



**2009 New Legislation
-by Roger McEowen****

2321 N. Loop Drive
Suite 200
Ames, IA 50010
Phone: (515) 294-5217
Fax: (515) 294-0700

TABLE OF CONTENTS

	Page
Part A - The Worker, Homeownership and Business Assistance Act of 2009	Tax Manual (Section R)
Part B - The American Recovery and Reinvestment Act of 2009	Tax Manual (Section R)
Part C - Energy Related Provisions - Recent Legislation	Tax Manual (Section R)
Part D - Wine Industry - New Rulings	Page 2
Part E - Domestic Production Activity Deduction - Members of Cooperatives	Page 4
Part F - Wind Energy Production: Legal Issues and Liability Concerns for Landowners	Page 10
Part G - Unharvested Crops in a Decedent's Estate	Page 31
Part H - Income Tax Consequences of the CWT Program ...	Page 36

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**Leonard Dolezal Professor in Agricultural Law, Iowa State University, Ames, Iowa; Director of the ISU Center for Agricultural Law and Taxation. Member of the Iowa and Kansas Bar Associations and licensed to practice in Nebraska. The Center's website is located at www.calt.iastate.edu.



2321 N. Loop Drive
Suite 200
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Phone: (515) 294-5217
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- + Farm Bill
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- + Iowa Cases
- + Real Estate
- + Regulatory Law
- + Secured Transactions
- + Taxation
- + Water Law
- + Other

Two rulings of importance to the wine industry

- by Roger McEowen

The Iowa wine industry has been reborn in recent years. About a century ago, Iowa was the sixth largest grape producing state in the nation. With Prohibition, the expanding market for corn and soybeans, damage to grapevines due to chemical drift from row crops and a severe blizzard in 1940, the industry declined significantly. However, in the last few years, the industry has made a comeback. According to the Agricultural Marketing Resource Center (AgMRC) at Iowa State University, there are now more than 70 wineries in Iowa that produce more than 240,000 gallons annually. More than 600 acres are planted to grapes in Iowa. So, while Iowa is not the Napa Valley, grape-growing is becoming a bigger deal. That makes these two recent rulings, one by the U.S. Tax Court, and the other by the IRS, important.

The Tax Court case was one that we have been talking about for several months in anticipation of the court's opinion. If you attended the ISU Tax Schools last fall, we covered the case and its importance to agriculture and mentioned that a decision was expected in early 2007.

The case involved a Sonoma County, California, vineyard and a dispute over the appropriate depreciation of trellises and irrigation systems. The case had been watched closely not only by the grape-growing industry, but by agriculture in general. IRS had taken the position that vineyard trellises and above-ground irrigation systems were depreciable land improvements rather than depreciable agricultural equipment. Land improvements are depreciable over 15 years as property with a 20-year class life, while ag equipment is depreciable over 7 years with a 10-year class life. The taxpayers treated all of the property (trellises, drip irrigation systems and a well) as ag equipment, and depreciated the property over seven years. The impact of the IRS position on the taxpayer meant that they owed an additional \$30,000 on their 2002 tax return.

Both IRS and the taxpayer cited the same 1975 Tax Court case for the tests to be utilized in determining whether an item is depreciable tangible personal property. There are six factors for consideration - (1) whether the property is capable of being moved; (2) whether the property is designed or constructed to remain permanently in place; (3) whether there are circumstances that show that the property may or will have to be moved; (4) how difficult and time-consuming it is to move the property; (5) how much damage the property will sustain if moved; and (6) how the property is affixed to the land. The taxpayer argued that the trellises and above-ground irrigation systems are not inherently permanent and are used as an integral part of the taxpayer's production activity. IRS argued that the trellises and irrigation systems, as a whole, are not moveable and are, therefore, land improvements with the same 20-plus-year lifespan as the vines. IRS pointed to the industry-standard long-term vineyard leases that protect the large investment in such systems and describe them as land improvements. Key to the IRS argument was that to move the system, the taxpayer had to take the entire system apart and, in the process of taking it apart, pieces of the trellises and irrigation system are destroyed.

The Tax Court agreed with the IRS as to the irrigation system and the well. The evidence established that the well, which was permanently affixed to and not readily removable from the earth, was a permanent land improvement that could be expected to work for a long time – approximately 30 years. While some of the irrigation system components were above-ground and could be removed, repaired and maintained, land improvement categorization was overall supported by the fact that the systems in great part were buried underground. As such, the court viewed them as permanent structures that were not readily movable. So, the entire irrigation system, including the above-ground drip lines were held to be land improvements that are depreciable over 15 years.

However, the court held that the trellises were depreciable ag equipment. The court reasoned that trellises are synonymous with fencing (fencing is ag equipment) in that they use posts that are not affixed in concrete (even posts affixed in concrete have been held to not be land improvements). The trellises could also be dismantled and moved, the court noted, and the taxpayer had actually done so in the past. The court also reasoned that the trellises were like machines inasmuch as the posts, stakes and wires could be adjusted to train grapevines to produce high-quality grapes.

The court's holding that trellises can be depreciated as farm equipment is a big win for the wine industry. Indeed, that was the most expensive part of the case for the taxpayers. The case might be appealed. In that event, the main focus of the case may be on the proper classification of the above-ground irrigation drip lines. Also, the appellate court may address the potential application of a 1974 U.S. Court of Claims opinion where the court held that something as permanent as a whiskey maturation facility (warehouse), when integral to the production of the product, is tangible personal property. The Tax Court didn't address the potential application of that case (it was raised in the taxpayer's brief). If it were deemed applicable, that could mean that all of the items at issue are depreciable as ag equipment. Now, that would really be big news. *Trentadue v. Comr.*, 128 T.C. No. 8 (2007).

The second development is an IRS ruling involving the uniform capitalization rules as applied to grapes. Those rules apply to

taxpayers that have a long-term crop with more than a two-year pre-productive period, and operate to bar deductions for the costs associated with that crop during the pre-productive period. Instead, the taxpayer has to add the associated costs to their tax basis in the crop. Production costs can include everything from direct labor and material costs to indirect rents, taxes and other costs.

The rule is a big deal for farmers in the nursery business, and almost all tree, vine or bush crops that require at least two years to reach production. For plants, the pre-productive period begins when the seed is planted or the plant is first acquired by the taxpayer. The pre-productive period ends when the plant is ready to be produced in marketable quantities or when the plant can reasonably be expected to be sold or otherwise disposed of. The pre-productive period, however, is determined not in light of the taxpayer's personal experience but in light of the weighted average pre-productive period determined on a nationwide basis. The IRS has provided a list of plants grown in commercial quantities in the U.S. that have a nationwide weighted average pre-productive period in excess of two years.

The rule is particularly problematic for grape growers. One question has been whether they have to capitalize all of their expenses up until the time the wine is sold. That would be a really tough rule for wineries because the wine-making process can take many years. But, a recent IRS ruling softens the blow. The ruling says that the IRS will treat grape growing and winery functions as separate businesses. That's the case, even though (1) the grapes are never subject to sale or other disposition (as those terms are used in tax law); and (2) the taxpayer does not operate their business as two separate and distinct businesses.

In conjunction with that reasoning, the IRS ruled that the actual pre-productive period of a grape crop grown for self-use ends no later than the crushing of the grapes. Extending the pre-productive period beyond crushing would result in the capitalization of inappropriate costs into a crop that no longer exists.

As for the costs incurred between the harvest of the grapes and blossoming of a later crop, IRS ruled that a taxpayer must capitalize the direct costs and an allocable portion of the indirect costs of producing the vine (such direct and indirect costs would include, for example, administration costs, depreciation and repairs on farm buildings and farm overhead). A special exception for "field costs" (irrigating, fertilizing, spraying and pruning) applies to the period between harvesting and the sale of the crop. These costs are not required to be capitalized because they don't benefit, and are unrelated to, the harvested crop. They merely maintain and improve the health of the vines, but they don't provide any benefits to the crop (which has already been severed from the vines). That field crop exception, however, ends when the pre-productive period of the crop ends, which is the onset of the crush. So, IRS concluded that pre-productive period costs incurred between the end of the pre-productive period and the blossoming of the later crop are generally deductible as the cost of maintaining the vine.

The bottom line, therefore, is that costs incurred between the harvest of the crop and the end of the pre-productive period must be capitalized unless they are "field costs" that provide no benefit to the already severed crop. *ILM 2007 13023 (Nov. 20, 2006)*.

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Domestic Production Activity Deduction for Members of Cooperatives

February 12, 2009

- by Philip E. Harris* and Roger A. McEowen**

Overview

Farmers are receiving Form 1099-PATR as well as statements about the pass-through of the domestic production activities deduction¹ (DPAD) from their cooperatives. These forms and statements have generated a number of questions from farmers and their income tax preparers. While the rules are confusing, they can have a significant positive effect on the tax returns of members of cooperatives that elect to pass the DPAD through to their members.

The most common question is how the increased amounts being reported in Box 3 of the Form 1099-PATR should be reported on a farmer's income tax return. To address that question and related issues, this article begins with a discussion of the DPAD as it applies to cooperatives and their members and then directly addresses the questions raised by the tax forms and statements being sent by cooperatives.

Statutory Background

I.R.C. § 199 allows taxpayers to claim a deduction on their income tax return based on their net income from most production activities in the United States. The domestic production activities deduction (DPAD) for tax years beginning in 2007, 2008 and 2009 is limited to the lesser of:

- 6% of the qualified production activities income (QPAI);
- 6% of the entity's taxable income without regard for I.R.C. § 199

(modified adjusted gross income for individual taxpayers); and

- 50% of Form W-2 wages paid during the year by the taxpayer

Note: The 6% rate increases to 9% for tax years beginning after 2009. (The deduction rate was 3% in 2005 and 2006.)

QPAI. QPAI equals domestic production gross receipts (DPGR) reduced by the sum of the following:

- Cost of goods sold (CGS) allocable to DPGR;
- Other deductions and expenses directly allocable to DPGR; and
- A share of other deductions and expenses that are not directly allocable to DPGR or another class of income

Observation: QPAI for many farmers is the sum of their net income reported on Schedule F (Form 1040), Profit or Loss from Farming, and net gain from sale of raised livestock reported on Form 4797, Sales of Business Property. However there are exceptions to this general rule.

DPGR. DPGR are receipts derived from the lease, rental, license, sale, exchange, or other disposition of qualifying production property that is manufactured, **produced, grown,** or extracted by the taxpayer in whole or in significant part within the United States.² Qualifying activities include cultivating soil,

raising livestock, and fishing as well as storage, handling, and other processing (other than transportation activities) of agricultural products.³

Wages. For many farmers, the 50% of wages limitation is the major limiting factor on their DPAD. Many farmers have little or no paid labor. In addition, wages for which withholding is not required are excluded from “Form W-2 wages.”⁴ Thus, wages paid in commodities, wages paid for agricultural labor to a child of the proprietor that is under age 18 or to a child under age 18 who is the child of all the partners in a partnership, and compensation paid in the form of nontaxable fringe benefits are not included in “Form W-2 wages.”

Note: For tax years beginning after May 17, 2006, only the wages allocable to DPGR are qualified wages for the 50% of wages limitation.

The DPAD and Cooperatives

In general. The DPAD can be confusing for members of cooperatives. Unlike the treatment of owners of other pass-through entities such as partnerships and S corporations, the DPAD deduction for products sold by a cooperative is calculated at the entity level and the cooperative can elect to pass part or all of the DPAD through to its members based on their patronage.⁵ Because the DPAD is calculated at the cooperative level and the deduction passes through to the members of the cooperative, the deduction on the member’s tax return is *not* limited by the member’s adjusted gross income or Form W-2 wages.

Cooperative’s DPAD. A cooperative engaged in marketing agricultural and horticultural products is treated as having produced any products that are produced by its patrons and marketed by the cooperative.⁶ In determining the pass-through DPAD, the cooperative’s taxable income and QPAI are computed without taking into account any deductions for patronage dividends, per-unit retain allocations, and nonpatronage distributions under I.R.C.

§ 1382(b) and (c).⁷

This rule led many cooperatives to take a closer look at how they characterize their payments to members for the members’ commodities. That characterization depends on the member agreement with the cooperative. The IRS was asked to examine several agreements last year, and issued five private letter rulings on the matter in 2008.⁸ In each of the rulings, IRS said that the payments a cooperative makes to its members for their commodities are advance per unit retains payments in money (PURPIM). Consequently, the cooperatives do not have to deduct those payments from their DPGR to compute their QPAI. The result is that a cooperative’s ability to treat the payments for commodities as PURPIM significantly increases the cooperative’s QPAI and potentially the DPAD the cooperative can elect to pass through to its members.

Example:

Ruraltown Farmer’s Cooperative is a marketing cooperative that had \$5,000,000 in gross receipts in 2008 from the sale of corn its members delivered to it, who are the farmers that produced the corn. Ruraltown paid \$4,000,000 to its members at the time they delivered the corn and another \$500,000 in patronage dividends after the close of the 2008 tax year. Ruraltown also had \$500,000 of other expenses that includes \$120,000 of wages.

Historically, Ruraltown treated the payments to its members at the time they delivered corn as payments for the purchase of the corn. However, after reviewing its membership agreement in light of the letter ruling issued by the IRS, Ruraltown concluded that those payments are advance PURPIM. Therefore, it did not deduct those payments from DPGR to compute its QPAI for 2008 and it included those payments in Box 3 of the 2008 Forms 1099-PATR it sent to its members.

Because Ruraltown marketed grain produced by its members, all of its receipts are DPGR. Consequently all of its expenses are allocable to DPGR and its QPAI is \$4,500,000 (\$5,000,000 - \$500,000).

Note: If Ruraltown’s payments to members at the time they delivered corn were purchases of

the corn, the \$4,000,000 cost of the corn would be an expense that is deducted from the cooperative's DPGR, which would reduce the cooperative's QPAI to \$500,000 (\$5,000,000 - \$500,000 - \$4,000,000).

Ruraltown's DPAD is \$30,000, which is the least of:

1. 6% of its \$4,500,000 QPAI, which is \$270,000
2. 6% of its \$500,000 taxable income, which is \$30,000, or
3. 50% of its \$120,000 wages, which is \$60,000.

The DPAD of Cooperative Members

The member's deduction is the DPAD of the cooperative that is allocable to the following:

- Patronage dividends paid to the patron in money, a qualified notice of allocation, or other property (except a nonqualified written notice of allocation); and
- Per-unit retain allocations that are paid to the patron in qualified per-unit retain certificates

Note: A cooperative must designate the patron's portion of the income allocable to QPAI in a written notice mailed by the cooperative to the patron no later than the fifteenth day of the ninth month following the close of the tax year.⁹

Example:

Based on the example above, Joe Corngrower, a member of Ruraltown Farmer's Cooperative, marketed 50,000 bushels of corn through Ruraltown in 2008, which was 2% of all the grain Ruraltown marketed that year. Ruraltown elected to pass its entire \$30,000 DPAD through to its members and allocated 2% (\$600) of it to Joe. Joe reports that \$600 DPAD on line 21 of his 2008 Form 8903, Domestic Production Activities Deduction. Joe can deduct that full \$600 regardless of his adjusted gross income (AGI) or Form W-2 wages because a DPAD that is passed through from a cooperative is not subject to

the 6% of AGI or 50% of wage limitations on the member's income tax return.

