Agricultural Law Update
VOLUME 6, NUMBER 11, WHOLE NUMBER 71 AUGUST 1989

Official publication of the American Agricultural Law Association

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Ninth Circuit rules no private right of action under Agricultural Credit Act of 1987

In one of the most important court rulings to date under the Agricultural Credit Act of 1987, the Ninth Circuit has ruled in *Harper v. Federal Land Bank of Spokane*, that the Act does not provide a private right of action. The decision reverses an earlier District Court ruling on the issue, *Federal Land Bank of Spokane*, 692 F. Supp. 1244 (D. Or. 1988), but is in accord with several other rulings. The same issue was argued to the Eighth Circuit Court of Appeals in December, in the case of *Zajac v. Federal Land Bank of St. Paul*, appealing pending No. 885353, but no decision has yet been rendered in that case.

The court applied the four-part test of *Cort v. Ash* to determine whether Congress intended to imply a private cause of action in the federal statute. 422 U.S. 66, 78 (1975).

The first issue under *Cort* is whether the Harpers were members of a class for whose special benefit the statute was passed. The court noted that while one purpose of the 1987 Act was to "provide borrowers with . . . limited rights," the overall purpose of the act and "the major impetus for the legislation was the financial crisis in the Farm Credit System."

On the second issue, that of whether Congress intended a private right of action to exist, the appeals court noted that at the time of consideration of the Act it was abundantly clear from litigation throughout the country that there was no implied

(Continued on page 2)

Criminal conviction under Migratory Bird Treaty Act for poisoning geese with pesticides reversed

In the case of *U.S. v. Rollins*, 706 F. Supp. 742 (D.C. Idaho 1989), the defendant farmer, who raised alfalfa on an island in the Snake River between Oregon and Idaho, was convicted by a federal magistrate of violating the Migratory Bird Treaty Act (MBTA), 16 U.S.C. §§ 703 and 707. The facts of the violation stemmed from the farmer's use of a mixture of granular pesticides, Furadan and Di-Syston, on fifty acres of seed alfalfa. Shortly after the pesticide was used, a flock of geese landed on the field, ate the alfalfa and the pesticide, and died from the ingestion. Rollins was subsequently charged with a violation of the Act and of the Federal Insecticide, Fungicide, and Rodenticide Act, although the later charges were dismissed.

The MBTA provides that, except as permitted by regulation, "it shall be unlawful at any time, by any means or in any manner, to pursue, hunt, take, capture, [or] kill . . . any migratory bird. . . ." The statute therefore creates a strict liability standard for criminal convictions, and does not require scienter. The magistrate found that even though the farmer had not applied the pesticide in a reckless manner, had used it in the past without causing the birds problems, and could not control the fact that the geese landed afterwards, the question of conviction rested on whether the island was a known feeding area for geese. The magistrate concluded that based on the evidence presented of frequent geese feedings in the area, "a reasonable person would have been placed on notice that alfalfa grown on West Lake Island in the Snake River would attract and be consumed by migratory birds."

On appeal, the U.S. District Court had to consider whether the MBTA criminal provision was unconstitutionally vague for failure to provide fair notice to farmers of what constitutes illegal conduct. The court noted that statutes such as the MBTA, which provide strict liability for criminal convictions, are prone to vagueness and thus subject to constitutional scrutiny. The court noted that such statutes can become a trap for those who attempt to act in good faith.

After reviewing the magistrate's findings concerning the farmer's conduct, the court determined that that was exactly what had happened in this case. The court

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right under the various predecessor statutes or regulations in effect prior to the 1987 Act. Further, the court noted that the normal rules of statutory construction would support the view that if an express right proposed in both houses of Congress was deleted in the final conference version of the Act, that was the clearest statement of Congressional intent that there was no implied private right of action intended. The appeals court concluded that the district court had given too much weight to the remarks of members of Congress on this issue.

The court went on to note that even if the Congressional statements are ambiguous on the creation of a private right of action, "our review of the administrative remedies provided by the 1987 Act convinces us that Congress intended administrative review to be the exclusive remedy." The court noted the availability of the Credit Review Committee process whereby borrowers could obtain lender review of restructuring denials. More importantly, the court also noted that the Farm Credit Administration has extensive enforcement powers to issue cease and desist orders to enforce the Act.

This is a particularly important ruling because one of the major arguments of the advocates of a private right of action is that resorting to the FCA for enforcement would be futile or ineffective. The court took note of these charges and agreed that while holding a private right of action existed would enhance the administrative remedies existing under the Act, enhancement was not an appropriate factor in the analysis of implied remedies.

Then, in one of the most significant portions of the opinion, the court noted that even though there is no private right of action, borrowers do have the apparent right in some states "to allege the failure to afford restructuring rights as an affirmative defense to foreclosure." The court cited *Federal Land Bank of St. Paul v. Bosch*, 432 N.W.2d 855 (N.D. 1988) (concerning the use of 1986 regulations) and *Federal Land Bank of St. Paul v. Overboe*, 404 N.W.2d 445 (N.D. 1987) (concerning use of the 1985 amendments). *But see Federal Land Bank of St Louis v. Hopmann*, 658 F. Supp. 92 (E.D. Ark. 1987) (rejecting the defense). The effect of the court's ruling and this passage may well mean that any private efforts by borrowers to allege violations of the Act may be litigated in the context of affirmative defenses to debt enforcement actions by system lenders.

