Top Ten Agricultural Law Developments of 2007

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We begin 2008 with our annual look at the most significant agricultural law developments of the previous year. Legal issues continue to be at the forefront of developments that are shaping the present and future of American agriculture, and it is very likely that the involvement of the legal system in agriculture will continue to grow. The following is my list of what I view as the top ten agricultural law developments of 2007 based on their impact (or potential impact) on U.S. agricultural producers and the sector as a whole.

1. U.S. Supreme Court Overrules Longstanding Antitrust Precedent. In late June, the U.S. Supreme Court, ina 5-4 opinion, reversed a significant antitrust decision of the Court rendered in 1911. In its 1911 opinion, the Court held that resale price maintenance agreements (agreements through which manufacturers or distributors specify minimum prices below which retailers are not permitted to sell goods) were per se (automatically) illegal. In this case, the Court's majority replaced the per se rule with a case-by-case "rule of reason" analysis. The Court reasoned that minimum resale price maintenance has the potential to give consumers more options so that they can choose among low-price, low-service brands; high-price, high-service brands; and brands that fall in between. The dissent criticized the majority's willingness to depart from longstanding precedent based on arguments that have been well-known for almost half a century, but which have not convinced the Congress to change the law. As a result of the Court's opinion, vertical minimum price fixing (which is almost always harmful to consumers) will only be prohibited if the manufacturer that imposes the minimum resale price restraint provides no reasonable, pro-competitive justification for it

The present case involved a dispute between a manufacturer of women's accessories and the owner of a retail shop in Texas. In violation of a price-setting agreement that the manufacturer imposed, the store discounted the manufacturer's products which prompted the manufacturer to ban the shop from selling its products in the future. The retail shop sued, claiming illegal price fixing. The jury agreed, awarding the shop $3.6 million in damages and $375,000 in attorney fees. The jury's decision was upheld by the United States Court of Appeals for the Fifth Circuit based on the Supreme Court's 1911 decision. *Leegin Creative Leather Products v. PSKS, Inc., 127 S. Ct. 2705 (2007).*

2. Two federal courts rule that USDA improperly advanced genetically modified crops. The introduction of biotech crops to the marketplace has been fraught with controversy. Some of the problem is the result of the USDA pushing the introduction of

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biotech crops too quickly without adequate field testing and regulation. In 2007, two different federal courts rendered opinions in cases involving the introduction of biotech crops to the market. The first case involved bentgrass that had been genetically modified to resist Monsanto's Roundup herbicide. Bentgrass is commonly used on lawns, athletic fields and golf courses. The plaintiffs claimed that USDA had violated federal law by permitting field tests of the genetically modified bentgrass to be conducted across the U.S. without adequately determining whether the grass was a plant pest pursuant to the Plant Protection Act (PPA) or preparing an environmental impact statement (EIS) or environmental assessment under the National Environmental Policy Act (NEPA). Based on evidence that the bentgrass had crossbred with wild grasses adjacent to the test fields, the court held that the plaintiffs had standing to bring the lawsuit, determined that USDA had acted arbitrarily in denying the plaintiff's claim that the bentgrass should be listed as a noxious weed under the PPA, and found that USDA had violated NEPA by failing to consider whether field trials were exempt from the need for an environmental assessment or EIS. *International Center for Technology Assessment, et al. v. Johanns, 473 F. Supp. 2d 9 (D. D.C. 2007).*

In the second case, the court criticized the USDA as being "cavalier" and held that USDA violated federal law by failing to assess the possible environmental impacts before approving genetically engineered alfalfa developed by Monsanto. Roundup Ready alfalfa allows growers to use Monsanto's Roundup herbicide to kill competing weeds without damaging the alfalfa. Monsanto had submitted a petition seeking non-regulated status for the alfalfa. Alfalfa farmers objected to the environmental assessment on the ground that planting the modified crops would affect other crops because of pollen transfer by bees, which in turn would affect the farmers' ability to label their produce "organic" or "not genetically modified." USDA disagreed and concluded that the farmers would not be affected because they would likely continue to have access to non-modified alfalfa and could avoid purchasing seeds for the modified crops. So, USDA deregulated the genetically modified alfalfa. That meant that USDA could no longer require that the modified alfalfa be grown two miles away from conventional or organic crops. The plaintiffs claimed that the biotech alfalfa could create super weeds resistant to herbicide, hurt production of organic dairy and beef products, and could cause farmers to lose export business due to risks of contamination to natural and organic alfalfa. The suit also alleged that contamination of conventionally grown alfalfa could force farmers to pay for Monsanto's patented gene technology whether they wanted it or not.