No double counting. The regulations specify that a qualified payment received by a patron of a cooperative is not taken into account by the patron for purposes of section 199.¹⁰ Therefore, patronage dividends paid to the patron in money, a qualified notice of allocation, or other property (except a nonqualified written notice of allocation) or in per-unit retain allocations that are paid to the patron in qualified per-unit retain certificates are not included in a member's DPGR.

It is important to note that this rule excludes the listed items from the member's DPGR whether or not the cooperative elects to pass part or all of its DPAD through to its members. Therefore, the cooperative's election to pass through DPAD to its members has no effect on the members' DPGR.

Example:

Based on the previous examples, Joe Corngrower cannot include the payments he received from Ruraltown in his DPGR because Ruraltown has characterized those payments as PURPIM and patronage dividends. He cannot include those payments in his DPGR even if Ruraltown passed none of its DPAD through to its members.

Effect of 5% safe harbor. There is no guidance on the interaction of Treas. Reg. § 1.199-6(l) and the safe harbor under Treas. Reg. § 1.199-1(d)(3)(i) that allows a taxpayer to treat all receipts as DPGR if less than 5% of the taxpayer's total gross receipts are non-DPGR. That raises a question as to whether a patron who qualifies for the 5% safe harbor can include qualified payments from a cooperative in DPGR because all receipts are included (due to the safe harbor). An alternative possibility is that Treas. Reg. § 1.199-6(l) overrides the 5% safe harbor and excludes the qualified payments from the

patron's DPGR.

In general, a more specific rule takes precedence over a more general rule if they are in conflict. Because Treas. Reg. § 1.199-6(l) is the more specific rule in this case it would seem to take precedence over the 5% safe harbor.

Cooperative's DPAD is not reduced. I.R.C. § 199(d)(3) and Treas. Reg. § 1.199-6 do not explicitly state the effect of a cooperative's election to pass its DPAD through to its patrons on the amount of the DPAD that the cooperative can claim. Neither the Code nor the Regulations require the cooperative to reduce its DPAD deduction. However, Example (2) of Treas. Reg. § 1.199-6(m) allows the cooperative, to deduct the full amount of the DPAD that it passed through to its patrons. In addition, IRS has ruled that a cooperative remains entitled to claim the entire section 199 deduction on its return (provided that it does not create or increase a patronage tax loss).¹¹

I.R.C. § 199(d)(3)(B) and Treas. Reg. § 1.199-6(b) require the cooperative to reduce the deduction it would otherwise claim against its taxable income under I.R.C. § 1382(b) for per-unit retain allocations and patronage dividends by the amount of the DPAD that it elects to pass through to its patrons. The reduction of that deduction has the same effect on the cooperative's taxable income as reducing the cooperative's DPAD by the DPAD passed through to the cooperative.

Reporting on Farmers' Tax Returns

Based on the preceding analysis, many of the questions raised by the Forms 1099-PATR and DPAD statements that are presently being sent to farmers by cooperatives can be addressed.

Question 1: The original 2008 Form 1099-PATR my client received from her cooperative reported \$10,000 in Box 3, which is the per unit retain that she received in January 2008 based on the grain she marketed through the cooperative in 2007. An amended 2008 Form 1099-PATR increases the amount reported in Box 3 by the \$100,000 of grain that she

delivered in 2008 and for which she was paid in 2008. If I report this entire amount on line 5b of Schedule F (Form 1040), the grain sales will be included in income twice. How should the amount in Box 3 be reported?

Answer 1: By reporting the \$100,000 the member received for grain sales in Box 3 of Form 1099-PATR, the cooperative is stating that the payment for grain is a per unit retain paid in money (PURPIM). That determination is based on the membership agreement. Because of that determination, the \$100,000 from the cooperative for the grain should not be reported as grain sales on line 4 of Schedule F (Form 1040). It should be included on both lines 5a and 5b of Schedule F (Form 1040).

Note: Reporting the \$100,000 for grain as part of the PURPIMs on line 5b of Schedule F (Form 1040) is consistent with the Treas. Reg. § 1.199-6(l) statement that those payments are not included in the member's DPGR. Your client's 2008 DPGR does not include the \$100,000 she received for the grain.

Question 2: This same client received a statement from her cooperative that says it has elected to pass through 60% of its DPAD to its members and my client's share of the pass-through is \$3,600. The \$3,600 is reported in Box 6 of her 2008 Form 1099-PATR. I understand that the \$3,600 is reported on line 21 of my client's 2008 Form 8903, Domestic Production Activities Deduction. Because that amount is only 60% of the DPAD that the cooperative could have passed through to my client, can I include 40% of her \$100,000 milk sales in her 2008 DPGR to calculate her DPAD?

Answer 2: No, because the cooperative has determined that its payments for members' grain are advance payments of PURPIMs, those payments are not included in the members' DPGR regardless of the cooperatives election to pass through some, all, or none of its DPAD.

Question 3: My client received a 2008 Form 1099-PATR with \$270,000 in Box 3. That

amount matches the \$20,000 he received in PURPIMs in 2008 and his \$250,000 of milk checks that he received in 2007. I reported that \$250,000 as milk income on his 2007 income tax return. How should I report the \$270,000 shown in Box 3 on his 2008 income tax return?

Answer 3: Some cooperatives calculated the 2008 DPAD that they passed through to a member based on the commodities the member delivered in 2007. They then reported the 2007 payments for commodities in Box 3 of the 2008 Form 1099-PATR so that it is consistent with the DPAD that is passed through in Box 6 of the 2008 Form 1099-PATR. With hindsight, they agree that the 2007 payments should have been reported in Box 3 of the 2007 Form 1099-PATR. However, they are not sending amended Forms 1099-PATR.

To work around this reporting problem, you should report the full \$270,000 from Box 3 of Form 1099-PATR on line 5a of the 2008 Schedule F (Form 1040) but report only \$20,000 on line 5b. Attach a statement to the return that says the \$250,000 was reported as milk income on your client's 2007 income tax return.

If you included the \$250,000 of milk income in your client's DPGR to calculate the client's 2007 DPAD, advise the client to amend the 2007 tax return to report a DPAD that is based on DPGR without the \$250,000 of milk income. That is true whether or not the cooperative elected to pass its DPAD through to its members. The cooperative's determination that the 2007 payments for milk are advance payments of PURPIM excludes those payments from the members' DPGR without regard to the cooperative's DPAD pass-through election.

Question 4: My client is member of a cooperative that received one of the private letter rulings in 2008 that are mentioned above. The cooperative sent two statements to my client – both in August of 2008. One reported my client's 2007 DPAD, and the other reported his 2008 DPAD. The 2008 Form 1099-PATR shows the DPAD for both years in box 6 as a deduction for the 2008 calendar year. Can I take only the 2008 DPAD and file an amended return

for 2007 using the 2007 DPAD allocation, or must I take the DPAD for both years in 2008?

Answer 4: The statements from the cooperative appear to be inconsistent with the Form 1099-PATR. You could request corrected Forms 1099-PATR for both 2007 and 2008. If the cooperative does not provide the corrected forms, you could report the DPAD shown in the statements on an amended 2007 return and an original 2008 return and attach a statement to each return explaining that the DPAD statements and Forms 1099-PATR did not match.

Question 5: Does the 2008 per unit retain allocation include the grain sold on a deferred payment contract that the cooperative member received in 2009?

Answer 5: No. If the cooperative has determined that payments to its members for grain are advance PURPIM, the deferred payments received in 2009 are PURPIM in 2009 and should be reported as per unit retain allocations on the 2009 Form 1099-PATR. If the cooperative has determined that payments to its members for grain are grain purchases, the deferred payments are not per unit retain allocations in either 2008 or 2009. They are grain sale revenue in 2009.

Summary

By itself, the DPAD is complicated and confusing. But, the tax rules for a cooperative's DPAD are even more complicated and they are different from the rules that apply to other entities. In addition, the differences among cooperatives add to the confusion. Some of the more confusing issues are:

1. Payments from cooperatives for members' commodities have traditionally been reported by the cooperative and the members as a sale of the commodity to the cooperative. The DPAD rules have caused cooperatives to look more closely at that characterization because of the tax benefits of treating those payments as per unit retains paid in money (PURPIM). Many cooperatives have concluded those payments

are PURPIM and therefore do not have to be subtracted from the cooperative's DPGR to compute their QPAI. Another consequence of that characterization is that the members cannot include the payments they receive from the cooperative in their DPGR when they compute their own DPAD.

2. The cooperative chooses how much, if any, of its DPAD that it passes through to its members. The cooperative's choice has no effect on its members DPGR because members cannot include PURPIM or patronage dividends in their DPGR regardless of the cooperative's choice of how much DPAD is passed through to members.
3. Some cooperatives have calculated their 2008 DPAD based on commodities delivered to them in 2007 while others have computed their 2008 DPAD based on commodities delivered to them in 2008. The year on which the DPAD is based affects the members of the cooperative because, in most cases, that is the first year the cooperative has treated all of its payments to its members as PURPIM or patronage dividends and therefore is the first year the members must exclude all payments from the cooperative from their DPGR.

¹¹ Priv. Ltr. Rul. 200838011 (Sept. 19, 2008).

* Department of Agricultural and Applied Economics
University of Wisconsin-Madison/Extension.

Member of the IL, IA and WI Bars.

** Leonard Dolezal Professor in Agricultural Law,
Iowa State University, Ames, Iowa, and Director of
the ISU Center for Agricultural Law and Taxation.
Member of the Iowa and Kansas Bar Associations
and licensed to practice in Nebraska.

¹ I.R.C. § 199

² I.R.C. § 199 (c)(4).

³ Treas. Reg. § 1.199-3(e)(1).

⁴ See Rev. Proc. 2006-22, 2006-22 I.R.B. 1033.

⁵ I.R.C. § 199(d)(3).

⁶ I.R.C. § 199(d)(3)(D); Treas. Reg. § 1.199-6(d).

⁷ I.R.C. § 199(d)(3)(C); Treas. Reg. § 1.199-6(c).

⁸ Priv. Ltr. Rul. 200838011 (Sept. 19, 2008); Priv.
Ltr. Rul. 200843015 (Oct. 24, 2008); Priv. Ltr. Rul.
200843016 (Oct. 24, 2008); Priv. Ltr. Rul.
200843023 (Oct. 24, 2008); Priv. Ltr. Rul.
200852022 (Dec. 26, 2008).

⁹ I.R.C. § 199(d)(3)(A)(ii).

¹⁰ Treas. Reg. § 1.199-6(l).

**Updated November 2, 2009
- by Roger McEowen***

Overview

Farmers have long used wind energy. Beginning in the 1800's, farmers installed several million windmills across the Midwest and Plains to pump water and generate power for lights and radios. Today, farmers, ranchers, and other rural landowners in suitable areas are utilizing wind energy in a different manner. But, where did the current emphasis on wind generation of electricity come from? There were early attempts dating back to the 1970s and 1980s, but it wasn't until the late 1980s and early 1990s, that Enron (an energy company based in Houston, TX) lobbied the Congress with a friendly "renewable energy" project, and packaged it with their "electricity deregulation" lobbying and political efforts. Their efforts were successful in getting laws passed at both the federal and state levels that would permit them to tie into the grid, require utilities to buy unreliable and unpredictable electricity (i.e., electricity generated by wind) under Renewable Portfolio Standards,¹ allow them to sell "renewable energy certificates" separate and apart from the electricity, and utilize a newly created production tax credit and take advantage of a special accelerated depreciation rule.

By leasing out or granting easements over a portion of their land to wind energy developers for the installation of high-tech wind turbines, rural landowners hope to diversify overall income and provide additional stability to the variability of farm income. However, wind

farming presents numerous legal issues that landowners must carefully consider before entering into an agreement with a wind development company.

The Potential for Wind Energy Development Nationally

Wind farms are clusters of wind turbines that generate electricity. They tend to be located in areas with reliable and favorable wind speeds that are near electric power transmission lines and, in some instances, large cities.² Private companies are developing most of the wind farms in the U.S., typically by obtaining easements or leases from private landowners and assigning the rights obtained to power marketers, electric utilities, and, in some instances, directly to specific companies or government agencies. Presently, wind generates less than two percent of the electric power utilized in the U.S., but it is believed that by 2020, six percent of the nation's power will be generated by wind.³

Because wind turbines require large areas of land with strong, steady winds, certain parts of the country have the potential to be a significant player in the future development of wind farming.⁴

Iowa's Growing Influence on Wind Energy Development

Currently, Iowa is the third largest producer of wind energy in the United States, ranking behind only Texas and California.⁵ According to Iowa State University's Iowa Energy Center, the potential for wind energy is the highest in northwest and north central Iowa, with average wind speeds of 15.7-17.9 mph.⁶ In 1996, the Iowa legislature approved the creation of the Alternative Energy Revolving Loan Program (AERLP), a program designed to promote the development of wind energy production across the state.⁷ Since its creation, the AERLP has provided nearly \$10.5 million of financing for renewable energy production, including financing of ten independent owners of wind turbines across Iowa.

Many state-wide producer-supported organizations, such as the Iowa Farm Bureau Federation (IFBF) support wind farming in Iowa. The IFBF estimates that Iowa alone has the potential to produce up to 4.8 times its own annual electrical consumption through wind power.⁸ Wind turbine construction facilities in Iowa are being formed and creating jobs for Iowans, including residents in communities such as Newton and Fort Madison.⁹ In addition, the Iowa Economic Development Board offers incentives such as forgivable loans and state tax credits and sales tax refunds to those companies seeking to invest in wind energy production in Iowa.¹⁰

Government Incentives for Wind Energy Production

Federal. Both the federal government and numerous states have provided incentives to encourage wind energy development. The federal Renewable Energy Production Tax Credit provides an income tax credit per kilowatt-hour for the production of electricity from a qualified wind energy facility placed in service after December 31, 1993, and before January 1, 2010.¹¹ The credit is presently 2.1 cents per kilowatt-hour and is adjusted annually for inflation. The credit applies to each kilowatt-hour of electricity produced from wind that is

sold to unrelated parties during the first 10 years after a wind energy facility is placed in service.¹² Likewise, the Renewable Energy Production Incentive Program provides financial incentive payments for electricity produced and sold by new qualifying renewable energy generation facilities. For depreciation purposes, renewable energy systems placed in service after 1986 are classified as 5-year property utilizing the double-declining balance method.¹³

Companies that own "wind farms" must have substantial taxable income from other sources to take advantage of these two tax provisions.¹⁴

State. At the state level, some states provide reductions or exemptions for state or local property, sales or other taxes applicable to "renewable energy property."¹⁵ and companies developing large-scale wind farms are typically given state income tax breaks.¹⁶ In some instances wind farm developers, in an attempt to curry favor with state and local officials and obtain positive public relations, make voluntary payments in lieu of taxes to offset part of the revenue lost by state and local governments as a result of the exemptions. However, the payments are not likely, in most instances, to adequately cover the costs that will be incurred because of the wind-farm development – such as for road construction and repair, as well as police and fire protection.¹⁷

Iowa tax incentives. Wind energy, including electricity generated by wind turbines, qualifies as an alternative and renewable energy source in the state of Iowa for purposes of the Iowa Renewable Energy Tax Credit.¹⁸ To qualify as an eligible wind energy conversion facility for the purpose of taking advantage of the credit, the facility must be located in Iowa, with at least 51% owned by an Iowa resident or authorized farming corporation, limited liability corporation, trust, family farm corporation, family trust, an electric cooperative association, or school district.¹⁹ The credit is 1.0 cent per kilowatt hour for energy sold by eligible wind energy producing facilities.²⁰ The maximum total to be applied toward personal income tax, business income tax, or a financial institution's tax is for 450 megawatts. To qualify for the

credit, the wind-generating facility must be approved by the Iowa Utilities Board.²¹

To further incentivize wind energy development, Iowa offers a special property tax valuation for “wind energy conversion property”- defined as the property with windmills, wind turbines, towers and electrical equipment and substations.²² To qualify for this special valuation, a city council or county board of supervisors must approve the application by ordinance, to be enacted, not less than 30 days after a public hearing is held.²³ Qualifying wind energy conversion property, first assessed on or after January 1, 1994, shall be valued for property taxes for the first year at zero percent of the net acquisition cost.²⁴ For subsequent years, the rate increases by five percentage points each year of the net acquisition costs.