On the third prong of the *Cort* test, consistency with legislative purpose, the court disagreed with the district court's interpretation that the availability of a private right of action would strengthen the Farm Credit System because it would force lenders to make cost effective decisions concerning the possibility of restructuring loans. The appeals court ruled that the primary purpose of the Act was "to restore financial integrity to the Farm Credit System" and "[a]llowing a private right of action undermines that objective by involving the Farm Credit System in costly litigation."

On the fourth issue under the *Cort* analysis, the issue of whether the rights were relegated to state law, the appeals court noted that the area of foreclosure proceedings is traditionally controlled by state law and as a result an implied right of action was not appropriate.

In conclusion, the appeals court held that none of the four factors in *Cort* supported finding an implied private right of action under the 1987 act. As a result, the court noted it was joining with several other courts that have rejected an implied private right of action under the 1987 Act. *See, e.g. Wilson v. Federal Land Bank of Wichita*, No. 88-4058-R (D. Kan. Jan. 30, 1989)(1989 WL 12731); *Neth v. Federal Land Bank of Jackson*, No. 88-0324-B-C (S.D. Ala. Dec. 30, 1988); *Zajac v. Federal Land Bank of St. Paul*, No. A3-88-115 (D. N.D. July 19, 1988), *but see Griffin v. Federal Land Bank of Wichita*, 708 F. Supp. 313 (D. Kan. 1989); *Leckband v. Naylor*, No. 3-88-167 (D. Minn. May 17, 1988); and *Martinson v. Federal Land Bank of St. Paul*, No. A2-88-31 (D. N.D. April 21, 1988).

As a final note in its opinion, the appeals court also reversed the district court's *sua sponte* holding that the Harpers had presented a section 1983 claim. The court noted that other courts have refused to apply section 1983 to the Farm Credit Act of 1971 and the 1985 farm credit amendments. The court ruled that the fact a state will permit Farm Credit System institutions to use foreclosure procedures and subsequent sheriff sales to execute judgments is not sufficient to constitute state action. Thus, no cause of action to maintain a section 1983 claim existed.

– *Neil D. Hamilton*

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VOL. 6 NO. 11 WHOLE NO. 71 AUGUST 1989

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CRIMINAL CONVICTION UNDER MIGRATORY BIRD TREATY ACT FOR POISONING GEESE WITH PESTICIDES REVERSED / CONTINUED FROM PAGE 1

noted that the findings portray the defendant as using due care in applying the pesticide and as having checked for the presence of geese prior to use. Although the pesticide had a warning label, the court noted that the farmer and his neighbors had used pesticides in the past without any geese being killed. On this basis, the court concluded that an ordinary person would not have expected the farmer's conduct to be criminal. The court noted that the MBTA does not state that poisoning migratory game birds by pesticides is a criminal violation, even though such specificity would not have been difficult for Congress to draft.

The court held that the MBTA is unconstitutionally vague as applied to the defendant Rollins under the circumstances of this case and reversed the conviction by the magistrate.

– *Neil D. Hamilton*

Federal Register *in brief*

The following is a selection of matters that have been published in the *Federal Register* in the past few weeks:

1. CCC; Proposed determinations with regard to the 1990 feed grains program provisions; comments due 9/1/89. 54 Fed. Reg. 28078.
2. CCC; Grains and similarly handled commodities; loan and purchase programs; interim rule. 54 Fed. Reg. 30714.
3. FCIC; General crop insurance regulations; high-risk land exclusion option; proposed rule. 54 Fed. Reg. 28428.
4. FmHA; Use of certification statements; final rule; effective date 8/11/89 54 Fed. Reg. 29329.
5. FmHA; Debt settlement; proposed rule; comments due 9/11/89. 54 Fed. Reg. 29569.
6. FmHA; Final implementation of farmer program loan provisions of the Disaster Assistance Act of 1988; final rule; effective date 7/25/89. Adopts interim rule published 1/19/89 [54 Fed. Reg. 2083] as final rule without change. 54 Fed. Reg. 30882.
7. INS; Admission or adjustment of status of replenishment agricultural workers; interim final rule; effective date 7/17/89. 54 Fed. Reg. 29875.
8. PSA; Certification of central filing system; Wyoming; 7/17/89. 54 Fed. Reg. 30584.

Linda Grim McCormick

Taylor Grazing Act appeals

Where a rancher holding a Taylor Grazing Act allotment grazes livestock beyond authorized use, and the facts reveal a willful trespass, the rancher's grazing authorization will be suspended until such time as assessed trespass damages are paid. *Kent Gregersen v. BLM*, 101 IBLA 269 (Mar. 8, 1988).