The court issued a preliminary injunction on March 12 that temporarily halted the planting of GMO alfalfa in the U.S. The injunction allowed the harvest, use and sale of Roundup Ready alfalfa, but placed limits on the purchase and planting of seed until further hearings were held. Farmers that had already planted Roundup Ready alfalfa had to plant it by March 30, and no new seed sales were allowed after March 12. On May 3,

the court made the injunction permanent. As such, Roundup Ready alfalfa is a regulated article under the Plant Protection Act. USDA subsequently issued an administrative order specifying mandatory production practices that must be implemented by Roundup Ready alfalfa producers. The court's opinion represents the first time a federal court has ever ordered a halt to planting and the first time a court has vacated a USDA decision to approve a genetically engineered crop. *Geertson Seed Farms, et al. v. Johanns, No. C06-01075 CRB, 2007 U.S. Dist. LEXIS 14533 (N.D. Cal. Feb. 13, 2007).*
Note: In early 2008, APHIS announced its intention to prepare an EIS in connection with making a determination on the status of the Monsanto and Forage Genetics International alfalfa lines designated as events J101 and J163 as regulated articles. The notice identifies potential issues and alternatives that will be studied in the EIS and requests public comment to further delineate the scope of the issues and regulatory alternatives. *73 Fed. Reg. 1198 (Jan. 7, 2008).*

3. Court rules that Equal Access to Justice Act (EAJA) applies to USDA administrative appeals. The EAJA provides that a party who prevails administratively against government action can recover fees and expenses if the administrative officer determines that the government's position was not substantially justified. However, the USDA's long-held position is that the EAJA does not apply to administrative hearings before the National Appeals Division (NAD) because NAD proceedings are not adversarial adjudications that are held "under" the Administrative Procedure Act (APA). The Eighth Circuit Court of Appeals rejected the USDA's position in 1997 and, in 2007, the Ninth Circuit agreed.

The USDA's position has been that successful appeals from adverse agency decisions are not subject to EAJA, because NAD appeals do not fall under the realm of the APA. According to the USDA, NAD administrative appeals involve an exclusive administrative appeal process that is not subject to the APA. But, that position was rejected by the U.S. Court of Appeals for the Eighth Circuit in a 1997 case, where the court determined that nothing in the NAD authorizing statutes stated that the NAD was to be the exclusive means of adjudicating issues with the USDA. The court further held that NAD proceedings involved an adversarial administrative adjudication thereby subjecting them to the EAJA by virtue of the APA.

The USDA has abided by the court's decision in the Eighth Circuit, but has continued to maintain its position that the Eighth Circuit case was wrongly decided and that the EAJA does not apply to NAD administrative appeals outside the Eighth Circuit. But, the Ninth Circuit's 2007 opinion on the issue may result in a change in the USDA's position. The case involved several Montana farmers who filed claims with the USDA's Farm Service Agency (FSA) under the Noninsured Crop Disaster Assistance Program (NAP) for losses to perennial grasses. FSA denied the claim on the basis that it was the state FSA's policy

that all perennial grasses were not covered during their first year. The farmers appealed to the NAD, and the NAD held a hearing which resulted in the NAD hearing officer reversing the FSA's decision on the basis that it was "over-restrictive and avoided the requirement for NAP coverage. The FSA did not request NAD Director review, which had the effect of making the hearing officer's decision final. The farmers applied for an award of attorney's fees and expenses under the EAJA in the amount of $17,943.84, and the NAD refused to consider the application based on the USDA's longstanding position that the EAJA did not apply to NAD proceedings outside the Eighth Circuit. The farmers filed a petition for judicial review and the Montana district court ruled in the farmers' favor, determining that the Eighth Circuit case was correctly decided and directly applicable to the case. The court remanded the case to the NAD, but the USDA appealed.