The Iowa Department of Revenue has issued a policy letter to explain that the sales price of a crane that is purchased for use in installing wind energy conversion property is exempt from sales and use tax.²⁵ However, the purchase of equipment used to construct roads for use in the construction of wind energy conversion property is not exempt.²⁶ The sales price from the sale of wind energy conversion property along with the sale of *materials* used to manufacture, install or construct wind energy conversion property is exempt from sales and use tax.²⁷ “Wind energy conversion property” means any device, including, but not limited to, a wind charger, windmill, wind turbine, tower and electrical equipment, pad mount transformers, power lines, and substation, which converts wind energy to a form of usable energy. So, IDOR has taken the position that a crane used to erect towers and raise nacelles and their contents and rotor blades to a proper height qualifies as “materials” used to install wind energy conversion property. IDOR specifically noted that “materials” commonly refers to “tools or apparatus for a particular task.”²⁸ However, a road used to get the “materials” to the site does not qualify as “wind energy conversion property.”²⁹ Thus, the equipment that is purchased for use in constructing these roads does not qualify for the tax exemption.³⁰

Iowa does impose a “replacement generation tax” of \$.06 per kilowatt hour of electricity produced in the state, in place of a property tax on energy generation facilities.³¹ However, the state exempts wind energy facilities and methane gas conversion facilities from this tax.³² Further, a city or county in Iowa is allowed to pass an ordinance for wind energy equipment to be given a special property tax valuation rate, beginning at zero percent of the net cost of acquiring the equipment and increasing by 5% annually (the maximum rate is 30%).³³ Additionally, the increase in value to a wind energy property is exempt from state property tax, creating a unique opportunity for tax payers.

Most recently, the Iowa legislature, on May 9, 2008, passed legislation allowing Iowa banks to qualify for tax credits for investment in wind energy facilities.³⁴ The bill extends, until 2012, the deadline for wind energy facilities to start producing energy to qualify for tax credits.³⁵ Additionally, the bill allows an unlimited credit transfer, allowing wind energy tax credits to be used for sales taxes.³⁶

Other states. Several states with substantial wind energy potential are supporting state tax credits and energy policy designed to incentivize the development of wind energy facilities and more efficient energy transmission. On May 6, 2008, the South Dakota legislature passed a bill providing tax incentives for the construction of wind energy facilities and energy transmission equipment with a capacity of less than 5,000 kilowatts of nameplate capacity.³⁷ Earlier in the year, the South Dakota Governor signed H.B. 1320 into law. The legislation exempts power-generating wind farms from most state and local taxes, but subjects them to an alternative annual tax that is based on the number of kilowatts a wind farm can produce. Also, the bill specifies that any company owning or leasing a wind farm is subject to retail sales and service taxes. But, wind energy facilities and energy transmission equipment is exempt for other state, county, municipal and district taxes.

This legislation was spurred by the stunning growth of the wind power industry in the United States. In 2006, nearly \$4 billion was invested in

new wind projects in 34 states, increasing the total wind power capacity in the U.S. by 45 percent.³⁸ Despite this growth, only one percent of the nation's total energy supply is derived from wind energy.³⁹

States are developing wind energy tax policy in response to efforts on the federal level. As mentioned above, I.R.C. §45 allows an income tax credit for wind energy production for utility-scale wind turbines at two cents per kilowatt-hour of produced electricity, causing the cost of production to fall dramatically.⁴⁰ The federal tax credit is vitally important to the growth of the industry, as lulls in U.S. wind development in the past ten years correspond with Congress' failure to renew the tax credit legislation periodically.⁴¹ The current credit legislation will expire at the end of 2009.

Because of the non-permanency of wind energy tax policy at the federal level, states are beefing up their wind energy tax incentives to attract wind developers. Altogether, 34 states have tax incentives for wind development, including property tax breaks, sales tax exemption on wind energy equipment purchases, corporate and financing incentives.⁴² The state of California was the first to offer a state investment tax credit for wind energy development and the legislature has recently adopted a solar and wind energy credit, providing personal and corporate income tax credits for the purchasing and installation of renewable energy systems.⁴³ Similarly, Minnesota has set a lofty goal of generating at least a quarter of its energy needs from renewable energy, most likely wind energy production.⁴⁴ In 2002, the state exempted all wind energy systems from state property tax, instead taxing the actual wind energy produced at variable rates, depending on the megawatts per system.⁴⁵

Texas, the national leader in wind energy production, takes a more complicated approach to wind energy tax policy, largely due to the deregulation of the Texas electric industry in 1999. Texas allows a deduction from state franchise tax for renewable energy sources and several property tax incentives.⁴⁶ A unique provision is the allowance of local property tax

abatements for wind projects in the state.⁴⁷ These abatements exempt all or part of the increase in real or tangible personal property from up to ten years.⁴⁸ Local governments are the sole grantors of these abatements used to create local "reinvestment" zones and foster job creation and economic development.⁴⁹

The Mechanics of Wind Turbines

The typical wind turbine sits atop a tower that ranges from 170 to 320 feet high. The blade diameter is 75 to 100 feet with a weight between 8,000 and 10,000 pounds. The cost to install is approximately \$1 million per megawatt of installed capacity, with the typical turbine having an installed capacity of 750 kilowatts to 1.5 megawatts. A 1.5 megawatt turbine can generally produce enough energy to power 400-500 homes annually. A section of land can house anywhere from six to twelve turbines. The turbines are very sophisticated machines with computerized controls. A turbine's generator output increases as wind speed increases, with maximum power typically generated with wind speeds of 30-35 mph. The turbines are usually programmed with cut-out wind speed of between 55 and 65 mph.

Liability Concerns- When Will Civil Damages Be Awarded to a Landowner?

There are several legal liability issues that may arise from the construction, maintenance, and energy production from wind turbines on agricultural land. Typically, a landowner is required to enter into written contractual agreements before a wind turbine is constructed on the land. It is important to keep in mind that tort liability may be assessed in cases where harm results as a result of a party's negligence with respect to the construction or maintenance of wind turbines. A rural landowner must be careful to specify in any contract that he is not liable for the negligence of others with respect to wind turbines. A farmer may further protect himself from negligence liability by taking reasonable care in the operation of the wind turbines and having liability insurance in place to cover all unexpected claims. Generally, if a farmer is not in charge of the maintenance or

operation of the wind turbine, he will be held to a lower standard of care. This does not mean, however, that a farmer or landowner will be immune from liability in a negligence suit.

Nuisance is another common tort in the realm of wind energy production, where a wind farm may interfere with another person's use or enjoyment of his or her property. To be held liable for a private nuisance, the interference must be substantial and unreasonable. It is very rare that a private nuisance claim holds leads to a finding of damages. A public nuisance is an "unreasonable interference with a right that is common to the general public", meaning that it interferes with "public health, safety, comfort, or convenience or is illegal."

The following are some additional potential liability concerns associated with wind energy development:

- Damages to adjacent property caused by the alteration of the flow of surface water due to the construction of access roads.
- Stray voltage from the turbines (this may be a particular concern for nearby dairy operations).
- Interference with electromagnetic fields.
- Fire caused either by malfunction of a turbine or as a result of a lightning strike.
- Possible interference with television and radio signals.
- Death of birds and/or bats that are protected by state and/or federal environmental laws

Criminal Liability for Fraudulent Conduct

While most liability disputes relating to wind energy projects are handled in civil court according to contract or property law, criminal violations are possible. For example, in September 2007, the pioneer of Minnesota's wind energy development initiative was charged with participating in fraudulent conduct in the Federal District Court in Minnesota.⁵⁰ Allegedly,

the wind developer overstated the amount of power being produced by wind generators in operation for 2003 and 2004, amounting to nearly \$388,000 in overcharges assessed to the energy purchasing company.⁵¹ The amount of wind energy produced in the state of Minnesota significantly increased from 25 megawatts in 1994, to almost 900 megawatts in 2007, making Minnesota the fourth largest wind energy producer in the nation.⁵² The wind developer, owner of a family-owned company with hundreds of community and private investors across southwestern Minnesota, vehemently denied the criminal charges, stating that the last thing he would want to do is defraud his purchasers.⁵³ However, a 2005 search warrant uncovered evidence of the overstatement in billing. A contributing factor in the Federal charges was the additional billing of nearly \$176,000, in 2003 and 2004, to the Minnesota Commerce Department for state wind energy incentive payments.⁵⁴ In late 2008, the developer was sentenced to 21 months in federal prison.

Valuation Issues

The placement of wind turbines on farmland will impact valuation for federal estate tax purposes upon the owner's death. For federal estate tax purposes, the key valuation date is as of the date of the decedent's death. Thus, a long-term wind energy agreement signed shortly before death likely has little impact on the date of death value of the property included in the decedent's estate. Because the agreement will have an initial development/prospecting phase that runs for several years before the primary phase of the easement, there remains uncertainty (as of the date of death) if death occurs within the prospecting phase as to whether wind generation will *ever* occur on the premises. Thus, there should be no valuation enhancement.

However, if death occurs after turbines have been installed and have become operational, IRS could argue for a valuation enhancement. But, there may be offsetting factors. At the present time, anecdotal data indicates that wind turbines have a depressing effect on nearby land values and are a drag on the ag real estate market.

Most recent anecdotal data from Illinois indicates that assessed value on farmland is dropping approximately 22-30 percent on farmland that is near land where wind turbines have been placed. Also, the increased risk of getting sued for nuisance has a dampening effect on value. Likewise, the annual payments, to an extent, are replacement income for the property rights that have been given up in getting the turbines in the first place. Many of the agreements are quite restrictive in terms of potential development of the property, farming activities, placement of buildings, etc. A willing buyer would take all of those factors into consideration when determining what price to pay for the property (IRS test).

Thus, to arrive at the proper valuation of an existing contract, the present value of the contract would have to be discounted in order to derive a value for the stream of payments. That result could then be offset by the factors mentioned above.

At the present time, IRS has not issued any guidance on the matter.

For federal estate tax purposes, agricultural land may be valued at its agricultural use value rather than its fair market value at the time of death. The executor of the decedent's estate must make an election to value the land at its use value and the election (for deaths in 2009) has the potential to reduce the value of the land included in the estate by up to \$1 million. With the federal estate tax rate presently set at 45%, which could lead to maximum tax savings of \$450,000. Numerous requirements must be satisfied for the estate to qualify to make the election, and the elected land must pass to family members that will continue to farm the land (or lease it under a lease where the lease income is based on crop prices or production levels) for 10 years after the decedent's death. If the property is converted to a non-agricultural use during that 10-year period, recapture tax is triggered. That means the heirs have to pay all of the tax savings achieved by making the election back to the government, with interest. In addition, at the time the election is made, IRS puts a lien on the

property to ensure payment in the event a recapture-triggering event occurs.

In one recent matter involving a Texas set of facts, the decedent died owning agricultural land. A special use valuation election was made and the property passed to the decedent's family members. The heirs were subsequently approached by a wind energy company about placement of wind turbines on the property. The heirs executed the wind energy lease which required that all existing liens be subordinated to the interests of the wind energy company - a common provision in wind energy leases. When the heirs approached the IRS about subordinating the IRS lien, IRS refused, viewed the wind energy lease as a disqualifying cash lease, and asserted recapture tax on all of the property subject to the election. Subsequent negotiations resulted in IRS asserting recapture tax on only the land actually removed from ag production. The heirs paid the tax. The heirs' refund suit is anticipated to be filed in the Federal District Court for the Northern District of Texas.

Note: The IRS has won a case in the U.S. Court of Appeals for the Third Circuit in which they asserted recapture tax upon the grant of an easement.⁵⁵ In that case, the trial court held that granting the state of New Jersey an easement in qualified farm property was *not* a disqualifying disposition of the property that triggered recapture tax under I.R.C. Sec. 2032A(c)(1). Instead, such a grant was merely a contract right under state law. The appellate court reversed, finding that there was a disposition of a property interest under federal law. Interestingly, the easement involved an ag preservation easement ensuring that the land would *not* be developed.

Other Legal Issues

Except in situations where malice is present, U.S. law does not recognize a negative easement

for the free flow of wind. In other words, the owner of tract A cannot restrict the activities of the owner of adjacent tract B on tract B that might impact the flow of the wind from tract B to tract A. If the uses to which tract B is put interfere with the flow of the wind across the tract, but are otherwise reasonable, the owner of tract A would not be able to stop those activities from occurring. To ensure that B's activities wouldn't impact wind energy development on tract A, the owner of tract A would have to purchase an easement over tract B (or purchase tract B).

Note: Some states have enacted wind easement statutes that secure wind access. The states enacting such statutes are: Minnesota, Montana, Nebraska, Oregon, South Dakota and Wisconsin. The Virgin Islands has also enacted a wind easement statute. Oregon law also authorizes municipalities to protect access to wind via local ordinance.

Recent National Case Law and Developments

Nuisance. There has been an increase across the nation in the filing of nuisance-type cases involving the construction and placement of wind farms. For example, in 2002 a windmill located in a residential area was held to be a nuisance because of the noise it created.⁵⁶ In a 2007 case,⁵⁷ a large-scale wind farm with 200 turbines was proposed to be constructed in close proximity to a residential development. The homeowners sued to permanently enjoin the construction and operation of the wind farm, citing possible noise, aesthetical impact on the viewshed, flicker and strobe effect of light reflecting from the turbine blades, potential danger from broken blades, ice throws and reduced property values. The court held that the wind farm could constitute a nuisance and that the plaintiffs' claims were sufficient to prospectively enjoin a nuisance. The court also noted that even though the State Public Service Commission had approved the facility, such approval did not abrogate the common law of nuisance.

