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USDA Judicial Officer announces new PACA policies

The USDA's Judicial Officer has announced three new policies regarding disciplinary actions for violations of the "full payment promptly" requirements of the Perishable Agricultural Commodities Act (PACA), 7 U.S.C. § 499a-499s. The new policies concern the standards under which cases will be deemed to be "slow-pay" and "no-pay" cases, when the payment of an antecedent debt for perishable agricultural commodities with a promissory note will constitute payment under PACA, and the factors that will be considered in deciding whether to impose a civil penalty or a license suspension in "slow-pay" cases. The new policies were announced in *In re Scamcorp, Inc.*, PACA No. D-95-0502 (Jan. 29, 1998).

Scamcorp, an Illinois corporation, has held a PACA license since it began operation in 1991. Doing business under the trade name Goodness Greeness, Scamcorp rapidly became the second largest distributor of organic produce in the United States. By 1996, it held most of the market share in Chicago and in states extending from Wisconsin to Pennsylvania.

PACA licensees are required to make full payment promptly for the produce they purchase. This "full payment promptly" standard requires a PACA licensee to pay its sellers within ten days after the day on which the produce is accepted unless the parties agree in writing before entering into the transaction to other terms and those terms are followed. See 7 U.S.C. § 499b; 7 C.F.R. § 46.2(aa)(5), (11). Sanctions for violating the requirement include publication of the facts and circumstances of the violation, license suspension or revocation, and civil penalties not to exceed $2,000 for each violative transaction or each day the violation continues. 7 U.S.C. § 499h.

During the period from April, 1993 through June, 1994, Scamcorp failed to make full payment promptly to thirty-five produce sellers in 165 transactions. The outstanding debt totaled $634,791.43.

Based on these transactions, the USDA Agricultural Marketing Service instituted disciplinary proceedings against Scamcorp in October, 1994. After a postponement, a hearing on the complaint was held in April 1996 pursuant to the USDA procedures for formal adjudications. Under these procedures, hearings are conducted by an Administrative Law Judge (ALJ), and either party may appeal to the USDA Judicial

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IN FUTURE ISSUES

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Failure to exhaust adminstrative remedies bars action against FCIC

The Second Circuit has upheld the dismissal of a declaratory judgment action against the Federal Crop Insurance Corporation (FCIC) brought by farmers who alleged that their crop insurance indemnities were calculated in a manner that violated the Federal Crop Insurance Act, 7 U.S.C. §§ 1501-1521. *Bastek v. Federal Crop Ins. Corp.*, No. 97-6221, 1998 WL 257305 (2d Cir. May 22, 1998). The court relied upon the statutory exhaustion requirement set forth in 7 U.S.C. § 6912(e). Enacted in 1994, that statute essentially provides that all administrative appeal procedures must be exhausted before a person can bring an action against the Secretary, the USDA, or a USDA agency, office, officer, or employee.

The plaintiffs were New York onion farmers who suffered major losses to their crops in 1996. Though their crops were insured under FCIC catastrophic risk insurance policies, the plaintiffs' attorney took issue with the announced basis on which the indemnities would be calculated. The attorney wrote to the Secretary and the USDA Office of Risk Management arguing that the indemnity formula violated the Federal Crop Insurance Act. The Acting Director of the Office of Risk Management responded with a general defense of the indemnity formula. A month later,

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Officer who renders the final decision on behalf of the Secretary. See 7 C.F.R. §§ 1.130-.151.

By the middle of the month preceding the hearing, Scamcorp had paid its outstanding indebtedness to all but one of its sellers and had entered into an agreement with the remaining seller. Under that agreement, the seller, Made In Nature, Inc., loaned Scamcorp $235,385.29. A portion of that sum was in cancellation of the produce debt Scamcorp owed to Made In Nature and was evidenced by a promissory note calling for the debt to be repaid in installments.

The evidence introduced by Scamcorp at the hearing attributed its failure to make prompt payment fully on its rapid growth and lack of internal controls. By the time of the hearing, however, Scamcorp had acquired expert financial guidance and had gone from having a negative equity to being within at least one month of having a positive equity. This improvement, coupled with its desire to keep Scamcorp in business as an outlet for its produce, were among the primary reasons why Made In Nature extended its loan to Scamcorp.

Following the hearing, the ALJ concluded that Scamcorp had violated PACA by failing to make full payment promptly in each of the 165 transactions. A civil penalty of $30,000 was imposed on Scamcorp. Seeking the suspension of Scamcorp's PACA license, the Agricultural Marketing Service appealed to the Judicial Officer.

