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Top Ten Agricultural Law and Tax Developments of 2016

Roger A. McEowen

Kansas Farm Bureau Professor of Agricultural Law and Taxation
Washburn University School of Law, Topeka, KS

roger.mceowen@washburn.edu

Overview

We begin 2017 with our annual look at the most significant agricultural law and agricultural tax developments of the previous year. Legal and tax issues continue to be at the forefront of developments that are shaping the present and will shape the future of American agriculture, and it is very likely that the involvement of the legal system in agriculture will continue to grow.

Almost, But Not Quite

There were many significant developments in 2016 that didn't make the cut. Here are a few important developments that didn't make the "Top Ten":

- **HRA Relief for Small Businesses.** Late in 2016, the President signed into law H.R. 6, the 21st Century Cures Act. Section 18001 of the legislation repeals the restrictions included in Obamacare that hindered the ability of small businesses (including farming operations) to use health reimbursement arrangements (HRAs). The provision allows a "small employer" (defined as one with less than 50 full-time employees who does not offer a group health plan to any employees) to offer a health reimbursement arrangement (HRA) that the employer funds to reimburse employees for qualified medical expenses, including health insurance premiums. If various technical rules are satisfied, the basic effect of the provision is that, effective for plan years beginning after December 31, 2016, such HRAs will no longer be a violation of Obamacare's market "reforms" that would subject the employer to a penalty of $100/day per affected person). It appears that the relief also applies to any plan year beginning before 2017, but that is less clear.
- **Veterinary Feed Directive Rule.** The Food and Drug Administration revised existing regulations involving the animal use of antibiotics that are also provided to humans. The new rules arose out of a belief of bacterial resistance in humans to antibiotics even though there is no scientific proof that antibiotic resistant bacterial infections in humans are related to antibiotic use in livestock. As a result, at the beginning of 2017, veterinarians will be required to provide a "directive" to livestock owners seeking to use or obtain animal feed products containing medically important antimicrobials as additives. A "directive" is the functional equivalent of receiving a veterinarian's prescription to use antibiotics that are injected in animals. *21 C.F.R. Part 558.*
- **Final Drone Rules.** The Federal Aviation Administration (FAA) issued a Final Rule on UASs ("drones") on June 21, 2016. The Final Rule largely follows the Notice of Proposed Rulemaking issued in early 2015 (80 Fed. Reg. 9544 (Feb. 23, 2015)) and allows for greater commercial operation of drones in the National Airspace System. At its core, the Final Rule allows for increased routine commercial operation of drones which prior regulations required commercial users of drones to make application to the FAA for permission to use drones - applications the FAA would review on a case-by-case basis. The Final Rule (FAA-2015-0150 at 10 (2016)) adds Part 107 to Title 14 of the Code of Federal Regulations and applies to unmanned

"aircraft" that weigh less than 55 pounds (that are not model aircraft and weigh more than 0.5 pounds). The Final Rule became effective on August 29, 2016.

- **County Bans on GMO Crops Struck Down.** A federal appellate court struck down county ordinances in Hawaii that banned the cultivation and testing of genetically modified (engineered) organisms. The court decisions note that either the state (HI) had regulated the matter sufficiently to remove the ability of counties to enact their own rules, or that federal law preempted the county rules. *Shaka Movement v. County of Maui, 842 F.3d 688 (9th Cir. 2016)* and *Syngenta Seeds, Inc. v. County of Kauai, No. 14-16833, 2016 U.S. App. LEXIS 20689 (9th Cir. Nov. 18, 2016).*
- **Insecticide-Coated Seeds Exempt from EPA Regulation Under FIFRA.** A federal court held that an existing exemption for registered pesticides applied to exempt insecticide-coated seeds from regulation under the Federal Insecticide, Rodenticide Act which would require their separate registration before usage. *Anderson v. McCarthy, No. C16-00068, WHA, 2016 U.S. Dist. LEXIS 162124 (N.D. Cal. Nov. 21, 2016).*
- **Appellate Court to Decide Fate of EPA's "Waters of the United States" Final Rule.** The U.S. Court of Appeals for the Sixth Circuit ruled that it had jurisdiction to hear a challenge to the EPA's final rule involving the scope and effect of the rule defining what waters the federal government can regulate under the Clean Water Act. *Murray Energy Corp. v. United States Department of Defense, 817 F.3d 261 (6th Cir. 2016).*
- **California Proposition Involving Egg Production Safe From Challenge.** California enacted legislation making it a crime to sell shelled eggs in the state (regardless of where they were produced) that came from a laying hen that was confined in a cage not allowing the hen to "lie down, stand up, fully extend its limbs, and turn around freely." The law was challenged by other states as an unconstitutional violation of the Commerce Clause by "conditioning the flow of goods across its state lines on the method of their production" and as being preempted by the Federal Egg Products Inspection Act. The trial court determined that the plaintiffs lacked standing and the appellate court affirmed. *Missouri v. Harris, 842 F.3d 658 (9th Cir. 2016).*
- **NRCS Properly Determined Wetland Status of Farmland.** The Natural Resource Conservation Service (NRCS) determined that a 0.8-acre area of a farm field was a prairie pothole that was a wetland that could not be farmed without the plaintiffs losing farm program eligibility. The NRCS made its determination based on "color tone" differences in photographs, wetland signatures and a comparison site that was 40 miles away. The court upheld the NRCS determination as satisfying regulatory criteria for identifying a wetland and was not arbitrary, capricious or contrary to the law. Certiorari has been filed with the U.S. Supreme Court asking the court to clear up a conflict between the circuit courts of appeal on the level of deference to be given federal government agency interpretive manuals. *Foster v. Vilsack, 820 F.3d 330 (8th Cir. 2016).*
- **Family Limited Partnerships (FLPs) and the "Business Purpose" Requirement.** In *Estate of Holliday v. Commissioner, T.C. Memo. 2016-51*, the court held that the transfers of marketable securities to an FLP two years before the transferor's death was not a bona fide sale, with the result that the decedent (transferor) was held to have retained an interest under I.R.C. §2036(a) and the FLP interest was included in the estate at no discount. In *Estate of Beyer v. Commissioner, T.C. Memo. 2016-183,* the court upheld the assessment of gift and estate tax (and gift tax penalties) with respect to transfers to an FLP because the court determined that every benefit claimed for the FLP was offered or could have been achieved by trusts and other arrangements.