In March 2008, a landowner in Missouri sued the county commission which approved the construction of a large-scale wind farm adjacent to his property. The landowner also claimed that he was physically attacked by a county commissioner for his public opposition to the siting of the wind turbines. In addition, the landowner claimed that the wind turbines were a nuisance, because his land was completely surrounded by the turbines, the turbines caused a "powerful strobe light effect," were loud and contributed to the loss of equity and marketability of his home and the loss of view and quiet enjoyment of his property. The Federal District Court for the Western District of Missouri dismissed the case, but noted that the plaintiff could amend his complaint to replace the county commission with a private party as the defendant.⁵⁸

On April 18, 2008, the Federal Aviation Administration (FAA) was ordered to reconsider its decision to allow the construction of a wind farm near the site of the new Las Vegas Airport.⁵⁹ The evidence presented indicated that the turbines would interfere with the airport's radar systems. The Federal district court determined that the FAA's determination was arbitrary and capricious.⁶⁰

In late August 2008, the Texas Court of Appeals upheld a trial court ruling that dismissed a nuisance lawsuit filed by property owners that complained about the "aesthetical impact" of a large-scale, 421-turbine wind farm.⁶¹ The plaintiffs asserted that the jury was entitled to consider the farm's "visual impact" along with descriptions of the wind turbines blinking lights, flickering shadows and noise. However, the court noted that the common-law doctrine of nuisance in Texas had never recognized a nuisance claim based on aesthetical impact. The court, while sympathetic to the plaintiffs' claims, refused to expand nuisance law to cover actions for aesthetical impact that causes emotional injury, determining that such an extension was beyond the purview of an intermediate appellate court.⁶²

Zoning. Zoning issues can also arise with respect to wind-farm development. Recently,

the Supreme Court of New York approved setback requirements for wind turbine placement away from residences, public roads, and properties that did not contain wind turbines.⁶³ The county agency's approval of minimum setback requirements was not a de facto unconstitutional taking within the scope of the New York Constitution.⁶⁴ Since the agency gave reasons for its determination, including environmental concerns, the surrounding property owners were able to distance themselves from the turbine facilities.⁶⁵ In a different case, the New York Supreme Court upheld the grant of a conditional use permit for the construction of a wind farm.⁶⁶ In the case, the court held that the local zoning board's determination that the wind farm constituted a public utility for zoning law purposes were entitled to deference and were not shown to be unreasonable or not rationally based. The court noted that the zoning board considered various environmental impact studies that the wind farm had submitted and held public hearings. A different New York case⁶⁷ illustrates the tension between landowners seeking additional revenue from wind turbines and adjacent property owners that place a high value on aesthetics. A town enacted a ban on the development of commercial wind farms. Supporters that voted for the ban included owners of second homes. However, the votes of the second-home owners was challenged by supporters of wind farm development on the basis that the owners were not residents of the town as defined by New York election law. The defendant agreed, but the court reinstated the voter registrations of the second-home owners - they had demonstrated significant and genuine contacts with the town such that their choice of the town as their residence for voting purposes should have been honored. Six of the eight second-home owners had homes in the town, but lived and worked in another city during the week. In addition, each second-home owner didn't vote anywhere else and listed the town as their residence on their driver's license.

On October 30, 2009, a unanimous Kansas Supreme Court upheld a Wabaunsee County ordinance banning commercial wind farms in the county.⁶⁸ The Court determined that the

county had properly followed state statutory procedures in adopting the ordinance, and that ordinance was reasonable based on County's consideration of aesthetics, ecology, flora and fauna of the Flint Hills. The county held numerous public hearings on the issue with the overwhelming majority of the public expressing lack of support for commercial wind farm development in the county. The Court cited the numerous adverse effects of commercial wind farms including damage to the local ecology and the prairie chicken habitat (including breeding grounds, nesting and feeding areas and flight patterns) and the unsightly nature of large wind turbines. The Court also noted that commercial wind farms have a negative impact on property values, and that agricultural and nature-based tourism would also suffer. The Court, however, ordered the parties to submit additional briefing and prepare for oral argument on whether the ordinance constitutes a "taking" of plaintiffs' property rights without just compensation, and whether the ordinance violates the Commerce Clause by discriminating against interstate commerce. Those issues are set to be considered in early 2010.

Property Values. In November 2007, a local Vermont Board of Civil Authority (BCA) ruled that a wind turbine reduced the value of adjacent property by 10 percent for real property tax purposes.⁶⁹ The evidence showed that the wind turbine was within 300 feet of the petitioner's home, and the petitioner claimed that the turbine's noise, blinking light, glare from the blades, and resulting vibrations decreased the home's value.⁷⁰ Before reaching their decision, the BCA sent a committee of three persons to visit the petitioner's property to evaluate the situation.⁷¹ The committee reported back that the turbine produced constant sound and flashing lights from its turning blades, and recommended an eight percent reduction in valuation of the petitioner's property.⁷²

Contractual Issues. In a recent New York case, the plaintiff bought the defendant's farm (including the residence) and sought to have the sale contract rescinded based on the seller's alleged fraud and misrepresentations for not disclosing that plans were in the works for the

construction of large wind turbines on an adjacent parcel.⁷³ The plaintiffs submitted the affidavit of a neighbor of the defendant who detailed two conversations with the defendant that occurred months before the defendant put his farm on the market during which the wind farm development was discussed.⁷⁴ The defendant, at that time, stated that the presence of commercial wind turbines on the adjacent tract would “force” him to sell his farm.⁷⁵ When the plaintiff sought to rescind the contract, the defendant claimed he had no duty to the plaintiff and that the doctrine of caveat emptor (“buyer beware”) was a complete defense to the action.⁷⁶ The court denied summary judgment for the seller and allowed the case to go to trial.⁷⁷

The Public Trust. The Public Trust doctrine holds that certain resources are preserved for public use, and that the government is required to maintain those resources for the public’s reasonable use. The Public Trust Doctrine was involved in a recent case brought against an owner/operator of a large-scale wind farm.⁷⁸ Under the facts of the case, an environmental group claimed that wind turbines at the Altamont Pass Wind Resource Area in Alameda and Contra Costa counties had killed tens of thousands of raptors and other birds since the 1982. The Alameda County Board of Supervisors was in the process of considering applications to extend and consolidate existing 20-year permits to operate the wind turbines when the plaintiffs sued. The plaintiff claimed that the operation of the wind farm violated state and federal law, including the public trust doctrine – a doctrine which holds that certain resources are preserved for public use, and that the government is required to maintain those resources for the public’s reasonable use. But, the trial court dismissed all claims except for the alleged public trust violation for lack of standing.

The appellate court affirmed, noting that the case was filed against the wrong party.⁷⁹ The plaintiffs sued the owners and operators of 5,000 wind turbine generators at the Altamont Pass wind farm. However, the court emphasized that wildlife, including birds, is considered a public trust resource, and that private parties can sue to

enforce the public trust. But, such an action (when brought by a “beneficiary”) must be brought against the “trustee” of the public trust – namely, the government agencies (such as the state and federal fish and game departments) charged with the responsibility to implement and preserve the “trust.” Only the trustee has the sole right to sue the owners and operators of the wind turbines for violation of the public trust. A “beneficiary” cannot sue the party that is believed to be harming trust property. In any event, the court noted that the public agencies responsible for protecting the public trust (such as the Department of Fish and Game) had done so.

So, the court would not let the case go forward without the expertise of the government agencies responsible for protecting the trust resources. The proper means to challenge the adequacy of the agencies’ measures was by petition for a writ of mandate after exhaustion of administrative remedies.⁸⁰

Recent Legal Developments in Iowa With Respect to Wind Energy

Several school districts in Iowa have taken an interest in wind-energy production. In 2003, when a school district began generating wind power from a donated wind turbine, they claimed to have an agreement with the city to sell the electricity.⁸¹ Relying on the agreement, the school constructed a new wind turbine.⁸² The city brought suit, claiming that any contract entered into between the school and the city was void, because the municipality lacked authority to make such an agreement.⁸³ The Iowa Supreme Court cautioned that the school was on notice that the city had no authority to enter into an agreement to purchase the electricity generated by its turbines.⁸⁴ The school was left without any recourse in this dispute. Presently, several other school districts across the state have become interested in wind-energy production as a possible revenue-raiser. It remains to be seen what the courts will allow.

In 2003, when a utility customer erected a wind turbine on his land and attempted to connect it with the electric service being provided to him

by his electric company, the Iowa Supreme Court determined the proper hierarchy of authority in this area.⁸⁵ The issue was whether the Iowa Code sections relating to alternative energy providers, such as wind turbines, applied to an electric company, regulated by The Federal Public Utility Regulatory Policies Act (PURPA).⁸⁶ The court found that since the electric utility was not subject to the Iowa Code, federal law prevailed here.⁸⁷

In a related context, Iowa Courts have recently addressed the issue of adjacent landowners' rights to input in the construction of cell phone towers. In this case, the plaintiff, a landowner, challenged the construction of a cell phone tower built across the road from his home, on the basis that he was not given adequate notice of the hearing held regarding the issuance of a permit for the tower's construction.⁸⁸ The Iowa Court of Appeals ruled that the landowner was only entitled to notice by publication at least seven days before the time set for public hearing.⁸⁹

The court noted that Iowa law requires that notice of a pending application for a conditional use permit must be reasonable under the circumstances.⁹⁰ So, rural landowners objecting to the construction of cell towers or wind turbines must be diligent in determining the time and place of public hearings.

Net metering. The Iowa Court of Appeals has rendered the latest court opinion in a legal battle over net metering that has been going on in Iowa for about 10 years. Iowa's net metering rule was a creation of the Iowa Utilities Board in 1983 and allows customers with alternative energy generation systems to sell electricity to their investor-owned utilities on a netted basis against their metered retail usage.⁹¹ In this case, the plaintiffs bought wind-powered generators from another plaintiff and tried to reduce their energy expenses by producing their own power and selling any excess energy to the defendant- a non-regulated utility. But, the Iowa net metering rules do not apply to electric cooperatives because they are not regulated by the Iowa Utilities Board (IUB). The plaintiffs sued in federal court, but the case was dismissed for lack

of subject matter jurisdiction. The plaintiffs then took the matter to the Federal Energy Regulatory Commission (FERC) on the basis that their wind energy system was a qualifying facility (QF) under the Public Utility Regulatory Policies Act (PURPA) and also filed an action in state district court.

In 2005, the Iowa Supreme Court reversed its previous ruling and concluded that net metering was not required by either Iowa or federal law. The court noted that the issue of net metering carried with it great policy concerns, and that FERC was the appropriate tribunal to decide whether net metering fit within the requirements of PURPA. Specifically, the Court held that PURPA did not require net metering by non-regulated utilities. Shortly after the Iowa Supreme Court issued its ruling, FERC found that even though PURPA did not explicitly require net metering, the defendant had to offer net metering to the plaintiffs.

Later in 2005, the President signed into law the Energy Policy Act of 2005 (Act). While the Act does not mandate federal net metering and interconnection standards, it does direct non-regulated utilities to consider whether to adopt net metering within three years of enactment of the Act. In early 2006, upon reconsideration of its 2005 order, FERC reversed itself in light of the Act vesting discretion in the defendant to determine whether net metering should be offered to customers. The plaintiffs sought enforcement of FERC's 2005 ruling, but the trial court refused.

On further review, the Iowa Court of Appeals affirmed. The court held that the trial court's ruling was consistent with the Act which entrusted the decision to offer net metering to the defendant and not FERC.⁹²

Federal Farm Program Payment Eligibility

When negotiating a wind energy easement, it is important for rural landowners to understand the impact such an agreement may have on their eligibility for federal farm program payments. Farmers should consult their local Farm Service Agency before entering into these agreements

for a more detailed explanation of the program rules and whether they will lose benefits or suffer serious financial penalties.

For those farmers considering wind energy easements and participating in the Direct and Counter-cyclical Payment Program, authorized by the 2002 Farm Bill, there is a prohibition on making nonagricultural use of acreage enrolled in the program. Farmers will need to consider if there will be a penalty for withdrawing acreage from the program for the purpose wind energy.

Tax Reporting Issues

When an agreement is entered into with a wind energy company, the landowner will commonly have three types of payments:

1. The payment for the company's acquisition of an easement or a lease over a part of the landowner's property;
2. Crop damage payments; and
3. Annual payments associated with turbines or the amount of production from the turbines.

Easement payments. The sale of an easement is treated as the sale of an asset.⁹³ But, if the taxpayer retains more than naked legal title to the property affected by the easement, the consideration received is treated as a return of capital.⁹⁴ As a result, the proceeds are applied as a reduction of the taxpayer's basis in the property, with any excess treated as capital gain.⁹⁵

The Treasury Regulations provide the following as a general rule:

When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts, and the gain realized or loss sustained on the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to such part. The sale of each part is treated as a separate transaction and gain or loss shall be computed separately on each part.

Thus, gain or loss shall be determined at the time of sale of each part and not deferred until the entire property has been disposed of.⁹⁶

The Treasury Regulation, therefore, presents two tax issues associated with allocating the landowner's income tax basis in the property:

- The allocation of basis between the portion of the property that is subject to the easement and the balance of the property that is not subject to the easement;⁹⁷ and
- The allocation of basis between the rights created by the easement and the balance of the rights in the property.

Based on the Regulation, one thing is clear – a taxpayer cannot compare the entire basis in the property from which an easement is acquired with the sale price of the easement. For example, in *Iske v. Comr.*,⁹⁸ the taxpayer sold easements during condemnation proceedings and did not include the compensation in gross income on the tax return for that year because, as the taxpayer argued, he did not receive a taxable gain on the sale of the easements. But, the court disagreed with the taxpayer's position. The court reasoned that Treas. Reg. §1.61-6(a) required the taxpayer to apportion his basis in the property between the land sold and the land retained. The taxpayer could not use his entire basis in the two parcels involved to offset the amount he received for the easements.

Example: Garrulous Energy Company paid \$4,000 for an easement along the eastern boundary of Marcia Megawatt's farm for the construction of an access road to the location on Marcia's farm where a wind turbine will be erected. The easement covers approximately five acres of Marcia's 160-acre farm. Marcia has an income tax basis of \$750 per acre in her farmland. For purposes of reporting gain from the \$4,000 easement payment, Marcia would be able to offset the \$4,000 payment by the \$3,750 income tax basis that is allocable to the five acres that the easement

impacts (\$750 per acre basis x 5 acres). Thus, Marcia must only report \$250 of gain from the sale of the easement.⁹⁹

If the easement impacts the taxpayer's entire property (which is uncommon), the amount received for the easement reduces the taxpayer's basis in the entire property for purposes of computing taxable gain.