Among the issues raised on appeal was whether the hearing had been rescheduled by the ALJ to give Scamcorp time to pay its sellers. Concluding that the rescheduling was done for another reason, the Judicial Officer observed that the then-current policy discouraged expeditious hearings. Under that policy, cases in which the respondent had failed to pay by the date of the hearing were referred to as "no-pay" cases. In such cases, the respondent's PACA license was revoked. On the other hand, if the respondent had paid its sellers in full by the hearing and was otherwise in full compliance with PACA, the case was deemed a "slow-pay" case. The sanction for "slow-pay" cases was license suspension. While this policy encouraged payment, it also gave respondents an incentive to seek to postpone hearings and to thus further delay payment.

To remedy this problem, the Judicial Officer announced a new "slow-pay/no-pay" policy. Under this policy, the case will be considered a "no-pay" case if:

• the "respondent has failed to pay in accordance with the PACA and is not in full compliance with the PACA within 120 days after the complaint is served on that respondent, or the date of the hearing, whichever comes first";

• the "respondent fails to file a timely answer to the complaint"; or

• the "respondent admits the material allegations in the complaint and makes no assertion that the respondent has achieved full compliance or will achieve full compliance with the PACA within 120 days after the complaint was served on the respondent, or the date of the hearing, whichever comes first. . . ." *In re Scamcorp, Inc.*, slip op. at 29-30.

In a "no-pay" case, license revocation will follow a finding of flagrant or repeated violations of the PACA.

The case will be considered a "slow-pay" case if the respondent is in full compliance with the PACA within 120 days after service of the complaint or the date of the hearing, whichever comes first. In a "slow-pay" case, the violator faces civil penalties or license suspension for a period of up to ninety days. In both cases, "full compliance" requires payment of all sellers and the absence of any credit agreements for more than thirty days. *Id.*

Another issue on appeal was whether Scamcorp was in full compliance with the PACA at the time of the hearing in view of the promissory note between Scamcorp and Made In Nature. Though the Judicial Officer concluded that Scamcorp and Made In Nature had intended for the promissory note to extinguish the produce debt owed by Scamcorp to Made In Nature, he agreed that the debt should be viewed for the purposes of the PACA as unpaid. Accordingly, as to future cases, the Judicial Officer adopted the policy that "payment of antecedent debt for perishable agricultural commodities with a promissory note ... will not constitute payment ... even if a respondent can show that the parties agreed that the promissory note would extinguish the debt and constitute payment and the agreement to accept the promissory note as payment was an arm's length transaction and not the product of a respondent's superior bargaining position." *Id.* at 50-51 (footnote omitted).

Finally, the Judicial Officer changed his policy regarding civil penalties to reflect his finding, based on the text and legislative history of the PACA civil penalty provision, that the imposition of a civil penalty should be considered in lieu of a license suspension or revocation in "slow-pay" cases. That finding was at odds with the position of the Agricultural Marketing Service, which contended, among other contentions, that neither license suspension nor revocation were "excessive" sanctions and that a civil penalty should not be considered as either the primary or sole alternative available to address violations of the PACA.

In adopting the new policy that a civil penalty may be imposed in a "slow-pay" case, the Judicial Officer stated the decision whether to impose a civil penalty or a license revocation would involve consideration of the following factors:

(1) the length of time during which a respondent was in violation of the payment requirements of the PACA; (2) the number of a respondent's violations and the dollar amounts involved; (3) the roll-over debt, if any, incurred by the PACA violator; (4) the time it takes the PACA violator to achieve compliance with the PACA; (5) the impact of the violations on the industry as a whole; and (6) whether the PACA violator's financial condition is such that an appropriate civil penalty, large enough to be an effective deterrent to future violations of the PACA, would

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

Contributing Editors: Drew L. Kershen, Norman, OK; Roger A. McEowen, Manhattan, KS; Christopher R. Kelley, Hastings, MN; Pat Traynor, Virginia Tech; 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.

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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.

Chloroplast transformation: biological containment for transgenes

Gene flow, or the exchange of genetic information between crops and wild relatives, is a naturally occurring phenomenon. The normal movement of genes via pollen dispersal provides a mechanism, however, for foreign genes to "escape" from a genetically engineered crop and spread to weedy relatives growing nearby. Gene flow becomes an environmental issue when the associated trait confers some kind of ecological advantage. This is a particular concern in the case of herbicide resistance genes, for example, where transfer of the resistance trait to weedy relatives raises the possibility of creating "super-weeds" that are more difficult to control.