"Top Ten" Ag Law and Tax Developments of 2016

1. **The Election of Donald Trump as President and the Potential Impact on Agricultural and Tax Policy.** Rural America voted overwhelmingly for President-elect Trump, and he will be the President largely because of the sea of red all across the country in the non-urban areas. So, what can farmers, ranchers and agribusinesses anticipate the big issues to be in the coming months and next few years and the policy responses? It's probably reasonable to expect that same approach will be applied to regulations impacting agriculture. Those with minimal benefit and high cost could be eliminated or retooled such that they are cost effective. Overall, the pace of the generation of additional regulation will be slowed. Indeed, the President-elect has stated that for every new regulation, two existing regulations have to be eliminated.

   Ag policy. As for trade, it is likely that trade agreements will be negotiated on a much more bi-lateral basis – the U.S. negotiating with one other country at a time rather than numerous countries. The President-elect is largely against government hand-outs and is big on economic efficiency. That bodes well for the oil and gas industry (and perhaps nuclear energy). But, what about less efficient forms of energy that are heavily reliant on

taxpayer support? Numerous agricultural states are heavily into subsidized forms of energy with their state budgets littered with numerous tax "goodies" for "renewable" energy." However, the President-elect won those states. So, does that mean that the federal subsidies for ethanol and biodiesel will continue. Probably. The Renewable Fuels Standard will be debated in 2017, but will anything significant happen? Doubtful. It will continue to be supported, but I expect it to be reviewed to make sure that it fits the market. Indeed, one of the reasons that bio-mass ethanol was reduced so dramatically in the EPA rules was that it couldn't be produced in adequate supplies. What about the wind energy production tax credit? What about the various energy credits in the tax code? Time will tell, but agricultural interests should pay close attention.

The head of the Senate Ag Committee will be Sen. Roberts from Kansas. As chair, he will influence the tone of the debate of the next farm bill. I suspect that means that the farm bill will have provisions dealing with livestock disease and biosecurity issues. Also, I suspect that it will contain significant provisions crop insurance programs and reforms of existing programs. The House Ag Committee head will be Rep. Conaway from Texas. That could mean that cottonseed will become an eligible commodity for Agricultural Risk Coverage (ARC) and Price Loss Coverage (PLC). It may also be safe to assume that for the significant Midwest crops (and maybe some additional crops) their reference prices will go up. Also, it now looks as if the I.R.C. §179 issue involving the income limitation for qualification for farm program payments (i.e., the discrepancy of the treatment between S corporations and C corporations) will be straightened out. Other federal agencies that impact agriculture (EPA, Interior, FDA, Energy, OSHA) can be expected to be more friendly to agriculture in a Trump Administration.