Example: Larry Landowner sells multiple easements to Tumescient Wind Corporation for access to a major wind turbine project on Larry's farm. The easements cover 50 acres and bisect Larry's property. Tumescient constructed fences on each side of every easement and installed gates in the fences so that Larry could move his livestock through the easements. For purposes of reporting gain from the sale of the easements, Larry should be able to reduce the basis in all of his ranchland by the amount he received for the easements. That's the result if Larry can establish that the easements impacted Larry's use of all of his property, rather than just the 50 acres covered by the easements.¹⁰⁰

Income tax basis must also be allocated between the rights that the taxpayer retains and the easement rights that are sold. For purposes of this basis allocation, the general rule is that the allocation of basis in the property must be allocated between the interest sold and the interest retained in the proportions that their respective fair market values bear to the fair market value of the entire property.¹⁰¹ But, if it is not possible to allocate basis of the entire property between the interest that is sold and the interest that is retained, then the amount received for the easement can be used to reduce the basis in the entire property affected.¹⁰²

An important issue to resolve is the actual amount of a client's property that is impacted by a wind farm project. The first place to start is to examine the terms of the particular easement. Many easements will prohibit the landowner from building anything else on the property that

would interfere with the maintenance of the windmill or block the wind that drives the windmill. In that case, the landowner has a reasonable argument that the easement impacts *all* of the landowner's property. If there is sufficient basis in the land to absorb the easement payment, the landowner will not have any gain to report.

Example: Tom owns an 80-acre tract of farmland with no improvements. It is entirely pastureland, and Tom paid \$40,000 for the tract in 1983. Tom has been approached by a wind energy company to construct three wind turbines on his property. The company is willing to pay Tom \$20,000 for an easement. The easement terms prevent Tom from building anything on this property that would obstruct the company's access to the wind turbines or that would block the wind to the turbines. Tom should be able to reduce the basis in his entire tract by the amount of the easement payment. That would result in his basis being \$20,000, and Tom would not have any gain to report.

Note: If the wind energy company were to pay Tom an additional amount for the right to construct additional wind turbines on his property in a future year, Tom would again reduce his remaining basis in his tract by the amount of the payment. To the extent the payment exceeds Tom's basis in his property, Tom would have a taxable gain that would be reported on Form 4797, Part 1 (where it is netted with other I.R.C. §1231 gains and losses).

There is caselaw supporting the argument that an easement can impact *all* of a taxpayer's property and, hence, allows the taxpayer's entire basis in the property to be applied against the easement payment.

- *Bledsoe v. United States*¹⁰³ - the landowner sold nine perpetual easements to the U.S. Army Corps of Engineers to allow road access to a dam. Although the easements covered only 47.3 acres, the court allowed the landowner to reduce the basis of the entire property because the easements restricted his use of the property. The easements varied in width from 100 to 400 feet and bisected his ranch. The easement holder then constructed a fence along the road on both sides and built gates in the fences so that the taxpayer could move his cattle across the easements. The court noted that the easements were not sales (that's contrary to the general rule) and that the taxpayer was entitled to apply the easement proceeds against the basis in the property.
- *Inja Land Com., Ltd. v. Comr.*¹⁰⁴ - the City of Los Angeles paid the landowner \$50,000 for an easement that allowed the city to flood the land when it diverted water into a river that flowed through the land. The easement did not cover the entire tract, but because it affected the use of the entire tract, the court allowed the payment for the easement to reduce the basis of the entire tract.

Crop damage payments. Payments that are made to a landowner (or a tenant) for damage to crops are reported as payments received for sale of the crop. Thus, the landowner reports the payment on line 4 of the landowner's Schedule F (Form 1040) as crop proceeds.

Lease payments. In addition to the payment for the easement, landowners commonly receive annual lease payments. Because these payments are not for land used in agricultural production, they are not subject to self-employment tax regardless of the landowner's participation in the activity.¹⁰⁵ That means that the annual income from the lease payment should be reported on Schedule E (Form 1040). It is unlikely that the landowner would have any deductible rental expenses.

Legal Issues for Landowners to Consider in Negotiating Wind Energy Easements

There are two parts to a typical wind development agreement. The first part involves an agreement for prospecting and development of the property, the terms of which will give the prospecting company the right to enter the premises, evaluate the property for potential wind energy development, and construct the necessary turbines and related structures if the developer deems the property to have the potential for wind energy development. This part of the agreement will typically give the developer the exclusive right to develop the property for a limited amount of time (usually 2-5 years), and may contain an option for the developer to extend the length of the development term. At the present time, development agreements are providing landowners with annual payments within a range of \$2 to \$10 per acre subject to the agreement. If wind energy development does not occur during the term of the agreement, the landowner may negotiate a new wind energy agreement with another developer, if possible and if desired.

The second part of the agreement involves the contract for the development and operation of wind turbines on the property. This part of the agreement will involve a much longer term (typically 20-50 years) with an option (or multiple options) to extend the agreement even further. Landowner compensation under this part of the agreement may be based on the number of turbines placed on the property, per megawatt of energy generated or on a royalty-based compensation structure. A key point for landowners is to make sure that the compensation structure contains an inflation-adjuster clause.

While both parts may be contained in a single document, landowners may benefit from having the two parts separated out and put in different agreements.

A wind energy agreement should never be negotiated without first having the agreement reviewed by legal counsel. Wind energy agreements are long-term agreements that will impact the land subject to the agreement for

many years, likely beyond the lifetime of the landowner who executes the agreement. The following is a list of questions that landowners should ask when analyzing any wind energy agreement:

Scope Questions:

- How much of the land will be subject to the agreement?

Note: The legal description of the covered property is critical.

- How long will the land subject to the agreement be affected?
- Based on the property rights that are given up, are the proposed payments adequate for the present time and for the life of the agreement? (Note: The answer to this question requires an understanding of the mechanics and economics of wind energy production.)

Estate Planning Issues

- Is it planned that the farming operation will expand in the future? If so, how will the placement of wind turbines on the property impact the farm's potential development and/or expansion?
- Has the issue of wind turbines development been discussed with the on-farm heirs?

Payment Questions:

- Is the landowner entitled to any or all energy credits related to the project?
- If the agreement offers an up-front lump-sum payment, is the payment representative of a fair amount of the rights involved?
- What are the tax consequences of wind energy payments that will be paid under the agreement? (Note: The answer to this question depends on tax changes at the federal and state levels – an area which is in

an almost constant state of flux.)

- Are payments under the agreement based on revenues generated by the wind turbines? Can the landowner get information as to how the owner's revenue will be calculated?
- If the wind energy company puts additional equipment on the towers and collects compensation for such placement is the landowner entitled to some of the additional compensation?
- Does the agreement guarantee that a set number of wind energy turbines will be constructed on the land by a specific date and, if not, is the developer willing to guarantee a minimum amount of payments?

What are the developer's rights?

- Does the developer want to develop the land or simply use a portion of the surface for a term of years?
- Is the developer able to sell or transfer without the landowner's consent any of the land use rights obtained under the agreement? If so, will the original developer remain liable if the new developer or holder of the easement right does not pay the landowner or otherwise defaults?
- What events trigger the developer's right to terminate the contract? Can the developer terminate the contract at any time without cause? If so, how are payments due under the agreement to be handled?

Cost Questions:

- Will any portions of the property require gating, fencing or limiting of access in any manner? If so, who pays for the cost or building and/or repairing such measures for restricting access?
- Is there any potential for environmental contamination or the release of hazardous materials onto the premises because of the

presence of wind turbines on the property?
If so, how are associated costs to be borne?

- Are any additional costs associated with compliance with governmental regulations of wind turbines, present and in the future, the responsibility of the landowner, developer or wind energy company?
- What is the cost of the landowner becoming an additional insured on the insurance policy of the wind energy company?
- Are there any potential costs of construction liens that might be placed on the property?
- If the agreement limits the ability of the landowner to expand the farm or make improvements (such as installing irrigation equipment, field tile, or additional structures), what are the economic costs to the overall operation of such limitations?
- The development of the property will require the construction of roads. Does the agreement provide compensation for any damage to existing drainage tile and/or additional costs associated with the change in the flow of surface water that could negatively impact adjacent property?
- If the development of the property with wind turbines increases the ad valorem real property valuation of the property, must the landowner pay the additional taxes?
- If an adjacent landowner files a lawsuit against the landowner based on nuisance or other tort theories, will the wind energy company pay the landowner's legal costs and any resulting judgment rendered against the landowner directly tied to the presence of the wind turbines?
- When the agreement ends or is otherwise terminated, does the landowner bear the cost of removing wind energy structures?

What are the landowner's rights?

- What termination rights does the landowner have? How does the landowner exercise those rights?

Note: Wind energy agreements often contain termination clauses designed to minimize the risk of termination to the developer so as to aid the developer in receiving financing. Accordingly, wind energy agreements typically prevent a landowner from terminating (or taking action against the wind energy company) an agreement due to noise, flicker, vibrations, air turbulence, electromagnetic interference with global positioning systems, and other effects caused by the wind turbines.

- If the agreement is terminated, whether by consent of the parties or otherwise, what happens to the wind energy structures and located facilities erected on the property? What is the developer required to remove? How soon must structures be removed? Who pays for their removal?

Crafting an Equitable Agreement

When a wind energy agreement is being negotiated, certain issues are critical to the creation of an equitable agreement. Unfortunately, a common problem with many wind energy agreements is that once they are proposed and submitted to a landowner, the company wanting to execute an agreement tends to refuse to negotiate changes to the terms of the agreement. The company's ability to refuse to negotiate terms of the proposed agreement will depend largely on whether a landowner has meaningful options and competent legal representation.¹⁰⁶ Key provisions to a wind energy agreement that require careful attention by legal counsel for landowners contemplating a wind farm include the following:

- Is the proposed contract a lease or an easement? If a lease is involved, it should be long enough for the developer to recoup its investment (probably at least 20 years). Does the developer have a right of renewal? If so, does the landowner have the right to

renegotiate any of the lease terms? Any lease should not be perpetual- a violation of the rule against perpetuities might be involved (at least in those states that have retained the rule).

- If an easement is involved, does the easement include turbine sites, substations, air space, buffer areas, vegetation restrictions, building restrictions, transmissions, and associated rights of way?
- Is a sale of the land contemplated? If so, how is the selling price computed? Any sale price should consist of the fair market value of the land plus the wind energy value.
- What are the setback requirements and fees to neighboring landowners?
- What is the amount of compensation to be paid? Take care to ensure that the definition of “gross revenue” is done properly. Is it defined as the sale of electrons or the sale of green credits, or is it calculated in some other manner?
- Is the revenue to be a flat amount annually, an annual payment per tower, a percentage of gross proceeds, a payment of a certain amount of kilowatt hours generated annually, or an amount based on the selling price of megawatts per year, whichever amount is greater?
- Is an inflationary factor built into the contract payment provisions? To protect the landowner’s interest, there should be.
- Does the agreement cover land that will not be needed for the wind farm and related structures? From the landowner’s perspective, there shouldn’t be such coverage.
- An up-front lump-sum payment has tax consequences- make sure they are understood.
- What are the intentions of the developer concerning the use of the land? That makes

understanding the use provisions of the agreement of primary importance. The construction clause should limit the construction of wind energy structures to not more than 3 or 4 years with adequate compensation paid to the landowner for restricting the use of the land during that time.

- Can the developer assign the agreement? If so, a clause should be inserted that ensures the original developer’s liability if the assignee defaults under the terms of the agreement. (Note: Developers want the ability to assign the agreement and subordination language.)
- Is the landowner willing to consent to a mortgagee of the developer? If so, a clause should be included that limits the landowner’s obligations to the mortgagee.
- Consider including an indemnification clause that indemnifies the landowner for any liability incurred as a result of permissive activities (such as crop tenants, custom harvesters, and subsurface tenants) on the property subject to the wind energy agreement.
- What are the landowner’s rights concerning usage of the property? For example, will the landowner be able to lease the property for hunting or other recreational activities? Will the landowner be able to mortgage or insure the property? Can the landowner develop any other potential mineral or renewable energy exploration?
- Consider the use of a clause that requires the landowner to be treated as favorably as neighbors (consider how to define “neighbor”) executing similar agreements.
- Include a clause requiring the removal of all improvements the developer makes upon termination (whether voluntary or otherwise) of the agreement. Relatedly, for developments in the Flint Hills (eastern Kansas), include a provision specifying

which party gets the rock that gets excavated to build the wind energy structures.

Note: Regardless of whether termination is voluntary or involuntary, it is critical to set-forth timing and costs associated with decommissioning.

- Require the agreement to be recorded (not just a “memorandum of agreement”) to eliminate the necessity of having to locate a copy of the lease in the event of sale or mortgage of the property.
- Never agree to confidentiality clauses concerning the terms and conditions of the agreement.
- Have the contract reviewed by the landowner’s insurance agent for analysis of any additional risks created by the wind energy project. In addition, consideration should be made as to whether a bonding should be required. Similarly, a landowner should consider being a payee on the developer’s insurance policy.
- Will the agreement violate any USDA land-use restrictions if the subject land is enrolled in a USDA program? If such a possibility exists, consider including in the agreement a clause requiring the developer to indemnify the landowner for any lost government payments or the imposition of any penalties.
- Will the wind farm development be designed so as to minimize interference with aerial crop dusting activities?
- Can the landowner sell the property, or can portions of the property be sold?
- Evaluate the agreement with an eye toward the risk faced by the landowner. This includes environmental concerns, issues that could be raised by neighbors (i.e., nuisance-related concerns), and potential violation of applicable zoning and set-back requirements.

State-Level Policy Issues

The growth of wind energy industry and development of agricultural real estate for large-scale wind farms raises a question as to whether state legislatures should enact statutory provisions addressing landowners’ concerns and provider uniformity as to certain lease/easement provisions. Potential areas to be addressed could include: (1) whether there should be a maximum length of easement terms before renegotiation occurs; the number of turbines that can be erected in a township; and a mechanism for determining the value of landowners’ wind rights; (2) whether there should be a statewide decommissioning fund to assure payment of costs for removal of obsolete facilities; (3) whether there should be a fund capturing some of the value of harvesting wind to be shared with the public; (4) whether there should be minimum standards required of all easement agreements for such things as reimbursement for crop loss, compaction, road and line easements; (5) whether developers should be allowed to sale easements to other persons or entities without a landowner’s consent; (6) whether a landowner should be able to void an easement agreement for non-development within a certain period of time; (7) whether counties should be required to adopt a permitting process to insure that developers operate publicly; (8) whether a landowner should be able to cancel an easement/lease if the final location of a turbine unreasonably interferes with the landowner’s intended use of the land; (9) whether standard terms for indemnification, insurance, payment of taxes and similar items should be statutorily provided.

Conclusion

From a landowner's perspective, many wind energy leases and/or easements are inadequate, unfair and offer limited economic benefits when compared to the revenues generated (and tax subsidies received) by large-scale wind energy developers. The most common shortcomings of such agreements include: (1) contractual terms extending too long into the future; (2) contractual language that binds landowners to unilateral amendments; (3) inadequate compensation clauses (and compensation

clauses that are difficult to understand); (4) provisions that are the result of unequal bargaining power. While some landowners are reporting better experiences in recent months - better contract terms and compensation levels - that may be the result of greater competition among wind energy developers, greater education on the part of landowners and lawyers, and increased oversight by state regulators (the vast majority of wind energy developers are not subject to the regulatory rules that most utilities are subject to).

