Agricultural Law Update

VOLUME 7, NUMBER 11, WHOLE NUMBER 83

AUGUST 1990

Official publication of the American Agricultural Law Association

INSIDE

IN FUTURE ISSUES

Nontaxable agricultural subsidy payments held to be farm income for Ch. 12 purposes

In a Chapter 12 bankruptcy proceeding, the United States Bankruptcy Court for the Southern District of Texas, Houston Division, recently addressed two important points concerning farm income as it relates to the family farm qualification of section 109(f) of the Bankruptcy Code. The court held that nontaxable agricultural subsidy payments qualified as "gross income," but refused to recognize director's fees paid to the debtor from two corporations as farm income from farming operations.

In *In re Way*, No. 89-09462-H4-12 (Bankr. S.D. Tex. June 25, 1990), the Texas Commerce Bank–Beaumont (TCB) asked the court to dismiss a debtor's Ch. 12 petition on the grounds that the debtor failed to qualify as a "family farmer" under section 101(17) of the Bankruptcy Code.

In 1988, the debtor's gross income totalled $138,179.00. Of that amount, $119,173.00 was received in agricultural subsidy payments, of which $54,168.00 was reported as taxable income on line 7b of Schedule F. As to the remaining $65,005.00 in government payments, the debtor reported the payments, but excluded them from taxable income.

TCB argued that nontaxable government payments should not be considered in determining whether the debtor received more than fifty percent of his gross income from farming operations. If so excluded, the debtor would not meet the "family farmer" definition of section 109(f) of the Bankruptcy Code for Ch. 12 purposes.

The bankruptcy court noted that while the term "gross income" is not defined in the Bankruptcy Code, the Seventh Circuit, in *In Matter of Wagner*, 808 F.2d 542 (7th Cir. 1986), held gross income under section 101(17)(A) to be equated with the gross income definition of section 61 of the Internal Revenue Code: "all income from whatever source derived, except for those items specifically excluded by the Code."

(Continued on next page)

Eighth Circuit finds no implied cause of action in Ag Credit Act of 1987

The Eighth Circuit has held that there is no implied private cause of action to enforce the borrowers' rights provisions of the Agricultural Credit Act of 1987. *Zajac v. Federal Land Bank of St. Paul*, No. 88-5353ND (8th Cir. July 31, 1990)(en banc). The decision follows the vacation of an earlier panel decision finding an implied cause of action. *Zajac v. Federal Land Bank of St. Paul*, No. 88-5353ND (8th Cir. Dec. 7, 1989)(1989 U.S. App. LEXIS 18809), *vacating*, 887 F.2d 844 (8th Cir. 1989).

The matter was before the court on an appeal by the Zajacs from the district court's refusal to enjoin state court foreclosure proceedings pending against them. The Zajacs premised their claim for injunctive relief on the failure of the bank to grant them a right to an independent appraisal of the collateral securing their loan at the credit committee review stage of the loan restructuring process as required by the Agricultural Credit Act of 1987. *See* 12 U.S.C.A. § 2202(d)(1)(West 1989).

In a 6-4 decision, the majority of the court expressly joined in the holdings of *Harper v. Federal Land Bank of Spokane*, 878 F.2d 1172, 1173 (9th Cir. 1989), *cert. denied*, 110 S. Ct. 867 (1990), and *Griffin v. Federal Land Bank of Wichita*, 902 F.2d 22, 24 (10th Cir. 1990). *Zajac, supra*, slip op. at 1. In addition, the majority relied heavily on the analysis employed by the *Harper* court. *Id.*, slip op. at 2-4.

In a lengthy and forceful dissent, Judge Heany, joined by Chief Judge Lay, argued that "*Harper* was wrongly decided." *Id.*, slip op. at 6. He construed the Act to permit the enjoining of state court foreclosure proceedings when specific rights, such as the right to an independent appraisal, were denied to borrowers. *Id.*, slip op. at 32-33.

Judge Arnold, joined by Judge McMillian, agreed with the dissent's analysis of the

(Continued on next page)

As to what constitutes gross income from farming operations, the court held that such income includes any amounts the farmer receives from cultivating the soil or raising or harvesting any agricultural commodities. Since a farmer who contracts with the ASCS not to place farmland in production foregoes the possibility of generating farm income from crops, agricultural program payments are also farm income. *See, In re Welch*, 74 Bankr. 401, 403 (Bankr. S.D. Ohio 1987); *In re Shepherd*, 75 Bankr. 501, 504 (Bankr. N.D. Ohio 1987).

Agricultural program payments can be excluded from income if the payments are for capital expenditures, if they do not substantially increase the farmer's annual income from the property, and if the Secretary of Agriculture certifies that the expenditures are made primarily for the conservation of soil and water resources, for environmental restoration, or for improvements to forests and wildlife habitat. I.R.S., U.S. Dept. of the Treas., Pub. No. 225, Farmer's Tax Guide, at 12 (1989).

Agricultural Law Update

VOL. 7, NO. 11, WHOLE NO. 83 AUGUST 1990

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Agricultural Law Update is published by the American Agricultural Law Association. Publication office: Maynard Printing, Inc., 219 New York Ave., Des Moines, IA 50313.

By permititng such exclusions from income, farmers are provided an incentive to actively participate in environmental protection programs.