Some strategies to reduce the risk of gene flow from transgenic crops, such as the use of male sterile plants, work well but are limited to a few species. For the many crops in which chloroplasts are strictly maternally inherited, which is to say not transmitted through pollen, transformation of the chloroplast genome should provide an effective way to contain foreign genes. As described in the April issue of Nature Biotechnology, Henry Daniell and colleagues at Auburn University introduced a gene for herbicide resistance into tobacco, showed that it was stably integrated into the chloroplast genome, and demonstrated that transgenic plants contained only transformed chloroplasts. This result advances the potential for chloroplast transformation to be an effective strategy to manage the risk of gene flow.

Glyphosate, a broad spectrum herbicide, works by inhibiting EPSPS, an enzyme involved in synthesis of aromatic amino acids in plants and microorganisms. Genes for glyphosate-resistant forms of EPSPS have been used to genetically engineer herbicide resistant crops. The Auburn group used two vectors to introduce a petunia EPSPS gene into tobacco together with a selectable marker gene conferring resistance to spectinomycin. One vector was designed specifically for integrating foreign genes

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Recent developments in estate and tax planning

By Roger A. McEowen

Deduction denied for interest paid with funds from same lender. *Davison v. Commissioner*, 98-1 U.S.T.C. (CCH) ¶ 50,296 (2d Cir. 1998).

The taxpayers formed a cash-basis partnership with other investors to acquire, operate, and sell farm properties. A life insurance company loaned $20 million to the partnership in May of 1980. Under the credit arrangement, the partnership was required to make an interest payment of $1.5 million in January of 1981. The partnership was short of cash and sought a $1.5 million loan from the life insurance company. The lender wired $1.5 million to the partnership's account, and the partnership wired back to the lender the next day $1.5 million to cover the interest payment. The Service disallowed the taxpayers' portion of the partnership's loss attributable to the partnership's interest deduction, and the Tax Court upheld the Service's determination. *Davison v. Commissioner*, 107 T.C. No. 4 (1996).

In a 1947 case involving a lender that gave up control of funds that were commingled with the taxpayer's funds before the interest was paid, the Tax Court developed the "unrestricted control" test for determining the deductibility of interest paid with funds obtained from the same lender. *Burgess v. Commissioner*,8 T.C. 47 (1947). Under this test, a cash-basis borrower can deduct interest used to satisfy an obligation borrowed from the original lender, but the lender must give up control of the borrowed funds, the funds must be commingled with the borrower's other funds in an account at an institution separate from the lender, and the borrower must have unrestricted use of the borrowed funds to make the interest payment. However, the Fifth and Eighth Circuits have rejected the unrestricted control test as being too easily manipulated by the borrower. *See Wilkerson v. Commissioner*, 655 F.2d 980 (9th Cir. 1981), *rev'g.* 70 T.C. 240 (1978); *Battelstein v. Internal Revenue Service*, 631 F.2d 1182 (5th Cir. 1980), *cert. denied*, 451 U.S. 938 (1981). These courts held that unrestricted control, standing alone, is not sufficient to justify a deduction if funds have been borrowed from the same lender for the primary purpose of financing interest on a prior loan. The Service has also indicated that it will deny an interest deduction if the taxpayer borrows funds from the same lender to satisfy the interest obligation to that lender, or rolls over the remaining balance of the loan into a new line of credit for the next year. I.R. News Rel. 83-93, July 6, 1983.

Here, the Tax Court acknowledged that the taxpayers appeared to have met the unrestricted control test since the funds were in the borrower's bank account. Even though the taxpayer had physical control of the funds for a short period of time, the Tax Court recognized that the borrower did not have unrestricted control over the borrowed funds in any meaningful sense. The court noted that the failure to make the interest payment would have resulted in a breach of the terms of the original credit with the lender. The Tax Court denied a deduction, concluding that the interest was deferred rather than repaid. (Arguably, if a borrower can demonstrate that it has other funds to pay the interest, it might be easier to justify a deductible interest payment.)

On appeal, the court agreed that if the purpose and economic substance of the transaction was to postpone, rather than extinguish, the borrower's interest obligation, the borrower should not be entitled to a tax deduction solely because the lender has temporarily placed the funds under the borrower's control. In addition, the court expressly rejected the Tax Court's "unrestricted control" exception. Thus, the vitality of *Burgess* appears questionable—having been rejected now by three circuit courts.

New home sale capital gains exclusion rules apply to bankruptcy estate. *In re Popa*, 98-1 U.S.T.C. (CCH) ¶ 50,276 (Bankr. N.D. Ill. 1998).