The Bureau of Land Management (BLM) may properly reject an application by a purchaser of base property to transfer grazing perferences where the application is filed more than ninety days after the sale. 43 C.F.R. section 4110.2-3(b) requires that such application be filed within ninety days from the date of the sale. *George Fasselin v. BLM*, 102 IBLA 9 (Apr. 5, 1988).

BLM may properly reject an application to transfer grazing preferences filed after the transferor has lost ownership or control of the pertinent base property by virtue of the filing of a petition in bankruptcy and a subsequent judicial sale of the property. *Id.*

A transfer or assignment of a grazing permit is not effective unless and until approved by BLM. If a transfer is prohibited by law, the proper action is to deny approval of the transfer. A decision cancelling a grazing permit because a transfer is not authorized will be set aside and the case remanded for a determination as to whether the assignor may retain the preference. Similarly, if a transfer is improperly approved, the proper action is to rescind the transfer, and not to cancel the permit. *Jeffery Ranches, Inc. v. BLM*, 102 IBLA 379 (June 17, 1988).

– Donald B. Pedersen

STATE ROUNDUP

OKLAHOMA. *PIK payments under Article 9.* The Grahams signed security agreements with commercial banks in two counties, giving them security interests in "growing crops and the proceeds thereof." The Grahams planted wheat in the fall and in the spring they decided to participate in the Payment-in-Kind Diversion Program. The Grahams then assigned the diversion payments to other commercial banks and farm suppliers as security for new loans and purchases. USDA paid the diversion payments on the Graham's wheat in one county to their general business account. The Grahams then wrote a check on that account to the assignees of the diversion payments. USDA paid the diversion payments on the wheat in the second county directly to the assignee of the diversion payments. The Grahams then defaulted on the loans secured by "growing crops and proceeds thereof" and took bankruptcy. The banks having the security interests in the "growing crops and proceeds thereof" sued the assignees of the diversion payments in conversion.

The Supreme Court of Oklahoma, in two cases of first impression for Oklahoma, upheld the conversion claims of the banks. *Farmers & Merchants National Bank v. Sooner Cooperative, Inc.*, 766 P.2d 325 (1988) and *Farmers & Merchants National Bank v. Fairview State Bank*, 766 P.2d 330 (1988).

Four issues were analyzed. First, does the UCC apply to assignments of diversion payments? The court ruled that UCC section 9-104(a) & (e) does not exclude government diversion payments from the UCC's coverage and that no federal law or regulation provides a method for creating security interests in diversion payments. Moreover, the court ruled that federal program payment regulations do not prohibit the creation or enforcement of security interests in government program payments.

Second, are diversion payments "proceeds" of growing crops? The court decided that diversion payments, at least when the crop was in fact planted, are a substitute for the growing crop. As such, diversion payments constitute proceeds of the collateral as an exchange or other disposition under UCC section 9-306(1).

Third, does a continuously perfected security interest exist in proceeds deposited into a general business account? The court determined that UCC sections 9-306(2) and 9-306(3)(b), relating to identifiable proceeds, rather than section 9-306(4), were controlling. Subsection (4) did not apply because the lawsuit between the competing creditors was for conversion and not an insolvency proceeding. The court then decided that the government benefits were identifiable cash proceeds. In the fact pattern where the USDA deposited the diversion payments into the general business account, the payments were identifiable cash proceeds because the payments could easily be traced into and out of the account. Moreover, the court ruled that the entities that received the diversion payments from the Grahams did not have a defense that they took the payments in the ordinary course of business because they had constructive knowledge of the secured party's properly perfected security interest.

Fourth, does a continuously perfected security interest exist in proceeds paid directly to an assignee of the proceeds? The court ruled that UCC section 9-306(3)'s ten-day reperfection period did not apply because the debtors (the Grahams) never received the proceeds. The USDA paid the diversion payments directly to the assignees. UCC section 9-302(2) states that a security interest continues in "identifiable proceeds." In the companion case, the court had already ruled that diversion payments traceable by normal common law principles are identifiable cash proceeds. USDA's direct payments to the assignees are traceable by normal common law principles and therefore constitute identifiable proceeds under UCC section 9-306(2).

Drew L. Kershen

LOUISIANA. *Version of UCC Article 9 adopted.* Louisiana has, at last, joined the rest of the nation in adopting Article 9 of the Uniform Commercial Code. The Louisiana version of Article 9 will become effective on January 1, 1990, and will apply to secured transactions entered into on and after that date. Louisiana UCC Article 9 is a modified and enhanced version of the Code provisions in effect in other states. Louisiana is the last state to adopt UCC Article 9.

– David S. Willenzik

FLORIDA. *UCC filing requirements amended.* The 1989 Florida legislature passed into law Senate Bill 452, which amended Fla. Stat. section 679.401(1)(a). The bill eliminates the requirement of filing in the county of the debtor's chief place of business for perfection of security interests in farming equipment.