Even though a farmer elects to declare some of his agricultural payments as nontaxable gross income, the payments are nevertheless income derived from farming. The court noted that most cases citing the *Wagner* decision focused on gross income without any business or itemized deductions used to arrive at adjusted grosss or taxable income results. *See, In re Fogle*, 87 Bankr. 493, 497 (Bankr. N.D. Ohio 1988); *Matter of Faber*, 78 Bankr. 934, 936 (Bankr. S.D. Ohio 1987); *In re Pratt*, 78 Bankr. at 280.

The court concluded that common sense dictates that subsidy payments are farm income and should be considered as gross income in determining whether a debtor meets the family farm income threshold requirement.

The court next addressed the issue of whether director's fees paid to the debtor constituted income from farming operations. The debtor owned a fifty percent interest in two corporations. The farmer asserted that he actively participated in the farming operations of the corporations and that thus the director's fees should be included in the calculation of farm income under section 101(20) of the Bankruptcy Code.

The court viewed the question as being whether the debtor, as an individual, owned or operated a farming operation sufficient to qualify under 11 U.S.C. section 101(17)(A). The court noted that the Seventh Circuit, in the case of *In re Armstrong*, 812 F.2d 1024 (7th Cir. 1970), had previously determined the existence of a farming operation based on whether the debtor was engaged in a risk-laden venture. While previous court decisions indicated a liberal construction of the term "farming activity," the cases also pointed out that wages, fees, or payments resulting from farm activity must somehow relate to the debtor's farming operation, and not the farming operation of others. *See, Matter of Burke*, 81 Bankr. 971, 977 (Bankr. S.D. Iowa 1987).

The court further noted that the debtor's ownership in the two corporations in question was limited to fifty percent of the corporations and, as such, the corporations would not qualify separately as a "family farmer" under 11 U.S.C. section 101(17)(B). The court found that the director's fees could not be considered as farm income because the principal risk of loss with regard to the farming activity rested with the separate corporate entities.

—John D. Copeland,
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**This material is based upon work supported by the USDA, Agricultural Research Service, under Agreement No. 59-32-U4-8-13. Any opinions, findings, conclusions, or recommendations expressed in this publication are those of the author and do not necessarily reflect the view of the USDA.*

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implied cause of action issue but concurred in the result. The concurring judges would have affirmed on the "ground that the Anti-Injunction Act, 28 U.S.C. § 2283, deprived the District Court of jurisdiction to entertain this suit for an injunction against a proceeding in a state court." *Id.*, slip op. at 4.

In concluding that the application of the Anti-Injunction Act could not be avoided on the ground that the rights created by the 1987 Act could be given their intended effect only in federal court, Judge Arnold reasoned that the Zajacs were "free to set up, by way of defense to the state-court foreclosure proceeding, their rights to an independent appraisal under the Agricultural Credit Act of 1987." *Id.*, slip op. at 4-5. He noted that "the state courts are open to consider, and in fact are obligated to consider, assertions of federal statutory right, whether they arise as part of someone's claim or as part of a defense." *Id.*, slip op. at 5.

Although mentioned only by the dissent, North Dakota, the jurisdiction in which the Zajacs' foreclosure was pending at the time of the district court's action, recognizes an "administrative forbearance defense" to foreclosures by the Federal Land Bank of St. Paul. *Id.*, slip op. at 22 n. 5 (citing *Federal Land Bank of St. Paul v. Overboe*, 404 N.W.2d 445 (N.D. 1987). Premised on the state court's equitable authority, not on the implication of an implied cause of action, that defense permits the court to examine whether the bank has established a general policy of forbearance and whether that policy was followed. *See Federal Land Bank of St. Paul v. Asbridge*, 414 N.W.2d 596, 597 (N.D. 1987); *Federal Land Bank of St. Paul v. Bosch*, 432 N.W.2d 855, 858 (N.D. 1988); *Federal Land Bank of St. Paul v. Huether*, 454 N.W. 2d 710, 715 (N.D. 1990).

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**This material is based upon work supported by the USDA, Agricultural Research Service, under Agreement No. 59-32-U4-8-13. Any opinions, findings, conclusions, or recommendations expressed in this publication are those of the author and do not necessarily reflect the view of the USDA.*

Law review articles on agricultural law

The following is a listing of recent law review articles relating to agricultural law.

Cooperatives, general

Copeland, *The Status of an Agricultural Cooperative When a Farmer Member Experiences Financial Distress*, 23 U.C.D. L. Rev. 551-588 (1990).

Environmental issues

Brussaard & Grossman, *Legislation to Abate Pollution From Manure: The Dutch Approach*, 15 N.C. J. Int'l L. & Com. Reg. 85-114 (1990).

Gould, *Agriculture, Nonpoint Source Pollution, and Federal Law*, 23 U.C.D. L. Rev. 461-498 (1990).

Note, *Conflict Between Wetland Protection and Agriculture: Exploration of the Farming Exemption to the Clean Water Act's Section 404 Permit Requirement [United States v. Larkins, 852 F.2d 189 (6th Cir. 1988) cert. denied, 109 S.Ct. 1131 (1989)]*, 35 S.D.L. Rev. 272-297 (1990).

Equine Law

Craigo, *Sales and Use Tax Planning for the Horse Industry*, 78 Ky. L.J. 601-614 (1989).

