Agricultural Law Update

VOLUME 2, NUMBER 12, WHOLE NUMBER 24 SEPTEMBER 1985

Official publication of the American Agricultural Law Association

INSIDE

- In Depth: Tax consequences upon the disposition of an agricultural partnership interest
- President Reagan's tax proposal
- Migrant farm housing — INS searches
- Antitrust ruling in the beef industry
- State Roundup

IN FUTURE ISSUES

- In Depth: Foreign investment in U.S. agricultural land
- Court upholds farmland preservation zoning
- Pseudorabies regulations upheld

Liberty without learning is always in peril and learning without liberty is always in vain.

— John F. Kennedy

President Reagan's tax proposal

The House Ways and Means Committee and the Senate Finance Committee have held hearings all summer on President Reagan's tax reform proposal, with more hearings scheduled for this fall. The President's proposal, frequently referred to as Treasury II, has become the benchmark for discussions about tax legislation. However, when any changes come, they are likely to fall somewhere between current law and the reforms proposed by President Reagan. This article discusses some of the President's proposals that would have a significant effect on farmers and ranchers if they become law.

1. Reduce Marginal Tax Rates

The administration's proposal would reduce the number of tax brackets and the level of the marginal tax rates. The new brackets would be zero for taxable income up to $2,900 on a single return ($3,600 for a married couple filing separately and $4,000 for a joint return); 15% for taxable income up to $18,000 for a single return ($23,000 for a married couple filing separately and $29,000 for a joint return); 25% for taxable income up to $42,000 for a single return ($52,000 for a married couple filing separately and $70,000 for a joint return); and 35% for taxable income over that amount. These rates would be effective July 1, 1986. Therefore, the effective rate for calendar year 1986 would be a blend of the new and old rates.

2. Revise Taxation of Business Property and Capital Assets

One theme that runs throughout the administration's proposal is to reduce the incentive to invest in certain activities solely to reap a tax benefit. Some types of agricultural production attract this kind of investment. The opportunity to claim accelerated depreciation and investment credit attracts investors, as does the opportunity to convert ordinary income into capital gains. The administration's proposal calls for changes that would affect not only those who invest solely for tax reasons, but also those engaged in farming and ranching as their primary means of making a living.

Outside investors put an upward pressure on the cost of resources used in farming (especially those that qualify for tax benefits) and a downward pressure on the price of agricultural products. Lessening the tax incentives to invest in agriculture may moderate these effects. The question for farmers and ranchers is whether the loss of the tax benefits on their own returns will be offset by the benefits of a decrease in competition from outside investors.

The incentives of the current law differ in their relative effect on high and low bracket taxpayers. Accelerated depreciation provides a greater incentive to high bracket taxpayers than to low bracket taxpayers because those in the high bracket can use it to offset income in a higher tax bracket. By contrast, the investment tax credit provides the same incentive to all taxpayers that have taxable income, because it allows all taxpayers to reduce their tax bill by the same amount.

Capital Cost Recovery System. The administration's proposal calls for replacing the current depreciation system (ACRS) with a new depreciation system called the Capital Cost Recovery System (CCRS). The existing investment tax credit scheme is to be repealed. Under CCRS, the recovery period for assets would be lengthened. For example, the recovery period for a tractor would be increased from five years to six years, while the recovery period for a barn that does not qualify as a single purpose agricultural structure would be increased from 18 years to 28 years.

In addition, the basis of depreciable assets would be increased each year to reflect the rate of inflation in the economy. This would be done by adding the inflation adjustment to the basis of each asset before the depreciation deduction is calculated each year. The system would allow a taxpayer to deduct more than the original cost of an asset as depreciation.

Under the administration's proposal, the repeal of ACRS and the investment tax credit would be effective for property placed in service after Jan. 1, 1986.

Capital gains. The administration's proposal would revise the taxation of capital gains by reducing the long term capital gain exclusion from 60% to 50%, and by making depreciable property used in a trade or business ineligible for the long term capital gains exclusion. In place of the long term capital gain exclusion, the basis of depreciable assets used in a trade or business would be increased each year to reflect the rate of inflation in the economy. The

(continued on next page)

continued from page 1

reduction in the long term capital gain exclusion would be effective for all sales after Jan. 1, 1986. Depreciable or depletable property used in a trade or business and placed in service after Jan. 1, 1986 would not be eligible for the long term capital gain exclusion.

These changes would affect farmers and ranchers who sell depreciable property used in the trade of business — such as breeding or dairy livestock, machinery as well as single purpose buildings — at a gain. Current law requires such gain to be reported as ordinary income — only to the extent depreciation deductions were claimed. A cash basis taxpayer has no depreciation to recapture on raised breeding and dairy livestock and therefore, can report the entire amount received on sale as a capital gain. The administration's proposal would require the entire gain to be reported as ordinary income.

The proposal would have little effect on the taxation of unimproved farmland since it would qualify for the 50% (rather than the current 60%) long term capital gain exclusion.

Capitalization of preproduction expenses. Under current law, taxpayers can postpone the recognition of income by deducting the cost of raising certain plants and draft, sport, breeding and dairy livestock as those expenses are incurred and reporting the income from such plants and livestock in later years. The administration's proposal would eliminate that opportunity by requiring taxpayers to capitalize preproduction expenses. That means the expenses could not be deducted as they were incurred, but must be added to the basis of the plants or livestock. When the plants or livestock become productive, the basis could be depreciated over the appropriate recovery period. This change would be made by revising and extending current Internal Revenue Code Section 278 so that it would apply generally to all plants and animals, rather than to nut orchards and vineyards only.

