
7. Natural Resources Conservation Service; Organization and functions; final rule; effective date 1/30/97. 62 Fed. Reg. 16659.

—Linda Grim McCormick, Alvin, TX

Agricultural law bibliography

Administrative law

Johnson, *A Regulatory "Wasteland": Defining a Justified Federal Role in Crop Insurance*, 72 N.D. L. Rev. 505-582 (1996).

Agricultural law: attorney roles and educational programs

Kelley, *Agricultural Law: A Selected Bibliography, October 1992-December 1995*, 61 Mo. L. Rev. 877-948 (1996).

Aquaculture

Note, *Aquaculture and the Public Trust Doctrine: Accommodating Competing Uses of Coastal Waters in New England*, 21 Vt. L. Rev. 335-374 (1996).

Biotechnology

Ashworth, *Development of the European Biotechnology Industry*, 33 Cal. W. L. Rev. 83-99 (1996).

Kloppenburg & Burrows, *Biotechnology to the Rescue? 12 Reasons Why Biotech is Incompatible With Sustainable Agriculture*, 26 Ecologist ___ (#2 Mar/Apr 1996).

Lehman, *Major Biotechnology Issues for the U.S. Patent and Trademark Office*, 33 Cal. W. L. Rev. 49-62 (1996).

McMahon, *NAFTA and the Biotechnology Industry*, 33 Cal. W. L. Rev. 31-48 (1996).

Energy issues

Richards, *Biomass Energy: An Agricultural Role in Pollution Control?*, 45 Drake L. Rev. 143-158 (1997).

Environmental issues

Centner, Houston, Fuchs, & Zeddies, *Employing Best Management Practices to Reduce Agricultural Water Pollution: Economics, Regulatory Institutions, and Policy Concerns*, 45 Drake L. Rev. 125-142 (1997).

Comment, *Environmental Law: The Clean Water Act —Understanding when a Concentrated Animal Feeding Operation Should Obtain an NPDES Permit*, 49 Okla. L. Rev. 481-509 (1996).

Henderer, *The Impact of Lucas v. South Carolina Coastal Council and the Logically Antecedent Question: A Practitioner's Guide to Fifth Amendment Takings of Wetlands*, 3 Envtl. L. 407-440 (1997).

Howarth, *Legal Approaches to the Prevention of Agricultural Water Pollution in England and Wales*, 45 Drake L. Rev. 197-218 (1997).

Moore, *Controlling Agricultural Nonpoint Source Pollution: The New York Experience*, 45 Drake L. Rev. 102-124 (1997).

Pratt, Frarey, & Carr, *A Comparison of US and UK Law Regarding Pollution from Agricultural Runoff*, 45 Drake L. Rev. 159-196 (1997).

Theis, *The Application of the Federal Five-year Statute of Limitations for Penalty Actions to Wetlands Violations under the Clean Water Act*, 24 N. Ky. L. Rev. 1-54 (1996).

Whitsitt, *Wetlands Mitigation Banking*, 3 Envtl. L. 441-478 (1997).

Farm policy and legislative analysis

International

Cardwell, *Common Agricultural Policy Quotas and the Environment*, 45 Drake L. Rev. 71-82 (1997).

Hawke, *Set-Aside and Environmental Protection*, 45 Drake L. Rev. 219-232 (1997).

Food and drug law

Centner & Lathrop, *Labeling rbST-Derived Milk Products: State Responses to Federal Law*, U. Kan. L. Rev. 511-556 (1997).

Note, *Impact of the Food Quality Protection Act of 1996*, 3 Envtl. L. 479-497 (1997).

Forestry

Anaya, *The Awas Tingni Petition to the Inter-American Commission on Human Rights: Indigenous Lands, Loggers, and Government Neglect in Nicaragua*, 9 St. Thomas L. Rev. 157-207 (1996).

Comment, *The Role of Ecolabeling in Sustainable Forest Management*, 11 J. Envtl. L. & Litig. 165-190 (1996).

Nollkaemper, *Protecting Forests Through Trade Measures: The Search For Substantive Benchmarks*, 8 Ga. Int'l Envtl. L. Rev. 389-421 (1996).

Note, *Halting Neotropical Deforestation: Do the Forest Principles Have What it Takes?*, 6 Duke Envtl. L. & Pol'y F. 105-156 (1996).

Note, *Failing to See the Forest For the Trees: Standing to Challenge National Forest Management Plans*, 16 Va. Envtl. L.J. 145-194 (1996).