Klein & Garrison, *Practice and Procedure Before Racing Commissions*, 78 Ky. L.J. 477-516 (1989).

Lester & Fleenor, *The Priority Race: Winner Takes the Horse*, 78 Ky. L.J. 615-658 (1989).

Meeker, *Thoroughbred Racing: Getting Back on Track*, 78 Ky. L.J. 435-446 (1989).

Miller, *The Sale of Horses and Horse Interests: A Transactional Approach*, 78 Ky. L.J. 517-600 (1989).

Robertson, *Thoroughbred Certificate Law: A Proposal*, 78 Ky. L.J. 659-703 (1989).

Vance, *Protecting Security Interests in Equine Collateral*, 78 Ky. L.J. 447-476 (1989).

Farm labor

Aliens

Santos, *Agriculture Labor Reform: Implications of the New Immigration Law and the 1989 Legislative Farm Worker Package*, 26 Willamette L. Rev. 375-400 (1990).

Collective bargaining

Note, *An Unsuccessful Attempt To Level Economic Fields in Labor Relations. (Comite Organizador de Trabajadores Agricolas v. Molinelli, 114 N.J. 87, 552 A.2d 1003 [1989])*, 42 Rutgers L. Rev. 667-684 (1990).

General & social welfare

Linder, *Paternalistic State Intervention: The Contradictions of the Legal Empowerment of Vulnerable Workers*, 23 U.C.D. L. Rev. 733-768 (1990).

Martin, *The Outlook for Agricultural Labor in the 1990s*, 23 U.C.D. L. Rev. 499-524 (1990).

Farm policy and legislative analysis

Rausser & Nielson, *Looking Ahead: Agricultural Policy in the 1990s*, 23 U.C.D. L. Rev. 415-430 (1990).

Farmers Home Administration

Lancaster, *Current Issues in FmHA Loan Servicing*, 23 U.C.D. L. Rev. 713-732 (1990).

Finance and credit

Massey & Schneider, *Title I of the Agricultural Credit Act of 1987: "A Law in Search of Enforcement"*, 23 U.C.D. L. Rev. 589-624 (1990).

Forestry

Comment, *The Timber Harvest Plan Exemption From the California Environmental Quality Act: Due Process and Statutory Intent*, 41 Hastings L.J. 727-756 (1990).

Comment, *Watershed and Water Quality Protection in National Forest Management*, 41 Hastings L.J. 1111-1133 (1990).

Fruits & vegetables

Looney, *Protection for Sellers of Perishable Agricultural Commodities: Reparation Proceedings and the Statutory Trust Under the Perishable Agricultural Commodities Act*, 23 U.C.D. L. Rev. 675-696 (1990).

Rynn, *Injunctive Relief Under the 1984 Trust Amendments to the Perishable Agricultural Commodities Act: A Necessary Means of Trust Enforcement*, 23 U.C.D. L. Rev. 625-636 (1990).

International trade

Heron & Walther, *Pacific Rim as a Future Market for U.S. Agricultural Trade*, 23 U.C.D. L. Rev. 525-550 (1990).

Smith, *United States-Mexico Agricultural Trade*, 23 U.C.D. L. Rev. 431-460 (1990).

Land sales/finance, mortgages/foreclosures

Case note, *Mortgages -- North Dakota's Anti-deficiency Statute Defined [Federal Land Bank v. Bergquist, 425 N.W.2d 360, N.D. 1988]*, 65 N.D.L. Rev. 127-137 (1989).

Note, *Constitutional Law: Oklahoma Mortgage Foreclosure Moratoriums ... Past, Present, and Future?*, 42 Okla. L. Rev. 647-662 (1989).

Land use regulation

Land use planning and preservation techniques

Comment, *Forever a Farm: The Agricultural Conservation Easement in Pennsylvania*, 94 Dick. L. Rev. 527-552 (1990).

Comment, *Preservation of Kentucky's Diminishing Farmland: A Statutory Analysis*, 5 J. Min. L. & Pol'y 305-324 (1989).

Soil erosion

Hamilton, *Legal Issues in Enforcing Federal Soil Conservation Programs: An Introduction and Preliminary Review*, 23 U.C.D. L. Rev. 637-674 (1990).

Leases, landlord-tenant

McEowen & Harl, *A Look at the Conservation Reserve Program (CRP) and How It Affects Owners and Tenants of Marginal Land*, 12 J. Agric. Tax'n & L. 121-159 (1990).

Marketing boards and orders

Garoyan, *Marketing Orders*, 23 U.C.D. L. Rev. 697-712 (1990).

Livestock and Packers & Stockyards

Meyer, *Animal Branding & Fence Law*, 12 J. Agric. Tax'n & L. 179-187 (1990).

Pesticides

Carnes, *The Proposed Environmental Protection Agency Pesticide Regulations*, 12 J. Agric. Tax'n & L. 170-178 (1990).

Noble, *Pesticide Use and Federal Protection of Wildlife*, 12 J. Agric. Tax'n & L. 160-169 (1990).

Public lands

Coggins & Nagel, *"Nothing Beside Remains": The Legal Legacy of James G. Watt's Tenure as Secretary of the Interior on Federal Land Law and Policy*, 17 B.C. Envtl. Aff. L. Rev. 473-550 (1990).