Tax policy. As for income taxes, it looks at this time that the Alternative Minimum Tax might be eliminated, as will the net investment income tax that is contained in Obamacare. Individual tax rates will likely drop, and it might be possible that depreciable assets will be fully deductible in the year of their purchase. Also, it looks like the corporate tax rate will be cut as will the rate applicable to pass-through income. As for transfer taxes, President-elect Trump has proposed a full repeal of the federal estate tax as well as the federal gift tax. Perhaps repeal will be effective January 1, 2017, or perhaps it will be put off until the beginning of 2018. Or, it could be phased-in over a certain period of time. Also, while it appears at the present time that any repeal would be "permanent," that's not necessarily a certainty. Similarly, it's not known whether the current basis "step-up" rule would be retained if the estate tax is repealed. That's particularly a big issue for farmers and ranchers. It will probably come down to a cost analysis as to whether step-up basis is allowed. The President-elect has already proposed a capital gains tax at death applicable to transfers that exceed $10 million (with certain exemptions for farms and other family businesses). Repeal of gift tax along with repeal of estate tax has important planning implications. There are numerous scenarios that could play out. Stay tuned, and be ready to modify existing plans based on what happens. Any repeal bill would require 60 votes in the Senate to avoid a filibuster unless repeal is done as part of a reconciliation bill. Also, without being part of a reconciliation bill, any repeal of the federal estate tax would have to "sunset" in ten years.

2. **TMDLs and the Regulation of Ag Runoff.** Diffused surface runoff of agricultural fertilizer and other chemicals into water sources as well as irrigation return flows are classic examples of nonpoint source pollution that isn't discharged from a particular, identifiable source. A primary source of nonpoint source pollution is agricultural runoff. As nonpoint source pollution, the Clean Water Act (CWA) leaves regulation of it up to the states rather than the federal government. The CWA sets-up a "states-first" approach to regulating water quality when it comes to nonpoint source pollution. Two key court opinions were issued in 2016 where the courts denied attempts by environmental groups to force the EPA to create additional federal regulations involving Total Maximum Daily Loads (TMDLs). The states are to establish total maximum daily TMDLs for watercourses that fail to meet water quality standards after the application of controls on point sources. A TMDL establishes the maximum amount of a pollutant that can be discharged or "loaded" into the water at issue from all combined sources on a *daily* basis and still permit that water to meet water quality standards. A TMDL must be set "at a level necessary to implement water quality standards." The purpose of a TMDL is to limit the amount of pollutants in a watercourse on any particular date. Two federal court opinions in 2016 reaffirmed the principle that regulation of nonpoint source pollution is left to the states and not the federal government.

In *Conservation Law Foundation v. United States Environmental Protection Agency, No. 15-165-ML, 2016 U.S. Dist. LEXIS 172117 (D. R.I. Dec. 13, 2016),* the plaintiff claimed that the EPA's approval of the state TMDL for a waterbody constituted a determination that particular stormwater discharges were contributing to the TMDL being exceeded and that federal permits were thus necessary. The court, however, determined that the EPA's approval of the TMDL did *not* mean that EPA had concluded that stormwater discharges required

permits. The court noted that there was nothing in the EPA's approval of the TMDL indicating that the EPA had done its own fact finding or that EPA had independently determined that stormwater discharges contributed to a violation of state water quality standards. The regulations simply do not require an NPDES permit for stormwater discharges to waters of the United States for which a TMDL has been established. A permit is only required when, after a TMDL is established, the EPA makes a determination that *further controls* on stormwater are needed.

In the other case, *Gulf Restoration Network v. Jackson, No. 12-677 Section: "A" (3), 2016 U.S. Dist. LEXIS 173459 (E.D. La. Dec. 15, 2016),* numerous environmental groups sued the EPA to force them to impose limits on fertilizer runoff from farm fields. The groups claimed that many states hadn't done enough to control nitrogen and phosphorous pollution from agricultural runoff, and that the EPA was required to mandate federal limits under the Administrative Procedure Act – in particular, 5 U.S.C. §553(e) via §303(c)(4) of the CWA. Initially, the groups told the EPA that they would sue if the EPA did not write the rules setting the limits as requested. The EPA essentially ignored the groups' petition by declining to make a "necessity determination. The groups sued and the trial court determined that the EPA had to make the determination based on a 2007 U.S. Supreme Court decision involving the Clean Air Act (CAA). That decision was reversed on appeal on the basis that the EPA has discretion under §303(c)(4)(B) of the CWA to decide not to make a necessity determination as long as the EPA gave a "reasonable explanation" based on the statute why it chose not to make any determination. The appellate court noted that the CWA differed from the CAA on this point. On remand, the trial court noted upheld the EPA's decision not to make a necessity determination. The court noted that the CWA gives the EPA "great discretion" when it comes to regulating nutrients, and that the Congressional policy was to leave regulation of diffused surface runoff up to the states. The court gave deference to the EPA's "comprehensive strategy of bringing the states along without the use of federal rule making…".