Fruits & vegetables—perishable agricultural commodities

Bederman, Christensen & Quesenberry, *Of Banana Bills and Veggie Hate Crimes: The Constitutionality of Agricultural Disparagement Statutes*, 34 Harv. J. Legis. 135-168 (1997).

Hunting, recreation & wildlife

Comment, *Preserving Wildlife For Resident Consumption: Is the Dormant Commerce Clause the Outfitters' White Knight?* 32 Land & Water L. Rev. 125-153 (1997).

Land use regulation

Land use planning and farmland preservation techniques

Baldwin, *Conservation Easements: A Viable Tool For Land Preservation*, 32 Land & Water L. Rev. 89-123 (1997).

Bishop, *Land Tenure Arrangements for Nature Conservation in the U.K.*, 45 Drake L. Rev. 83-102 (1997).

Grossman, *Habitat and Species Conservation in the European Union and the United States*, 45 Drake L. Rev. 19-50 (1997).

Harbison, *Constitutional Jurisprudence in the Eyes of the Beholder: Preventing Harms and Providing Benefits in American Takings Law*, 45 Drake L. Rev. 51-70 (1997).

Hollingshead, *Conservation Easements: A Flexible Tool For Land Preservation*, 3 Envtl. Law. 319-361 (1997).

Maraist, *A Statutory Beacon in the Land Use Ripeness Maze: The Florida Private Property Rights Protection Act.* 47 Fla. L. Rev. 411-458 (1995).

Myers, *Why is the "Jeffersonian Moment" So Enduring?*, 45 Drake L. Rev. 1-18 (1997).

Patents, trademarks & trade secrets

Comment, *Protecting Plant Varieties Under TRIPS and NAFTA: Should Utility Patents be Available For Plants?*, 32 Tex. Int'l L.J. 139-154 (1997).

Roht-Arriaza, *Of Seeds and Shamans: The Appropriation of the Scientific and Technical Knowledge of Indigenous and Local Communities*, 17 Mich. J. Int'l. L. 919-965 (1996).

Pesticides

Mahaney, *Assessing the Fitness of Novel Scientific Evidence in the Post-Daubert Era: Pesticide Exposure Cases as a Paradigm For Determining Admissibility*, 26 Envtl. L. 1161-1185 (1996).

Public lands

Comment, *Equal Footing, County Supremacy, and the Western Public Lands*, 26 Envtl. L. 1263-1286 (1996).

Comment, *Law West of the Pecos: The Growth of the Wise-Use Movement and the Challenge to Federal Public Land-use Policy*, 30 Loy. L.A. L. Rev. 275-321 (1996).

Jeffery, *Public Lands Reform: A Reluctant Leap into the Abyss*, 16 Va. Envtl. L.J. 79-144 (1996).

Torts

Hannah, *Uncertainty About the Premises Liability of Illinois Farmers*, 21 S. Ill. U. L.J. 61-71 (1996).

Note, *Res Ipsa Loquitur and the Great Cattle Caper: Inferred Negligence in Escaped Livestock-automobile Collisions After ... (Roberts v. Weber & Sons, Co., 348 Neb. 243, 533 N.W.2d 664, 1995)*, 75 Neb. L. Rev. 308-331 (1996).

Veterinary law

Centner, *Legal Rights of Veterinarians Under Veterinary Good Samaritan Statutes and Equine Liability Statutes*, 210 J. Am. Veterinary Med. Ass'n. 190-194 (1997).

Water rights: agriculturally related

Mossman, *"Whiskey is For Drinkin' But Water is For Fightin' About": A First-hand Account of Nebraska's Integrated Management of Ground and Surface Water Debate and the Passage of L.B. 108*, 30 Creighton L. Rev. 67-104 (1996).

If you desire a copy of any article or further information, please contact the Law School Library nearest your office.

— Drew L. Kershen, Professor of Law, The University of Oklahoma, Norman, OK

Testimony before the Senate Committee on Agriculture, Nutrition and Forestry of the United States Senate, February 26, 1997

By Professor Neil E. Harl

Capital gains

The Tax Reform Act of 1986 eliminated the 60 percent exclusion for long term capital gains effective for taxable years after 1986.[1] In 1990, the Congress restored a limited tax break for capital gains in the hands of higher income individuals by imposing a 28 percent maximum rate on long-term capital gains income.[2]

Proposals pending in Congress would create varying degrees of preferential treatment for long-term capital gains. For several reasons, I believe that enlarging the preferential treatment for long-term capital gains would be a mistake. Such a move would be costly, would distort resource allocation and would perpetuate a major contributor to complexity of the Internal Revenue Code.