Taxation

Daughtrey, Varnon, Burckel, *Recent Tax Legislation Results in a New Crop of Tax Changes for Farmers*, 12 J. Agric. Tax'n & L. 99-120 (1990).

Uniform Commercial Code

Article Two

Meyer, *Animal Branding & Fence Law*, 12 J. Agric. Tax'n & L. 179-187 (1990).

Article Nine

Dieball, *Addressing Priority Disputes Between a Statutory Landlord's Lien and an Article Nine Security Interest in Texas*, 31 S. Tex. L. Rev. 191-222 (1990).

Anyone desiring a copy of any article should contact the nearest law school library.

—Drew L. Kershen,
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AG LAW
CONFERENCE CALENDAR

Sixth Annual Farm, Ranch & Agri-Business Bankruptcy Institute
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Rent paid to a spouse

by Philip E. Harris

Before the Omnibus Budget Reconciliation Act (OBRA) of 1987[1], many farmers reduced their social security taxes by paying their spouses a wage for work done on the farm. The wages were deductible on the farmer's Schedule F and therefore reduced the farmer's self-employment income and self-employment taxes.[2] Since the wages paid to a spouse were not subject to the FICA tax, the total social security taxes paid by the farmer and his or her spouse were reduced.

Non-cash wages

The OBRA of 1987 included a provision that made wages paid to a spouse subject to the FICA tax. That change caused many farmers to look for alternative means of reducing social security taxes.[3] One means that is available is paying non-cash wages. Under I.R.C. section 3121(a)(8)(A), non-cash wages paid for agricultural labor are not subject to the FICA tax. As more farmers began using non-cash wages as a means to avoid paying social security taxes, some IRS auditors challenged the practice. Generally, farmers have prevailed with their position that the non-cash wages are not subject to the FICA tax as long as the employee has dominion and control of the commodity used to pay the wages *before* the commodity is sold. While non-cash wages successfully reduce social security taxes, not all farmers can easily use that method because it requires the farmer's spouse to work for the farm business and a transfer of ownership in a non-cash asset.

Rent paid to a spouse

Another means of reducing social security taxes is paying rent to the non-farming spouse for his or her share of the farm property. The rent paid is deducted on the farmer's Schedule F and therefore reduces self-employment taxes. If the farmer's spouse does not materially participate in the farm business, the rent income is reported on Schedule E and is not subject to self-employment taxes.[4] This means of reducing social security taxes has also come under attack by the IRS in the course of auditing farm income tax returns. The IRS has made two arguments regarding the deduction of rent paid to a spouse are: (1) that it is not an arm's length transaction and is therefore not deductible under I.R.C. section 482; and (2) that the farmer has "equity" in the property and therefore cannot deduct the rent under I.R.C. section 162(a)(3). Rebuttals to those arguments are discussed below.

Arm's length transaction

Apparently, the IRS is arguing that paying rent to a spouse is not an arm's length transaction and therefore the rent cannot be deducted. That argument confuses the existence of control with the use of the control to distort income. The last sentence of Treas. Reg. section 1.482-1(b)(1) states: "The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." Therefore, in the case of rent paid to a spouse, the question is whether the same rent would have been paid to an unrelated taxpayer. In other words, if the rent that is claimed as a deduction is a fair rental rate for the spouse's interest in the property, it can be deducted by the farm operator.

In several cases, courts have held that rent paid to a married couple who owned property as joint tenants is divided between the spouses for purposes of federal income taxes.[5] Similarly, courts have held that interest earned on a note held jointly by husband and wife is to be divided between them.[6]

In a few cases, the court has ignored state law and taxed income to the party who had "control" of the income rather than the party who had legal title to the income.[7] However, in those cases, the taxpayer in "control" had made a gift to the other taxpayer. Many farmers will be able to distinguish those cases by the fact that the joint tenancy was not created by gift. It can also be argued that those cases are in error in reassigning income away from the legal owner of an asset that plays a material role in generating income.[8]

Attacking payments to a joint tenant is similar to attacking payments to a tenant in common, to a partner where the farm is operated by a partnership, to a shareholder where the farm is operated by a corporation, and to many other related party cases. The IRS has lost on that argument in previous cases. In *Interior Securities Corp.*[9] the court rejected the Commissioner's arguments that a partnership was a sham and that rental income should be reallocated under I.R.C. section 482. The court stated: "But common control alone is not sufficient to justify the application of this section, *Grenada Industries, Inc.*, 17 T.C. 231, aff'd. 202 F.2d 873 (C.A. 1953). It is only where there is a shifting of income from one controlled unit to another that any allocation is justified under section 482." Similarly, in two different cases involving the same taxpayer,[10] the court rejected the Commissioner's argument that rental income should be reallocated from a corporation to its shareholders because the amount of rent paid was consistent with an arm's length transaction.

Equity argument

I.R.C. section 162(a)(3) says rent can be claimed as a deduction when paid on "property... in which [the taxpayer] has no equity." Apparently the IRS argument is that a farmer cannot deduct rent paid to his or her spouse who owns the other share in tenancy-in-common property since the farmer has "equity" in that property. That argument appears to misinterpret the use of the term "equity" in I.R.C. section 162(a)(3).