Also, in 2016 the U.S. Supreme Court declined to review a decision of the U.S. Court of Appeals for the Third Circuit which had determined in 2015 that the EPA had acted within its authority under 33 U.S.C. §1251(d) in developing a TMDL for the discharge of nonpoint sources pollutants into the Chesapeake Bay watershed. *American Farm Bureau, et al. v. United States Environmental Protection Agency, et al., 792 F.3d 281 (3d Cir. 2015), cert. den., 136 S. Ct. 1246 (2016).*

3. **The IRS and Self-Employment Tax.** Two self-employment tax issues affecting farmers and ranchers have been in the forefront in recent years – the self-employment tax treatment of Conservation Reserve Program (CRP) payments and the self-employment tax implications of purchased livestock that had their purchase price deducted under the de minimis safe harbor of the capitalization and repair regulations. On the CRP issue, in 2014 the U.S. Court of Appeals ruled that CRP payments in the hands of a non-farmer are not subject to self-employment tax. The court, in *Morehouse v. Comr., 769 F.3d 616 (8th Cir. 2014), rev'g, 140 T.C. 350 (2013),* held the IRS to its historic position staked out in Rev. Rul. 60-32 that government payments attributable to idling farmland are not subject to self-employment tax when received by a person who is not a farmer. The court refused to give deference to an IRS announcement of proposed rulemaking involving the creation of a new Rev. Rul. that would obsolete the 1960 revenue ruling. The IRS never wrote the new rule, but continued to assert their new position on audit. The court essentially told the IRS to follow appropriate procedure and write a new rule reflecting their change of mind. In addition, the court determined that CRP payments are "rental payments" statutorily excluded from self-employment tax under I.R.C. §1402(a). Instead of following the court's invitation to write a new rule, the IRS issued a non-acquiescence with the Eighth Circuit's opinion. *A.O.D. 2015-02, IRB 2015-41.* IRS said that it would continue audits asserting their judicially-rejected position, even inside the Eighth Circuit (AR, IA, MN, MO, NE, ND and SD).

In 2016, the IRS had the opportunity to show just how strong its opposition to the *Morehouse* decision is. A Nebraska non-farmer investor in real estate received a CP2000 Notice from the IRS, indicating CRP income had been omitted from their 2014 return. The CP2000 Notice assessed the income tax and SE Tax on the alleged omitted income. The CRP rental income was in fact included on the return, but it was included on Schedule E along with cash rents, where it was not subject to self-employment tax. The practitioner responded to the IRS Notice by explaining that the CRP rents were properly reported on Schedule E because the taxpayer was not a farmer. This put the matter squarely before the IRS to reject the taxpayer's position based on the non-acquiescence. But, the IRS replied to the taxpayer's response with a letter informing the taxpayer that the IRS inquiry was being closed with no change from the taxpayer's initial position that reported the CRP rents for the non-farmer on Schedule E.

On the capitalization and repair issue, taxpayers can make a de minimis safe harbor election that allows amounts otherwise required to be capitalized to be claimed as an I.R.C. §162 ordinary and necessary business expense. This de minimis expensing election has a limit of $5,000 for taxpayers with an Applicable Financial Statement (AFS) and $2,500 for those without an AFS. Farmers will fall in the latter category. In both cases, the limit is applied either per the total on the invoice, or per item as substantiated by the invoice. One big issue for farmers and ranchers is how to report the income from the sale of purchased livestock that are held for productive use, such as breeding or dairy animals for which the de minimis safe harbor election was made allowing the full cost of the livestock to be deducted. It had been believed that because the repair regulations specify when the safe harbor is used, the sale amount is reported fully as ordinary income that is reported on Schedule F where it is subject to self-employment tax for a taxpayer who is sole proprietor farmer or a member of a farm partnership. In that event, the use of the safe harbor election would produce a worse tax result that would claiming I.R.C. §179 on the livestock.

An alternative interpretation of the repair regulations is that the self-employment tax treatment of the gain or loss on sale of assets for which the purchase price was deducted under the de minimis safe harbor is governed by Treas. Reg. §1.1402(a)-6(a). That regulation states that the sale of property is not subject to self-employment tax unless at least one of two conditions are satisfied: (1) the property is stock in trade or other property of a kind which would properly be includible in inventory if on-hand at the close of the tax year; or (2) the property is held primarily for sale to customers in the ordinary course of a trade or business. Because purchased livestock held for dairy or breeding purposes do not satisfy the first condition, the question comes down to whether condition two is satisfied – are the livestock held primarily for sale to customers in the ordinary course of a trade or business? The answer to that question is highly fact-dependent. If the livestock whose purchase costs have been deducted under the de minimis rule are *not* held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, the effect of the regulation is to report the gain on sale on Part II of Form 4797. This follows Treas. Reg. §1.1402(a)-6(a) which bars Sec. 1231 treatment (which would result in the sale being reported on Part I of Form 4797). In that event, the income received on sale would not be subject to self-employment tax.