Complexity of tax law

Without a doubt, different treatment for long-term capital gains is the single biggest factor contributing to complexity of the Internal Revenue Code. The Code is shot through with provisions for limiting or targeting the benefits from the preferential treatment of long-term capital gains. And it's more than just the Code. A substantial body of regulations and rulings focuses upon distinctions among capital assets, assets used in the trade or business and inventory-type property. Moreover, many, many cases are litigated each year over those distinctions.

Many of us toiling as educators as well as practitioners agree with taxpayers that the system is incredibly complex and should be simplified. Certainly one good place to start would be to strip away all distinctions among classes of assets and treat all income as ordinary income.

The Tax Reform Act of 1986, which was touted as bringing simplicity into the tax system, hardly achieved that objective. Indeed, tax simplification has somehow managed to elude the Congress.

While I believe that one highly important objective of any tax system should be simplicity and I would like nothing better than to leave the next several generations a legacy of tax simplification, I have concluded with some reluctance that the largest and most complex economy in the world would probably not be well served with a simple tax.

Neil E. Harl is Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics at Iowa State University, Ames, Iowa.

Impact on the budget deficit

The evidence is compelling that further reduction in rates for long-term capital gains would be costly for the Treasury. The Joint Committee on Taxation estimates that the more extreme proposals could cost $33.1 billion over the next five years (1997-2002) and nearly $129.3 billion over the next ten years (1997-2008).[3]

In my opinion, this would be a dangerous move. The first principle of any tax system is to generate the funding needed to pay for the services provided by government. It is the responsibility of the Congress and the President to take the long view and keep fiscal considerations always in mind.

Effect on growth

The advocates of cuts in the tax rates for long-term capital gains argue that the lost revenue would be made up with higher levels of economic growth. Certainly reductions in capital gains rates would increase investment incentives. However, the evidence is less than compelling that the cuts in rates advocated would produce the kind of economic buoyancy projected. The effective rate of income tax on long-term capital gains is already low (some estimate the figure to be about seven percent). That is because taxes on long-term capital gains can be deferred,[4] the gain on such assets is typically forgiven at death[5] and, in any event, rates are capped at 28 percent for individuals.[6] Moreover, a substantial part of capital gains accrue to tax-exempt investors for whom a tax cut would be worthless. In addition, about a third of investment is financed with debt capital rather than equity. Estimates indicate that reducing the maximum rate on long-term capital gains to 14 percent would likely reduce the cost of capital by only a modest amount.

It is well to remember that the economic growth rate in this country has been quite respectable in recent years without the cuts. It is also well to remember that the growth rate is heavily dependent upon policy of the Federal Reserve. Cutting tax rates (and thus increasing the deficit) is not a promising way to assure an easing of Fed policy.

Tax cuts have been viewed for a very long time as a way to spur the economy in times of economic downturn. To cut taxes at a time with the economy is growing and the Federal Reserve is dispensing monetary medicine to limit economic growth and contain inflationary pressures is questionable at best. To justify tax cuts on the grounds that economic growth will be spurred is hardly a new idea. But to do so when economic growth is already constrained by Fed policy is wrongheaded.

Tax shelters

One of the important features of tax policy over the past 30 years has been the gradual curbing of tax shelters. If investors could borrow and deduct the interest at rates up to 39.6 percent with the funds invested in assets that generate long-term capital gains which are then taxed at 14 percent, or even less, tax shelter activity would be encouraged. The result is a distortion in resource allocation.

Agriculture has been particularly susceptible to tax-motivated investment because of the availability of the cash method of accounting (even though inventories are a material income determining factor) and the biological nature of the sector as assets are created in the form of animals or crops. Those features have afforded opportunities for investors to deduct costs against other income and, in some instances, to sell the assets at reduced tax rates. Tax shelter activity in the agricultural sector reached a peak in the last 1960s with substantial amounts of investment capital flowing into feedyard activity, much of which was in the Southwest; cow-calf and dairy herds; and tree crops. The extremely generous depreciation allowance, the tax advantages of leasing arrangements, and the higher level of investment tax credit in the 1981 tax act also influenced investment activity.