Effective for sales and exchanges after May 6, 1997, the Taxpayer Relief Act of 1997 amended I.R.C. § 121 to provide an exclusion of up to $500,000 for married couples ($250,000 for other taxpayers) on the sale of a principal residence every two years, as long as the taxpayer has owned and lived in the residence two of the previous five years. Pub. L. No. 105-34, § 312(a), 111 Stat. 188, *amending* §§ 121, 1034. Section 121 formerly provided that taxpayers over age 55 were entitled to a one-time exclusion of $125,000 on the sale of their principal residence. In this case, the court held that the debtor's bankruptcy estate was entitled to the new I.R.C. § 121 exclusion.

When the debtors filed bankruptcy, the principal residence (titled only in the husband's name) was scheduled with an estimated fair market value of $150,000, subject to a mortgage of $110,000. A sale of the residence would have yielded $8,600 of equity after accounting for the mortgage, commissions, sale costs, the trustee's fee, and the taxpayer's homestead exemption of $7,500, but without taking into account the capital gains tax due on the sale. Since the taxpayer's cost basis in the property was approximately $70,000, the court calculated a capital gains tax due of approximately $12,000. The debtor argued that the estate was not entitled to the $250,000 exclusion of I.R.C. § 121. The debtor sought to have the property abandoned because, after two homestead exemptions and payment of the capital gains tax, no sale proceeds would be available for creditors.

The court held that under local (Illinois) law, only the husband was entitled to a homestead exemption because the wife did not have an ownership interest in the residence. [The court noted that the Rights of Married Persons Act (750 Ill. Comp. Stat. 65/0.01 *et. seq*.) did not give the wife a sufficient ownership interest in the residence to entitle the wife to an exemption.] The court also concluded that the estate succeeded to the taxpayer's holding period and that the property's character included its use as the taxpayer's principal residence for at least two of the previous five years. The court held that because the bankruptcy estate succeeded to those attributes, it also succeeded to the I.R.C. § 121 exclusion. The court noted that its holding was consistent with the principle of treating the bankruptcy estate as the debtor, and that bankruptcies should mirror nonbankruptcy entitlements instead of changing the character of a particular transaction.

Create your own basis—court holds that unsecured promissory note increased shareholder's basis in contributed property. *Peracchi v. Commissioner*, 1998 U.S. App. LEXIS 8174

Roger A. McEowen is Associate Professor of Agricultural Economics and Extension Specialist, Agricultural Law and Policy, Kansas State University, Manhattan, Kansas, and is a Member of the Kansas and Nebraska Bars.

(9th Cir. Apr. 29, 1998), *rev'g*, T.C. Memo. 1996-191.

In general, a shareholder can contribute capital to a corporation without recognizing gain on the exchange if certain requirements are met. *See, e.g.*, I.R.C. § 351. However, contributing property with liabilities in excess of basis triggers immediate recognition of gain as to the amount of the excess. *See* I.R.C. § 357(c). This is a serious concern especially upon incorporation of farm and ranch operations because of the typically low basis (compared to fair market value) of many of the operational assets. Here the taxpayer faced this problem and attempted to escape gain recognition by also contributing an unsecured promissory note so as to increase the taxpayer's basis. The taxpayer claimed that the note had a basis equivalent to its face value, which made the taxpayer's total basis in the property contributed greater than the total liabilities associated with the property. Accordingly, the taxpayer argued that gain was not triggered under I.R.C. § 357(c), and that no tax was due.

The taxpayer, in order to comply with Nevada's minimum premium-to-asset ratio for insurance companies, contributed two parcels of real estate to the taxpayer's closely-held corporation. The transferred properties were encumbered with liabilities that together exceeded the taxpayer's total basis of the properties by more than $500,000. In order to avoid the immediate gain recognition of I.R.C. § 357(c) as to the amount of excess liabilities over basis, the taxpayer also executed a promissory note, promising to pay the corporation $1,060,000 over a term of ten years at eleven percent interest. The taxpayer remained personally liable on the encumbrances even though the corporation took the properties subject to the debt. The taxpayer did not make any payments on the note until after being audited, which was approximately three years after the note was executed. The Service argued that the note was not genuine indebtedness and should be treated as an enforceable gift. In the alternative, the Service argued that even if the note were genuine, its basis was zero because the taxpayer incurred no cost in issuing the note to the corporation. As such, the Service argued, the note did not increase the taxpayer's basis in the contributed property.