Clearly, wind farming has the potential to provide significant economic benefits for rural landowners. However, substantial peril exists that landowners who don't carefully evaluate proposed agreements with developers can be taken advantage of significantly. Landowners should have any proposed agreement evaluated by legal counsel and attempt to negotiate any unfavorable terms. Failure to do so could result in many years of dissatisfaction for landowners.

*Leonard Dolezal Professor in Agricultural Law, Iowa State University, Ames, Iowa, and Director of the ISU Center for Agricultural Law and Taxation, Member of the Iowa and Kansas Bar Associations and admitted to practice in Nebraska.

¹ A renewable portfolio standard is a mandate that requires a certain amount a state's energy needs to be met by "renewable" technologies regardless of the cost of producing such energy.

² The leading states in wind energy production are California, Texas, Iowa and Minnesota. The top five states for wind energy potential are North Dakota, Texas, Kansas, South Dakota and Montana. The proper siting is critical for wind availability and minimization of wind flow interference and landowner conflicts.

³ According to the Wind Energy Association, wind *could* produce over 10 billion kilowatts annually. That is three times the amount of power used presently in the United States. But, wind turbines generate electricity only about 40 percent of the time and can change output almost constantly which can create problems for modern electric grids that cannot vary in voltages by more than a few percentage points.

⁴ In his book, "The Wind Farm Scam," John Etherington points out that wind turbines cannot generate enough energy to reduce global CO₂ levels to any meaningful degree. Etherington points out

that the wind energy industry is excessively subsidized and cannot achieve cost efficiency.

⁵ <http://www.energy.iastate.edu/renewable/wind> (Iowa Energy Center, Renewable Energy and Energy Efficiency). Iowa ranks second in wind power generating capacity, according to the American Wind Energy Association.

⁶ *Id.*

⁷ Iowa Code §476.46 (\$5.9 million were funneled toward Iowa's investor-owned utilities to be managed by the Iowa Energy Center.)

⁸ <http://www.iowafarmbureau.com/windassessments>

⁹ <http://domesticfuel.com/2008/02/18/wind-energy-bringing-more-jobs-to-iowa/>. However, in early 2009, a Wisconsin-based company announced that it was scrapping its plans to build a \$90 million wind tower facility in Keokuk, Iowa. Also, a recent economic study from King Juan Carlos University in Madrid, Spain, debunks the theory that increased renewable energy subsidies result in job creation. The study, based on Spain's experience with wind and solar energy production (in Spain, wind generates 11 percent of electrical power demand), concluded that for every new position that depends on energy tax subsidies, at least 2.2 jobs in other industries are eliminated. Further, Spain paid \$775,000 for every green job they created through subsidies since 2000 (\$100,000 per year per job). Why? The researchers concluded that wind energy is very inefficient when compared to fossil fuels and generating energy from wind (and solar) causes energy prices to rise and industries to move out. High-tech industries that rely on cheap energy, in an economic downturn, would have little choice but to move on. The study noted that Spain's Acerinox SA the nation's largest stainless-steel producer, blamed domestic energy costs for deciding to expand its operations in countries with cheaper energy costs. The study also noted that Microsoft and Google moved their servers to the Canadian border because they benefitted from cheaper energy at that location. The author of the study is Gabriel Calzada, an economics professor at King Juan Carlos University.

¹⁰ *Id.*

¹¹ I.R.C. §45(d).

¹² As an illustration of the tax benefit to a wind-farm owner of the provision, consider the following: A company proposes to construct a 150 MW "wind farm" in Iowa. Assuming a 40 percent capacity factor, the amount of the tax credit (in 2008) would be \$11,037,600 - (150,000 kW x 8,760 hours x .40 x \$.021). The federal tax credit is a direct reduction of tax liability on a dollar-for-dollar basis.

¹³ The five-year 200 percent double-declining balance method can be used for capital costs of facilities

using wind to produce electricity for sale. Nearly all other electric generating facilities must use 20-year depreciation. Accordingly, MidAmerican Energy should be able to deduct from taxable income its entire \$386 million capital investment in its 360 megawatt (MW) “wind farm” in Iowa during the period from 2004-2010. Assuming marginal tax rates of 35 percent for federal and 12 percent for Iowa corporate income tax, the depreciation deductions would reduce tax liability by \$181 million during the period from 2004-2010. That is in addition to the roughly \$300 million in tax benefits over 20 years from the project due to the Federal Production Tax Credit (\$175 to \$195 million) and forgiveness of Iowa property tax (\$130 million).

¹⁴ This is one reason why small “wind farm” development companies often sell off their project to larger companies or find ways to “sell” the tax benefits.

¹⁵ These states include, for example, New York, West Virginia, Wisconsin, Minnesota, South Dakota and Kansas. See, e.g., Kan. Stat. Ann. §79-201.

¹⁶ The generous federal accelerated depreciation deduction allowed for wind farms (see note 10 *supra* and accompanying text) provides a large state tax benefit also in those states that follow the federal rule. For example, in Kansas, corporate income is taxed at the basic rate of 4 percent with a 3.35 percent surtax on income above \$50,000. The beginning point in determining Kansas taxable income is the federal taxable income of the corporation. Thus, the accelerated depreciation provision at the federal level reduces the taxable income basis used before applying Kansas’ 7.35 percent marginal income tax rate. This benefit is even greater in states with higher corporate income tax rates such as Iowa, with a 12 percent rate. Minnesota and Nebraska also have relatively high tax rates on businesses.

¹⁷ Typically, such payments are offered only in the early years of a project to help gain public and political support for the necessary approvals to construct the wind-farm.

¹⁸ Iowa Code § 469.31 (2008).

¹⁹ Iowa Code §476C.1(2008) (at least one owner for each two must have one-half megawatts of nameplate generating capacity or the energy production capacity equivalent for hydrogen fuel or heat for a commercial purpose of the otherwise eligible renewable energy facility.)

²⁰ *Id.*

²¹ *Id.*

²² Iowa Code § 427B.26. The provision is limited by Iowa Code §476B.4, which disallows wind-energy production tax credit for kilowatt-hours of electricity

produced on “wind-energy conversion property.” In addition, no tax credits are allowed if the electricity is sold to a related person.)

²³ *Id.*

²⁴ *Id.*

²⁵ IDOR Policy Letter, 2008-08300008 (Jan. 30, 2008).

²⁶ *Id.*

²⁷ IOWA CODE § 423.3(54) (2008).

²⁸ IDOR Policy Letter, 2008-08300008 (Jan. 30, 2008).

²⁹ *Id.*

³⁰ *Id.*

³¹ Billy Hamilton, *Blowin’ in the Wind—Wind Energy and Tax Policy*, 48 State Tax Notes, 421 (May 5, 2008).

³² *Id.*

³³ *Id.*

³⁴ Jack Hunt, *Iowa Governor Approves Wind Energy Tax Credits Bill*, 2008 State Tax Analysts State Tax Today, 2008 STT 91-7 (May 9, 2008).

³⁵ *Id.*

³⁶ *Id.*

³⁷ South Dakota Final HB 1320, 2008 STT 88-35 (May 6, 2008).

³⁸ Billy Hamilton, *Blowin’ in the Wind—Wind Energy and Tax Policy*, 48 State Tax Notes, 421 (May 5, 2008).

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *Id.*

⁴³ *Id.*

⁴⁴ Billy Hamilton, *Blowin’ in the Wind—Wind Energy and Tax Policy*, 48 State Tax Notes, 421 (May 5, 2008).

⁴⁵ *Id.* However, wind energy systems generating under 250 kilowatts are exempt from production tax in Minnesota.

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ *Wind Energy Pioneer Facing Federal Fraud Charges*, THE BISMARCK TRIBUNE, North Dakota News Section, Sept. 23, 2007, available at <http://www.bismarcktribune.com/articles/2007/09/23/news/state/139817.txt>.

⁵¹ *Id.*

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ Estate of Gibbs v. United States, 161 F.3d 242 (3d Cir. 1998).

⁵⁶ *Rose v. Chaikin*, 187 N.J. Super. 210 453 A.2d 1378 (N.J. Super. 1982).

⁵⁷ *Burch v. Nedpower Mount Storm, LLC*, 220 W. Va. 443, 647 S.E.2d 879 (2007).

⁵⁸ *Porter v. Gentry County Commission*, No. 08-6029-CV-SJ-FJG, 2008 U.S. Dist. LEXIS 58800 (W.D. Mo. Aug. 4, 2008).

⁵⁹ *Clark County v. Federal Aviation Administration*, 522 F.3d 437 (D.C. Cir. Apr. 2008).

⁶⁰ *Id.*

⁶¹ *Rankin, et al. v. FPL Energy, LLC, et al.*, 266 S.W.3d 506 (Tex. Ct. App. 2008)

⁶² *Id.* Thus, the court seems to have indicated that an appeal to the state Supreme Court would be in order

⁶³ *Advocates for Prattsburgh, Inc., v. Stueben County Industrial Development Agency*, 48 A.D.3d 1157, 851 N.Y.S.2d 759 (2008).

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ *In re West Beekmantown Neighborhood Association, Inc., et al. v. Zoning Board*, 53 A.D.3d 954, 861 N.Y.S.2d 864 (2008).

⁶⁷ *In re Willkie*, 865 N.Y.S.2d 739 (N.Y. Ct. App. 2008).

⁶⁸ *Zimmerman, et al. v. Board of County Commissioners*, No. 98,487, 2009 Kan. LEXIS 1073 (Kan. Sup. Ct. Oct. 30, 2009).

⁶⁹ *Orleans County Vermont, Town of Derby, Board of Civil Authority Ruling*, November 2007.

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² *Id.*

⁷³ *Boyle, et al. v. McGlynn, et al.*, 814 N.Y.S.2d 312 (2006).

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ *Id.*

⁷⁸ *Center for Biological Diversity, Inc. v. FPL Group, Inc., et al.*, 166 Cal. App. 4th 1349, 83 Cal. Rptr. 3d 588 (2008).

⁷⁹ *Id.*

⁸⁰ *Id.*

⁸¹ *City of Akron v. Akron-Westfield Community School District*, 659 N.W.2d 223 (Iowa 2003).

⁸² *Id.*

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ *Office of Consumer Advocate v. Iowa Utilities Board*, 656 N.W. 2d 101 (Iowa 2003).

⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ *McClure v. Verizon Wireless*, No. 7-394/06-0244, 2007 Iowa App. LEXIS 1061 (Iowa Ct. App., Oct. 12, 2007).

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ The rule (Iowa Admin. Code §199-15.11(5)) applies to all customer classes. There is no mention of a limit on either the size of a net metering system or on total enrollment. The rule requires that utilities purchase customers' net excess generation at avoided cost- the utility's incremental cost for capacity or energy (or both) that, but for the acquisition of energy or capacity from another source, the utility would have to incur.

⁹² *Windway Technologies, Inc., et al. v. Midland Power Cooperative*, No. 6-836/06-0276, 2007 Iowa App. LEXIS 284 (Iowa Ct. App. Mar. 14, 2007). The plaintiffs appealed the court's denial of their motion for a new trial and motion to recuse. The court noted that the appeal failed to comply with the Iowa Rules of Appellate Procedure and should be dismissed. The court stated that the fact that the plaintiffs weren't represented by legal counsel did not excuse them from following the rules. In addition, the court stated that it would not perform the plaintiffs' research and advocacy for them. However, the court declined to award attorney fees to the energy company. *Windway Technologies, Inc., et al. v. Midland Power Cooperative*, No. 8-434/07-1222, 2008 Iowa App. LEXIS 445 (Iowa Ct. App. Jul. 16, 2008).

⁹³ Generally, if the grant of an easement deprives the taxpayer of practically all of the beneficial interest in the land, except for the retention of mere legal title, the transaction is considered to be a sale of the land that the easement covers. In such cases, gain or loss is computed in the same manner as in the case of a sale of the land itself under I.R.C. §§1221 or 1231. See Rev. Rul. 54-575, 1954-2 C.B. 145.

⁹⁴ See, e.g., *Conway v. United States*, 73-1 U.S.T.C. ¶9,318 (W.D. Ky. 1973).

⁹⁵ See Rev. Rul. 59-121, 1959-1 C.B. 212; *Wineberg v. Comr.*, 326 F.2d 157 (9th Cir. 1963)(under Kentucky law, warranty deed conveying right-of-way constituted conveyance of an easement and not fee simple title to real estate; under facts of case, interest conveyed was easement because title would revert to taxpayer upon abandonment and because no grantee could relinquish fee simple title by abandonment; taxpayers also reserved mineral rights and right of ingress and egress across easement; accordingly, taxpayer entitled to apply easement grant proceeds to reduction of basis in remaining tracts of land).

⁹⁶ Treas. Reg. §1.61-6(a).

⁹⁷ If the easement affects only a specific portion of the tract, only the basis allocable to the affected portion is reduced by the price received from the easement. Rev. Rul. 68-291, C.B. 1968-1, 351.

⁹⁸ T.C. Memo. 1980-61.

⁹⁹ The gain would be I.R.C. §1231 gain. For further guidance on the calculation technique utilized in the example, see Rev. Rul. 68-291, 1968-1 C.B. 351.

¹⁰⁰ See, e.g., *Bledsoe v. United States*, 67-2 U.S.T.C. ¶9,581 (N.D. Okla. 1967); *Conway v. United States*, 73-1 U.S.T.C. ¶9318 (W.D. Ky. 1973).

¹⁰¹ Rev. Rul. 77-413, 1977-2 C.B. 298.

¹⁰² Rev. Rul. 77-414, 1977-2 C.B. 299.

¹⁰³ 67-2 U.S.T.C. §9,581 (N.D. Okla. 1967).

¹⁰⁴ 9 T.C. 727 (1947).

¹⁰⁵ I.R.C. §1402(a)(1).

¹⁰⁶ Of particular concern is a provision in many wind energy agreements under which the landowner agrees to indemnify and reimburse the developer if a third party on the property with the landowner's permission damages the wind farm structures. For example, if a landowner contracts with a custom cutter to harvest crops on the premises that is also subject to a wind energy lease, and the custom cutter's activities set the field on fire, causing damage to the wind farm structures, the landowner, under such an indemnification provision, is liable for the resulting damage. Another concern is that with some wind energy agreements, the landowner executes the contract with a shell corporation created solely for liability purposes.

Tax Issues Associated with Unharvested Crops in a Decedent's Estate

February 10, 2009

- by Roger McEowen*

Overview

The presence of unharvested crops in a decedent's estate raises income tax and, if the estate is large enough, estate tax issues. The matter can be complicated if the decedent's farmland was rented and crop rent had accrued but had not yet been received as of the date of the decedent's death.