The campaign to curb tax shelter investments began with the imposition of depreciation recapture in 1962 and 1964 and continued with the Tax Reform Act of 1969 which implemented new hobby loss rules; legislation enacted in 1976 which added rules limiting the tax advantages enjoyed by "farming syndicates;" statutory enactments in the early 1980s which imposed "at risk" rules; and the Tax Reform Act of 1986 which contributed additional limits on the deductibility of prepaid expenses, the far-reaching rules on deducting passive losses, and the repeal of the 60 percent long term capital gains exclusion.

Most agree that tax breaks or inducements affect investor behavior in encouraging investment to be targeted to areas of greatest tax advantage, thus distorting economic activity. Agriculture has been particularly impacted in a negative manner by tax shelter activity because of inelastic demand for most farm commodities. With inelastic demand, increases in supply are rewarded with a disproportionate drop in price and in profitability. Since 1986, the level of tax induced investment in agriculture has been at the lowest level in modern time.

The various proposals for rate cuts for long-term capital gains should be evaluated in part on the basis of whether the provisions would return the tax system to a higher level of tax shelter activity. It is my belief that lower tax rates for long-term capital gains would have that result.

Assets used in the business

The same preferential treatment for long-term capital gains would be available for assets used in the business under the proposals.[7] An example, for which we have some experience, is animals held for draft, dairy and breeding purposes.[8] While this move would be greeted warmly by taxpayers viewing the situation on a micro basis, the result would almost certainly be increased investment in assets eligible for such treatment. Moreover, we know from observing tax behavior in the years before 1987 that taxpayers would be inclined to maximize the benefits of the provision by selling sows, for example, after meeting the holding period requirement (12 months)[9] even though economic and management considerations would suggest keeping sows for more litters.

The greatest impact, however, would be to induce more investment in eligible assets, thus driving up the supply. Taxpayers do respond to economic signals. An example of this occurred in 1978 when farmers lobbied for and obtained an extension of the investment tax credit to siugle purpose agricultural structures (confinement livestock facilities). It was later conceded, even by the most ardent proponents of the move, that it was an economic mistake for farmers. The outcome was that more facilities were built (the price dropped to 90 percent of cost as the U.S. Government picked up the cost for the other 10 percent) and, once built, were generally kept filled with hogs. Not solely for this reason, but undoubtedly affected thereby, more than half of the months from 1981 to 1985 were loss months in hog production.

Preferential treatment for capital assets and assets used in the business distorts resource allocation.

Land

A major argument for restoring a capital gains tax break is to encourage older individuals to sell their assets. It is true that an historically disproportionate amount of farmland ownership, for example, now rests with older landowners.

One of the legacies of the farm debt crisis of the 1980s has been an increase in concentration of land ownership by older individuals. In 1992, half of Iowa farmland owned by noncorporate owners was owned by individuals 61 years of age or older. This is compared with half of Iowa farmland owned by individuals age 56 and older in 1982.[10]

The 1992 study showed that 49.3 percent of the landowners anticipate disposing of their land by will, another 14.4 percent plan to put their land in trust and only 17.3 percent expect to sell their land.

However, implementing a lower income tax rate for long-term capital gains is unlikely to "unlock" assets. So long as a new income tax basis is obtained by retaining land ownership until death, many individuals are unlikely to change their plans even if the effective maximum rate of 28 percent drops to 14 percent or even lower.

Moreover, the "lock in" effect is probably substantially overstated for other taxpayers. The lock-in effect is the most serious when a shift to a more productive use of the resource is blocked. It is difficult to make a compelling case on that basis for corporate stock or, for that matter, for much of the investment in land. Assets tend to gravitate into their highest and best use because of basic economic pressures in any event.

Equity considerations

The distributional impact of a cut in the income tax rates on long-term capital gains would he suhstantial. Much of the benefit would accrue to households in the top five percent of the income distribution.

Long-term considerations

A good case can be made that the competitive position of the United States in the next half century will relate more to the productivity of its human capital than to productivity of its capital base in the form of real assets. It is my view that the focus as we move forward in to the twenty-first century should be on encouraging a higher level of development of human resources at all levels and in encouraging the development of a climate for innovation and entrepreneurship rather than persisting with what I consider to be an outmoded concept of providing breaks for capital investment in real assets. Focusing attention on tax breaks for capital assets is an idea whose time has passed.