On appeal, the USDA continued to maintain that the Eighth Circuit case was incorrectly decided because NAD administrative proceedings are, in the USDA's view, the sole and exclusive procedure for determining eligibility for farm program benefits and, as such, are not subject to the EAJA. The Ninth Circuit rejected the USDA's argument, agreeing with the Eighth Circuit that the statutory language governing NAD proceedings did not create an exclusive means of adjudicating issues with the USDA. Thus, the pertinent question became whether NAD proceedings were subject to the EAJA by virtue of the APA. On that issue, the court noted that the USDA's position at the NAD hearing was represented by two program specialists. Thus, USDA had taken a position which had the effect of making the proceeding adversarial – a threshold requirement for potential EAJA application. Second, on the question of whether NAD proceedings are "under" Section 554 of the APA, the court noted that the governing statute required a NAD adjudication that was on the record and also required an opportunity for a hearing. As such, the court reasoned that NAD proceedings occur "under" Section 554 of the APA and are subject to the EAJA. In addition, the court noted that the statute governing NAD proceedings provide for judicial review pursuant to the provisions of the APA.

While the Eighth Circuit's 1997 decision did not result in a change of USDA policy on the issue of whether the EAJA applied to NAD proceedings, the Ninth Circuit's 2007 opinion could cause the agency to rethink its position. *Aageson Grain and Cattle, et al. v. United States Department of Agriculture, 500 F.3d 1038 (9th Cir. 2007)*

4. New Tax Provisions Enacted. On May 25, 2007, the President signed into law H.R. 2226, the war onterror funding bill known as the U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act, 2007 (Act). Title VIII of the bill contains numerous tax provisions that are designed, at least in part, to offset the impact on businesses and lower-skilled workers of the increase in the minimum wage which is also included in the bill.

Here is a short summary of the major tax provisions of the H.R. 2206 that are important to agricultural producers, rural landowners and residents of non-urban areas:

- **Expense method depreciation.** Under current law, for tangible depreciable personal property used in the taxpayer's business, part or all of the income tax basis can be deducted currently in the year in which the property is placed in service, regardless of the time of year the asset was placed in service. The bill increases the aggregate basis amount eligible for the deduction from $112,000 to $125,000 for 2007. The amount eligible to be expensed is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $500,000 (up from $450,000 for 2007). The amount eligible to be expensed for any tax year may not exceed the taxable income for a tax year that is derived from the active conduct of the taxpayer's trade or business. Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). The increased expense method amount is indexed for inflation beginning in 2008, and is effective through 2010. After that, without further legislation, the expense method amount will drop back to $25,000 with that amount reduced (but not below zero) for tax years in which the cost of qualifying property placed in service during the taxable year exceeds $ 200,000 (with those amounts not indexed for inflation). Act, Secs. 8212 and 8221, amending I.R.C. §§179 and 1400N(e).

- **Work Opportunity Tax Credit (WOTC).** The legislation amends the WOTC to expand its availability to businesses in rural communities that hire a "designated community resident." That's a person who is at least 18 years of age, but under age 40 as of the date they are hired and who has a residence established in a rural renewal" area – a county outside of a metropolitan statistical area that has experienced net population declines from 1990-1994 and 1995-1999. IRS has identified 31 states that have counties with the required population decline on page four of the instructions to Form 8850. The credit is 25 percent of the first $6,000 of wages paid to the employee if the employee works at least 120 hours during the first year after being hired. Once an employee works 400 hours during the first year of employment, the credit is 40 percent of the first $6,000 of wages paid.

  Other requirements: (1) the employee must be certified either at the time of hire or within 28 days after beginning work by the state workforce agency (via IRS Form 8850 and ETA Form 9061 or 9062) and a copy of employee's W-4 must be submitted with the certification request; (2) the employee must have not

previously worked for the employer or be the employer’s dependent or a related party; (3) for ag employees, wages that can be taken into account for the credit must be subject to FUTA tax – thus, wages paid in-kind don’t count (but, due to a special rule, ag wages paid in cash do count even if they are not subject to FUTA tax).