There are several possible ways to determine the value of unharvested crops.¹ One approach is to arrive at a value by discounting the crop by the amount of risk involved between the date of death and harvest with the amount of risk tied to the type of lease involved. Alternatively, the crop could be valued by the amount of a loan, secured by the crop that could have been negotiated as of the date of death. Or, perhaps the simplest (and least beneficial to the decedent's estate) approach would be to pro-rate the allocation of the crop proceeds between the pre-death and post-death periods. It is this pro-rata approach that IRS utilizes to address both estate tax and income tax issues involving unharvested crops in a decedent's estate. In addition, some states (such as Iowa) follow the pro-rata approach for purposes of state-level taxes.

Character of Income and Basis Issues.

General rule. Under the general rule, property interests of a decedent that the decedent owns at death are valued for estate tax purposes at their fair market value as of the date of the decedent's death.² For income tax basis purposes, the basis

of property that is included in a decedent's estate equals the value of the property as of the date of the decedent's death.³ This is generally known as the "stepped-up" basis rule, although it is also possible that property values could have declined as of the date of death. The rule operates to eliminate any taxable gain in the property upon later sale by an heir at the date of death value.

Exception. Income in respect of decedent (IRD) property does *not* receive any basis step-up.⁴ IRD is taxable income that is received after a taxpayer has died – it is income the taxpayer earns before death, but is not included on the decedent's final income tax return because the taxpayer was not eligible to collect the income before death. IRD is subject to both income tax and (for large estates) estate tax. So, while IRD does not receive a basis step-up by virtue of being included in the decedent's estate, the recipient of the IRD is entitled to a deduction for the federal estate tax that is attributable to the IRD as a result of its inclusion in the decedent's estate.⁵

Application of the IRD Rule

The IRD issue turns on the status of the decedent at the time of death. Two questions are relevant – (1) was the decedent an operating farmer or a farm landlord? and (2) if the decedent was a farm landlord, was the decedent a materially participating landlord or a non-materially participating landlord?

Operating farmers and materially participating landlords: For operating farmers (including a materially participating farm landlord) unsold livestock, growing crops and grain inventories are *not* IRD.⁶ The rule is the same if the decedent was a landlord under a material participation lease.⁷ Those assets are included in the decedent's gross estate and receive a new basis equal to their fair market value as of the decedent's death.⁸ No allocation is made between the decedent's estate and the decedent's final income tax return.⁹

Non-materially participating landlords: For non-materially participating farm landlords that die during a rent period, the matter is more complex. If a cash basis landlord rents out land under a non-material participation lease, the landlord normally includes the rent in income when the crop share is reduced to cash or a cash equivalent, not when the crop share is first delivered to the landlord. In this situation, a portion of growing crops or crop shares or livestock that will be sold post-death will be IRD and a portion will be post-death ordinary income to the landlord's estate. That is the result if the crop share is received by the landlord before death, but is not reduced to cash until after death. It is also the result if the decedent had the right to receive the crop share, and the share is delivered to the landlord's estate and then reduced to cash. In essence, an allocation is made with the portion of the proceeds allocable to the pre-death period (in both situations) being IRD in accordance with a formula set forth in Rev. Rul. 64-289.¹⁰ In these situations, IRD is not incurred until the crop share is sold. However, if the landlord received the crop share and sold it *before* death, the income realized is includable on the landlord's final return and is not IRD.¹¹

Note: If the estate sells grain inventory within six months after death, the income from the sale is treated as long-term capital gain if the basis in the crops are not IRD (in other words, if the basis in the crops was determined under the I.R.C. §1014 date-of-death fair market value

rule).¹² Also, while the sale of raised crops or livestock in the estate of an active farmer usually triggers ordinary income, the sale by the estate of land with growing crops results in capital gain treatment for the income that is attributable to the crop.¹³ The same result can be achieved when the crops are harvested during the process of liquidating the farming operation and the land is sold. But, ordinary income treatment occurs if the crop is being raised on land that is leased to a tenant.¹⁴

The allocation formula set forth in Rev. Rul. 64-289 splits out the IRD and estate income based on the number of days in the rental period before and after death.

Example:

On February 4, 2008, Jerry Mander leased his farm to a tenant on a 60/40 crop share lease (i.e., Jerry gets 40 percent of the crop and pays for 40 percent of the expenses). The lease ran from March 1, 2008 through February 28, 2009, and was for the growing of corn and soybeans on Jerry's farm. Jerry died on July 4, 2009. The tenant harvested the corn on October 15 and sold it later the same day for \$135,000. The soybeans were harvested on October 7 and stored. The soybeans were later sold on January 27, 2009, for \$40,000.

The allocation formula would operate as follows: The lease period was for 365 days (March 1 to February 28) and Jerry was alive for 126 of those days. Thus, 126/365 of the amount that the estate received for the corn is IRD - \$18,641.10 (.4 x \$135,000 (126/365)). The balance of the amount received by the estate (\$35,358.90) is taxable to the estate as ordinary income. The entire amount that the estate received for the soybeans (\$16,000) is taxed to the estate as ordinary income.

Note: Expenses attributable to IRD items are deducted as an expense on Schedule K of Form 706 (federal estate tax return) and are deducted as an expense item on the income tax return of the person or estate when the expense item is paid.

Note: If Jerry had died *after* the crop shares were sold (but before the end of the rental period), the proceeds would have been reported on Jerry's final return. No proration would have been required.

Note: If Jerry had received his crop share in-kind and held it until death with the heirs selling it after death, the sale proceeds would be allocated between IRD and ordinary income of the estate under the formula set forth above.

For crop share rents of a non-materially participating landlord that are fed to livestock *before* death, if the animals are also owned on shares, IRD results. If the decedent utilized the livestock as a separate operation from the lease, the in-kind crop share rents (e.g., hay, grain) would be treated as any other asset in the farming operation – included in the decedent's gross estate and entitled to a date-of-death fair market value basis.

Crop share rents fed to livestock after the landlord's death are treated as a sale at the time of feeding¹⁵ with an offsetting deduction.

State-Level Taxation

Some states have specific rules for handling unharvested crops at death for tax purposes. In Iowa, for example, the Iowa Department of Revenue (IDOR) follows the pro-rata approach. Thus, growing crops owned by a decedent at death are valued via a formula.¹⁶ Under the

formula, the cash value of the crop realized upon sale is prorated by attributing a portion of the value to the period before death and a portion to the period after death. The amount attributed to the pre-death period is the value for Iowa inheritance tax purposes. The numerator of the ratio expresses the number of days the decedent lived during the growing season (corn and soybeans) – which is considered to be May 15 through October 15 (153 days). The 153-day period is the denominator. The ratio is multiplied by the number of bushels realized upon harvest with that result multiplied by the local elevator price at the time of maturity. However, if the estate sells the crop within a reasonable time after harvest in an arm's length transaction, the selling price can be used as the fair market value basis. The regulation provides the following example:¹⁷

Example:

The decedent raised corn and beans and died on August 15. Thus, the decedent lived 92 days of the growing season. In the fall, the estate harvested 2,000 bushels of corn which were sold to a local elevator for 3.10/bushel. As a result, the value of the crop for Iowa inheritance tax purposes would be \$3,728.10 ($92/153 \times 2,000 \times \3.10).¹⁸

The regulations also address the valuation issue if the decedent was a farm landlord with a tenant operating under a cash lease.¹⁹ In that situation, the Iowa inheritance tax value of the crop is determined in accordance with a formula in which the cash rent for the entire rental period is prorated over the entire year. The proration period is the number of days the decedent lived during the rental period, divided by 365 days. The resulting percentage is then applied to the total cash rent for the entire year. The regulation allows a deduction for rent payments made before death and specifies that if such a deduction results in a negative amount, no refund or credit is allowed.²⁰

Note: Apparently, crop harvesting costs can be deducted from the value of

the crop that results from the use of the formula.

Other states don't have specific procedures for valuing unharvested crops.²¹ In those states, value is arrived at by either discounting the crop by the amount of risk involved between the date of death and harvest with the amount of risk tied to the type of lease involved or by pegging the crop's value to the amount of a loan, secured by the crop that could have been negotiated as of the date of death. There may also be other acceptable methods of arriving at a reasonable value for unharvested crops.

Deceased Farm Landlords - Crop Rental Income Income Tax Issues

Crop rents that have accrued as of the date of the decedent's death, but which the decedent did not receive before death are included in the decedent's gross estate.²² They are not allocated between the estate and the decedent's final income tax return.²³ According to the IRS, a crop rent which is not payable until harvest is included, to the extent it has accrued, in the decedent's gross estate even though the decedent died before harvest. For estate tax valuation purposes, the crop is valued as of the date of death or six months after death if the executor makes an alternate valuation election.²⁴ If an alternate valuation election is made, any increase in value attributable to crop growth during the six-month alternate valuation period is not directly included in the gross estate.²⁵ Instead, the crop value (for both date-of-death and alternate valuation purposes) is allocated between the pre-death and post-death period in accordance with a formula. The formula multiplies the value by a fraction. The numerator of the fraction is the number of days in the part of the rental period which ends with the decedent's date of death, and the denominator is the total number of days in the rental period. When the crop is later sold (or fed to livestock) the sale proceeds (or the value of the crop on the date of disposition by feeding to livestock) are plugged into the formula to determine which portion of the crop rental is

income in respect of decedent (IRD) and which portion is income to the estate.

*Leonard Dolezal Professor in Agricultural Law, Iowa State University, Ames, Iowa, and Director of the ISU Center for Agricultural Law and Taxation. Member of the Iowa and Kansas Bar Associations and licensed to practice in Nebraska.

¹ The following possible ways to value an unharvested crop were suggested to the author as a first-year practicing attorney by Donald H. Kelley, then of Kelley, Scritsmier and Byrne in North Platte, NE.

² I.R.C. §2031.

³ I.R.C. §1014(a)(1).

⁴ I.R.C. §691.

⁵ The deduction occurs in the year the income from the IRD property is recognized. I.R.C. §691(c). The deduction is computed at the average estate tax rate and is determined by the ratio that the value of the items bear to the gross estate. This is because the amount subject to tax is lesser than the value of the gross estate. In addition, the deduction is allowed regardless of whether the IRD item is used to fund a marital deduction for the surviving spouse (in estate of the first spouse to die). Thus, in larger estates, it may be wise practice to fund the marital deduction with IRD items or with property items that are intended to be held by the recipient rather than resold or which have relatively low appreciation.

⁶ Rev. Rul. 58-436, 1958-2 C.B. 355.

⁷ Rev. Rul. 64-289, 1964-2 C.B. 173. While the Internal Revenue Code and the Treasury Regulations are unclear on the issue, it appears that the decedent could achieve material participation through an agent.

⁸ See, e.g., Estate of Tompkins v. Comr., 13 T.C. 1054 (1949). This is the rule for decedents on the cash method. For those on the accrual method, the items would be included in the decedent's closing inventory on the final return.

⁹ Treas. Reg. §20.2031-1(b).

¹⁰ 1964-2, C.B. 173 (1964). The formula is directed to decedents who were on the cash method and specifies that for decedent's dying during the rent period, only the crop (or livestock share) rents attributable to the rent period ending with the decedent's death are IRD.

¹¹ *Id.*

¹² I.R.C. §1223(11). But, this treatment does not apply to cattle (which must be held for 24 months) or other livestock (which must be held for 12 months) if the animals were used in the decedent's trade or business and were held for draft, breeding or sporting purposes. Rev. Rul. 75-361, 1975-2 C.B. 344. The ruling points out that there is no exception under

I.R.C. §1223(11) from the special holding period requirements of 24 months for cattle and 12 months for other livestock. See I.R.C. §1231(b)(3)(A)-(B). However, the holding period requirements don't apply to livestock held for sale, such as non-replacement calves. This type of livestock, if included in the estate of an active operator or a materially participating landlord are classified as property and are entitled to a basis equal to the date of death value, and any resulting gain upon sale is entitled to long-term capital gain treatment.

¹³ I.R.C. Secs. 268, 1231(b)(4).

¹⁴ See, e.g., *Bidart Brothers v. U.S.*, 262 F.2d 607 (9th Cir. 1959).

¹⁵ Rev. Rul. 75-11, 1975-1 C.B. 27.

¹⁶ IAC §701-86.11(7).

¹⁷ *Id.*

¹⁸ The resulting amount can be reduced by harvesting costs. Such reduction does not appear to be mandatory and, if taken, will increase the income tax payable by reason of the resulting increase of IRD.

¹⁹ IAC §701-86.11(8).

²⁰ *Id.* The regulation also states that the valuation formula is to be utilized whether the decedent is the landlord or tenant of the property.

²¹ Conversely, some states not having established procedures for valuing unharvested crops may have rules for valuing mineral interests at death. In Kansas, for example, interests associated with oil and gas leases are treated as tangible personal property. If the interest is large enough, an appraisal will be necessary. But, for smaller interests the state may prescribe the valuation approach to be used. For example, in Kansas, with respect to oil leases and royalties, the average annual income from production for the immediate three years before death is to be multiplied by 3.5. For a gas well, the average annual production for the five years immediately preceding death is to be multiplied by 10. If no production had occurred in the prior five years, valuation can be based on original cost if the gas well was purchased within a reasonable time before death and there has not been activity in the area to cause an increase in value.

²² I.R.C. §691(c).

²³ *Id.*

²⁴ See, e.g., I.R.C. §2032.

²⁵ Compare Priv. Ltr. Rul. 7743007 and Priv. Ltr. Rul. 7805008.



Income Tax Consequences of the CWT Program

2321 N. Loop Drive, Ste 200 • Ames, Iowa 50010

www.calt.iastate.edu

Updated July 20, 2009
- by Philip E. Harris
Center for Dairy Profitability
University of Wisconsin-Madison/Extension

Background

The National Milk Producers Federation began sponsoring a program in 2003 to reduce the supply of milk in order to increase the price dairy producers receive for their milk. The program is called CWT, which stands for Cooperatives Working Together. Under the program, members of participating cooperatives and other dairy producers who join the program contribute 10¢ per hundredweight (cwt.) of milk they send to market. (Initially, the contribution was 5¢ per hundredweight.) Currently, 70% of the nation's milk supply is paying into the program. The fund is used to pay producers who agreed to send their dairy herd to the slaughter market.

The six previous herd retirement program conducted by CWT retired 276,000 cows representing 5.2 billion pounds of annual milk production.

Revised Dairy Herd Retirement Program

The Dairy Herd Retirement Program continues to pay producers who agree to send their entire dairy herd to a slaughterhouse. Producers submit bids that are based on their production measured in hundredweights. CWT will choose among the producers who submit bids in a manner that will minimize the cost of reducing production. The initial concern that the program would adversely affect the supply of milk in one or more regions proved to be unfounded, so the "regional safeguards" that limited the volume of milk that could be removed in each of the five regions of

the country were removed. That means all producers have the same opportunity for their bid to be accepted regardless of the region in which they farm.

The CWT payment is now paid in two installments. 90% is paid when the producer verifies that the herd has gone to slaughter. The remaining 10% is paid with interest 12 months later if neither the producer who received the payment nor the dairy facility in which he or she produced milk has been engaged in commercial production and marketing of milk during the 12 months following the CWT farm audit.