Estate and gift tax reform

Various proposals would increase the federal estate and gift tax unified credit from the current level of $192,800 (equivalent to a deduction of $600,000) to a level of $248,300 (equivalent to a deduction of $750,000) or higher. That move would constitute a tax break amounting to $55,500 for the heirs of the wealthiest property owners in the country if the credit were increased to $750,000.[11] Proposals to repeal the federal estate tax would amount to a tax break of just under $5 million for someone with a taxable estate of $10,000,000. The critical issues are—(1) the impact of the proposals on farms and small businesses, (2) the effect on revenue and (3) the long-term effect on concentration of wealth.

The system of transfer taxes exists for two reasons—(1) to generate revenue and (2) to curb, to a modest degree, the concentration of wealth. The revenue from estate and gift tax is not insignificant. But the wealth concentration problem deserves examination.

Impact on farms and small businesses

The need to "save" farms, ranches and other small businesses is a frequently cited justification for an increase in the federal estate and gift tax unified credit. This argument seems to have been uncritically accepted at face value. More reflective consideration suggests that the increase would miss most of the alleged target group. More importantly, it may well have a counterproductive effect by further concentrating the ownership of land and exacerbating the already seriously unbalanced federal budget.

The popular belief is that family farms are handed down from generation to generation like some sort of heirloom. That is rarely the case. In most instances, family farm *businesses* are born and die within a lifetime.[12] The land may remain in the family. But the farm business ends with the retirement or death of the sole proprietor. And more than 80 percent of the farms are operated as sole proprietorships.[13] Typically, they last a lifetime and cease to exist when the farmer retires or dies. In the usual case of two or three surviving children, only one of them will be in farming. But that one will typically be aged 50 years or more at the deaths of the parents and would be looking to retrenchment and disposition of farming assets rather than acquisition and expansion.

The proportion of farms that are trying to defy the family farm cycle and to survive into the next generation and succeeding generations *as going farm businesses* is growing but is still a small percentage of the total. A good case can be made for a modest increase in the unified estate and gift tax credit (and adjusting the credit for inflation) and for easing the burden of paying the federal estate tax where a farm or other small business is involved and the owners are pursuing an objective of continuation *of the business* into the next generation.

Land values down from peak levels

Another important fact has been lost in the debate. The existing estate tax law

Continued on page 6

now allows a great deal more farmland to be passed tax free to heirs than it did when present tax free levels were set in the early 1980s. Nationally, farmland values declined by nearly 35 percent in the 1980s with some states registering drops of nearly twice that level. In Iowa, for example, farmland values declined by 63 percent between 1981 and 1986. Since 1986, land values in many states have not recovered the losses in the 1980s. As of December 1996, average Iowa farmland values stood at $1,682, still well below the peak of $2,147 in average value in 1981.

Even without considering special use valuation, discussed below, the $600,000 tax-free level set in 1981 would have, when fully effective, protected about 280 acres at 1981 prices from the estate tax. Today, that same tax-free level would protect more than 350 acres of Iowa farmland.

With the cutbacks envisioned in government spending over the next several years, farmland values are not expected to rise dramatically. Indeed, reductions in federal funding are expected to act as a damper on valuation increases.

Special breaks available

Since 1977, farmland (and other land used in business) has been eligible for a special valuation procedure for federal estate tax purposes. That procedure, referred to as "special use valuation," can reduce the federal estate tax gross estate by as much as $750,000. Although few achieve that level of savings, special use valuation typically produces values ranging from 40 to 70 percent of fair market value of farmland depending upon the region and the year of death.

Under the most advantageous valuation formula for special use valuation, the average annual gross cash rent for comparable land in the locality for the last five years (minus property taxes on comparable land) is divided by the average federal land bank interest rate for new loans on land in the district where the land is located.

As an example, assume a 640-acre farm in Iowa is owned by a farmer and spouse. The farmer died in 1996. Assume the average annual cash rental on comparable land in the locality for the last five years is $120 per acre, the average per acre real property taxes for the past five years we'll assume are $20 per acre. The valuation formula becomes—

V= 120-20/.0838
= 1,193

The special use valuation would be $1,193 per acre (using the Omaha Federal Land Bank District five-year interest rate of 8.38 percent).

Land that would have produced cash rentals of $120 average for the five-year period of 1991-1995 would likely sell for $1,800 to $2,200 per acre. Thus, the special use value would fall, in this example, somewhere between 54 and 66 percent of the fair market value. For land near major cities, the discount is even greater.