The provision is effective for persons hired after May 25, 2007, and before September 1, 2011. Act, Sec. 8211, amending I.R.C. §51(b).

- **“Kiddie” tax.** Special rules apply to the net unearned income of certain children. Generally, the kiddie tax applies to a child if: (1) the child has not reached the age of 18 by the close of the taxable year and either of the child's parents is alive at such time; (2) the child's unearned income exceeds $ 1,700 (for 2007); and (3) the child does not file a joint return. The kiddie tax applies regardless of whether the child may be claimed as a dependent by either or both parents, and taxes the child’s net unearned income over $1,700 (for 2007) at the parents' tax rates if the parents' tax rates are higher than the tax rates of the child. The remainder of a child's taxable income (i.e., earned income, plus unearned income up to $ 1,700 (for 2007), less the child's standard deduction) is taxed at the child's rates, regardless of whether the kiddie tax applies to the child.

  The kiddie tax is calculated by computing the "allocable parental tax." This involves adding the net unearned income of the child to the parent's income and then applying the parent's tax rate. A child's "net unearned income" is the child's unearned income less the sum of (1) the minimum standard deduction allowed to dependents ($ 850 for 2007), and (2) the greater of $850 (for 2007) or the amount of allowable itemized deductions that are directly connected with the production of the unearned income.

  Effective for tax years beginning after May 25, 2007, the Act expands the kiddie tax to apply to children who are 18 years old or who are full-time students over age 18 but under age 24. The expanded provision applies only to children whose earned income does not exceed one-half of the amount of their support. Act, Sec. 8241, amending I.R.C. §1(g).

5. U.S. Army Corps of Engineers “incidental fallback” regulation invalidated (again). The federalEnvironmental Protection Agency (EPA) and U.S. Army Corps of Engineers (Corps) regulate “wetlands” under the Clean Water Act. The CWA prohibits the “discharge of any pollutant” into regulable waters without a federal permit. The

CWA defines "discharge" as the "addition of any pollutant to navigable waters from a point source." In the early 1990s, the EPA and the Corps issued a joint regulation requiring permits for wetland excavation activities that resulted in "incidental fallback" of dredged materials, including a mere redeposit (which is not an "addition of a pollutant") of dredged material. The regulation was invalidated by the Federal District Court for the District of Columbia in 1997 and that decision was affirmed by the U.S. Circuit Court of Appeals for the D.C. Circuit in 1998. In 2000, the Corps issued a new regulation stating that a regulable discharge of dredged material was presumed to result from mechanized landclearing, ditching, channelization, in-stream mining, or other mechanized excavation activity in regulable waters. The presumption could be overcome by the party proposing the activity demonstrates that only incidental fallback would result from its activity. The regulation went on to define "incidental fallback" (which is exempt from the permit requirement) as the redeposit of small volumes of dredged material. The same trial court has now invalidated the new regulation for continuing to define "incidental fallback" in terms of volume rather than in terms of being an "addition of a pollutant" to a regulable water. The court termed the Corps' regulation as reflecting a "degree of official recalcitrance that is unworthy of the Corps." *National Association of Home Builders, et al. v. U.S. Army Corps of Engineers, et al., No. 01-0274 (JR), 2007 U.S. Dist. LEXIS 6366 (D. D.C. Jan. 30, 2007).*

6. Issue exhaustion required when pursuing USDA administrative appeals. It is critical for agricultural
clients to have a general understanding of how administrative agencies must first be dealt with in accordance with the particular agency's own procedural rules before a matter in dispute can be addressed by a court of law. This is known as exhausting administrative remedies. But, does the exhaustion of administrative remedies by completing the administrative appeal process also require that legal issues must be raised during the administrative process so as to be preserved for judicial review? That issue was recently addressed in a case involving converted wetlands.