This requirement would apply only to plants and livestock whose preproduction period is two years or more. In the case of plants, the preproductive period would begin with the time the plant or seed was first planted, and would end with the time that the plant became productive. For example, in the case of an orchard, the preproductive period would begin with the time the seedlings or saplings were purchased, and would end with the time the tree first bore fruit.

In the case of breeding livestock, the preproductive period would start at the time the mother of the breeding animal was bred, and would end at the time the animal was ready to be bred. Although the proposal is not clear, the preproductive period for dairy cows would apparently end when the cow produces marketable quantities of milk. Therefore, the preproductive period for beef cows would be less than two years (if they are ready to be bred at less than 15 months of age). The preproductive period for most dairy cows would be more than two years, since their own gestation cycle (as well as their mother's) is apparently included in the preproductive period.

To properly capitalize preproduction expenses, farmers would be required to allocate a portion of all costs that are attributable to raising plants and livestock that are to be used in production. That would significantly increase the chore of keeping records, since part of the expenses for depreciation, taxes, insurance, labor, feed and other inputs would have to be allocated to preproduction plants and livestock.

The administration's proposal includes an alternative to the capitalization of preproduction expenses. In lieu of capitalizing preproduction expenses, farmers could use an inventory valuation method such as the farm/price or unit/livestock/price method. These alternatives would require more recordkeeping than current law, but less than capitalizing preproduction expenses.

In the long run, this provision may be beneficial to farmers and ranchers because it removes some of the tax incentive for outside investors to invest in agricultural production. In the short run, however, the provision would have a devastating effect on some farmers and ranchers. Farmers and ranchers who have a raised breeding or dairy herd have no tax basis in the herd.

Therefore, in the first year this provision is in effect, they would have no depreciation to replace the preproduction expense deduction that they would lose. As the raised replacements for which expenses have been capitalized are added to the herd, they will acquire a tax basis in the herd and will eventually (when all the herd has been replaced) have a depreciation deduction that equals the expense deduction they lost. The years of transition will be devastating for some because their tax bill will increase without any increase in farm profits.

3. Capitalize Soil and Water Management Expenditures

Under the president's proposal, existing special elections to currently deduct a portion of certain soil and water conservation, soil enrichment and land clearing expenditures would be repealed. The repeal would affect such expenditures paid or incurred on or after Jan. 1, 1986, by making capitalization mandatory.

4. Repeal Income Averaging

The administration's proposal would repeal the income averaging rules effective for taxable years beginning on or after Jan. 1, 1986. The justifications given for this change are: (1) the wider brackets allow yearly income to fluctuate more — without causing the income in the high years to be pushed into a higher bracket; and (2) the lower marginal tax rates reduce the effect of having income taxed in the higher bracket.

Since farmers and ranchers are subject to extreme fluctuations in income, they will be particularly affected by this proposed change. Yearly accounting is somewhat artificial for an industry that completes only one production cycle in a year. The income averaging rules are helpful to relieve the harshness of yearly accounting. Farmers whose marginal income is pushed from the 15% bracket into the 25% bracket would pay 66% more tax on that income as a result of the yearly accounting rules.

— Philip E. Harris

Agricultural Law Update

VOL. 2, NO. 12, WHOLE NO. 24 SEPTEMBER 1985

AALA Editorial Liaison . . . . Donald B. Pedersen
University of Arkansas

Editor Nancy Harris
Century Communications Inc

Contributing Editors Terence J. Centner, University of Georgia; Gary E. Flinn, Flinn and Muntean Co. C.P.A.; Philip E. Harris, University of Wisconsin, Donald B. Pedersen, University of Arkansas, Gerald Torres, University of Minnesota, John J. Watkins, University of Arkansas

State Reporters: E. Leon Geyer, Virginia; Neil Hamilton, Iowa, Gerald A. Harrison, Indiana, Marvin Martin, Texas, Stephen F. Matthews, Missouri, Gerald Torres, Minnesota.

For AALA membership information, contact Margaret R. Grossman, University of Illinois, 151 Bevier Hall, 905 S Goodwin, Urbana, IL 61801; (217) 333-1829

Agricultural Law Update is owned exclusively by **Century Communications Inc.** and published in conjunction with the American Agricultural Law Association. Publication office: Century Communications Inc., 5520-G Touhy Ave., Skokie, IL 60077; (312) 676-4060. Philip C. Miller, president, Marilyn M. Miller, vice president, Lynn O. Henderson, vice president; Christine A. Waligorski, secretary.

First class postage paid at Skokie, IL 60077.

Letters and editorial contributions are welcome and should be directed to Don Pedersen, director of the Graduate Agricultural Law Program, University of Arkansas, Waterman Hall, Fayetteville, AR 72701

Agricultural Law Update is edited for those with a professional interest in agricultural law including attorneys, farm managers, agricultural lenders and agricultural land owners. Subscription $75.00 in U.S., Canada and Mexico. $100.00 to all other countries. Back copies, when available, are $9.00 each for U.S., Canada and Mexico. All other countries add $6.00. All U.S. funds. Payment must accompany order.