Just what this means can be shown by an example assuming valuation of land at the midpoint of the range set out above, $2,000 per acre. Assuming our hypothetical farm of 640 acres, nearly twice the size of the average farm in the Middle West, if a couple managed to save an additional $200,000 and owned the farm as tenants in common free and clear of debt, the value of their assets would be $1,480,000. Assuming that they do minimal planning and also qualified for the special use valuation of $1,193 per acre, each would have an estate of only $481,760, well below $600,000, the present level exempted by the unified credit. They can hand down to their heirs more than $1.5 million without any estate tax at all.

The policy represented by this example is the result of nearly 20 years of easing estate tax burdens on farms and small businesses. It has been effective. More than 95 percent of farms can be transferred to heirs without any estate tax at all under the existing unified credit.

Even if federal estate tax were due on an estate in the above example, the amount of the tax (up to $153,000) attributable to a business should be eligible for installment payment at 4 percent interest over nearly 15 years after death. The installment payment provision is available with minimal planning. Over the 177-month installment period, if a firm would otherwise be paying 10 percent interest on its borrowed funds, a firm borrowing from the government at 4 percent interest would save more than enough to pay the original tax bill.

Mention should also be made of reductions from fair market value for federal estate tax purposes in the form of discounts for—(1)co-ownership of assets (up to 20 percent)[14] and (2) discounts for minority interest and non-marketability (30 to 35 percent)[15] of interests in corporations and even, in some instances, partnerships.

Double taxation?

The point is sometimes made that transfer taxes, notably death taxes, are not needed as part of a tax system because the wealth involved has already been subjected to income taxation. While that is the case with some property, there are vast amounts of asset value that represent appreciation in value and have not been subject to income taxation. Stock market gains and investments in real estate are prominent among the assets with substantial amounts of potential gain.

If the federal estate and gift tax system were repealed, and the adjustment in basis at death to farm market value[16] were to be left in place, as many anticipate, vast amounts of asset value would escape taxation altogether.

Revenue implications

The impact on revenue from the proposed reductions in federal estate tax burden would be substantial. An increase in the unified estate and gift tax credit from the present level (exemption equivalent of $600,000) to $1 million (with the level increasing by $50,000 per year) would cost $10.2 billion in revenue for the period 1997-2002 and $40.1 billion for the period 1997-2007.[17] Enactment of the family-owned business exclusion would cost $8.3 billion for the period 1997-2002 and $26 billion for the period 1997-2007.[18] Proposed modifications in installment payment of federal estate tax would have modest revenue implications.[19]

Suggestions

If the desire is to benefit farms and small businesses, a targeted approach to business continuation makes more sense than benefitting investors in all sectors. Making installment payments of federal estate tax more attractive is one such targeted approach. While the four percent rate of interest on unpaid federal estate tax under the provision currently available (allowing payment over 14 years and 9 months after death)[20] is generous, reducing the rate further for small businesses, extending the payment period and enlarging the amount deferrable up to a reasonable level would seem to be a good response to pleas for relief and still be faithful to objectives of containing revenue loss for budget-balancing reasons and continuing a modest effort to limit concentration of wealth. Clarifying whether heirs could mortgage property in the 177-month period after death and exempting dispositions of property in the ordinary course of business from the rule accelerating the unpaid tax are other examples of the types of changes that would enhance the usefulness of the provision. Only small businesses would benefit from that type of change. A phased increase of the unified estate and gift tax credit to $750,000 over six years could be justified on the grounds of catching up with inflation since 1987. In contrast, repeal of the federal estate and gift tax would amount to a substantial windfall for the estates of the wealthiest property owners in the country, including many with only an investor's connection with a business, if that.

Antigovernment rhetoric[21]

One of the more disturbing aspects of the current debate on tax policy is the decidedly anti-government tone to the discusison. While I know that we all become frustrated with government from

Estate planning: odds and ends on life insurance

The following life insurance policy ideas are offered for the reader's consideration. The author welcomes comments and suggestions.

Duplicate premium notices: Not all insurance companies will send out two premium notices. Those that do can make your life a lot easier. When life insurance exists to compliment the estate or business transition plans it often has someone other than the insured as the owner. Having one premium notice sent to the insured and another notice to the owner tends to maximize the likelihood the insurance will be in force when needed.