The best discussion of the I.R.C. section 162(a)(3) requirement that the taxpayer have no equity in the property that is rented is in *Mathews v. Commissioner*.[11] In that case, the issue was whether the taxpayer could deduct rent paid to trusts that the taxpayer had created for his children. The taxpayer had given the real estate used in his funeral business to the trusts for a period of ten years and one day, at which time the real estate reverted to the taxpayer. The court does an excellent job of analyzing the purpose of the "no equity" requirement in I.R.C. section 162(a)(3). That analysis points out that the purpose is to fill in the gaps of the I.R.C. section 162(a)(3) requirement that the taxpayer does not have and is not acquiring title to the property. In other words, the purpose of I.R.C. section 162(a)(3) is to sort out payments that are made to purchase property (which are not deductible but are added to basis) from payments that are made to rent property (and therefore are deductible). Consequently, the court concludes that the "equity" that is fatal to a rent deduction is equity that is acquired from the lessor. Since a farmer who is renting property from his or her spouse does not acquire equity from his or her spouse, the farmer does not have the fatal equity according to the *Mathews* analysis.

To make the point that Congress could not have intended that *all* equitable interests would cause a rent deduction to be denied, the *Mathews* court raises the case of rent paid by an owner of an undivided interest. "Likewise, respondent's interpretation would seem to bar the owner of an undivided interest in an asset from leasing the remaining interests from his coowners, and this for no good reason which has been pointed out to us. In order to avoid

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ascribing to the Congress so capricious a limitation on the rental deduction, we hold that the property in which the taxpayer should have no equity does not include a reversionary interest, not derived from the lease or from the lessor, which is scheduled to become possessory after the expiration of a lessor's term of years." It appears that the *Mathews* court would allow a farmer to deduct rental payments made to his or her spouse.

Unfortunately, the tax court was reversed in the *Mathews* case.[12] The Fifth Circuit opinion in *Mathews v. Commissioner* is troublesome in arguing against the IRS position because it seems to say that legal rights can be ignored when determining tax consequences. The court stated: "If we stood at the top of the world and looked down at this transaction—ignoring the flyspeck of legal title under state law— we would see the same state of affairs the day after the trust was created that we saw the day before." The damage of the Fifth Circuit's opinion in *Mathews* to the argument against the IRS position can be limited by pointing out the distinguishing facts. In *Mathews*, the rent was paid to a trust that, in the court's view, was controlled by the taxpayer. In the case of land that is co-owned by the farmer's spouse, the spouse has a legal right to collect rent— a right than can be enforced against the wishes of the farmer.

The tax court opinion in *Mathews* was cited with approval in *Quinlivan v. Commissioner*.[13] The *Quinlivan* opinion discusses the split among the courts of appeals on the deductibility of rent paid to a trust set up by the taxpayer and concludes that the majority view is that the rent is deductible if four requirements are met. First, the taxpayer must not retain the same control over the property that he had before he gave the property to the trust. Second, the leaseback should be in writing and must require payment of reasonable rent. Third, the leaseback must have a bona fide business purpose. Fourth, the taxpayer must not possess a disqualifying "equity" in the property within the meaning of the statute.[14]

The requirements listed in *Quinlivan* suggest the following guidelines for renting property from a spouse. It would be preferable to have the lease in writing, but at minimum, the farmer and spouse should agree upon a rental rate before the lease term. The rental rate should be a fair rental rate.

Another authority against the IRS position is Rev. Rul. 74-209.[15] In that ruling, the IRS concludes that rent paid by a husband to his wife for the use of their jointly owned Wisconsin real estate that the husband used in his business is deductible as a business expense on the husband's separate income tax return. On its face, that ruling seems to reject the equity argument of the IRS. However, in two letter rulings, Lt. Rul. 8535001, May 3, 1985 (husband paid wife for bookkeeping services) and Lt. Rul. 8104004, September 23, 1980 (husband paid wife rent for her separate property), the IRS distinguishes Rev. Rul. 74-209, *supra*, by the fact that the taxpayers in the letter rulings filed a joint return rather than a separate return. The letter rulings conclude that filing a joint return makes the two taxpayers one taxable unit and therefore the payment from husband to wife had no substance because the taxable unit merely reallocated income within itself.

While the letter rulings cannot be cited as authority,[16] they do indicate the IRS position on the issues addressed and therefore, may predict the IRS position in an audit. If the IRS asserts the position taken in the letter rulings, that position can be attacked by examining the authorities that are cited to support the position.

In Lt. Rul. 8535001, the IRS cites *Helvering v. Janney*,[17] to support its holding that when a married couple files a joint return, one spouse is not allowed to deduct payments made to the other spouse because they have become one taxable unit. *Helvering v. Janney* addressed the question of whether capital losses of one spouse could be deducted against capital gains of the other spouse. In holding that they could, the court pointed out that on a joint return, tax is computed on the aggregate income of the two taxpayers, which is calculated by deducting one spouse's excess deductions from the other spouse's net income. The issue of allowing a deduction for payments made by one spouse to the other was not before the court and was not addressed by the court. Therefore, the case is not on point and does not support the IRS position.[18]

In *Coerver v. Commissioner*,[19] the Tax Court discussed *Helvering v. Janney* and *Taft v. Helvering* and rejected the taxpayer's argument that those cases hold that a married couple filing jointly becomes one taxpayer for all purposes. The issue in *Coerver* was whether or not the wife's cost of commuting to her job in another city could be deducted as an employee expense. The court held that her tax home was in the city where she worked and therefore, her trips to the city were not "away from home." To reach that holding, the court rejected the taxpayer's argument that filing a joint return made them a "taxable unit" and, therefore, that their tax home was in the city where the husband lived and worked. "The concept of a 'taxable unit' under the joint return provision, section 6013, merely means that while there are two taxpayers on a joint return, there is only one taxable income. It does not create a new tax personality which would be entitled, in its own right, to deductions not otherwise available to the individual spouses under the pertinent sections of the code."[20] Similarly in the case of rent paid to a spouse, a married couple does not become a new tax personality that is not allowed to deduct rent paid by one spouse to the other simply because they choose to file a joint return.