In Rev. Rul. 68-629, 1968-2 C.B. 154, the Service held that a note given to a corporation to cover the excess indebtedness on contributed property over that property's basis did not give the taxpayer a basis for I.R.C. § 357 purposes because it cost the taxpayer nothing to write the note. The Tax Court adopted this reasoning (*Alderman v. Commissioner*, 55 T.C. 662 (1971)), but the Second Circuit Court of Appeals in *Lessinger v. United States*, (872 F.2d 519 (2d Cir. 1989), *rev'g* 85 T.C. 824 (1985)), held that a shareholder's personal note, while having a zero basis in the shareholder's hands, had a basis equivalent to its face amount in the corporation's hands under I.R.C. § 357.

In this case, the Tax Court avoided the chicanery of *Lessinger* by concluding that the indebtedness was not genuine. However, the Ninth Circuit reversed the Tax Court and held that the taxpayer had a basis of $1,060,000 (face value) in the note. As such, the aggregate liabilities of the property contributed to the corporation did not exceed aggregate basis, and no gain was triggered under I.R.C. § 357(c). The court reasoned that the Service's position ignored the possibility that the corporation could go bankrupt, an event that would suddenly make the note highly significant. The court also noted that the taxpayer and the corporation were separated by the corporate form, which was significant in the matter of C corporate organization and reorganization. Contributing the note placed a million dollar "nut" within the corporate "shell," according to the court, thereby exposing the taxpayer to the "nutcracker" of corporate creditors in the event the corporation went bankrupt. Without the note, the court reasoned, no matter how deeply the corporation went into debt, creditors could not reach the taxpayer's personal assets. With the note on the books, however, creditors could reach into the taxpayer's pocket by enforcing the note as an unliquidated asset of the corporation. The court noted that, by increasing the taxpayer's personal exposure, the contribution of a valid, unconditional promissory note had substantial economic effect reflecting true economic investment in the enterprise. The court also noted that, under the Service's theory, if the corporation sold the note to a third party for its fair market value, the corporation would have a carryover basis of zero and would have to recognize $1,060,000 in phantom gain on the exchange even if the note did not appreciate in value at all. The court reasoned that this simply could not be the correct result. In addition, the court noted that the taxpayer was creditworthy and likely to have funds to pay the note. The note bore a market rate of interest related to the taxpayer's credit worthiness and had a fixed term. In addition, nothing suggested that the corporation could not borrow against the note to raise cash. The court also pointed out that the note was fully transferable and enforceable by third parties.

The Ninth Circuit did acknowledge that its assumptions would fall apart if the shareholder were not creditworthy, but the Service stipulated that the shareholder's net worth far exceeded the value of the note. That seems to be a key point that the circuit court overlooked. If the taxpayer was creditworthy, then a legitimate question exists concerning why the taxpayer failed to make payments on the note before being audited. Clearly, the taxpayer never had any intention of paying off the note. Thus, the note did not represent genuine indebtedness. The Ninth Circuit also appears to have overlooked the different basis rules under I.R.C. § 1012 and I.R.C. § 351. An *exchanged* basis is obtained in accordance with an I.R.C. § 351 transaction which precludes application of the basis rules of I.R.C. § 1012.

The Ninth Circuit was careful to state that the court's rationale was limited to I.R.C. § 357(c) involving C corporations. Thus, the opinion will not apply in the S corporation setting for shareholders attempting to create basis to permit loss pass-through. Likewise, Rev. Rul. 80-235, 1980-2 C.B. 229, specifies that a partner in a partnership cannot create basis in a partnership interest by contributing a note. In any event, the Service is likely to continue challenging "basis creation" cases on the ground that the contribution of a note was not a bona fide transfer. The more prudent approach would be to have creditworthy shareholders of closely-held corporations borrow the money from an independent third party under a binding contractual arrangement and contribute the borrowed funds to the corporation.

Sale of conservation servitude on special use elected land did not trigger recapture. *Estate of Gibbs v. United States*, 98-1 U.S.T.C. (CCH) ¶60,307 (D. N.J. 1997).

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RECENT DEVELOPMENTS/*Cont. from page 5*

An estate did not trigger recapture tax on the sale of a conservation servitude on special use elected land to the state of New Jersey. The servitude stipulated that the land was to be maintained as a farm in perpetuity. By virtue of the special use election, the value of the farmland in the decedent's estate was reduced from a fair market value of $988,000 to a special use value of $349,770 for estate tax purposes. The heirs sold the servitude to the state for $1,433,493.72. The deed of easement imposed restrictions on the property that ran with the land, thereby binding the heirs and all future title holders to its provisions.