– Sid Ansbacher

Forgiving debt in agriculture

by Neil E. Harl

Although structuring of debt in agriculture began in earnest in 1985, and eventually was responsible for an estimated $25 billion of the $60 billion reduction in U.S. farm debt, the various ways in which excess debt is forgiven continue to be plagued with income tax problems. The sudden emergence of debt forgiveness in agriculture seemingly unveiled a lengthy array of weaknesses in the income tax system, only a few of which have been fully resolved to date. The current wave of Farm Credit System and Farmers Home Administration restructurings under the Agricultural Credit Act of 1987 adds a note of urgency to the need for guidance in these areas.

In this essay, three of the more serious problem areas are examined.

Forgiving principal

If a seller of assets under installment reporting of gain cancels or forgives principal to help a financially troubled buyer, the last thought on the seller's mind is that the forgiven or cancelled principal amount must be reported for income tax purposes as though the seller had collected the amount. Yet, I.R.C. section 453B(f), on its face, seemingly requires that outcome.

Under that statute, enacted as part of the Installment Sales Revision Act of 1980, cancellation or forgiveness of principal is treated as a disposition of the obligation. Thus, if the seller forgives or cancels the obligation to pay amounts due, the result is the same as a disposition of the obligation. If the seller and buyer are unrelated, the gain on cancellation or forgiveness is calculated using the fair market value of the installment obligation.[1] With one significant exception, the fair market value of the obligation should parallel the fair market value of the collateral. Hence, if land values have declined, so too has the fair market value of the installment contract or contract for deed. Indeed, if land values have fallen to the level of the seller's income tax basis in the obligation, there is no gain on disposition of the obligation. The exception is where the buyer has ample non-exempt assets reachable by creditors to satisfy a deficiency judgment. In that event, the fair market value of the installment obligation may be its face value.

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In the event the seller and buyer are related, the calculation of gain on cancellation or forgiveness must use the face value of the obligation, not its fair market value.[2] Therefore, the more serious problem of gain on cancellation or forgiveness of principal is where the seller and buyer are related.[3]

The reason for the 1980 amendment cracking down on cancellation or forgiveness of principal was the practice that intensified during the 1970's of selling property to children, qualifying the transaction for installment reporting, and then canceling payment obligations, often at Christmas time. The belief had emerged that the potential gain in the cancelled payments did not have to be reported for income tax purposes. The resulting legislation required that cancelled or forgiven payments had to be reported in income by the seller.

But do the 1980 amendments apply to cancellation or forgiveness of principal to help a financially troubled buyer? The statute does not draw a distinction between financially healthy and financially troubled buyers. And the statute arguably is broad enough to encompass all types of cancellation or forgiveness of principal.

In the only formal pronouncement to date, in a private letter ruling, the Internal Revenue Service has indicated that cancellation or forgiveness of principal for a financially troubled buyer does not result in income to the seller under I.R.C. section 453B. The problem is that the ruling[4] cites to revenue rulings issued in the 1950's[5] and 1960's[6] and completely ignores the enactment of I.R.C. section 453B in 1980.[7]

Despite more recent informal statements that the Service does not intend to pursue the matter with sellers forgiving principal to help financially troubled buyers, a definitive statement by the Service is needed to lay to rest the residue of concern persisting in this area.

Abandonment in bankruptcy

Stripped to its barest essentials, bankruptcy is a concept for – (1) providing honest but poor debtors a "fresh start" in their financial life, and (2) assuring a fair distribution of property among the unsecured creditors. Secured creditors are assured, of course, of receiving the value of their collateral.

Whenever the fair market value of a debtor's asset is less than the amount owed on the asset, the unsecured creditors gain nothing and there is no good reason for the bankruptcy trustee to spend time and money administering that property. The usual procedure is for the trustee to "abandon" the property.[8] That is typically done whenever particular items of property are "burdensome to the bankruptcy estate or of inconsequential value and benefit to the estate." Freely translated, that means there is nothing for the unsecured creditors.

Meaning of abandonment

Section 554 of the Bankruptcy Code recognizes four abandonment possibilities – (1) after notice and a hearing, the trustee in bankruptcy may abandon property that meets the test; (2) on the request of a party in interest and after notice and a hearing, the court may order the trustee to abandon any property of the estate that is of no benefit to the bankruptcy estate; (3) scheduled property not administered before a bankruptcy case is closed is deemed abandoned to the debtor and is considered to have been administered; and (4) unless the court orders otherwise, property of the estate that is not abandoned and that is not administered in the case remains property of the estate. Abandonment of property is farm bankruptcies has become quite common in many districts since the mid-1980's.

The pressing question with abandonments in recent years has been the income tax consequences.