Co-ownership of policies: Two or more people often own an insurance policy on the life of another. This may be from a buy-sell agreement or it may be for estate settlement by family members. Most insurance companies tend to put these owners into a "joint tenancy with rights of survivorship" type ownership arrangement. When this occurs, the gifting, if any, associated with this arrangement becomes a "future" interest and does not quality for the $10,000 present interest gift tax exclusion. Noting on the insurance company form "tenants in common and not as joint tenants with rights of survivorship" enables the "present" interest requirement to be met.

Third-party ownerships: Every seminar teaches people about the tax code including life insurance in the insured's estate if he or she dies within three years of transferring the policy and that this is an egregious thing to have happen, tantamount to malpractice. Their suggestion is always for someone other than the insured to be the applicant and owner. From time to time this is a trustee, but also, from time to time, it is one or more of the insured's children. You know the "theory." Is this, however, the final chapter of the book? Maybe yes, maybe no. There might be a sequel that is unintended. Remember that property acquired during marriage is "marital property" and subject to division by the divorce court. Remember, too, that property received by gift or inheritance is generally considered to be "nonmarital" property. You might want to ask the parents, presumably your clients, the following question: "John, is it more likely that you will die within three years or that your child will get a divorce before you die?" If your clients are similar to those that I've worked with, they will choose the latter as having the higher probability. In that case (i) let the insured-parent be the initial owner and applicant, later assigning-gifting his/her interest to the selected family member(s) and then (ii) make a note in your file to this effect.

Last-to-die policies: Although very very heavily touted by many estate planners, the rates of these policies are still set by the same actuaries for the company who set each of the company's other policy's rates. If the company has been straight-up initially, then the costs of a last-to-die contract are neither less expensive nor more expensive than the company's single insured type products. To the chagrin of many who purchased last-to-die policies, and also those who recommended them in the first place, many of the insurance companies have dramatically increased the cost of their premiums for this type of policy. For some, this has been done through a higher current premium. Through others, this has been done through a reduction in dividends. Both the good ones and the bad ones generally have a doubling of the premium at some point in the future. If there ever was a legitimate spread between the two, that gap has narrowed, if not disappeared entirely. If your planning involves "tax minimization" type planning (essentially by funding only Trust "B"), then a last-to-die policy is not compatible. If your planning involves the regular "tax deferral" type planning (funding both Trust "A" and Trust "B" in the typical fashion) associated with a formula marital, then it does. If however, you don't know what the future will hold and would appreciate having a choice between the two, then a single insured policy should be used. If you are willing to have the client's farming son be 75 years old before he has insurance to purchase the client's machinery, then a last-to-die policy is your choice. If this is not realistic, then a single insured policy is more appropriate.

Split beneficiary designations: Dividing the life insurance proceeds is generally limited only your imagination. A formal "split-dollar" agreement takes time and more than a page or two of legal mumbo-jumbo. Additionally, the IRS seems to now be reassessing its prior favorable treatment of this popular concept. Requesting that the life insurance company pay out "an amount equal to the premiums paid on the policy to Mom and the balance, if any, to Farming Son" is a relatively easy way for many to achieve the same end results. The same type of beneficiary designation can also be used for "reverse split-dollar" arrangements.

Sometimes very little money exists in checking for clients who are, at least on paper, reasonably wealthy. A split-beneficiary agreement calling for "25,000 to Sweet-Thing if she survives by 10 days and the balance, if any, to The Sweet-Thing Nonmarital Trust created in the insured's last will and testament" offers help.

Sometimes multiple marriages have occurred with his, hers, and our children. A split-beneficiary agreement designating "$X for Harley and Davidson (children born to the insured in a prior marriage and the balance, if any, to Mercedes (born to the union of Junior and Sweet-Thing)" permits the older children to get at least something when the parent dies.

Sometimes there will be an age gap between the children. If a minor child exists while the other children are adults then a beneficiary designation calling for "$X shall be payable to the trust created for the benefit of Fifi, and the balance, if any, distributed to Peaches and Bubbles" might be useful.

Sometimes a child has been most helpful to the parents. A beneficiary designation calling for "A sum equal to $10,000 times the number of years between the time this policy is issued and the date of death shall be paid to my Charming Wonderful Kid with the balance, if any, paid to Fifi, Peaches, and Bubbles." might be a way to reflect those services. The same concept is equally useful for the single client who has a "significant other," a live-in probably suffering the slings and arrows of outraged family members who are not terribly happy about the fact that some of them are older than she is.