In 2016, the IRS, in an unofficial communication, said that the alternative interpretation is the correct approach. However, the IRS was careful to point out that the alternative approach is based on the assumptions that the livestock were neither inventoriable nor held for sale, and that those assumptions are highly fact dependent on a case-by case basis. The IRS is considering adding clarifying language to the Farmers' Tax Guide (IRS Pub. 225) and/or the Schedule F Instructions.

4. **Prison Sentences Upheld For Egg Company Executives Even Though Government Conceded They Had No Knowledge of Salmonella Contamination.** The defendant, an executive of a large-scale egg production company (trustee of the trust that owned the company), and his son (the Chief Operating Officer of the company) pled guilty as "responsible corporate officers" to misdemeanor violations of 21 U.S.C. §331(a) for introducing eggs that had been adulterated with salmonella into interstate commerce from the beginning of 2010 until approximately August of 2010. They each were fined $100,000 and sentenced to three months in prison. They appealed their sentences as unconstitutional on the basis that they had no knowledge that the eggs at issue were contaminated at the time they were shipped. They also claimed that their sentences violated Due Process and the Eighth Amendment insomuch as the sentences were not proportional to their "crimes." They also claimed that incarceration for a misdemeanor offense would violate substantive due process.

   The trial court determined that the poultry facilities were in poor condition, had not been appropriately cleaned, had the presence of rats and other rodents and frogs and, as a result, the defendant and his son either "knew or should have known" that additional salmonella testing was needed and that remedial and preventative measures were necessary to reduce the presence of salmonella. The appellate court agreed, finding that the evidence showed that the defendant and son were liable for negligently failing to prevent the salmonella outbreak and that 21 U.S.C. §331(a) did not have a knowledge requirement. The appellate court also did not find a due process violation. The defendant and son claimed that because they did not personally commit wrongful acts, and that due process is violated when prison terms are imposed for vicarious liability felonies where the sentence of imprisonment is only for misdemeanors. However, the court held that vicarious liability was not involved, and that 21 U.S.C. §331(a) holds a corporate officer accountable for failure to prevent or remedy "the conditions which gave rise to the charges against him." Thus, the appellate court determined, the defendant and son were liable for negligently failing to prevent the salmonella outbreak. The court determined that the lack of criminal intent does not violate the Due Process Clause for a "public welfare offense" where the penalty is relatively small (the court believed it was), the defendant's reputation was not "gravely" damaged (the court believed that it was not) and congressional intent supported the penalty (the court believed it did). The court

also determined that there was no Eighth Amendment violation because "helpless" consumers of eggs were involved. The court also found no procedural or substantive due process violation with respect to the sentences because the court believed that the facts showed that the defendant and son "had reason to suspect contamination" and should have taken action to address the problem at that time (even though law didn't require it).

The dissent pointed out that the government stipulated at trial that its investigation did not identify any corporate personnel (including the defendant and son) who had any knowledge that eggs sold during the relevant timeframe were contaminated with salmonella. The dissent also noted that the government conceded that there was no legal requirement for the defendant or corporation to comply with stricter regulations during the timeframe in issue. As such, the convictions imposed and related sentences were based on wholly nonculpable conduct and there was no legal precedent supporting imprisonment in such a situation. The dissent noted that the corporation "immediately, and at great expense, voluntarily recalled hundreds of millions of shell eggs produced" at its facilities when first alerted to the problem. As such, according to the dissent, due process was violated and the sentences were unconstitutional. *United States v. Decoster, 828 F.3d 626 (8th Cir. 2016).*

5. **Pasture Chiseling Activity Constituted Discharge of "Pollutant" That Violated the CWA.** The plaintiff bought approximately 2,000 acres in northern California in 2012. Of that 2,000 acres, the plaintiff sold approximately 1,500 acres. The plaintiff retained an environmental consulting firm to provide a report and delineation map for the remaining acres and requested that appropriate buffers be mapped around all wetlands. The firm suggested that the plaintiff have the U.S. Army Corps of Engineers (COE) verify the delineations before conducting any grading activities. Before buying the 2,000 acres, the consulting firm had provided a delineation of the entire tract, noting that there were approximately 40 acres of pre-jurisdictional wetlands. The delineation on the remaining 450 acres of pasture after the sale noted the presence of intact vernal and seasonal swales on the property along with several intermittent and ephemeral drainages. A total of just over 16 acres of pre-jurisdictional waters of the United States were on the 450 acres – having the presence of hydric soils, hydrophytic vegetation and hydrology (1.07 acres of vernal pools; 4.02 acres of vernal swales; .82 acres of seasonal wetlands; 2.86 acres of seasonal swales and 7.40 acres of other waters of the United States). In preparation to plant wheat on the tract, the property was tilled at a depth of 4-6 inches to loosen the soil for plowing with care taken to avoid the areas delineated as wetlands. However, an officer with the (COE) drove past the tract and thought he saw ripping activity that required a permit. The COE sent a cease and desist letter and the plaintiff responded through legal counsel requesting documentation supporting the COE's allegation and seeking clarification as to whether the COE's letter was an enforcement action and pointing out that agricultural activities were exempted from the CWA permit requirement. The COE then provided a copy of a 1994 delineation and requested responses to numerous questions. The plaintiff did not respond. The COE then referred the matter to EPA for enforcement. The plaintiff sued the COE claiming a violation of his Fifth Amendment right to due process and his First Amendment right against retaliatory prosecution. The EPA refused the referral due to the pending lawsuit so the COE referred the matter to the U.S. Department of Justice (DOJ). The DOJ filed a counterclaim against the plaintiff for CWA violations.