The Service argued that the granting of an easement to the state triggered recapture because an interest in real property was conveyed. The Service also maintained that recapture tax was due because the heirs realized the developmental value of the property during the recapture period. The heirs argued that the state's acquisition of the conservation servitude was not a disqualifying disposition of an "interest" in the farm because the easement grant imposed only a contractual restriction upon the farmland's future use guaranteeing that the property would be used as farmland well beyond the recapture period.

In ruling for the estate, the court noted that New Jersey law construes land use restrictions as "equitable servitudes" involving contract rights rather than property interests. Thus, according to the court, the granting of a conservation servitude did not create a possessory interest in the burdened land because the burden imposed was enforceable only as a contract right. Accordingly, the grant of a conservation servitude was not a disposition of an interest in land resulting in recapture of estate tax under I.R.C. § 2032A(c)(1).

The court's opinion in *Gibbs* is questionable. Real property servitudes similar in nature to the one presented in *Gibbs* have been treated as interests in real property for tax purposes. For example, in Rev. Rul. 77-414, 1977-2 C.B. 299, the taxpayer sold the development rights in his farm to the county in accordance with a county statute designed to ensure the preservation of farmland. The ruling concluded that the disposition constituted the sale of an interest in real property for purposes of §§ 1221, 1231 and 453(b)(1)(A) of the Code. Similarly, in Priv. Ltr. Rul. 8940011, Jun. 30, 1989, the mere *donation* of a conservation easement to the county triggered recapture tax. Under the facts of the ruling, the grant of the easement would have restricted the use of the land in perpetuity to agricultural and related uses, generally prohibiting all institutional, industrial, and commercial use of the elected land. The Service noted that even if a conservation easement in gross were classified as a restrictive covenant, such classification would not negate the characterization of the servitude as an interest in property. See 5 R. Powell, Powell on Real Property, § 60.01[2] at 60-10 (rev. ed. 1997), which states "the great weight of authority regards equitable restrictions as recognitions of an equitable property interest in the burdened land, appurtenant to the benefitted land, similar to an easement." Indeed, the Uniform Conservation Easement Act specifically characterizes a conservation easement as an interest in real property. Uniform Conservation Easement Act, § 1(1), 12 U.L.A. 170 (1996). The preferatory note to the Uniform Act indicates that the drafters intentionally designated the interests covered by the Act as "easements." *Id*.

Also, in Technical Advice Memorandum 8731001, Mar. 19, 1987, the transfer of an agricultural preservation easement for consideration resulted in recapture of estate tax. Five years after the decedent's death, a qualified heir executed a deed of easement for all of the elected farmland in favor of the state for $490,000. The easement restricted subdivision of the farm so as to preserve the farm solely for agricultural use. The Service cited Rev. Rul. 59-121, 1959-1 C.B. 212, for the notion that consideration received for the granting of an easement with respect to land constitutes proceeds from a sale of an interest in real property. As such, the grant of the preservation easement for consideration was a disposition resulting in the imposition of recapture tax under I.R.C. § 2032A(c)(1).

However, in Priv. Ltr. Rul. 9035007, May 25, 1990, the granting of a subsurface pipeline easement was ruled to not be a recapture-triggering event because, the easement neither interrupted nor affected the use of the elected land. Similarly, in Rev. Rul. 88-78, 1988-2 C.B. 330, the grant of a lease in subsurface oil and gas interests that also involved the extraction of oil and the disposition of royalty rights on elected land did not trigger recapture tax. Normally, the interest of a lessee in oil and gas in place is an interest in real property for federal income tax purposes (*see, e.g*., Rev. Rul. 68-226, 1968-1 C.B. 362), and a royalty interest is a fee interest in mineral rights and real property (Rev. Rul. 73-428, 1973-2 C.B. 303). Thus, the disposition of oil rights would usually be considered the disposition of an interest in real property. However, a 1976 committee report involving I.R.C. § 2032A states that "elements of value which are not related to the farm or business use (such as mineral rights) are not to be eligible for special use valuation." H.R. Rept. No. 1380, 94th Cong. 2d Sess. 24 (1976). Consequently, the disposition of oil rights was ruled not to be a disposition triggering recapture tax. Rev. Rul. 88-78, 1988-2 C.B. 330. The ruling did state, however, that "well-drilling activity and the subsequent extraction process" would constitute a "cessation of use" for purposes of recapture because farming activity would be interrupted.