In Lt. Rul. 8535001, the IRS also cites three cases in which the taxpayers created trusts for the benefit of their minor children, conveyed an office building to the trust, and then rented the office building from the trust for a medical practice.[21] In each of those cases, the court examined the nature of the transaction and concluded that it had no economic substance since the taxpayer had economic control of the building before and after the transfer, the amount of rent that was paid was not set at a fair rental rate, and there was no written lease obligating the rent to be paid. Rent paid to a spouse can be distinguished from those facts because a spouse who is a joint tenant has the legal right to collect his or her share of rent from the property. Therefore, if the standard of these three cases is applied, the rental deduction will be allowed.

The IRS did not follow the conclusion of Lt. Rul. 8535001 and Lt. Rul. 8104004 in Lt. Rul. 8742007, June 26, 1987. In the later ruling, husband and wife filed a joint return. Husband was allowed to deduct wages paid to his wife on his Schedule F. The "taxable unit" is not discussed in the ruling so it is impossible to know if the IRS has abandoned that argument or merely forgot it at the time of writing the later ruling.

Conclusion

Changes made by the OBRA of 1987 caused farmers to look for alternatives to cash wages paid to their spouses as a means of reducing their social security tax bill. Non-cash wages have been used successfully by many farmers but that method is not available to a farmer whose spouse does not work for the farm business or if the farmer has no non-cash assets that can be conveniently paid to the

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farmer's spouse.

In many farm families, the farmer's spouse owns an interest in some or all of the land used in the farm business. Regardless of whether that ownership is in the spouse's name alone or as a co-owner with the farmer in the form of a tenancy-in-common, joint tenancy, tenency-by-the-entirety, or community property, the farmer's spouse has a right to collect rent on his or her share of the property. Therefore, payment of fair market rent by the farmer to the spouse under a bona fide rental agreement should be allowed as a deduction on the farmer's Schedule F, which will reduce self-employment taxes if the farmer's FICA wages and self-employment income are under the social security base income. If the farmer's spouse does not materially participate in the farm business, the rental income should be reported on Schedule E where it is not subject to the self-employment tax.

[1] Pub. L. No. 89-670, 101 Stat. 1330 (1987).

[2] The farmer's self-employment tax was reduced only if the sum of his or her FICA wages and self-employment income was below the social security wage base for the year. (That base is $51,300 for 1990). If the sum of those incomes was above the base and the deduction of wages paid to a spouse did not reduce the sum below the base, the farmer would be subject to the maximum social security tax even with the spousal wage deduction.

[3] It should be noted that the disadvantage of minimizing social security taxes is a potential reduction in social security benefits. Benefits are based on the beneficiary's earnings that were subject to social security taxes. In some cases, a spouse's benefits as the spouse of a covered taxpayer may be greater than he or she would receive because of his or her own earnings. If that is the case, paying social security taxes may not increase the benefits. Some taxpayers may be able to purchase disability and retirement policies in the private market for less money than the social security taxes that have to be paid.

[4] Arguing that rent paid for the spouse's interest in the property can be deducted is not inconsistent with the position that no rent has to be reported by the farmer for his or her share of the property. Imputed rent paid to oneself has never been treated as income in the U.S. income tax system. In *Helvering v. Independent Life Ins. Co.*, 292 U.S. 371 (1934), the court observed, in dictum, that imputed rental income from the use of real property was not within the sixteenth amendment meaning of income.

[5] See *Tracy v. Commissioner*, 25 B.T.A. 1055 (1932).

[6] See *Haynes v. Commissioner*, 7 B.T.A. 465 (1927).

[7] See for example *Lanna v. Kelm*, 221 F.2d 725 (8th Cir. 1955) and *White v. Fitzpatrick*, 193 F.2d 398 (2d Cir. 1951).

[8] See the dissenting opinion in *White v. Fitzpatrick, supra.*

[9] 38 T.C. 387 (1962).

[10] *Carroll v. Commissioner*, 37 TCM 736 (1978) and *Carroll v. Commissioner*, 52 TCM 1523 (1987).

[11] 61 T.C. 12 (1973).

[12] *Mathews v. Commissioner*, 520 F.2d 323 (5th Cir. 1975).

[13] 599 F.2d 269 (8th Cir. 1979).

[14] If the farmer has not paid rent to the farmer's spouse for many years, and then begins to pay rent, the IRS could potentially argue that there is no economic reality to the rental payments. The taxpayer can refute that argument by pointing out that a spouse's failure to collect rent in past years does not prevent the spouse from collecting rent for the current and future years.

[15] 1974-1 C.B. 46.