   The court granted the government's motion on the due process claim because the cease and desist letter did not initiate any enforcement that triggered due process rights. The court also dismissed the plaintiff's retaliatory prosecution claim. On the CWA claim brought by the defendant, the court determined that the plaintiff's owner could be held liable as a responsible party. The court noted that the CWA is a strict liability statute and that the intent of the plaintiff's owner was immaterial. The court then determined that the tillage of the soil causes it to be "redeposited" into delineated wetlands. The redeposit of soil, the court determined, constituted the discharge of a "pollutant" requiring a national pollution discharge elimination system (NPDES) permit. The court reached that conclusion because it found that the "waters" on the property were navigable waters under the CWA due to a hydrological connection to a creek that was a tributary of Sacramento River and also supported the federally-listed vernal pool fairy shrimp and tadpole shrimp. Thus, a significant nexus with the Sacramento River was present. The court also determined that the farming equipment, a tractor with a ripper attachment constituted a point source pollutant under the CWA. The discharge was not exempt under the "established farming operation" exemption of 33 U.S.C. §1344(f)(1) because farming activities on the tract had not been established and ongoing, but had been grazed since 1988. Thus, the planting of wheat could not be considered a continuation of established and ongoing farming activities. *Duarte Nursery, Inc. v. United States Army Corps of Engineers, No. 2:13-cv-02095-KJM-AC, 2016 U.S. Dist. LEXIS 76037 (E.D. Cal. Jun. 10, 2016).*

6. **No Recapture of Prepaid Expenses Deducted in Prior Year When Surviving Spouse Claims Same Deduction in Later Year.** The decedent, a materially participating Nebraska farmer, bought farm inputs in 2010 and deducted their cost on his 2010 Schedule F. He died in the spring of 2011 before using the inputs to

put the spring 2011 crop in the ground. Upon his death, the inputs were included in the decedent's estate at their purchase price value and then passed to a testamentary trust for the benefit of his wife. The surviving spouse took over the farming operation, and in the spring of 2011, took a distribution of the inputs from the trust to plant the 2011 crops. For 2011, two Schedule Fs were filed. A Schedule F was filed for the decedent to report the crop sales deferred to 2011, and a Schedule F was filed for the wife to report the crops sold by her in 2011 and claim the expenses of producing the crop which included the amount of the inputs (at their date-of-death value which equaled their purchase price) that had been previously deducted as prepaid inputs by the husband on the couple's joint 2010 return. The IRS denied the deduction on the basis that the farming expense deduction by the surviving spouse was inconsistent with the deduction for prepaid inputs taken in the prior year by the decedent and, as a result, the "tax benefit rule" applied. The court disagreed, noting that the basis step-up rule of I.R.C. §1014 allowed the deduction by the surviving spouse which was not inconsistent with the deduction for the same inputs in her deceased husband's separate farming business. The court also noted that inherited property is not recognized as income by the recipient, which meant that another requisite for application of the tax benefit rule did not apply. *Estate of Backemeyer v. Comr., 147 T.C. No. 17 (2016).*