The Bankruptcy Tax Act

Unfortunately, the Bankruptcy Tax Act of 1980, although providing highly useful guidance in handling some bankruptcy tax matters, failed to deal with the tax consequences of abandonment. Here's what we know –

• The movement of the debtor's property into the bankruptcy estate (for individuals filing under Chapter 7 or 11 bankruptcy) does not trigger adverse tax consequences.[9] A recent bankruptcy court case in opposition to that statutory provision, *In re Rasmussen*,[10] involves the highly novel theory that the property transfer upon bankruptcy filing involves a "sale or exchange." Apparently *Rasmussen* was not appealed.[11]

Indeed, the statute makes it clear that a transfer of an asset from the debtor to the bankruptcy estate is not to be treated as a disposition "for purposes *of any provision of this title* . . . and the estate shall be treated as the debtor would be treated with respect to such asset."[12] Thus, not only should there be no gain or loss triggered on bankruptcy filing, there should be no recapture of depreciation or investment tax credit, no recapture of soil and water conservation or land clearing expense, and no recapture of government cost sharing payments. Moreover, because of reference to "this title," there should be no recapture of special use valuation benefits and no acceleration of payment of federal estate tax deferred under the installment payments options.

This provision assures that movement of assets into the bankruptcy estate should not trigger adverse tax consequences to the debtor.

• In a similar manner, the movement of assets (that survive bankruptcy) from the bankruptcy estate back to the debtor at the "termination of the estate" does not trigger adverse tax consequences.[13] Again, the debtor is treated as the bankruptcy estate would be treated with respect to the asset and the transfer is "not . . . treated as a disposition."

• If property of the bankruptcy estate is sold or disposed of in a taxable exchange to third parties (for example, stored grain sold at the local elevator), the usual non-bankruptcy rules govern the transaction. Gain or loss is recognized on the exchange.

• Nothing is said in the Internal Revenue Code about the tax consequences of abandonments in bankruptcy. As is nearly always the case when there is no statutory guidance in a tax matter, the courts struggle for coherence and uniformity.

Possible theories

Several years ago, two theories were identified as to the tax consequences of abandonment.[14] One theory, the *entrapment* theory, was premised on the assumption that abandoned assets had entered the bankruptcy estate without adverse tax consequences, courtesy of I.R.C. section 1398(f)(1), and that later abandonment from the bankruptcy estate triggered the usual tax consequences of a sale or exchange.[15] Any gain or loss and any recapture consequences would be the concern of the bankruptcy estate as a separate taxpayer. The debtor would take over the property with an income tax basis equal to its value so there would be no gain or loss to the debtor when the creditor exercised available remedies to acquire the property in satisfaction of the debt after abandonment.

The other theory, termed the *deflection* theory, assumed the abandoned property never entered the bankruptcy estate. Language in *Mason v. Commissioner*[16] and *In re Cruseturner*[17] supports the view that abandoned property is treated as if bankruptcy had not been filed. Rather, the property was deflected back to the debtor. Upon foreclosure or the exercise of other creditor remedies, the debtor faces recognition of gain or loss and the full range of recapture consequences. Both theories were discussed in detail in a 1988 article by Nelson.[18]

The differing outcomes from application of the two theories can be illustrated by the following example.

Example: A farmer files Chapter 7 bankruptcy owning only a bin of shelled corn valued at $60,000. The local bank has a security interest in the bin of corn for $75,000. Thus, more is owed on the corn than the corn as collateral would bring in a sale of the corn at the local elevator. The trustee abandons the bin of shelled corn back to the debtor. The question is who pays income tax on the $60,000 of gain triggered when the local bank satisfies the security interest by possessing and selling the corn. With the entrapment theory, the bankruptcy estate has $60,000 of ordinary income on abandonment. With the deflection theory, the debtor has $60,000 of ordinary income when the corn as collateral is taken over by the bank.

The debtor's tax burden under the deflection theory may be even greater in some instances because of the position taken by the I.R.S. that because of the discharge of the debtor's personal liability in bankruptcy, the debt survives abandonment as a nonrecourse obligation.[19] That result is consistent with *Commissioner v. Tufts*.[20] The outcome is that the fair market value of the property becomes irrelevant and the full difference between the debtor's basis in the property and the amount of the debt is gain (or loss) to the debtor. In the above example, the debtor would have $75,000 of ordinary income, rather than $60,000.

Attempts to resolve

In January of 1985, the author attempted to interest the IRS, the Department of the Treasury, and the Joint Committee on Taxation in seeking solutions to the problem, but to no avail. In June of 1986, the Iowa State Bar Association and the Illinois Bar Association forwarded a joint resolution to IRS asking that the problem be resolved. Reportedly, a rulings project was created and repeated assurances were given that IRS was proceeding with a ruling, with informal indications that the service would embrace the "entrapment" theory. By mid-1987, it became apparent that no ruling would be forthcoming and the matter reportedly was turned over to the Congress for solution.

The cases

Three bankruptcy court cases have addressed the question of the tax consequences of abandonment.

