



Ag Decision Maker



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Top ten agricultural law developments in 2004

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(last in a series)

8 Federal Court issues key ruling on the enforceability of liquidated damages clause in seed technology agreement.

On April 9, the United States Court of Appeals for the Federal Circuit reversed a trial court's ruling on the enforceability of Monsanto's liquidated damages clause contained in a technology agreement signed by a Mississippi soybean farmer. Monsanto owns a patent for genetically modified soybeans, and the farmer signed the technology agreement in connection with the license of the patented seeds. The trial court held that the farmer breached the technology agreement when he replanted soybeans saved from his prior year's crop. On appeal, the court affirmed the trial court's ruling that the farmer had violated Monsanto's patent by replanting the patented seed. The federal

court also affirmed the trial court's ruling that Monsanto was not in violation of antitrust law by tying second-generation seeds to the patented seeds. The court held that Monsanto's replanting restrictions were proper because the patent applied to all generations of the soybeans. However, the appellate court reversed the trial court on the enforceability of the liquidated damages clause in the technology agreement that required the farmer to pay 120 times the \$6.50/bag technology fee. The farmer admitted that he saved 1,500 bushels of seed from his 1998 crop (enough to plant about 1,500 acres) and replanted it in 1999, then saved 3,075 bags of soybeans from his 1999 crop and replanted those the next year. The court held that the 120 multiplier was "not a reasonable estimate of the harm that would be anticipated to flow from breach of the prohibition prohibiting replanting seed."

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Handbook updates

For those of you subscribing to the handbook, the following updates are included.

Iowa Corn and Soybean County Yields – A1-14 (4 pages)

2005 Corn and Soybean Loan Rates – A1-34 (2 pages)

2005 Iowa Farm Custom Rate Survey – A3-10 (4 pages)

Please add these files to your handbook and remove the out-of-date material.

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Monsanto argued that the damages calculation was warranted to allow the company to recover costs and pay for future research. The company has filed over 70 lawsuits against farmers in recent years over the issue. *Monsanto Co. v. McFarling*, 363 F.3d 1336 (Fed. Cir. 2004).

9. American Jobs Creation Act of 2004.

On October 22, President Bush signed into law the American Jobs Creation Act of 2004 (AJCA). The new tax law contains several provisions of importance to agricultural producers. The key agricultural provisions include:

a. The Act extends from two years to four years (for tax years after 2002 in areas designated as eligible for assistance by the federal government) the period of reinvestment of the proceeds from sale of livestock held for draft, dairy, or breeding purposes because of weather-related conditions. The treasury secretary is given authority to extend, on a regional basis, the period for replacement if the weather-related conditions continue for more than 3 years. Generally, the excess livestock sold because of weather-related conditions must be replaced with livestock held for the same purpose as the animals disposed of. However, if it is not feasible to reinvest the proceeds in property similar or related in use, the proceeds can be reinvested in other property used for farming purposes (except for real estate). But, once the two-year replacement period is exceeded (if the longer period applies), the replacement property must be livestock that is similar or related in service or use to the animals disposed of.

b. The Act provides that, in computing alternative minimum tax, the regular tax liability for farmers and fishermen is determined without regard to income averaging. Thus, a farmer receives the full benefit of income averaging. The Act also extends income averaging to fishermen. The provision is effective for taxable years beginning after 2003.

c. Under the Act, expense method depreciation is continued through 2007 at the level of \$100,000 (inflation adjusted). The figure is \$102,000 for 2004, \$105,000 for 2005. However, the Act limits expense-method depreciation for sport utility vehicles (SUVs) to \$25,000 for property placed in

service after October 22, 2004. Under the definition of "sport utility vehicle," cargo vans would largely not be included, but SUVs driven for personal or business purposes would be included.

d. The Act denies tax-free exchange status to a principal residence acquired in a like-kind exchange within the prior five-year period beginning with the date of property acquisition. The provision is designed to counter situations where

- (1) the property is exchanged for residential real property, tax-free, under the like-kind exchange rules;
(2) the property is converted to personal use; and
(3) a tax-free sale is arranged under the existing rule for tax-free sale of a principal residence.

e. The legislation repeals the 2000 ETI Act effective for transactions after 2004, subject to transitional rules for 2005 and 2006, and binding contract in effect on Sept. 17, 2003. The phase-out rule provides taxpayers with 80 percent of their otherwise applicable ETI benefits for transactions during 2005 and 60 percent of their otherwise applicable ETI benefits for transactions during 2006. The legislation replaces the ETI Act with a deduction ultimately equal to nine percent of the lesser of the "qualified production activities income" of the taxpayer for the taxable year or taxable income for the year. The transition percentage is three percent for 2005 and 2006 and six percent for years 2007-2009. The deduction cannot exceed 50 percent of the W-2 wages of the employer for the taxable year. The term "qualified production activities income" equals the taxpayer's domestic production gross receipts over the sum of the cost of goods sold, other expenses allocable to such receipts and a ratable portion of other expenses and losses not directly allocable to such receipts. A key part of the provision is the definition of "domestic production gross receipts" which includes gross receipts derived from "any lease, rental, license, sale, exchange or other disposition of qualifying production property which was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States."