How do these rulings square with *Gibbs*? It appears that the court reached the right result in, but for the wrong reason. The *Gibbs* court reached its conclusion on the narrow ground that the qualified heirs did not dispose of an interest in land because, under New Jersey law, land use restrictions are construed as "equitable servitudes" involving contract rights rather than property interests. However, as mentioned above, the rulings do not generally support that position. *See, e.g*., Rev. Rul. 77-414, 1977-2 C.B. 299; Priv. Ltr. Rul. 8940011; TAM 8731001. A better reason for holding that the granting of a conservation servitude does not constitute a disqualifying disposition under I.R.C. § 2032A(c)(1) is that there was no interruption of the surface use in *Gibbs.* Revenue Ruling 88-78, 1988-2 C.B. 331, and Private Letter Ruling 9035007, May 25, 1990, support that proposition. That is the result irrespective of whether the grant of a conservation easement involves an interest in real property under state law. *See, e.g.,* Rev. Rul. 88-78, 1988-2 C.B. 330; H.R. Rept. No. 1380, 94th Cong. 2d Sess. 24 (1976).

Chloroplast/*Cont. from p. 3*

into tobacco chloroplasts; the other is a universal expression and integration vector used to transform chloroplasts genomes of several plant species. Both vectors include chloroplast gene sequences flanking the EPSPS and marker genes to promote insertion into the chloroplast DNA by homologous recombination.

Transformed plants were characterized to determine whether the genes had, in fact, integrated into the chloroplast genome. Pairs of primers were designed such that one would 'land' within the inserted sequence and the other would anneal to native chloroplast sequence adjacent to the insertion site. PCR analysis produced fragments of the size expected for chloroplast integration of the foreign genes by both vectors.

The authors established that the plants are homoplasmic, having copies only of the transgenic genome and not the native untransformed genome. Southern blot

Continued on page 7

CHLOROPLAST/*Cont. from p. 6*

analysis showed that DNA from transformed plants lacked a specific fragment characteristic of the native chloroplast genome, but did contain an extra fragment generated by insertion of the transgenes. Transformed plants containing a mixture of transformed and untransformed chloroplast would give rise to variegated progeny when grown on spectinomycin. Seeds collected after the first self-cross all germinated normally in the presence of spectinomycin and the seedlings remained green. The lack of variegated progeny confirms that the transgenic plants are homoplasmic. The tobacco chloroplast genome is present in 5,000 to 10,000 copies per cell. By showing that all of the chloroplasts contain inserted DNA, the authors estimate there are 5,000 to 10,000 copies of the EPSPS gene *per cell* in the transformed plants.

Herticide resistance was tested by spraying transformed and control tobacco plants with varying concentrations of glyphosate. Control plants died within a week of spraying with 0.5 mM glyphosate, but transgenic plants survived concentrations as high as 5 mM. Given that the petunia EPSPS used in these studies has a relatively low tolerance to the herbicide, it may be possible to achieve significantly greater levels of resistance by using genes from other sources. Bacterial genes would be good candidates as they would likely be expressed at higher levels in the prokaryotic-like chloroplast compartment of the cell. This approach may prove to be a significant tool for ensuring the environmentally safe use of herbicide resistant crops where the presence of weedy relatives is a cause for concern.

—Pat Traynor, reprinted with permission from ISB News Report—April 1998, pp. 2-3.

EDITOR'S NOTE REPRINTED: [We reprint a clarification to a previous reprint of an ISB News Report.] An article in the December ISB News Report, "Gene Flow Between Crops and Distantly Related Weeds," contained potentially misleading statements that need to be clarified. The article reported on the escape of a transgene for herbicide resistance from oilseed rape plants to wild radish. First, it was not made explicit that the News Report article was based on a note in the Scientific Correspondence section of the journal Nature, not on a peer-reviewed research paper. Secondly, the News Report article referred to the maternal transmission of the transgene and raised the question as to whether chloroplast transformation of crop plants, proposed as a means of containment for engineered genes, is as benign as claimed by by its proponents. In fact. The Nature correspondence described maternal transmission of a nuclear transgene, not a chloroplast transgene. The reported observations had no bearing on the biosafety applications of chloroplast transformation, thus the comment was inappropriate. We regret the error.

FCIC/*Cont. from page 1*

plaintiffs filed their declaratory judgment action challenging the indemnity calculations. The next day, the Office of Risk Management sent a letter to each of the plaintiffs denying their claims for indemnity at a rate higher than the announced rate and notifying them of their administrative appeal rights, including the right to appeal to the USDA National Appeals Division (USDA NAD). The plaintiffs did not file administrative appeals, and the time for filing administrative appeals lapsed.