7. **Capitalization Required For Interest and Real Property Taxes Associated with Crops Having More Than Two-Year Preproductive Period.** The petitioner (three partnerships) bought land that they planned to use for growing almonds. They financed the purchase by borrowing money and paying interest on the debt. They then began planting almond trees. They deducted the interest and property taxes on their returns. The IRS objected to the deduction on the basis that the interest and taxes were indirect costs of the "production of real property" (i.e., the almonds trees that were growing on the land. The Tax Court agreed with the IRS noting that I.R.C. §263A requires the capitalization of certain costs and that those costs include the interest paid to buy the land and the property taxes paid on the land attributable to growing crops and plants where the preproductive period of the crop or plant exceeds two years. I.R.C. §263A(f)(1) states that "interest is capitalized where (1) the interest is paid during the production period and (2) the interest is allocable to real property that the taxpayer produced and that has a long useful life, an estimated production period exceeding two years, or an estimated production period exceeding one year and a cost exceeding $1 million." The corresponding regulation, the court noted, requires that the interest be capitalized under the avoided cost method. The court also noted that the definition of "real property produced by the taxpayer for the taxpayer's use in a trade or business or in an activity conducted for profit" included "land" and "unsevered natural products of the land" and that "unsevered natural products of the land" general includes growing crops and plants where the preproductive period of the crop or plant exceeds two years. Because almond trees have a preproductive period exceeding two years in accordance with IRS Notice 2000-45, and because the land was "necessarily intertwined" with the growing of the almond trees, the interest and tax cost of the land is a necessary and indispensable part of the growing of the almond trees and must be capitalized. *Wasco Real Properties I, LLC, et al. v. Comr., T.C. Memo. 2016-224.*

8. **Proposed Regulations Under I.R.C. §2704.** In early August, the IRS issued new I.R.C. §2704 regulations that could seriously impact the ability to generate minority interest discounts for the transfer of family-owned entities. Prop. Reg. – 163113-02 (Aug. 2, 2016). The proposed regulations, if adopted in their present form, will impose significant restrictions on the availability of valuation discounts for gift and estate tax purposes in a family-controlled environment. Prop. Treas. Regs. §§25.2704-1; 25.2704-4; REG- 163113-02 (Aug. 2, 2016). They also redefine via regulation and thereby overturn decades of court decisions honoring the well-established willing-buyer/willing-seller approach to determining fair market value (FMV) of entity interests at death or via gift of closely-held entities, including farms and ranches. The proposed regulations would have a significant impact on estate, business and succession planning in the agricultural context for many agricultural producers across the country and will make it more difficult for family farm and ranch businesses to survive when a family business partner dies. Specifically, the proposed regulations treat transfer within three years of death as death-bed transfers, create new "disregarded restrictions" and move entirely away from examining only those restrictions that are more restrictive than state law. As such, the proposed regulations appear to exceed the authority granted to the Treasury by Congress to promulgate regulations under I.R.C. §2704 and should be withdrawn. A hearing on the regulations was held in early December.

9. **COE Jurisdictional Determination Subject to Court Review.** The plaintiff, a peat moss mining company, sought the approval of the Corps of Engineers (COE) to harvest a swamp (wetland) for peat moss to use in landscaping projects. The COE issued a jurisdictional determination that the swamp was a wetland subject to the permit requirements of the Clean Water Act (CWA). The plaintiff sought to challenge the COE determination, but the trial court, in a highly disingenuous opinion in light of the unanimous U.S. Supreme Court opinion in *Sackett v. Environmental Protection Agency, 132 S. Ct. 1367 (2012),* ruled for the COE, holding that the plaintiff had three options: (1) abandon the project; (2) seek a federal permit costing over $270,000; or (3) proceed with the project and risk fines of up to $75,000 daily and/or criminal sanctions

including imprisonment. On appeal, the court unanimously reversed, strongly criticizing the trial court's opinion. Based on Sackett, the court held that COE Jurisdictional Determinations constitute final agency actions that are immediately appealable in court. The court noted that to hold elsewise would allow the COE to effectively kill the project without any determination of whether it's position as to jurisdiction over the wetland at issue was correct in light of *Rapanos v. United States, 547 U.S. 715 (U.S. 2006).* The court noted that the COE had deliberately left vague the "definitions used to make jurisdictional determinations" so as to expand its regulatory reach. While the COE claimed that the jurisdictional determination was merely advisory and that the plaintiff had adequate ways to contest the determination, the court determined that such alternatives were cost prohibitive and futile. The court stated that the COE's assertion that the jurisdictional determination (and the trial court's opinion) was merely advisory ignored reality and had a powerful coercive effect. The court held that the Fifth Circuit, which reached the opposition conclusion with respect to a COE Jurisdictional Determination in *Belle Co., LLC v. United States Army Corps. of Engineers, 761 F.3d 383 (5th Cir. 2014), cert. den., 83 U.S.L.W. 3291 (U.S. Mar. 23, 2015),* misapplied the Supreme Court's decision in *Sackett. Hawkes Co., Inc., et al. v. United States Army Corps of Engineers, 782 F.3d 984 (8th Cir. 2015), rev'g., 963 F. Supp. 2d 868 (D. Minn. 2013).* In a later decision, the court denied a petition to rehear the case en banc and by the panel. *Hawkes Co., Inc., et al. v. United States Army Corps of Engineers, No. 13-3067, 2015 U.S. App. LEXIS 11697 (8th Cir. Jul. 7, 2015).* In December of 2015, the U.S. Supreme Court agreed to hear the case and affirmed the Eighth Circuit on May 31, 2016. The Court, in a unanimous opinion, noted that the memorandum of agreement between the EPA and the Corps established that jurisdictional determinations are “final actions” that represent the Government’s position, are binding on the Government in any subsequent Federal action or litigation involving the position taken in the jurisdictional determination. When the landowners received an “approved determination” that meant that the Government had determined that jurisdictional waters were present on the property due to a “nexus” with the Red River of the North, located 120 miles away. As such, the landowners had the right to appeal in Court after exhausting administrative remedies and the Government’s position take in the jurisdictional determination was judicially reviewable. Not only did the jurisdictional determination constitute final agency action under the Administrative Procedure Act, it also determined rights or obligations from which legal consequences would flow. That made the determination judicially reviewable. *United States Army Corps of Engineers v. Hawkes Company, 136 S. Ct. 1807 (2016).*