Sometimes a daughter has married a person who has been working closely with her parents and, at least for business purposes, the parties are comfortable with this arrangement. having the daughter own the policy on her father/mother/both but with the proceeds payable to both daughter and son-in-law might be a practical answer for their needs.

Interest rates: The decrease in interest rates has caused the reappearance of "vanished" premiums. It has also impacted more heavily those insurance policies with term riders and for universal life policies set up for low annual premiums. When the interest rate being credited to the policy declines, then the cash value portion of the policy grows at a slower rate. Reduced income results in the purchase of more term insurance inside the policy, the retention of the term riders much longer than originally anticipated, or both. Many of these policies will lapse and not provide the originally intended death benefit.

—Paul A. Meints, Esq. CLU, ChFC,
Bloomington, IL

Editor's Note: This article first appeared in the September '96 Agricultural Law publication of the Illinois State Bar Association.

TESTIMONY/Continued from page 6

time to time, it is important to remember that "government" is us. More importantly, though, I fear that we lack an appreciation for the role government plays in our lives. We should consider that our system of governance and economic organization has brought unprecedented and unparalleled prosperity to this country. Let us ponder that fact very carefully before we go charging off in a new direction with some grand experiment in taxation or in governance.

[1] Pub. L. No. 99-514, §. 301(a), 100 Stat. 2216 (1986).

[2] Pub. L. No. 101-508, § 11101(c). 104 Stat. 1388-1 (1990).

[3] See Joint Committee on Taxation, "Description of S.2 ("American Family Tax Relief Act"), January 21, 1997. The estimates assume enactment of (a) a 50 percent reduction for individuals, 2-for-1 loss offset; (b) collectibles taxed at a 28 percent maximum rate; (c) present law section 1250 recapture; (d) allow deduction for individual AMT; (e) indexing starting in 1997 for individuals with 1/1/97 mark-to-market option. with three year post 1996 holding period required; (f) small business stock taxed at a 14 percent maximum rate for individuals and a reduced corporate rate; and (g) a 28 percent maximum rate for corporations. The estimates are revenue loss of $25.3 billion for individuals and $7.8 billion for corporations from 1997-2002. From 1997-2007, the estimated revenue loss would be $112.4 billion for individuals and $16.9 billion for corporations.

[4] See, e.g., I.R.C. § 453.

[5] I.R.C. § 1014(a).

[6] I.R.C. § 1(h).

[7] I.R.C. § 1231.

[8] I.R.C. § 1231(b).

[9] I.R.C. § 1231(b)(3)(B).

[10] See Schultz, Ann M. and Neil E. Harl, "Iowa Farmland Ownership and Tenure 1982-1992: Analysis and Comparison," Iowa State University, 1995.

[11] Much of this section is drawn from Neil E. Harl, "Does Farm and Ranch Property Need a Federal Estate and Gift Tax Break?" Tax Notes, August 14, 1995, p. 875.

[12] See 5 Harl, Agricultural Law § 41.02 (1997).

[13] Census of Agriculture, 1992, vol. 1, Table 47. p. 63 (of the 1,927,073 farms, 1,653,491 are sole proprietorships).

[14] E.g., Estate of Cervin, T.C. Memo, 1994-550, appeal docketed, 5th Cir., Aug. 31, 1995.

[15] See 8 Harl, Agricultural Law § 58.05[2][c](1997).

[16] I.R.C. § 1014(a).

[17] Joint Committee on Taxation, "Description of S.2 ("American Family Tax Relief Act"), p. 23, January 21, 1997.

[18] Id.

[19] Id.

[20] I.R.C. § 6166.

[21] See Harl, "Perspectives on Tax Policy," Tax Notes, September 11, 1995.

Agricultural Law Update
219 New York Avenue
Des Moines, Iowa 50313

ADDRESS
CORRECTION REQUESTED

AMERICAN AGRICULTURAL LAW ASSOCIATION NEWS

Proceedings of the Anglo-American Law Symposium

issues

Members of the American Agricultural Laws Association will have recently received their two copies of the Drake Law Review that contain the proceedings of the Anglo-American Agricultural Law Symposium. The symposium was the joint effort of the Agricultural Law Association, the American Agricultural Law Association and The Comité Européen de Droit Rural. These issues were published and mailed to all members of the AALA compliments of the Drake Agricultural law Center through an arrangement reached with Neil Hamilton, who is director of the Center and one of the coordinators of the Oxford conference.