Attorney's Fees Awarded in *Curry v. Block;*

President Signs New Equal Access to Justice Act

A federal district judge has awarded $55,000 in attorneys' fees under the Equal Access to Justice Act (EAJA) to the plaintiffs in *Curry v. Block,* the landmark decision holding that the Secretary of Agriculture has a mandatory duty to implement the so-called "moratorium provision" governing Farmers Home Administration (FmHA) loans. In a related development, President Reagan has signed into law a bill making the EAJA permanent — after vetoing similar legislation last fall.

In June 1982, Chief Judge Anthony Alaimo, of the U.S. District Court for the Southern District of Georgia, granted summary judgment for borrowers who challenged the FmHA's implementation of the loan servicing and foreclosure avoidance mechanisms found in 7 U.S.C. § 1981a. The U.S. Court of Appeals for the 11th Circuit subsequently affirmed. *See Curry v. Block,* 541 F.Supp. 506 (S.D. Ga. 1982), *aff'd,* 738 F.2d 1556 (11th Cir. 1984). Plaintiffs then sought attorneys' fees under the EAJA.

The fee application to Judge Alaimo was based upon two separate provisions. First, plaintiffs sought an award under 28 U.S.C. § 2412(b), which, as amended by the EAJA, gives courts discretion to award fees against the federal government to the same extent that the common law or other fee-shifting statutes would permit an award against any other party. This provision was not affected by the EAJA's "sunset" clause, under which the bulk of the Act automatically expired on Oct. 1, 1984. Alternatively, plaintiffs sought a mandatory award under 28 U.S.C. § 2412(d), the "experimental" portion of the EAJA, which would authorize the assessment of fees against the federal government unless its position was "substantially justified," or in cases in which special circumstances would make an award unjust. Although this provision did expire on Oct. 1, 1984, the sunset clause made the Act applicable "through final disposition of any action commenced before the date of repeal," thereby reaching the *Curry* case.

Relying both on § 2412(b) and on § 2412(d), Judge Alaimo made an award of $55,643.50, which fully covered plaintiff's litigation costs. However, his application of the statutory provisions is not without its troublesome aspects. First, he held that § 2412(b) permits a discretionary award against the federal government because another statute, 42 U.S.C. § 1988, allows assessment of attorneys' fees against *state* officials who violate federally protected rights. This construction, which would permit fee awards in *Bivens*-type actions against federal officials, has been rejected by most courts, as Judge Alaimo candidly conceded. *See, e.g., Premachandra v. Mitts,* 753 F.2d 635 (8th Cir. 1985) (en banc); *Unification Church v. INS,* 762 F.2d 1077 (D.C. Cir. 1985).

Secondly, Judge Alaimo reasoned that § 2412(d) authorized a mandatory fee award because the federal government's position in the *Curry* litigation was not "substantially justified." This standard is essentially one of reasonableness, and the judge had little sympathy for the government's argument (subsequently abandoned on appeal) that the use of the word "may" in § 1981a gave the secretary discretion to implement the statute's loan deferral provisions. While the government's argument may well have been weak, the issue was one of first impression in *Curry,* a factor other courts have considered important in evaluating the substantial justification question. *E.g., Donovan v. Dillingham,* 668 F.2d 1196, *rev'd on other grounds,* 688 F.2d 1367 (11th Cir. 1982) (en banc). Also, at least one appellate court later concluded that § 1981a is, by its terms, permissive, not mandatory. *U.S. v. Hamrick,* 713 F.2d 69 (4th Cir. 1983).

Although *Hamrick* is most certainly the minority view, the split of authority suggests that the government's position in *Curry* was not altogether unreasonable. *See Donovan v. Miller Properties Inc.,* 547 F.Supp. 785 (M.D. La. 1982) (division of authority supports finding of substantial justification), *aff'd,* 711 F.2d 49 (5th Cir. 1983). Finally, the EAJA's legislative history makes it clear that the government's position is not to be considered unreasonable "simply because it lost its case."

Two other points made in *Curry* merit mention in light of the "permanent" EAJA signed by President Reagan in August. Judge Alaimo, following 11th Circuit precedent, pointed out that the government's litigation position was to be considered in evaluating substantial justification. In contrast, the new Act provides that both the government's arguments in the litigation and the agency action (that made resort to the courts necessary) must be examined. To satisfy President Reagan's objections to this provision (stated in his veto message of a similar bill last fall), the Congress added a provision to make it clear that the "substantial justification" determination will not involve additional evidentiary proceedings or additional discovery of agency files solely for EAJA purposes.

Judge Alaimo also held in *Curry,* consistent with the majority view, that fee applications under § 2412(d) are timely — if filed within 30 days of the conclusion of the final appeal. There is authority to the contrary, however, but the new Act contains an expanded definitional section adopting the majority position.

The new Act is expressly made retroactive to cases commenced on or after Oct. 1, 1984, when the original EAJA expired under the sunset provision. In addition, the Act raises § 2412(d)'s "net worth" eligibility limitations for individuals (from $1 million to $2 million) and for organizations (from $5 million to $7 million). Agricultural cooperatives continue to be exempt from the net worth limitation if they have fewer than 500 employees.

— *John J. Watkins*

Migrant farm housing — INS searches

A district court injunction barring the Immigration and Naturalization Service (INS) from conducting farm and ranch checks of migrant farm housing without a warrant, probable cause or articulable suspicion has been affirmed. *LaDuke v. Nelson,* 762 F.2d 1318 (9th Cir. 1985). This class action involved the Spokane sector (Washington, Idaho and Montana).