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f. The law eliminates reduced rates of excise tax for most alcohol-blended fuels and imposes the full rate of excise tax on most alcohol-blended fuels. In place of reduced rates, the legislation creates two new excise tax credits – the alcohol fuel mixture credit and the biodiesel mixture credit. The sum of these credits may be taken against the tax imposed on taxable fuels. Also, the legislation extends the present-law alcohol fuels income tax credit through 2010.

g. The Act imposes limits on donated property, such as used automobiles, boats and airplanes, with a claimed value in excess of \$500 by requiring contemporaneous substantiation of value and providing that sale of the vehicle by the donee (without improvements or significant intervening use) limits the charitable deduction to the gross proceeds received from the sale. The provision is effective for contributions made after 2004.

10. IRS acknowledges that commodity certificate gain is taxable, but refuses to order information reporting.

In a March 18 news release, the IRS issued a reminder to farmers concerning the income tax treatment of subsidies received in the form of marketing assistance benefits by means of commodity certificates. While the IRS noted that commodity certificate gain is taxable, it refused to require the USDA to issue a Form 1099G to report the gain to the IRS and the taxpayer for commodity certificate gains. The problem was brought to light by an article published in the May 12, 2003, issue of Tax Notes by professors Neil Harl and Roger McEowen that pointed out a serious inconsistency in how government farm payments are handled by the USDA and the IRS. As discussed in the article, federal farm subsidies are paid in three forms:

- (1) direct payments;
- (2) counter-cyclical payments; and
- (3) marketing assistance benefits.

All three are to be reported as ordinary income. The problem is with marketing assistance benefits, which are paid under four mutually exclusive methods of payment. Payments under three of the methods are reported to the IRS and the taxpayer by the USDA. The fourth method (the use of commodity certificates to pay a CCC loan), which

is used almost exclusively by large cotton and rice producers (because the payment is not subject to the per person payment cap), is not reported even though the benefit is virtually indistinguishable from the other three.

In the news release, the IRS restated the above and conceded that the commodity certificate gain is taxable. However, the IRS refused to require the USDA to issue a Form 1099G to report the gain to the IRS and the taxpayer. So, while acknowledging the commodity certificate gain is taxable, but pointing out that no information reporting is required, the IRS has probably increased the incidence of non-reporting. Certainly, the Congress has no choice but to statutorily order information reporting for all government farm program payments – including commodity certificate gains. In the news release, the IRS also noted that a farmer who reports CCC loans as income, and thus has an income tax basis in the commodity, accounts for the market gain by reducing the basis of the commodity. That position was staked out by the IRS in a 1987 Revenue Ruling. *IRS News Release, IR 2004-83, Mar. 18, 2004.*



Should you participate in value-added agriculture?

by Don Hofstrand, co-director AgMRC, Iowa State University Extension, (641)423-0844, dhof@iastate.edu

Value-added agriculture has been touted as the solution to the problems facing farmers and rural residents. People promoting value-added agriculture claim that it will increase income and reduce financial stress in the farm sector and lead to the revitalization of rural communities. However, for a farm family suffering from low income and rural communities suffering from the loss of economic vitality, value-added agriculture may not be a panacea. So, should you participate in value-added agriculture or stick with traditional farming? The following discussion will shed light on the topic.

Long-range solution

Value-added agriculture's potential lies in creating long-term solutions rather than short-term fixes. It contains the elements for solving many of the problems facing farmers and rural America over the coming decades. It allows for an increase in the amount of income flowing into the pockets of farmers and rural residents. By doing so, production agriculture will rely on market forces and move away from the annual infusions of money from the federal government.

It allows you to move away from the "Pac Man" growth strategy so common in farming in recent decades. This is a growth strategy where farmers gobble-up neighboring farms. This results in fewer farmers and smaller rural communities.

Value-added agriculture provides an alternative growth strategy that allows you the opportunity to expand by moving upward in the food chain rather than expanding horizontally. This opportunity is available because the food supply chain is becoming more integrated. By moving aggressively, farmers have the opportunity to

play a role in the development of this new integrated system. This opportunity will provide farmers a greater role in the ownership and control of the new system.

However, because of its long-range focus, it takes time to implement. If you are considering any of the value-added opportunities that are available, you must remember that it may take a considerable amount of time before the benefits from these value-added activities are received. So, if you are expecting value-added agriculture to be a "silver bullet" that will provide a "quick fix" for the problems you are facing, you will probably be disappointed.