In this case, the plaintiff, an Iowa resident, owned and operated farmland in Missouri. Upon his purchase of the farmland at issue in 1996, the seller informed the plaintiff that the farm did not contain any wetlands and no wetland delineation had been made. The plaintiff cleared woody vegetation and other plants from approximately five acres of the property for conversion to crop production and then enrolled the property in the farm program. In 2002, the local Farm Service Agency (FSA) sought a determination from the Natural Resources Conservation Service (NRCS) that the plaintiff's farm, for crop year 2000, was in compliance with the highly erodible and wetland provisions of the 1985 Farm Bill. The wetland provisions of that legislation prohibit the conversion of "wetlands" to crop production on land enrolled in the farm program. NRCS made field visits to the plaintiff's farm in 2002 and again in late 2003, ultimately concluding that the

plaintiff had converted 4.5 acres of wetlands.

The plaintiff appealed the NRCS' decision to the county FSA, specifically stating that he had not sought an exception for "good faith" or pursued mitigation. Apparently, the plaintiff believed that doing so would have amounted to his agreement (or acquiescence) with the NRCS wetland determination. The county FSA affirmed the NRCS' determination, and the plaintiff filed an administrative appeal with the USDA's National Appeals Division (USDA NAD). USDA NAD affirmed the county FSA's decision, and the plaintiff further appealed administratively to the USDA Deputy Director. The Deputy Director likewise affirmed. After exhausting all administrative appeals, the plaintiff filed suit in federal district court.

The plaintiff clearly exhausted his administrative remedies before filing suit in federal district court – there was no administrative body remaining that could hear an appeal. So, the plaintiff was entitled to move his case to federal court. However, at the district court, the plaintiff raised several issues that had not been raised during the administrative appeal process. The plaintiff argued that NRCS improperly relied on data from field visits that occurred at times outside of the crop growing season; that NRCS did not follow the proper wetland determination methodology; and that NRCS failed to determine whether his conversion activities had a minimal effect on wetland functions. The court ruled that it could not consider these issues because the plaintiff had not raised them during the administrative appeal process - it was insufficient for the plaintiff to merely exhaust administrative remedies. Instead, the court ruled that the plaintiff must also raise and exhaust legal issues in the administrative process (known as "issue exhaustion) in order to preserve them for further review in the judicial process. The plaintiff appealed.

The United States Court of Appeals for the Eighth Circuit affirmed. The court noted that the U.S. Supreme Court, in 2000 had established the rule that issue exhaustion applies in administrative appeal proceedings if required by statute or, if no statute applies, if the proceeding is adversarial in nature. In applying that rule to this case, the court noted that while no statute requires issue exhaustion in the context of wetland appeals, the applicable regulations (after the filing of an appeal) prohibit ex parte communications between NAD officers or employees and interested persons, provide for the subpoenaing of evidence and witnesses and generally describe a process that is similar to a trial. In addition, the regulations state that the party challenging an agency decision bears the burden of proof to establish by a preponderance of the evidence that the agency decision was erroneous. The regulations also specify that the NAD is independent from all other USDA agencies and offices at all levels. Based on these factors, the court reasoned that the USDA administrative appeal process (at least as applied to wetland determinations) was adversarial in nature, and that the plaintiff had a duty to develop the administrative record and preserve legal issues for eventual judicial review. The court also noted that it

had previously required issue exhaustion in a wetland determination case.

Clearly, the lesson of the case is that producers must take care to preserve evidence, all disputed factual issues, and raise all potential legal issues during the administrative process that could help their case upon eventual judicial review. While it is not the rule that issue exhaustion automatically applies in administrative appeal proceedings, it is the general rule. As such, agricultural producers should seriously consider retaining legal counsel at the beginning of the administrative appeal process, and practitioners should communicate to clients the need and rationale for representation. *Ballanger v. Johanns, 495 F.3d 866 (8th Cir. 2007).*

7. Court Upholds USDA's Rule Relaxing Ban on Canadian Beef and Cattle Imports. The United States Court of Appeals for the Ninth Circuit, largely on procedural and evidentiary grounds, has upheld a USDA Final Rule allowing limited imports of cattle from Canada, despite additional occurrences of Mad Cow Disease in Canadian cattle since the Final Rule was promulgated. The court reasoned that USDA did not rest its decision to finalize the rule on "completely baseless assumptions" at the time the Final Rule was developed, and did not take into consideration additional evidence that the Final Rule was ineffective in preventing infected cattle from showing up in the U.S. cattle herd.