It was the periodic practice of armed INS border patrol agents to cordon off migrant housing during early morning or late evening hours, surround the residences in emergency vehicles with flashing lights, approach the homes with flashlights, and station officers at all doors and windows. There would then be a house-to-house search, either without consent or with alleged "knowing" consent of the occupants.

The trial transcript included detailed testimony as to INS practices. Agents sometimes would grasp the belt of the person answering the door. Agents would surround a house and peer through the windows. Agents would enter darkened homes at night with flashlights and approach the bed of sleeping residents.

One agent testified that since at least 1974, he had never had any specific information in advance that identified a particular subject or dwelling for ranch ehecks. There was an indication that even where anonymous tips had been received, the tips were usually just vague references to geographic areas or farm locations. Agents testified that it was INS policy to conduct complete sweeps of all community residences, with our without information as to the

(continued on page 6)

Tax consequences upon the disposition of an agricultural partnership interest

by Gary L. Flinn

Prior tax planning as a part of the disposition of an agricultural business can be of benefit to all parties involved in such a transfer. In addition to facilitating the orderly transfer of property, prior tax planning can maximize financial benefits in the form of preferred tax treatment.

In addition to the disposition of business interests as a part of normal business cycles, more and more agriculturalists are examining the transfer of business assets as a means to relieve financial stress. Some members of the senior generation are considering earlier retirement. Some agriculturalists, discouraged by current economic conditions, are considering other professional endeavors, while some are contemplating a sale of business assets as a means to satisfy creditors. Whatever the reason, the transfer of agricultural business interests is on the rise. Therefore, to avoid unnecessary taxation, it behooves agriculturalists to review the tax consequences surrounding the disposition of a business interest.

This article is directed toward the fundamental tax consequences of the disposition of one of the more popular forms of doing business in the agricultural sector — the partnership. Even though the rules surrounding partnership taxation are complex, tedious, and often-times simply boring, they do provide an opportunity to effectuate substantial tax savings — if properly implemented. This article summarizes pertinent rules so that the reader can better understand the need for careful planning. In its preparation, an assumption has been made that the reader has a basic working knowledge of partnership taxation.

Sale of a Partnership Business Interest

Gain or loss is usually recognized on the sale or exchange of an interest in a partnership unless a specific, non-recognition provision is applicable.[1] These non-recognition provisions include transfers to controlled corporations for stock or securities,[2] and losses incurred on sales to certain related parties.[3] The Tax Reform Act of 1984 specifically excludes like/kind exchanges as an exception to the non-recognition of gain.[4]

The gain or loss recognized to the transferor partner is usually considered to be a capital gain or loss, so long as the requisite holding period has been met. This rule does not, however, apply to "unrealized receivables" or "substantially appreciated inventory," generally referred to as "Section 751 property."

Unrealized receivables include any right to payments for goods delivered,[5] services rendered,[6] or other types of property that have the potential for generating ordinary income when sold — including Section 1245 and 1250 property,[7] farm recapture property,[8] farmland,[9] and oil and gas or geothermal property.[10]

More specific examples of unrealized receivables may include crops which the partnership has contracted to sell, but for which it has not yet been paid, or most depreciable farm assets (including farm machinery, equipment, buildings and fences, as well as producing fruit and nut trees or vines). Inventory items are considered to have substantially appreciated if their fair market value exceeds 120% of their adjusted basis in the hands of the partnership, and 10% of the fair market value of all partnership property, other than money.[11]

For example, substantially appreciated inventory might include grain which has been stored, but not sold. Since the basis will likely be zero (assuming the costs of producing the grain have been deducted as business expenses), the value of the stored grain would necessarily exceed 120% of the partnership's basis in such grain.

In the case of Section 751 property, money or property received by the transferor partner in exchange for his or her interest in the partnership's unrealized receivables or substantially appreciated inventory will result in the recognition of ordinary income.[12] The amount of this ordinary income is equal to the difference between the amount realized by the transferor partner for the Section 751 property, and the portion of his or her basis in the entire partnership interest attributable to such property.[13]

The tax consequences to the transferee partner and the partnership that result from a disposition of a partnership interest revolve around the adjustment of the basis of the interest being transferred. The transferee partner's basis of the partnership interest is equal to the purchase price,[14] plus any liabilities assumed by the transferee partner.[15]

The basis of an individual partnership asset, however, is not usually adjusted upon the transfer of a partnership interest.[16] For example, if a purchaser buys an interest in a partnership for more than the adjusted basis of his or her share of the partnership assets, the partnership usually does not receive a step-up in basis of the partnership asset. Similarly, if the purchase price is less than the adjusted basis of the purchaser's share of the partnership assets, the partnership is not required to adjust the basis downward.

One should note, however, that the partnership may make a Section 754 election, which will allow the basis of the partnership assets to be adjusted.[17] Adjustment in basis under a Section 754 election is designed to reduce the difference between the fair market value and the adjusted basis of the partnership assets. Among other things, this basis adjustment may have an advantageous effect on the transferee partner's depreciation schedule, depletion allowance, and the gain or loss recognized on subsequent transfers.[18] Although a Section 754 election is not a universal panacea for the payment of tax surrounding the transfer of a partnership interest, it does present a rather unusual opportunity to ease the overall tax burden through basis adaptations.