The district court dismissed the declaratory judgment action on the grounds that the plaintiffs had failed to exhaust their administrative remedies as required by 7 U.S.C. § 6912(e). On appeal, the plaintiffs argued that the exceptions to the judicially created exhaustion requirement should apply to the statutory exhaustion requirement. Relying on *McNeil v. United States*, 508 U.S. 106 (1993), and other authority for the proposition that unambiguous statutory exhaustion requirments cannot be ignored by the courts, the Second Circuit affirmed the dismissal.

The Second Circuit also rejected the plaintiffs claim that exhaustion should be excused because they were challenging the generally applicable indemnity formula. The court noted that while the USDA NAD does not have jurisdiction to hear challenges to rules of general applicability, under 7 U.S.C. § 6992(d) the USDA NAD does have the authority to determine whether an appeal presents such an issue. It therefore ruled that the plaintiffs should have first presented their claims to the USDA NAD: "Under the clear terms of the statute, plaintiffs' argument that their broad challenges to FCIC calculations could not adequately have been presented within normal administrative channels is itself an argument that was required to be tested and exhausted before being presented in federal court." *Bastek*, 1998 WL 257305 at *5.

—Christopher R. Kelley, Hastings, MN

Conference Calendar

1998 Summer Agricultural Law Institute

Drake Univ. L. School, Des Moines, IA

June 8-11: Taxation of Agricultural Businesses (Prof. Jim Monroe)

June 15-18: Agricultural Insurance: Liability and Property Coverage (Prof. John Copeland)

June 22-25: Formation of "New Wave" Farmer Cooperatives (Sarah Vogel)

July 6-9: Law and the New Agriculture: Direct Marketing (Prof. Neil Hamilton)

July 13-16: Water Law and Agricul-ture (Prof. Jake Looney)

For info., call 515-271-2947.

PACA/*Cont. from page 2*

> not substantially increase the risk that the PACA violator's future produce sellers may not be paid in accordance with the PACA.

Id. at 55-56 (footnote omitted).

As explained by the Judicial Officer, the imposition of a civil penalty may promote the public interest better than a license suspension. For example, the imposition of a civil penalty on a financially strong violator reduces the risk posed by a license suspension "that a PACA violator may not pay those who sell produce to the violator between the time of the hearing and the effective date of the sanction, thereby thwarting one of the purposes of the PACA." *Id*. at 57. Also, a suspension is more likely than a civil penalty to put the violator out of business, a result that may not be in the public interest.

As to "no-pay" cases, however, civil penalties do not apply. In the words of the Judicial Officer, "a civil penalty would not be an appropriate sanction in a "no-pay" case in which the violations are flagrant or repeated because the PACA violator's failure to get back into compliance with the PACA promptly would indicate that the violator continues to be financially irresponsible, and limiting participation in the perishable agricultural commodities industry to financially responsible persons is one of the primary goals of the PACA." *Id*. at 57-58 (footnote omitted).

As to Scamcorp, the Judicial Officer rejected the request by the Agricultural Marketing Service that Scamcorp's PACA license be suspended for ninety days. The Judicial Officer, however, concluded that the facts warranted an increase in the civil penalties assessed against Scamcorp by the ALJ to $500.00 per violation, for a total of $82,500.00.

—Christopher R. Kelley, Hastings, MN

Federal Register *in brief*

The following is a selection of items that were published in the *Federal Register* from March 27 to April 28, 1998.

1 **Farm Credit Administration**. Interest rate risk management; proposed policy statement with request for comments by 6/22/98. 63 Fed. Reg. 27962.

— Linda Grim McCormick, Alvin, TX

AALA Award nominations sought

The AALA Awards Committee is seeking nominations from the general membership for consideration in the following categories:

1. AALA Award for Excellence in Scholarship for 1998;
2. AALA Award for Excellence in Student Writing for 1998;
3. AALA Award for the ***Ag Law Update*** for 1998; and
4. AALA Distinguished Service Award for 1998.

The deadline for submitting nominations is July 1, 1998. Winners will be honored during the 1998 annual educational conference on Oct. 23-24 in Columbus, Ohio. Nominations should be submitted to the 1998 AALA Awards Committee Chairman: David C. Barrett, Jr., National Grain and Feed Association, 1201 New York Ave., N.W., Washington, DC 20005; phone: 202-289-0873; e-mail: **dbarrett@ngfa.org**.