Bred Heifer Option

The CWT also added a bred heifer option that allows producers who have accepted bids for retiring their herds to receive a single set payment from CWT for each bred heifer they sell on the slaughter market. In the Spring 2009-1 Herd Retirement, CWT paid \$1,225 per bred heifer. In the 2009-2 round, CWT is paying \$700 per bred heifer. To qualify for this payment, the CWT auditor must verify that the heifers are in good physical condition, the heifers have not been given antibiotics that would delay selling the animals as slaughter animals, the heifers' identification numbers match those reported by the producer on the bid form, and the veterinary's pregnancy certificates are valid and in good order.

Tax Consequences

Assessment

The 10¢ per hundredweight assessment is similar to other assessments of producers for product marketing programs. It is a payment by producers to enhance the price they receive for their milk. Therefore, it is a deductible business expense. As with other expenses that are deducted from a producer's milk check, the CWT assessment should be reported separately as an expense on Schedule F (Form 1040) rather than netted out of the milk income reported on line 4 of Schedule F (Form 1040).

Example 1. Assessment

Duane Plug is a member of a coop that is participating in the CWT program. He is assessed 10¢ per hundredweight for CWT, which was a total of \$630 for 2009. His \$138,600 gross milk checks were also reduced by \$1,223 of trucking expenses. Duane reports his milk income on line 4, his trucking expense on line 20 and his CWT assessment on line 34 of his 2009 Schedule F (Form 1040) as shown in Figure 1.

Figure 1: CWT Assessment

SCHEDULE F (Form 1040)		Profit or Loss From Farming		OMB No. 1545-0074	
Department of the Treasury Internal Revenue Service (99)		▶ Attach to Form 1040, Form 1040NR, Form 1041, Form 1065, or Form 1065-B. ▶ See Instructions for Schedule F (Form 1040).		2009	
Name of proprietor				Social security number (SSN)	
Duane Plug				162 09 1040	
Part I Farm Income—Cash Method. Complete Parts I and II (Accrual method. Complete Parts II and III, and Part I, line 11.) Do not include sales of livestock held for draft, breeding, sport, or dairy purposes. Report these sales on Form 4797.					
1	Sales of livestock and other items you bought for resale	1			
2	Cost or other basis of livestock and other items reported on line 1	2			
3	Subtract line 2 from line 1	3			
4	Sales of livestock, produce, grains, and other products you raised	4			138,600
19	Fertilizers and lime	19			
20	Freight and trucking	20		1,223	
21	Gasoline, fuel, and oil	21			
33	Veterinary, breeding, and medicine	33			
34	Other expenses (specify):	34			
	a CWT assessment	34a			315

Dairy Herd Retirement Program

In Notice 87-26, 1987-1 CB 470, the IRS stated that payments from the Dairy Termination Program (DTP) were payments from the sale of cattle to the extent the slaughter price the producer received for the cattle was less than the value of the cattle as milking dairy cows. That position was upheld in *Standley v. Commissioner*, 99 TC 259 (1992). Because the CWT Dairy Herd Retirement Program payment is unlikely to exceed the difference in slaughter and milking value of the cows, all of that payment should be treated as an amount received from the sale of the cows.

In Notice 87-26, the IRS stated that the prices reported in "Agricultural Prices" published by the USDA can be used to determine the value of the cattle as milking cows. Notice 87-26 treated the excess as a replacement for milk receipts because the DTP required the producer to stay out of dairy production for 5 years. The new CWT Dairy Herd Retirement Program requires the producer and the premises to stay out of production for 12 months to get the final 10% of the payment plus interest. Consequently, the IRS could take the position that if the total of the CWT payments and the amount received from sale on the slaughter market exceed the "Agricultural Prices" value of the herd, then the

excess (limited to the 10% deferred payment) must be reported on Schedule F (Form 1040) as ordinary income that is subject to self-employment income. It is unlikely that the IRS will require the deferred 10% to be reported on Schedule F (Form 1040) if the total CWT payments and the amount received on the slaughter market is less than the “Agricultural Prices” value.

Bred Heifer Option

The amount received from the CWT for bred heifers is likely to be treated in the same manner as the amount received for milking and dry cows except that heifers that have been held for less than 24 months do not qualify for I.R.C. § 1231 treatment. Therefore, gain on those heifers is ordinary income reported in Part II of Form 4797 and is not subject to self-employment tax.

Example 2. Dairy Herd Retirement

Sue Zookie’s \$5.00 per cwt. bid for her 18,000 cwt. of production ($\$5.00 \times 18,000 = \$90,000$) was accepted by CWT under the Spring 2009-1 Dairy Herd Retirement Program. Sue sold her 100 head of raised milking and dry cows on the slaughter market for \$52,000 and received an \$81,000 (90% of \$90,000) payment from CWT in 2009. She also sold 25 heifers on the slaughter market for \$17,000 (\$680 per head) and received a \$30,625 ($\$1,225 \times 25$) payment from CWT under the Bred Heifer Option. Sue will receive the remaining \$9,000 (10% of \$90,000) CWT payment with interest in 2010.

For the month of sale, the USDA “Agricultural Prices” reports that the price of milk cows in Sue’s state was \$1,500. Because that is more than the \$1,420 [$(\$52,000 + \$90,000) \div 100$] of CWT and slaughter sale proceeds that Sue received for each milking and dry cow, she can report all of the CWT payment and slaughter sale proceeds as the amount received for the sale of the cows. However, the \$1,905 ($\$680 + \$1,225$) that Sue received for each heifer from the slaughter sale proceeds and CWT bred heifer option exceeds the \$1,500 “Agricultural Prices” value of the bred heifers. The IRS is likely to take the position (as they did in Notice 87-26) that the \$405 ($\$1,905 - \$1,500$) excess per head ($\$405 \times 25 \text{ head} = \$10,125$) must be reported on Schedule F (Form 1040) as ordinary income subject to self-employment tax because it is a payment for lost milk production during the year that Sue is required to stay out of dairy production.

If Sue elects out of installment reporting, she reports the \$52,000 she received for her milking and dry cows from the slaughter market as well as her \$90,000 CWT herd retirement payment ($\$52,000 + \$90,000 = \$142,000$) for the cows in Part I of Form 4797 as shown in Figure 2. She reports the \$17,000 slaughter sale proceeds for the heifers and \$20,500 ($\$30,625 - \$10,125$) of the CWT bred heifer option payment she received for the heifers ($\$17,000 + \$20,500 = \$37,500$) in Part II of Form 4797 as shown in Figure 2. She reports the remaining \$10,125 on line 4 of Schedule F (Form 1040) as shown in Figure 3.

Figure 2: Slaughter Payment and CWT Payment

Form 4797		Sales of Business Property (Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))			OMB No. 1545-0184	
Department of the Treasury Internal Revenue Service (99)		▶ Attach to your tax return. ▶ See separate instructions.			2009 Attachment Sequence No. 27	
Name(s) shown on return Sue Zookie				Identifying number 162-99-4797		
1 Enter the gross proceeds from sales or exchanges reported to you for 2009 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions)				1		
Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year (see instructions)						
2	(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale
	100 cows	various	09/15/2009	142,000	0	0
Part II Ordinary Gains and Losses (see instructions)						
10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):						
	25 heifers	various	9/15/2009	37,500	0	37,500

Figure 3: CWT Payment

SCHEDULE F (Form 1040)		Profit or Loss From Farming			OMB No. 1545-0074	
Department of the Treasury Internal Revenue Service (99)		▶ Attach to Form 1040, Form 1040NR, Form 1041, Form 1065, or Form 1065-B. ▶ See Instructions for Schedule F (Form 1040).			2009 Attachment Sequence No. 14	
Name of proprietor Sue Zookie				Social security number (SSN) 162-99-4797		
A Principal product. Describe in one or two words your principal crop or activity for the current tax year. Milk				B Enter code from Part IV ▶ 1 1 2 1 2 0		
C Accounting method: (1) <input checked="" type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual				D Employer ID number (EIN), if any		
E Did you "materially participate" in the operation of this business during 2009? If "No," see page F-3 for limit on passive losses. <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No						
Part I Farm Income—Cash Method. Complete Parts I and II (Accrual method. Complete Parts II and III, and Part I, line 11.) Do not include sales of livestock held for draft, breeding, sport, or dairy purposes. Report these sales on Form 4797.						
1	Sales of livestock and other items you bought for resale			1		
2	Cost or other basis of livestock and other items reported on line 1			2		
3	Subtract line 2 from line 1			3		
4	Sales of livestock, produce, grains, and other products you raised			4		10,125
5a	Cooperative distributions (Form(s) 1099-PATR)	5a		5b	Taxable amount	5b

Observation—2009-2 Heifer Payments.

The 2009-2 CWT payments for bred heifers is \$700 rather than \$1,225, which reduces the total payments received for the heifers. However, the value of heifers in "Agricultural Issues" may also be lower for those contracts.

For example, assume Sue's \$5.00 bid was accepted in the 2009-2 CWT buyout, she sold her heifers on the slaughter market for \$480, and the "Agricultural Prices" value of heifers was

\$1,200. The total of her slaughter sale price and the CWT payment would be \$1,180 (\$480 + \$700), which is less than the \$1,200 "Agricultural Prices" value of heifers. Therefore, Sue should report the entire \$1,180 per heifer in Part II of Form 4797 and none on Schedule F (Form 1040).

Installment Reporting

If the producer does not elect out of the installment method of reporting, the sale should

be reported as an installment sale. The contract price is the amount received from the slaughter market plus the full CWT payment. The installment payment to be reported in 2009 is the 90% of the CWT payment received in 2009 plus the amount received from the slaughter market. The remaining 10% of the CWT payment is the installment payment to be reported in 2010.

plus interest from CWT in 2010. The 200 head in Derry's herd include 150 head that were purchased and depreciated and 50 that were raised. He paid \$225,000 for the purchased cows and claimed \$187,515 depreciation on them before they were sold.

Derry must report the \$90,000 he received from the slaughter market and the \$119,800 he received from CWT in 2009 (\$119,800 + \$90,000 = \$209,800) on Forms 6252 and 4797 as shown in Figures 4 and 5. He will report the remaining \$13,320 plus interest that he receives from the CWT in 2010 on his 2010 income tax return.

Example 3. Two Installments

Derry Heir's \$4.44 per cwt. bid for his 30,000 cwt. of production ($\$4.44 \times 30,000 = \$133,200$) was accepted by CWT. Derry sold his 200 head of milking and dry cows on the slaughter market for \$90,000 and received a \$119,880 (90% of \$133,200) payment from CWT in 2009 and the remaining \$13,320 (10% of \$133,200) payment

Figure 4 CWT PAYMENT

Form 6252		Installment Sale Income		OMB No. 1545-0228	
Department of the Treasury Internal Revenue Service		▶ Attach to your tax return. ▶ Use a separate form for each sale or other disposition of property on the installment method.		2009 Attachment Sequence No. 79	
Name(s) shown on return Derry Heir				Identifying number 162-98-6252	
1 Description of property ▶ 150 purchased and 50 raised dairy cows					
2a Date acquired (month, day, year) ▶ mm/yy/yy b Date sold (month, day, year) ▶ mm/yy/yy					
3 Was the property sold to a related party (see instructions) after May 14, 1980? If "No," skip line 4 <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No					
4 Was the property you sold to a related party a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and the 2 years after the year of sale <input type="checkbox"/> Yes <input type="checkbox"/> No					
Part I Gross Profit and Contract Price. Complete this part for the year of sale only.					
5	Selling price including mortgages and other debts. Do not include interest whether stated or unstated	5		223,200	
6	Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions)	6	0		
7	Subtract line 6 from line 5.	7	223,200		
8	Cost or other basis of property sold	8	225,000		
9	Depreciation allowed or allowable	9	187,515		
10	Adjusted basis. Subtract line 9 from line 8	10	37,485		
11	Commissions and other expenses of sale	11	3,500		
12	Income recapture from Form 4797, Part III (see instructions)	12	129,555		
13	Add lines 10, 11, and 12	13	170,540		
14	Subtract line 13 from line 5. If zero or less, do not complete the rest of this form (see instructions)	14	52,660		
15	If the property described on line 1 above was your main home, enter the amount of your excluded gain (see instructions). Otherwise, enter -0-	15	0		
16	Gross profit. Subtract line 15 from line 14	16	52,660		
17	Subtract line 13 from line 6. If zero or less, enter -0-	17	0		
18	Contract price. Add line 7 and line 17	18	223,200		
Part II Installment Sale Income. Complete this part for the year of sale and any year you receive a payment or have certain debts you must treat as a payment on installment obligations.					
19	Gross profit percentage (expressed as a decimal amount). Divide line 16 by line 18. For years after the year of sale, see instructions	19	0.2359		
20	If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-	20	0		
21	Payments received during year (see instructions). Do not include interest, whether stated or unstated	21	209,880		
22	Add lines 20 and 21	22	209,880		
23	Payments received in prior years (see instructions). Do not include interest, whether stated or unstated	23			
24	Installment sale income. Multiply line 22 by line 19	24	49,511		
25	Enter the part of line 24 that is ordinary income under the recapture rules (see instructions)	25	0		
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797 (see instructions)	26	49,511		

FIGURE 5: CWT PAYMENT

Form 4797 Department of the Treasury Internal Revenue Service (99)	Sales of Business Property (Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2)) ▶ Attach to your tax return. ▶ See separate instructions.	OMB No. 1545-0184 2009 Attachment Sequence No. 27						
Name(s) shown on return Derry Heir		Identifying number 162-98-6252						
1 Enter the gross proceeds from sales or exchanges reported to you for 2009 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions)		1						
Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year (see instructions)								
2	(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)	
3	Gain, if any, from Form 4684, line 43						3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37						4	49,511
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824						5	
Part II Ordinary Gains and Losses (see instructions)			10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):					
11	Loss, if any, from line 7						11	
12	Gain, if any, from line 7 or amount from line 8, if applicable						12	
13	Gain, if any, from line 31						13	129,555
14	Net gain or (loss) from Form 4684, lines 35 and 42a						14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36						15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824						16	
Form 4797 (2009)			Page 2					
Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255 (see instructions)								
19	(a) Description of section 1245, 1250, 1252, 1254, or 1255 property:			(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)			
A	150 purchased cows			various	09/22/2009			
B								
C								
D								
These columns relate to the properties on lines 19A through 19D. ▶				Property A	Property B	Property C	Property D	
20	Gross sales price (Note: See line 1 before completing.)			20	167,400			
21	Cost or other basis plus expense of sale			21	225,000			
22	Depreciation (or depletion) allowed or allowable			22	187,515			
23	Adjusted basis. Subtract line 22 from line 21			23	37,485			
24	Total gain. Subtract line 23 from line 20			24	129,555			
25 If section 1245 property:								
	a Depreciation allowed or allowable from line 22			25a	187,515			
	b Enter the smaller of line 24 or 25a			25b	129,555			
26	If section 1250 property: If straight line depreciation was used,							
Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.								
30	Total gains for all properties. Add property columns A through D, line 24						30	129,555
31	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13						31	129,555
32	Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 37. Enter the portion from other than casualty or theft on Form 4797, line 6						32	0