The amount of the basis adjustment under a Section 754 election must be divided between capital assets, Section 1231 property, and any other partnership property.[19] The allocated basis adjustment between capital assets and other partnership property can be accomplished through procedures established in the Regulations,[20] or the partnership may make application to the appropriate district director of the Internal Revenue Service (IRS) for permission to make other allocations.[21]

In order to make a Section 754 election, the partnership must file a timely statement of intent with the partnership tax return, and the election can be revoked only with the permission of the appropriate district director.[22] The transferee partner must also file a statement with his or her return — to the extent that the adjustment in basis is pertinent in determining his or her income tax.[23]

One should note that prior to the Tax Reform Act of 1984, a series of partnership arrangements could be utilized to manipulate the basis adjustments under a Section 754 election to defer (or completely avoid) gain on the sale of partnership assets. This was generally referred to as "basis stripping." The new law now prevents this result

Gary L. Flinn is a member of Flinn and Muntean Co. L.P.A., a law firm located in Greenville, Ohio. Flinn holds a Ph.D. in agriculture from The Ohio State University, and a J.D. from the University of Akron.
The author wishes to thank Donald B. Pedersen and Lonnie R. Beard, both of the University of Arkansas, and Philip E. Harris, of the University of Wisconsin, for their assistance in the preparation of this article.

by providing that the election to adjust basis applies to a partnership that transfers an interest in another partnership that has not made a similar election.[24]

Tax Consequences of a Partnership Distribution

Even though a distribution may transfer all (or even just a part) of a partner's interest in the partnership, the tax consequences may be very different from those that result from a sale or exchange. A partner who receives a distribution of money and property from a partnership generally recognizes gain only to the extent that any money received exceeds the adjusted basis of the distributee partner's interest in the partnership before the distribution.[25] Therefore, if no money is distributed, the distributee partner recognizes no gain. Any gain recognized by the distributee partner is usually considered gain from the sale or exchange of a capital asset.[26]

No loss is generally recognized by the distributee partner upon the distribution of partnership property (including money) that is not in complete liquidation of his or her interest.[27] Even though the general rule typically includes ordinary income property, such property generally retains its ordinary income character in the hands of the distributee partner for calculating gain or loss on a subsequent disposition. Property that was partnership inventory may, however, lose its ordinary income status in the hands of the distributee partner if more than five years have passed since the date of distribution, and if the property that was once partnership inventory is no longer ordinary income property of the distributee partner.[28]

Notwithstanding the general rule, a non-pro rata distribution of Section 751 property may result in the recognition of gain or loss to the distributee partner.[29] For example, if a distributee partner receives Section 751 property in exchange for his or her interest in other partnership property, then the distributee partner may recognize gain or loss equal to the difference between his or her adjusted basis in the other partnership property and the fair market value of the Section 751 property that he or she received.[30]

Whether the distributee partner experiences ordinary gain or loss, or capital gain or loss, depends on the character of the other partnership property that was exchanged for his or her non-pro rata share of Section 751 property.[31] The partnership may recognize ordinary gain or loss to the extent that the partnership's adjusted basis in the Section 751 property differs from the fair market value of the other partnership property exchanged by the distributee partner.[32]

Moreover, if a distributee partner receives other property for an interest in Section 751 property, gain or loss to the distributee partner and the partnership is calculated in a similar manner. That is, the partner is deemed to have been distributed Section 751 property and then to have exchanged the Section 751 property for other partnership property.[33] The distributee partner experiences ordinary gain or loss, while the partnership's gain or loss depends on the character of the other partnership property which was deemed to have been exchanged.[34]

With some limitations, the basis of the distributed property to the partners is generally the carry-over basis of the partnership.[35] Under certain circumstances, the distributee partner may elect to have the basis of the distributed property determined as if there had been a Section 743(b) adjustment resulting from a Section 754 election.[36] The Regulations set forth the procedure for making this special election.[37]

Liquidation Distributions

A liquidation is a complete distribution of a partner's interest in the partnership.[38] The tax consequences of a liquidation to the liquidating partner are determined by classifying the distribution payments as either a Section 736(a) or Section 736(b) payment.[39]

A Section 736(b) payment is one that is made in exchange for a liquidating partner's interest in partnership property. A Section 736(a) payment is characterized as guaranteed payments, or distributive shares.[40] A payment is considered to be a guaranteed payment if the amount is for services rendered, or in return for the use of capital.[41] A payment is considered a distributive share if the sum is determined with regard to the income of the partnership.[42] Examples of distributive shares include unrealized receivables, and, in some cases, good will.[43]

After the payments to the liquidating partner have been categorized under Section 736, the tax consequences of the transfer are determined by the other sections of the Internal Revenue Code (IRC).[44] A payment under Section 736(b) is taxed as a distribution to the liquidating partner.[45] Gain or loss is usually treated as a capital gain or loss, unless the liquidating partner has exchanged substantially appreciated inventory.[46] A Section 736(a) payment is usually taxed as ordinary income to the liquidating partner.[47]

Generally, the partnership does not recognize a gain or loss upon the distribution to a liquidating partner unless there is a non-pro rata distribution of property.[48] With some exceptions, the basis of distributed property to a liquidating partner is calculated as current distributions are calculated.[49] Likewise, the basis allocation rules utilized for the transfer of a partnership interest also apply to liquidating distributions for property remaining in the hands of the partnership.[50] If the partnership has a Section 754 election in play, then the basis of the remaining partnership property must be adjusted. The basis adjustment rules that apply to liquidating distributions for Section 751 property are similar to those for current distributions for such property except that, unlike current distributions — in which only positive adjustments can be made — the remaining partnership assets following a liquidating distribution can be decreased.[51]