• In *Matter of Bentley*,[21] the bankruptcy trustee in 1986 had abandoned to the debtor the *proceeds* of a 1983 sale of corn by the bankruptcy estate. The 1983 sale was free and clear of liens with the understanding that the Commodity Credit Corporation (CCC) interest, if any, would attach to the proceeds and interest earned on the proceeds. In 1986, the trustee determined that the CCC claims were valid and exceeded the value of the crop. Accordingly, the trustee applied to abandon the proceeds. IRS argued that had the corn been abandoned prior to sale, the gain would not have accrued to the bankruptcy estate. But once the trustee sold the grain, the estate should be liable for the income tax on the proceeds. The bankruptcy court stated:

> The effect of the IRS position would have the estate pay taxes on property to which the estate is not entitled, did not retain and from which it received no benefit (because it was all abandoned) because the proceeds became property of the estate while subject to a lien which greatly exceeded its value. Such a result will not be countenanced.[22]

The case was reversed on appeal to the U.S. District Court.[23]

• The second case, *In re McGowan*,[24] involved abandonment of farm machinery and equipment valued at $58,614. The trustee reported the gain on the bankruptcy estate's income tax return. The Iowa Department of Revenue objected and was eventually joined by IRS, with both agencies taking the position that the debtor was responsible for the tax. Initially, the IRS position was that the tax was the bankruptcy estate's responsibility.

The bankruptcy court held that the abandonment of the property by the trustee was not a "sale or exchange" that would trigger tax liabilities chargeable to the bankruptcy estate. The court reached its conclusion by convincing itself that "termination of the estate"[25] could be stretched to cover abandonments. Thus, the court seemed to be taking the position that the property enters the bankruptcy estate, conceptually, and then is abandoned to the debtor, tax-free to the bankruptcy estate. The court stated: *(Continued on next page)*

This court has difficulty with the notion that the mere act of abandoning burdensome property creates tax liability for the trustee. The effect of such a rule could be to place the burden of any taxes arising from such 'dispositions' upon the unencumbered assets which might otherwise be distributed to unsecured creditors.[26]

- In the third case, *In re Olson*,[27] the bankruptcy trustee abandoned two tracts of land to the debtor. Apparently, the bankruptcy trustee did not file state or federal income tax returns. Accordingly, the debtors proceeded to prepare *and file* state and federal fiduciary income tax returns for the bankruptcy estate, duly reporting the gain.

The bankruptcy court in *Olson* relied upon the earlier case of *In re McGowan*,[28] but acknowledged that *McGowan* might have been "overbroad" in defining property abandonment as involving "termination of the estate" under I.R.C. section 1398(f)(2) but in a puzzling leap of logic concluded that "abandonment during administration should also be covered by § 1398(f)(2)." The court stated:

The definition of 'transfer' within the Bankruptcy Code is broad enough to encompass abandonments, and § 1398(f)(2) of Title 26 enables the court to determine the liability issue. The court concludes from the foregoing, that the abandonment by the trustee was a transfer other than by sale or exchange which is excepted from tax consequences under 26 U.S.C. § 1398(f)(2).[29]

The obvious outcome was income tax liability for the debtor.

As for the charge that the debtor prepared and filed the income tax returns which were the responsibility of the trustee to file,[30] the court in response to the trustee's complaint and request for damages, agreed that the filing was not malicious and indicated that a separate hearing would be set on the issue of damages and costs.

- The U.S. District Court for Minnesota in 1989 reversed the bankruptcy court in *In re Laymon*, Civ. 6-89-235 (D. Minn. 1989) and held that the bankruptcy court had erroneously approved the trustee's request for abandonment. At issue was approximately $17,000 of income tax liability on farmland. The trustee had collected two years of rental on the land totaling about $22,000 before seeking to abandon the property. The court noted that the trustee had a duty to the debtor as well as to the unsecured creditors and pointed out that the trustee has a "general duty not to burden unduly the debtor's opportunities for a fresh start." The court said that the impact of abandonment on debtors "is one aspect to consider on the issue of burdensomeness."

Other developments. In 1988, the acting U.S. Trustee for the Districts of Minnesota, Iowa, North Dakota, and South Dakota advised all panel trustees of opposition to the entrapment theory and further advised that, moreover, panel trustees *"will not be authorized to abandon property to a specific designated party."*[31] Such abandonments "to a specific designated party," namely to creditors, have been approved by other bankruptcy courts.[32]

Under date of March 14, 1989, in response to a request from the Executive Office for the United States Trustees, the IRS Office of Chief Counsel stated that ". . . it is our position that abandonment is not a taxable event under I.R.C. § 1398."

Further arguments favoring entrapment. In addition to the points made above relative to the technical correctness of the entrapment theory, two additional arguments are worthy of note.

The first is that the deflection theory is completely inconsistent with the idea of a "fresh start" for the debtor. As stated in a recent bankruptcy case:

The Bankruptcy Code provides an honest debtor with a fresh start, free from the burden of past debts. *Brown v. Felsen*, 442 U.S. 127, 128, 99 S.Ct. 2205, 2207, 60 L.Ed.2d 767 (1979). This fresh start has been described as the most extensive 'since the seven year release described in the Old Testament.' *Bailey v. Bailey (In re Bailey)*, 53 B.R. 732, 736 (Bankr. W.D. Ky. 1985); *Fox v. Cohen (In re Cohen)*, 47 B.R. 871, 873 (Bankr. S.D. Fla. 1985). . . .[33]

To leave a debtor with tens of thousands of dollars of tax liability, which is not dischargeable in that bankruptcy, is scarcely in accord with the concept of a fresh state.