[16] I.R.C. § 6110(j)(3).

[17] 311 U.S. 189 (1940).

[18] See also *Taft v. Helvering*, 311 U.S. 195 (1940) where the issue was whether the charitable contribution deduction limitation was to be calculated for each spouse separately or for the two jointly on a joint return. As in *Helvering v. Janney*, the court in *Taft v. Helvering* explained that the two spouses become a taxable unit for purposes of calculating income taxes but does not deny a deduction that would have been allowed on separate returns.

[19] 36 T.C. 252 (1961).

[20] *Id.* at 254.

[21] *Furman v. Commissioner*, 45 T.C. 360 (1966), aff'd, 381 F.2d 22 (5th Cir. 1967); *Van Zandt v. Commissioner*, 341 F.2d 440 (5th Cir. 1965), affirming 40 T.C. 824 (1964), cert. denied, 382 U.S. 814; and *Penn v. Commissioner*, 51 T.C. 144 (1968).

Recreational use statutes interpreted

Two recent decisions of Pennsylvania appellate courts provide guidance on the extent of protection afforded by Pennsylvania's Recreation Use of Land and Water Act, Pa. Stat. Ann. tit. 68, §§ 477-1 to 477-8. These cases are important examples of ongoing interpretation of the rules of landowner liability and statutory programs enacted in response to them.

In *Friedman v. Grand Central Sanitation, Inc.*, 571 A.2d 373 (1990), the Pennsylvania Supreme Court faced the question of whether to extend protection of the Act to a landowner who did not invite the public to use its land or otherwise make it available for recreational purposes. Friedman, a hunter, inadvertently wandered onto land owned by Grand Central that was used as a sanitary landfill. While on the land, Friedman alleged that he was overcome with fumes from the waste material, fell into a large open trench, and suffered personal injuries. Among several defenses raised by Grand Central were the following: that Grand Central posted its property to warn trespassers; it deployed personnel to patrol its property; it prosecuted trespassers; and that it was entitled to immunity under the Recreation Use statute. The trial court granted defendant's motion for summary judgment, and the superior court affirmed without an opinion. Friedman appealed to the Pennsylvania Supreme Court.

On appeal, Friedman argued that since the purpose of the Recreation Use statute is to encourage owners to make their land available to the public for recreation, the Act should not be extended to any owner, such as Grand Central, that did not extend an invitation and moreover took specific steps to prevent people from entering its property.

The court noted that under the Recreation Use statute, an owner's liability is limited if either the owner encourages others to use the owner's land (section 477-1) *or* under the rule providing an owner has neither a duty of care to keep the premises safe for entry or to warn of a dangerous use, condition, or structure (section 477-3). In the court's view, the second grant of immunity replaced an earlier statute providing for broad immunity to landowners. When the Recreation Use statute was adopted and the broad grant of immunity was lost, the legislature apparently felt the need to replace it with another broad immunity provision, such as that found in section 477-3, even though it did not directly further the statutory purpose as expressed in section 477-1. The language in section 477-3 is clear. If it were interpreted to require it applied only to landowners who invite the public to recreate on their land, it would be mere surplusage to the remainder of the statute.

The court further noted that requiring the landowner to invite the public to use his or her property under the guise of fulfilling the purpose of making land available to the public for recreation is to "... enter a thicket entangled with speculation as to the motives of the landowner in permitting use of the land." Such a requirement could also be interpreted to preclude application of the Recreation Use statute to any land that was open to recreational use before the Act was passed in 1966. If landowners made their land available to the public before the statute was passed, how could the statute encourage them to do something they were already doing?

Federal Register *in brief*

The following is a selection of matters that have been published in the *Federal Register* from July 1 to July 31, 1990.

1. EPA; Underground storage tanks containing petroleum; financial responsibility requirements; proposed rule. 55 Fed. Reg. 27837.

2. EPA; FIFRA; availability of enforcement response policy. 55 Fed. Reg. 30032.

3. FmHA; Processing and servicing FmHA assistance to employees, relatives, and associates; proposed rule; comments due 9/7/90. 55 Fed. Reg. 28057.

4. FmHA; Servicing and liquidation of chattel security; effective date 7/11/90. 55 Fed. Reg. 28370.

5. FmHA; Single family housing, farmer program, and community program borrowers; credit needs and graduation eligibility; proposed rule; comments due 9/17/90. 55 Fed. Reg. 29032.

6. FCA; Reorganization authorities; proposed rule. 55 Fed. Reg. 28639.

7. FCA; Ag. Credit Act; implementation; correction. 55 Fed. Reg. 28885.

8. PSA; Amendment and certification of central filing system— Oklahoma. 55 Fed. Reg. 28791.

9. USDA; Rules of practice governing formal adjudicatory administrative proceedings instituted by the Secretary; final rule; effective date 7/27/90. 55 Fed. Reg. 30673.

—Linda Grim McCormick

State Roundup

ARIZONA. *Bad feed: contract claim or tort?* The Arizona Supreme Court in *Drew v. United Producers and Consumers Cooperative*, 778 P.2d 1227 (1989), clarified the circumstances under which an Arizona contract action (breach of warranty) may be a tort (product liability action). Drew Livestock, a feeder pig operation, sued United Producers and Consumers Cooperative, alleging its feed failed to conform to express and implied warranties. As a result, piglets were born underweight, ill, and/or dead because of the feed's lack of agreed upon nutrients and medication. United filed a motion to dismiss, asserting that the Uniform Commercial Code statute of limitations was not applicable where the result of the breach of warranties was property damage and the applicable statute of limitations for a product liability action had run.