Capital required

A major ingredient for many value-added businesses is money. This is especially true for value-added business ventures where farmers commit commodities (corn, soybeans, hogs) for processing. These processing facilities are usually capital intensive. Although the potential payoff from these ventures can be significant, there are many value-added business ventures where the payoff has been low, and some that have failed. So, if capital is limited, you must determine whether your limited capital will yield the greater return by investing in your farm business, investing in a value-added business venture or some of both. This will require a careful risk/reward analysis on your part.

New skills required

New skill sets are required if you are going to participate in new value-added business ventures. Whether it is producing organic foods, growing specialty grains, or processing agricultural commodities, you will need to develop a whole new set of skills that are not commonly used in commodity agriculture.

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New production skills will be needed in the production of value-added crops and livestock. For example, preserving the identity of crops and livestock, certifying the quality of crops and livestock (ie. ISO 9000) and keeping detailed records on the production, handling, storage and marketing of crops and livestock are practices and procedures in which commodity producers usually don't participate.

In addition to new production skills, new business skills are also needed. Creating and operating a value-added business venture is different than most farm businesses. For example, marketing a food product is much different than marketing a commodity. Product marketing involves identifying customers, designing and implementing a promotional plan, pricing your product, identifying and analyzing competitors and a host of other activities. You also will be involved in conducting feasibility studies and designing and implementing business plans.

Other skills involve human relationships. As you move from commodity production to value-added activities, relationships with others become more important. Value-added activities often involve groups who work together to accomplish business objectives. Teamwork, communications and conflict management skills become more important. Working with customers, employees, producers, distributors, processors and others are important to your success.

From working with value-added groups, I have assembled the following list of skills that are important for successful value-added business development:

- ◆ Leadership
- ◆ Entrepreneurial
- ◆ Decision making
- ◆ Business management
- ◆ Teamwork

- ◆ Strategic management
- ◆ Negotiation
- ◆ Financial and risk management
- ◆ Time management
- ◆ Marketing/selling
- ◆ Communication
- ◆ Organization and planning
- ◆ Conflict management
- ◆ Public relations
- ◆ Inter-personal
- ◆ Personnel management
- ◆ Stress management

Over the coming year, AgMRC will be providing information and tools to help you improve your business, relationship and production skills. Keep abreast of these activities on our Web site at <http://www.agmrc.org/agmrc/default.html>.

Developing and honing these new skills can only be accomplished gradually over a period of time. But the payoff can be great. Individuals who develop these skills will have an advantage in creating and maintaining successful value-added business ventures.

The illusion of prosperity

Don't get caught in the illusion that things are getting better when they are not. Higher prices and/or yields generated over a broad geographic area are often capitalized into higher cash rental rates and land values. Although this rewards the farm owner, the farm operator is often no better off. For example, value-added corn processing that raises the price of corn in northwest Iowa may provide little long-term benefit for farm operators.

You should focus on value-added business ventures where you not only capture more income but also retain these income levels over the long-term. These business opportunities are difficult to identify and capture. They may require capital, new skills and commitment. But the long-term rewards may be great.



Higher fuel prices push up custom rates

by William Edwards, extension economist, (515) 294-6161, wedwards@iastate.edu

With prices for diesel fuel up 50 percent or more over a year ago, farm custom rates have begun to creep upwards, as well. A recently completed survey of custom rates paid or charged by Iowa farmers showed small but consistent increases in nearly every operation. Most operations showed increases of two to eight percent over the 2004 average rate, with five percent being about the average change. Tillage operations showed higher percentage increases than harvesting, since fuel is a larger portion of the total cost for tillage.

While the price of diesel fuel has the most immediate impact on a custom operator's costs, prices for both new and used machinery have jumped significantly, as well. This is due

in part to higher prices for steel, but also to a strong demand for machinery purchases. Farm income has been relatively good the past two years, and the limits for first-year deductions of machinery purchases have been raised by the IRS.

The Iowa Farm Custom Rate Survey sampled 185 farmers, custom operators, farm managers and lenders. Respondents were asked what they expected to pay or charge for various operations in 2005. Rates may vary from the average based on timeliness, size and shape of the fields, condition of the crop, quality of the machine and skill of the operator. A summary of the survey, including average values and ranges reported, is available as information file A3-10.

Updates, continued from page 1

Internet updates

In addition to those listed on page one, the following updates have been added to www.extension.iastate.edu/agdm.

Charting Commodity Futures—A2-20 (5 pages)

Grain Price Hedging Basics— A2-60 (3 pages)

Using Hedging in a Marketing Program— A2-61 (4 pages)

Hedging vs. Forward Cash Contracting— A2-62 (2 pages)

Historic Iowa Farmland Custom Rate Survey— A3-12 (3 pages)

Historic County Cropland Rental Rates – C2-11 (5 pages)

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