The second point is the obvious inequity of the deflection theory. That inequity can best be illustrated with an example.

Example 1: Farmer X files Chapter 7 bankruptcy with only two assets, A and B, both tracts of farmland.

	A	B	TOTAL
BASIS	50,000	70,000	120,000
FAIR MARKET VALUE	100,000	100,000	200,000
SECURED DEBT	80,000	80,000	160,000

In addition, the debtor owes $100,000 of unsecured debt for a total debt of $260,000 against assets of $200,000. The debtor is clearly insolvent. The trustee in bankruptcy would not be expected to abandon either asset inasmuch as the secured debt is less than the fair market value of the assets in each instance. Rather, the trustee would be expected to sell both assets, thereby triggering $80,000 of gain ($200,000 in combined fair market value less $120,000 of combined basis). The debtor would receive a fresh start, the debtor should owe no federal income tax, and the trustee in bankruptcy would have $40,000 (less income tax liability on $80,000 of gain) for distribution to unsecured creditors.

Example 2: Assume now a neighbor, Farmer Y, files Chapter 7 bankruptcy with two assets, C and D, both tracts of farmland.

	C	D	TOTAL
BASIS	50,000	70,000	120,000
FAIR MARKET VALUE	100,000	100,000	200,000
SECURED DEBT	100,000	60,000	160,000

In addition, Farmer Y owes $100,000 of unsecured debt for a total debt of $260,000, the same as Farmer X. The basis figures are the same for the two farmers.

Yet in the case of Farmer Y, the trustee in bankruptcy would be expected to abandon tract C inasmuch as the property is worth no more than what is owed on it.

1. With the deflection theory, Farmer Y has $50,000 of gain when the secured creditor acquires tract C from the debtor. The bankruptcy estate presumably sells tract D, realizing $30,000 of gain, and distributes $40,000 to the unsecured creditors (less income tax liability on $30,000 of gain).

2. With the entrapment theory, the $50,000 of gain is trapped in the bankruptcy estate, the income tax basis on tract C becomes $100,000, Farmer Y has no gain, and the bankruptcy trustee distributes $40,000 to the unsecured creditors (less income tax liability on $80,000 of gain). *Note that only with the entrapment theory are the two examples treated the same.*

It is submitted that, as a matter of policy, bankruptcy procedures should at least strive to treat equals equally. That would not be the case with the deflection theory. The debtor ends up with a tax liability, the unsecured creditors receive a greater distribution, and the debtor is denied a fresh start.

Tax fate of Chapter 12 filers

The final problem area inhibiting the restructuring of farm debt is the tax status of filers under Chapter 12 of the Bankruptcy Code.

Chapter 12 bankruptcy estates are not eligible for separate entity status under the Bankruptcy Tax Act of 1980 for federal income tax purposes.[34] That legislation, which provides detailed guidance to handling tax matters in bankruptcy, is applicable only to individuals filing under Chapter 7 and 11. Indeed, the 1980 legislation *denies separate entity status to other bankruptcy filers.*[35] This

(Continued on next page)

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seemingly overrides earlier law recognizing separate entity status in other settings.[36] Moreover, before enactment of the Bankruptcy Tax Act, even with separate entity status, the transfer of a bankrupt's assets to the trustee in bankruptcy was not a taxable event and the basis carried over to the trustee.[37] By specifically denying separate entity status to filers other than individuals filing under Chapters 7 and 11, it is clear that Chapter 12 filers are not eligible for separate entity status either under the Bankruptcy Tax Act or under pre-1980 case law and rulings.

Under the state of the law before enactment of the Bankruptcy Tax Act of 1980, investment tax credit was recaptured on the transfer of assets to the trustee in bankruptcy unless it was a mere change in the form of doing business.[38] Investment tax credit is not recaptured, not is recapture triggered otherwise, for filings governed by the Bankruptcy Tax Act of 1980.[39]

The 1980 legislation also specifies that administrative expenses in bankruptcy are deductible for individuals filing under Chapter 7 or 11.[40] There was authority, before enactment of the Bankruptcy Tax Act, that at least some of the expenses of the bankruptcy estate were deductible under I.R.C. section 212.[41] For Chapter 12 filers, there is no clear authority even for deducting the administrative expenses.

Quite clearly, legislation is needed to make those filing for Chapter 12 bankruptcy eligible for separate entity status for federal income tax purposes. Merely amending I.R.C. section 1398(a) to include Chapter 12 filers in the list of those eligible to utilize the Bankruptcy Tax Act of 1980 is all that would be required It is noted that separate entity status already exists for Chapter 12 filers for purposes of state and local income taxes.