10. **Court Obscures Rational Basis Test To Eliminate Ag Exemption From Workers' Compensation Law.** While this is a state Supreme Court decision, its implications are significant. Most, if not all, states have a statutory exemption from workers’ compensation for employers that are engaged in agriculture. The statutory exemption varies in scope from state to state and, of course, an employer that is otherwise exempt can choose to be covered by the statute and offer workers’ compensation benefits to employees. In this case, the plaintiffs claimed that their on-the-job injuries should be covered under the state (NM) workers' compensation law. One plaintiff tripped while picking chile and fractured her left wrist. The other plaintiff was injured while working in a dairy when he was head-butted by a cow and pushed up against a metal door causing him to fall face-first into a concrete floor and sustain neurological damage. The plaintiffs' claims for workers' compensation benefits were dismissed via the exclusion from the workers' compensation system for employers. On appeal, the appellate court reversed. Using rational basis review (the standard most deferential to the constitutionality of the provision at issue), the court interpreted Sec. 52-1-6(A) of the New Mexico Code as applying to the primary job duties of the employees (as opposed to the business of the employer and the predominant type of employees hired), and concluded the distinction was irrational and lacked any rational purpose. The appellate court noted that the purpose of the law was to provide "quick and efficient delivery" of medical benefits to injured and disabled workers. Thus, the court determined that the exclusion violated the constitutional equal protection guarantee. The court further believed that the exclusion for workers that cultivate and harvest (pick) crops, but the inclusion of workers that perform tasks associated with the processing of crops was a distinction without a difference. The court also made no mention that the highest court in numerous other states had upheld a similar exclusion for agriculture from an equal protection constitutional challenge.

    On further review, the state Supreme Court affirmed. The court determined that there was nothing to distinguish farm and ranch laborers from other ag employees and that the government interest of cost savings, administrative convenience and similar interests unique to agriculture were not rationally related to a legitimate government interest. The court determined that the exclusion that it construed as applying to ag laborers was arbitrary discrimination. A dissenting judge pointed out that the legislature’s decision to allow employers of farm and ranch laborers to decide for themselves whether to be subject to workers’ compensation or opt out and face tort liability did not violate any constitutionally-protected right. The dissent noted that such ability to opt out was a legitimate statutory scheme that rationally controlled costs for New Mexico farms and ranches, and that 29 percent of state farms and ranches had elected to be covered by workers’ compensation. The dissent also noted that the majority’s opinion would have a detrimental economic impact on small, economically fragile

farms in New Mexico by imposing an additional economic cost of $10.5 million annually (as projected by the state Workers' Compensation Administration). On this point, the dissent further pointed out that the average cost of a claim was $16,876 while the average net farm income for the same year studied was $19,373. The dissent further concluded that the exemption for farming operations was legitimately related to insulating New Mexico farm and ranches from additional costs. In addition, the dissent reasoned that the majority misapplied the rational basis analysis to hold the act unconstitutional as many other state courts and the U.S. Supreme Court had held comparable state statutes to satisfy the rational basis test. The dissent pointed out forcefully that the exclusion applied to *employers* and that the choice to be covered or not resided with employers who predominately hired ag employees. As such there was no disparate treatment between ag laborers and other agricultural workers. *Rodriguez, et al. v. Brand West Dairy, et al., 378 P.3d 13 (N.M. Sup. Ct. 2016), aff'g., 356 P.3d 546 (N.M. Ct. App. 2015).*

Conclusion

As you can see, agricultural law and agricultural taxation play a very prominent role in the agricultural industry and the production of agricultural products. Don't expect that to change. 2017 promises to be another active year, particularly on the agricultural policy and tax policy front. Being aware of those developments as they occur and their implications can be critical for any particular farm, ranch, rural landowner or agribusiness.