The trial court and the Arizona Court of Appeals agreed that the action should have been one for product liability and thus was time barred. The Arizona Supreme Court, however, reversed and remanded, finding that: (1) a complaint is not required to state a claim only for economic or commercial losses before the complaint falls outside the product liability statute's scope; (2) Drew Livestock's claim for "damages in an amount to be proved at the time of trial" was sufficient to state a claim for economic damage for breach of contract; and (3) to the extent the complaint sought compensation for economic damage to Drew Livestock's business, the product liability statute cannot control.

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The court held, therefore, that Pennsylvania's Recreation Use statute immunizes a landowner whose land is used for recreational purposes by the public without charge, whether or not he or she has invited or permitted the public to enter.

In the second case, *Zackhery v. Crystal Cave Co., Inc.*, 571 A.2d 464 (1990), Crystal Cave operated an underground cave as a tourist attraction. In addition to the underground cave, the facility had 125 acres of land, several buildings, and a playground with permanently installed sliding boards. In 1986, Robert Zackhery, a minor, broke his leg after falling from the sliding board at the playground. As part of its operation, Crystal Cave charges a fee, but only to visitors of the underground cave. No charge applies to the use of the parking lot or playground.

In response to Zackhery's suit for damages, Crystal Cave filed an uncontested motion for summary judgment based on a claim of immunity under the Recreation Use statute. The trial court granted the motion and plaintiff appealed to the superior court. On appeal, the issue was whether the immunity granted by the Recreation Use statute is extinguished as to all adjoining land owned by a defendant that charges admission to a portion of its land.

The superior court began its analysis by noting that under the Recreation Use statute, a "landowner is entitled to immunity when three conditions coalesce: (1) the landowner did not willfully or maliciously fail 'to guard or warn against a dangerous condition, use, structure, or activity on the land,' (section 477-6), (2) the landowner did not charge the plaintiff for the recreational use of the land, (*Id.*), and (3) the injured plaintiff entered the land for 'recreational purposes.'(section 477-3). 571 A.2d 465."

The *Zachery* court noted with approval the case of *Kniaz v. Benton Borough*, 112 Pa. Commw. 416, 535 A.2d 308 (1988), wherein the Pennsylvania Commonwealth Court held a plaintiff who was injured at a public park where a volunteer fire company was conducting a bingo game had to contend with the Borough's immunity under the Recreation Use statute. Even though the injured party paid a fee to participate in the bingo game, such payment could not be construed as an admission charge by the Borough for entry to its facilities.

On the basis of *Kniaz*, the superior court reasoned that although Zackhery would have been charged a fee to enter the cave, it does not change the fact that his use of the playground was free. Reviewing the Recreation Use statute failed to uncover even a hint that immunity afforded by the statute would be lost for an entire parcel if an owner charges admission to a different portion of the same parcel. Furthermore, the court noted such a conclusion would be inconsistent with the statute's purpose. Therefore, the superior court affirmed the grant of summary judgment in favor of Crystal Cave.

These and other issues concerning landowner liability and the impact of Recreation Use statutes were discussed in the April 1990 issue of the *Agricultural Law Update*. As these decisions indicate, important interpretations of Recreation Use statutes are still being made by the courts. Further discussion and analysis of this subject will take place at the annual meeting of the AALA in Minneapolis, Minnesota, October 5 and 6, 1990.

—John C. Becker,
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AMERICAN AGRICULTURAL LAW ASSOCIATION NEWS

1990 ANNUAL MEETING—ROOMS FOR SATURDAY NIGHT, OCTOBER 6, 1990. Hotel rooms are becoming scarce in downtown Minneapolis for Saturday night, October 6, 1990. As a consequence, we have blocked additional hotel rooms at the Omni Northstar Hotel. The Omni is centrally located in the downtown area and connected to the Skyway System for easy access to the Marriott City Center, as well as sports, shopping, entertainment, and dining. Room rates are $79.00 single/double. Reservations may be made by calling the hotel directly at (612) 338-2288 or Omni Reservations at 1-800-THE-OMNI. You must specify that you are with the American Agricultural Law Association when making your reservation.

1990 ANNUAL MEETING—AIRPORT TRANSPORTATION. Airport transportation is available to the downtown hotels through Airport Limousine Service and leaves every half-hour from 5:00 A.M. to 10:30 P.M. daily. The cost is $7.50 one way and $11.50 round trip.

JOB FAIR. The American Agricultural Law Association's Sixth Annual Job Fair will be held concurrently with the 1990 Annual Meeting, October 5-6, 1990, Marriott City Center, Minneapolis, Minnesota.
Prior to the annual meeting, known positions and information regarding scheduled on-site interviews will be circulated to placement offices at ABA-approved law schools by the Job Fair Coordinator. Placement offices will forward resumes to interested firms and organizations. Employers may schedule interviews for any time during the Conference.
To obtain further information or to arrange an interview, please contact the Job Fair Coordinator: George R. Massie, Room 203, University of Arkansas School of Law, Fayetteville, AR 72701. (501) 575-3706.