In the mid-1990s the British government determined that the consumption of BSE-contaminated meat could cause Creutzfeldt-Jakob Disease in humans. Shortly thereafter, FDA and USDA promulgated new regulations prohibiting the use of mammalian proteins in cattle feed, and the use of "specified risk materials" – such as cattle brains, spinal cords, and nerve tissue in human food. A ban was then put into place on imports of all cattle products from countries where BSE was known to exist. The USDA added Canada to this list of countries in May 2003, after a cow in Alberta was diagnosed with BSE. While Canada had instituted a feed ban in 1997, it was likely that the cow was exposed before the ban and that the disease had incubated for a period of years. In August of 2003, USDA partially changed course and announced that certain "low-risk" cattle products could be imported from Canada, including meat from cows under 30 months of age. In November 2003, USDA announced a proposed rule creating a new category of "minimal risk" regions - a category that would include Canada. Before finalization of the rule, a Canadian-born cow with BSE showed up in the state of Washington. USDA then reopened the comment period, eventually publishing the Final Rule which modified existing regulations to allow imports of Canadian cattle under 30 months of age for purchase by feedlots or meatpacking companies. The rule also allowed Canadian beef products from cattle of all ages to be imported.

After the Final Rule was in effect, two older cows in Canada were diagnosed with BSE, and the USDA attributed the disease to contaminated feed manufactured before the

Canadian feed ban. USDA then announced its intention to suspend the part of the rule that would relax the ban on meat from cattle over 30 months old. Shortly thereafter, the plaintiff filed a complaint alleging that the USDA rulemaking violated the Administrative Procedure Act (APA), as well as with other federal statutes. The Federal District Court in the District of Montana agreed, issued a preliminary injunction, finding that the plaintiff had demonstrated a likelihood of success on its claim that the rule was arbitrary and capricious, in violation of the APA. The Ninth Circuit reversed on the basis of the wide discretion granted to USDA to promulgate regulations on the matter, and remanded the case to the trial court. The trial court issued a one-paragraph opinion, noting it had been instructed by the Ninth Circuit to respect the USDA's judgment and expertise. The plaintiff appealed. During the pendency of the appeal, additional instances of Canadian-born infected cows occurred in Canada. Accordingly, the plaintiff argued that the additional instances of infected cows bolstered their case that the USDA acted improperly in finalizing its rule, and argued that the trial court improperly determined that it was bound by the Ninth Circuit's opinion reversing the trial's court earlier issuance of preliminary injunction in the plaintiff's favor. As such, the plaintiff requested that the Ninth Circuit send the case back to the trial court for analysis of the developing record support of the motion for summary judgment.

The Ninth Circuit, however, refused to remand the case to the trial court, and ruled against the plaintiff on the basis that the discovery of additional BSE-infected cattle in Canada and new evidence calling into question USDA's methodology and analysis was outside the administrative record and could not be taken into account. Thus, at the time the USDA promulgated the Final Rule, the court reasoned that the USDA's basis for promulgating the rule was not arbitrary and capricious. The court noted that the Congress gave the Secretary of Agriculture wide discretion in dealing with the importation of animal and plant products and did not require the USDA, via regulation, to eliminate all risk that BSE would enter the country. As such, USDA's approach utilized in adopting its regulation was not arbitrary and capricious, even though USDA's predictions with respect to the possibility of BSE-infected cattle coming into the United States were erroneous. The court did note, however, that the evidence of additional occurrences of BSE-infected cattle entering the United States from Canada, and the additional scientific data proffered by the plaintiff which cast doubt on the USDA's analysis concerning the spread of the disease into the domestic meat supply could be entertained by the plaintiff filing a petition to reopen ruling-making under federal law. *Rancher's Cattlemen Action Legal Fund United Stockgrowers of America v. United States Department of Agriculture, 499 F.3d 1108 (9th Cir. 2007).*

8. EPA consent agreements with animal feeding operations upheld. In early 2005, EPA announced the Air Quality Compliance Consent Agreement to facilitate the development of scientifically credible methodologies for estimating emissions from

animal feeding operations (AFOs). A key part of the agreement is a two-year benchmark stud of the air emissions from livestock and poultry operations. Based on the findings of the study, EPA will set national air policies, identify farm emission thresholds and then regulate excessive levels.