In practice, Section 736 payments are usually made over a period of time. Therefore, the liquidating partner and the remaining partners can decide how the periodic payments are divided among Section 736(a) and Section 736(b) property, so long as the amount allotted to Section 736(b) property does not exceed the fair market value of such property at the time of liquidation.[52] In the absence of an agreement, allocation formulas are set forth in the Regulations.[53]

Partnership Termination

The date of termination of a partnership for tax purposes may be different from the termination date under local law.[54] For purposes of taxation, a partnership is deemed terminated if no partnership business is carried on in the partnership form, or if there is a sale or exchange of at least 50% of the total interest in partnership capital and profits within a 12-month period.[55] The partnership is deemed terminated through the cessation of business activity on the date the winding-up process is completed.[56] The partnership is deemed terminated through a sale or exchange on the date the total interest in the partnership capital and profits individually reach the 50% level.[57] Upon termination, each partner must include his or her distributive share of partnership items on his or her individual return in the taxable year in which the termination occurred.[58]

(continued on next page)

TAX CONSEQUENCES
CONTINUED FROM PAGE 4

If a merger or a division of a partnership occurs, special termination rules apply. When partnerships merge, the new partnership is deemed to be a continuation of the partnership whose members own more than 50% of the capital and profits of the resulting partnership.[59] If the 50% test cannot be met, then all merging partnerships are deemed terminated.[60] If a partnership is divided into several partnerships, the resulting partnerships are deemed to be a continuation of the prior partnership if the resulting partners own more than 50% of the capital and profit of the prior partnership.[61] More than one new partnership can be deemed a continuation of the former partnership. Conversely, if the 50% test cannot be met, then the prior partnership is deemed terminated.[62]

Conclusions

Although a detailed analysis of the tax consequences surrounding the disposition of a partnership business is beyond the scope of this article, a cursory examination points out the need for prior tax planning. The immediate tax consequences and the future tax positions of the partners and the partnership are affected by the manner in which the transfer of partnership assets is structured. Local, professional advice should be sought to avoid undesirable consequences, and to maximize the tax-advantaged options that are available.

For a detailed examination of the tax consequences surrounding the disposition of partnership interests, see T. Ness & W. Indoe, *Tax Planning For Disposition of Business Interests* (Warren, Gorham & Lamont Inc. 1985).

Footnotes

1. IRC § 741.
2. IRC § 351.
3. IRC § 267.
4. IRC § 1031.
5. Reg. § 1.751-1(c)(l)(i).
6. Reg. § 1.751-1(c)(l)(ii).
7. IRC §§ 1245(a)(3); 1250(c).
8. IRC § 1251(e)(l).
9. IRC § 1252(a).
10. IRC § 1254.
11. IRC § 751(d)(l).
12. IRC § 751.
13. Reg. § 1.751-1(a)(2).
14. IRC § 742.
15. IRC § 752(d).
16. IRC § 743.
17. IRC § 754.
18. IRC § 743(b).
19. IRC § 755(b).
20. Reg. § 1.755-1(a)(l).
21. IRC § 755(a)(2).
22. Reg. §§ 1.754-1(b)(l); 1.754-1(c).
23. Reg. § 1.743-1(b)(3).
24. IRC § 734(b).
25. IRC § 731(a)(l).
26. IRC §§ 731(a); 741.
27. IRC § 731(a)(2).
28. IRC § 735(a)(2).
29. Reg. § 1.751-1(b)(l).
30. Reg. § 1.751-1(b)(2)(iii).
31. Id.
32. Reg. § 1.751-1(b)(2)(ii).
33. Reg. §§ 1.751-1(b)(3)(ii); 1.751-1(b)(3)(iii).
34. Id.
35. IRC § 732(a).
36. IRC § 732(d).
37. Reg. §§ 1.732-1(d)(l)(vi)(2); 1.732-1(d)(l)(vi)(3).
38. IRC § 761(d).
39. Reg. § 1.736-1.
40. IRC § 736(a).
41. IRC § 736(a)(2).
42. IRC § 736(a)(l).
43. Reg. §§ 1.736-1(a); 1.736-1(b).
44. Reg. §§ 1.736-1(a)(2); 1.736-1(a)(4).
45. IRC §§ 731; 732; 751(b).
46. IRC § 751(b).
47. IRC § 736(a)(2).
48. IRC § 731(b).
49. IRC § 732.
50. IRC § 731(b).
51. IRC § 734(b)(2).
52. Reg. § 1.736-1(b)(5)(iii).
53. Reg. §§ 1.736-1(b)(5)(i); 1.736-1(b)(5)(ii).
54. Reg. § 1.755-1(b)(l).
55. IRC § 708(b)(l).
56. Reg. § 1.708-1(b)(l)(iii)(a).
57. Reg. §§ 1.708-1(b)(l)(ii); 1.708-1(b)(iii)(b).
58. Reg. § 1.706-1(b)(l).
59. IRC § 708(b)(2)(A).
60. Reg. § 1.708-2(b)(2)(i).
61. IRC § 708(b)(2)(B).
62. Reg. § 1.708-2(ii).

MIGRANT FARM HOUSING
CONTINUED FROM PAGE 3

occupants of specific residences.