1 I.R.C. §§ 453(B)(f)(1), 453B(a).

2 I.R.C. § 453B(f)(2)

3 For this purpose, related party is defined as in I R C § 318(a), except for paragraph (4), and I R C § 267(b)

4 Ltr. Rul 8739045, June 30, 1987. *See* Harl, "Forgiveness of Principal of Installment Obligations," 10 J. Agr. Tax'n & L 67 (1988)

5 Rev. Rul 55-429, 1955-2 C B 252

6 Rev Rul 68-419, 1968-2 C.B. 196.

7 Installment Sales Revision Act of 1980, Pub L No. 96-471, Sec. 6(a)(1), 49 Stat. 2247 (1980)

8 11 U S C § 554

9 I.R.C § 1398(f)(1). *Contra: In the Matter of Rasmussen*, 95 Bankr. 657 (Bankr. W D Mo 1989).

10 *In re Rasmussen*, 95 Bankr. 657 (Bankr. W.D. Mo. 1989).

11 The court, in *In re Rasmussen*, supra note 9, refers twice to the "personal liability" of the bankruptcy trustee for federal income tax due from the estate. Such is not the case. *See* 31 U.S.C. § 3713(b)(bankruptcy trustee specifically excused from personal liability for federal tax). If bankruptcy trustees were to bear personal liability for federal taxes, as is the case with other fiduciaries, a more responsible attitude might be encouraged among trustees for filing tax returns and paying taxes due

12. I R C. § 1398(f)(1).

13. I.R.C. § 1398(f)(2).

14 *See* Harl, *Debtor-Creditor Relations: Annotated Materials*, Part One at 1-27, 1-28 (1986).

15. *See Yarbro v. Commissioner*, 737 F.2d 479 (5th Cir 1984).

16. 646 F.2d 1309 (9th Cir. 1980).

17 8 Bankr 581, 591 (Bankr. D. Utah 1981).

18. "Taxation of Abandonments in Bankruptcy," 10 J. Agr Tax'n & L 221 (1988).

19. Ltr. Rul. 8918016, Jan. 31, 1989

20. 461 U S 300 (1982).

21. 79 Bankr 413 (Bankr S.D. Iowa 1987).

22 79 Bankr. at 416

23. F. Supp. (S.D. Iowa 1988)

24 95 Bankr. 104 (Bankr N D. Iowa 1988).

25 *See* I R.C. § 1398(f)(2).

26. 95 Bankr 104.

27 Bankr No. 85-02333S (Bankr. N D. Iowa 1989).

28. *See* note 24 supra.

29. *In re Olson*, Bankr (Bankr. N.D. Iowa 1989).

30 *See* I R C §§ 6012(a)(9), 6012(b)(4)

31 Emphasis in the original memorandum from Wesley B Huesinga, Acting U.S. Trustee, dated January 5, 1988.

32. *See In re Butler*, 51 Bankr 261 (Bankr. D D.C. 1984).

33. *In re Dias*, 95 Bankr. 419 (Bankr. N.D. Tex. 1988).

34. *See* I R.C. § 1398(a)

35. I.R.C. § 1399.

36. E.g , Ralph Roger Bergman, T C. Memo 1985-256 (individual's hankruptcy estate was separate taxable entity); Rev. Rul 78-134, 1978-1 C.B. 197 (separate entity for individual bankruptcy); Rev Rul 72-387, 1972-2 C.B. 632 (same); Rev. Rul. 68-48, 1968-1 C.B. 301 (separate entity created for bankruptcy partnership treated as estate)

37. Rev. Rul. 78-134, 1978-1 C.B. 197.

38 *See* Henry C. Mueller, 60 T.C. 36 (1973), *aff'd and rev'd on other issues*, 496 F.2d 899 (5th Cir. 1974) (voluntary petition in bankruptcy to liquidate); Rev. Rul. 74-26, 1974-1 C.B 7 (transfer to trustee to liquidate business).

39. *See* I.R.C. § 1398(f)(1).

40. I.R.C. § 1398(h)(1).

41. Rev. Rul. 68-48. 1968-1 C.B. 301, 302 ("usual costs of administration, including the referee's compensation, statutory compensation for the trustee and for the bankrupt's attorney, the trustee's bond premium. . . .") *See* Ralph Roger Bergman, T.C. Memo. 1985-256 (deductions for real estate taxes, interest, and legal fees available to bankruptcy estate, not debtor); Herbert E. Cox, T.C. Memo. 1981-552 (bankrupts allowed to deduct portion of attorney's fee representing portion of dehts that were business debts); Maurice Artstein, T.C. Memo. 1970-220 (portion of attorney's fee for filing bankruptcy petition not deductible in voluntary petition to liquidate in bankruptcy because not sufficiently related to trade or business and not deductible as expense in connection with transaction entered into for profit).

42. 11 U.S.C. § 1231.

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American Agricultural Law Association News

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Annual meeting and educational conference of the American Agricultural Law Association.
Watch this page for details. Mark your calendar now.

Job Fair — The American Agricultural Law Association's Fifth Annual Job Fair will be held concurrently with the 1989 Annual Meeting, Nov. 3-4, 1989, at the Nikko Hotel, San Francisco, California.
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