Participating AFOs must pay a civil penalty and pay an additional amount into a fund for a nationwide emissions monitoring program. Participating AFOs must apply for all applicable permits, comply with the permit conditions, install technology to control air emissions, and report any releases of regulated substances. AFOs that satisfy these conditions receive a covenant not to sue for past violations of the Clean Air Act permitting requirements. The consent agreements were challenged as beyond the scope of the EPA and that EPA was basically giving a "pass" to AFOs that had violated federal law. However, the court upheld the EPA's ability to enter into the consent agreements. Community and environmental groups had challenged the consent agreements as rules disguised as enforcement actions, that the EPA had not followed proper procedures for rulemaking and that EPA had exceeded its statutory authority by entering into the agreements. The court disagreed, holding that the consent agreements did not constitute rules, but were enforcement actions within EPA's statutory authority that the court could not review. *Association of Irritated Residents v. EPA, 494 F.3d 1027(D.C. Cir.2007).*

9. Another federal court rules on federal jurisdiction over isolated wetlands. For purposes of CleanWater Act (CWA), the federal government has jurisdiction over "waters of the United States." Under the CWA, a permit is required before a "pollutant" can be discharged into such waters. The definition of "pollutant" is very broad, as is the definition of "waters of the United States." In 2001, the U.S. Supreme Court ruled that the federal government had no regulatory authority over isolated wetlands that did not have a substantive connection to interstate commerce. That had the effect of removing federal jurisdiction over private ponds and seasonal or ephemeral waters were the only connection with interstate commerce is migratory waterfowl. But, later court opinions have indicated that other factors are relevant in determining whether the federal government can regulate isolated water where the potential connection with interstate waters is more than migratory waterfowl. In any event, federal jurisdiction over open waters that ultimately flow into interstate waters or waters that are navigable-in-fact still exists. The key question in any particular case was whether the isolated wetland had a sufficient connection with "waters of the United States" to be subject to the permit requirement of Section 404 of the CWA.

In this case, Cargill was sued for allegedly discharging pollutants into "waters of the United States" without a permit. The isolated water body at issue is a non-navigable, intrastate pond which, by itself, is not a regulable wetland. The pond collects runoff within Cargill's waste containment facility at its salt-making operations located near the

edge of San Francisco Bay. The pond is adjacent to a slough that is a protected "water of the United States." The slough is a tributary to other protected waters. The pond is separated from the slough by a berm which regularly leaked during high tide. The trial court ruled that the pond qualified as a "water of the United States" due to the adjacency to the protected waters. However, the appellate court reversed. The court pointed out that mere adjacency provides a basis for CWA coverage only when the relevant waterbody is itself a "wetland." *San Francisco Baykeeper, et al. v. Cargil*l, *481 F.*3d *700 (9th Cir.2007).*

10. Medical reimbursement plans fail for lack of taxpayer records. Employees don't generally have to includein their income amounts received from either health insurance that the employer pays for or amounts the employer pays for directly. Medical reimbursement plans don't generally work for sole proprietors, but IRS issued a Revenue Ruling in 1971 providing a chance for sole proprietors to use medical reimbursement plans where the spouse of the sole proprietor works for the business. However, the spouse must be a bona fide employee of the business and receive reasonable compensation (including the medical reimbursement) for the services actually rendered. In a 2006 case, the taxpayer prevailed against an IRS attack on the medical reimbursement plan the taxpayer had adopted that covered her spouse/employee. The Tax Court ruled in that case that the spouse was truly an employee of the enterprise and that a proper plan existed. The court was impressed with the quality of the records the taxpayers retained on the work the husband performed – that was the key to the case. In a 2007 case, a farm couple purchased a medical reimbursement plan under which the farm reimbursed one of the spouse's for medical insurance and paid the spouse's non-insured medical expenses. The court held that the direct payments and reimbursements were deductible as ordinary and necessary business expenses. But, IRS has prevailed in several cases in 2007 due largely to lack of substantiation.