The 9th Circuit Court concluded that the plaintiffs had Article III standing to seek an injunction. *Los Angeles v. Lyons*, 461 U.S. 95 (1983), was distinguished on a number of grounds.

The District Court held that INS's pattern of conduct violated the plaintiff's Fourth Amendment rights under either of two distinct theories. The actions of INS officers were found to constitute a "seizure" of the occupants, and because the seizure preceded the alleged consent, the question of consent became immaterial to the finding of the Fourth Amendment violation. The 9th Circuit Court affirmed the District Court's conclusion that a seizure of the entire housing unit was routinely accomplished and noted that *INS v. Delgado*, 104 S.Ct. 1758 (1984), reinforced the District Court's position.

In the alternative, the District Court had concluded that in light of INS's standard farm check practices, the consent given by the farm labor housing occupants was not voluntary. The government had the burden of proving that consent was voluntary. Given the show of official force and the vulnerable nature of the migrant work force, the 9th Circuit Court found no basis to reverse the District Court's finding that consent came as a result of fear, rather than voluntary cooperation.

The INS complained that the District Court's injunction was overly broad. The 9th Circuit Court disagreed. The injunction, as it had amended below, bars the following: warrantless entries of farm dwellings to search or arrest unless the officers have "clear consent" or probable cause; warrantless arrests or searches of migrant farm housing residents unless based on probable cause; and "stopping, detaining and interrogating [class members] by force, threats of force or a command based upon official authority," absent a warrant, probable cause or reasonable suspicion. The 9th Circuit Court emphasized that in this non-border context, the Fourth Amendment requires at least articulable suspicion of both alienage and unlawful presence, absent a warrant. As amended, the injunction does not prohibit clearly consensual entries, such as those made for the purpose of gathering an arrested alien's belongings.

In addition, the 9th Circuit Court found that the plaintiff class was property certified under Federal Rule of Civil Procedure 23(d)(2), and that there had been an appropriate award of attorney's fees and costs to plaintiffs' counsel under the Equal Access to Justice Act.

— *Donald B. Pedersen*

Antitrust ruling in the beef industry

The 10th Circuit Court of Appeals issued a significant antitrust ruling concerning the livestock in *Monfort of Colorado Inc. v. Cargill Inc.*, 761 F.2d 560 (10th Cir. 1985). The court found that a private competitor, Monfort of Colorado Inc., had antitrust standing to seek injunctive relief under Section 16 of the Clayton Act (15 U.S.C. § 26). After reviewing the district court's findings concerning the relevant product market and barriers to entry, the court found that the evidence established that a substantive antitrust violation was imminent. The court thereby enjoined defendants Cargill and Excel from acquiring another competitor, Spencer Beef Division of Land O'Lakes Inc.

— *Terence J. Centner*

State Roundup

IOWA. *Farm Lease - Partnership?* The Iowa Supreme Court has ruled that it should not be presumed that a farm lease creates a partnership in the absence of evidence or agreements clearly showing such a relationship. The court indicated that the creation of a partnership requires mutual consent of the parties and a meeting of the minds. The decision reversed a district court ruling and an appeals court's 3-3 affirmation that two leases, a crop share and a stock share lease had created a partnership that rendered the defendant landowner liable for debts incurred by the tenant in buying feed.

The court concluded that there was not evidence of a partnership agreement and that the conduct of the parties did not establish a partnership. In addition, the court reversed the district court and held that the landlord was not liable on agency or quantum meruit theories. *Chariton Feed & Grain Inc. v. Harder*, No. 83-983 (Iowa, June 19, 1985).

— *Neil Hamilton*

INDIANA. *Living Will.* Effective Sept. 1, 1985, there is a living will statute in Indiana. It authorizes two forms of written declaration for persons 18 years of age or older to provide instructions to health care providers when an illness or condition is determined to be terminal. The declarant may sign a declaration directing the withholding of or withdrawal of medical procedures which serve only to artificially prolong the dying process.

Alternatively, a person may direct the use of life-prolonging procedures. The statute provides: procedures for revoking a declaration; sanctions against a physician who refuses to comply with the patient's declaration; and relief from civil and criminal liability for health care providers who fail to provide medical treatment when honoring a living will declaration.

— *Gerald A. Harrison*

MINNESOTA. *Remedies of Farm Creditors.* Minn. Laws (1985) Chapter 306; as amended by Chapter 18, 1985 First Special Session. Chapter 306 had been passed by both the House of Representatives and Senate during the last, hectic days of the regular session. Immediately thereafter, lenders and their lobbyists began pressing to have the law amended. The crux of the lender's argument was that because Chapter 306 had expanded the state program to allow for the delay of home and farm mortgage foreclosures, mortgages would be more difficult to afford, interest rates would climb, and the lenders might be forced to pull out of Minnesota. These lobbying efforts resulted in one of the swiftest reversals the state Legislature has made in recent memory.

The special session bill nullified various Chapter 306 provisions, including: the limit on the coverage of crop financing statements to the crops of a single growing session; the allowance to debtors of a 60- to 90-day "grace period" from the service of notice until termination of contracts for conveyance of homestead property; the extension of the right to petition the courts for a postponement of a foreclosure (to mortgages and contracts for deed entered into after May 1983); and language that made it optional to reduce the amount of statutory redemption time for debtors who have been granted delays.

The legislators did leave some provisions of Chapter 306 intact. For instance, the increase in the amount of farm machinery and implements which are exempt from creditor's liens remained the same (from $5,000 to $10,000).

— *Gerald Torres*

MISSOURI. *Farm Buyers Obtain Rescission.* In *Lane v. Unger*, 599 F.Supp. 63 (E.D. Mo. 1984), farm purchasers sought and received rescission, based on failure of sellers and realtors to inform them that over $24,000 was due within six months of sale to holder of first deed of trust. The total purchase price for the 755-acre Missouri farm was $912,000. The buyers had expected a bill for about $8,000, rather than for $24,230.50. The court held that both the sellers and the realtors had superior knowledge and that the buyers reasonably relied upon the lack of disclosure (material fact). Even though innocently or negligently made, concealment of a material fact allows the party which has been falsely induced into a contract to either affirm the contract and sue for damages, or rescind the contract. This occurred despite the fact the buyers were represented by an attorney.

— *Stephen F. Matthews*

TEXAS. *Guest Statute Struck Down.* On July 10, 1985, the Texas Supreme Court ruled that the Texas automobile guest statute is unconstitutional. *Whitworth v. Bynum*, No. C3547 (Tex. July 10, 1985). Justifications for guest statutes have traditionally included elimination of collusive lawsuits and protection of hospitality. However, Justice Kilgarin, author of the majority opinion, wrote that the guest classification is not rationally related to a legitimate state interest. The Texas ruling leaves only three states with guest statutes.

Whitworth, while not an agricultural decision, reminds agricultural lawyers of the need to be alert for constitutional challenges to agriculture legislation that involves classifications different than those in similar legislation for the general society. Such classifications may not relate to legitimate state interests under the equal protection and due process clauses of *state* constitutions.

— *Marvin Martin*

VIRGINIA. *Secured Transactions -Farm Products.* The Virginia Legislature passed a resolution establishing a legislative committee to study the feasibility of requiring computerized filings of secured transactions relating to farm products.

— *L. Leon Geyer*

VIRGINIA. *Dogs Chasing Livestock.* The Virginia Legislature passed a bill to allow owners of livestock, or their agents, to kill dogs chasing livestock which are on the land used by the livestock, as well as when circumstances show the chasing is harmful to the livestock. This relaxes the current law, which provided for "self-help" against dogs only when the dog was in the "act of killing or injuring livestock or poultry." Va. Code Sec. 29-213.85 (1985).

— *L. Leon Geyer*

AMERICAN AGRICULTURAL LAW ASSOCIATION NEWS

Sixth Annual AALA Conference, October 3-4, Columbus, Ohio
Topics and Speakers

Thursday, Oct. 3, 1985

Keynote Address - The Architecture of Public Policy: Neil E. Harl, Charles F Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University.

Structural Issues in U.S. Agriculture and Farm Debt Perspectives: C. B. Baker, Professor of Agricultural Economics, University of Illinois, Urbana-Champaign.

Luncheon - Presidential Address: Agricultural Credit and the Uniform Commercial Code: A Need for Change?: Keith G Meyer, Professor of Law, University of Kansas.

Is the Agricultural Security Interest Legally Healthy?: David A. Lander, Husch, Eppenberger, Donahue, Elson & Cornfeld.

A Practicing Lawyer's Look at the Farm Operator in Financial Trouble: Gail W. Saint, Gail Saint & Associates.

Local Land Use Controls Will Not Save Agricultural Lands: Orlando E. Delogu, Professor of Law, University of Maine.

Agriculture and Environmental Regulations - New Limits on Property?: Gerald Torres, Professor of Law, University of Minnesota.

Soil, Subsidies and Sodbusting: Recent Legislative Proposals for Soil Conservation: Linda A. Malone, Assistant Professor of Law, University of Arkansas

For further information about the conference, call Dave Myers at 219-464-5477
The AALA is holding a Job Fair (recruiting event) concurrent with the 1985 Annual Meeting. For information, call Gail Peshel at 219-464-5498

Friday, Oct. 4, 1985

Breakfast Discussion Groups for Law Teachers, Extension Educators and Practitioners.

Estate Planning in an Era of Declining Values: Paul L. Wright, Associate Professor of Agricultural Law, The Ohio State University.

Transfer of the Farm Business: Planning for Non-farm Heirs: C. Allen Bock, Professor of Agricultural Law, University of Illinois, Urbana-Champaign.

Transition from a Common Law Property System to a Marital Property System - The Effects on Farm Estate Planning: Philip E. Harris, Assistant Professor of Agricultural Economics and Law, University of Wisconsin, Madison.

Estate Planner's Accountability in the Representation of Agricultural Clients: Gerald T. Johnston, Professor of Law, Washington University.

Luncheon: The Legal Profession Serving the Family Farm of Tomorrow: William Richards, President, Richards Farm Inc.

Biotechnology - Prospects and Perspectives: Dr. E.G. Jaworski, Director of Biological Sciences, Distinguished Science Fellow, Monsanto Co.

Confidential Business Information vs. the Public's Right to Know - Biotechnology at the Interface: Stanley H. Abramson, Associate General Counsel, Pesticides and Toxic Substances Division, United States Environmental Protection Agency.

The Impact of Biotechnology on Agriculture: Michael S. Ostrach, Vice President and General Counsel, Cetus Corp

Biotechnology: Can A New Technology Survive in Today's Governmental Environment?: W. Wayne Withers, Assistant General Counsel, Monsanto Co