In the one case, the taxpayer adopted a plan that provided reimbursement of all health insurance premiums and up to $3,000 in other medical expenses to eligible employees for themselves and their immediate family. The taxpayer executed an employment agreement with her husband late in 2000 where she agreed to pay him $480 in wages annually and made him an eligible employee under the plan. During the tax year at issue, the husband was paid $480 in wages and received benefits under the plan of $10,355, of which $3,906 represented health insurance premiums under a policy for the taxpayer. The IRS took the position that the taxpayer failed to show that the husband actually paid those premiums or that he was reimbursed by the business if he did. IRS took the position that those premiums were deductible to the extent of 60 percent – the amount allowed for self-employed persons in 2000 (the deduction was an "above-the-line" deduction and would also not count as a deduction against self-employment tax). The court agreed with the IRS. The taxpayer didn't produce any cancelled checks, receipts or

premium statement showing that the husband actually paid or had the obligation to pay the premium (which would have made the premium fully deductible). That's a tough outcome. The form of the transaction must be correct, not just the substance. Here, all the couple had to do was have the husband pay the premium and then get reimbursed by the wife's business. They tried to short-circuit the process and lost some of the tax benefit as a result. *Snorek v. Comr., T.C. Memo. 2007-34.*

In another case, the husband had been a sole proprietor farmer for 40 years. His wife helped him by doing chores and other miscellaneous odd jobs around the farm, but had never received any compensation for those tasks. The husband adopted a medical reimbursement plan in 1991 that allowed health insurance costs to be paid for eligible employees, and provided for additional reimbursement for up to $8,000 of other medical expenses. In 1997, the wife signed an employment agreement. She kept the farm's books, ran errands for the farm and answered telephone calls. He annual salary was $2,004, and she participated in the medical reimbursement plan. Her employment agreement did not, however, set forth the number of hours of work or establish the days or times she would be available to work. In the year at issue (2001), the wife performed services for the farm, but there was no documentation of hours worked or what she had actually done. She was reimbursed $9,502 for the year in question, with $5,571 being paid on a joint health insurance policy and a Medicare supplement for the husband. So, her total compensation for 2001 was $11,500. The husband deducted the entire amount of the medical reimbursement on Schedule F. IRS denied the $9,502 deduction for reimbursed medical expenses and the court agreed. While the court was troubled as to whether there was proof of a bona fide employment relationship, that wasn't determinative of the outcome. Instead, the court held that the couple failed to establish whether any compensation paid to the wife in excess of the $1,988 actually paid (IRS conceded that amount was deductible) was reasonable insomuch as the couple failed to document any hours or times the wife may have performed services for the farm. So, a full deduction would have been available if the couple had kept records. *Francis v. Comr., T.C. Memo. 2007-33.*

In yet another case, a married couple operated a farm. The wife was also employed off the farm. The couple entered into an employment agreement under which the wife was to be paid a monthly salary in compensation for tasks completed on the farm. The court found that the wife did perform those tasks and the monthly salary, less withholding, was paid. The husband obtained a medical reimbursement plan which obtained health insurance for the couple and their children. The husband paid the premiums. The couple incurred medical expenses in one tax year and the husband included deductions for the premiums and the medical expenses on Schedule F as employee benefit program expenses. The court disallowed a deduction for the premiums because the policy was not obtained by the husband for the wife as an employee. The court also disallowed a

deduction for the medical expenses because the taxpayers could not establish that the wife actually incurred the expenses and that the husband paid them as an ordinary and necessary business expense of farming. *Albers v. Comr., T.C. Memo. 2007-44.*

IRS also had success in another case against a taxpayer that owned and operated a farm tiling business and had an unwritten policy to pay for the medical insurance premiums for the taxpayer's spouse as an employee. The taxpayer claimed a business deduction for $5,000 in premiums paid in one tax year as employer-provided health insurance coverage. The court held that the taxpayer failed to provide sufficient evidence that the taxpayer, as the spouse's employer, paid the premiums. As such, the premium costs could not be deducted as business expenses. *Eyler v. Comr., T.C. Memo. 2007-350.*

The bottom line for self-employed persons using "boilerplate" medical reimbursement plans – pay attention to the details. There is more to the matter than simply adopting a plan and forgetting about it.