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Federal court strikes down Nebraska corporate farming law*

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In late 2005, the Federal District Court for the District of Nebraska held, in *Jones, et al. v. Gale, et al.*, that the Nebraska Constitutional provision restricting unauthorized corporate involvement in certain types of agricultural activities is unconstitutional on "dormant commerce clause" grounds and on the basis that the provision violates the Americans with Disabilities Act (ADA). The Nebraska Attorney General is appealing the ruling to the United States Court of Appeals for the Eighth Circuit, which has ruled twice on anti-corporate farming restrictions in other states in recent years. The case represents the most recent judicial pronouncement concerning the ability of a particular state's citizenry to shape the future structure of agriculture within that state.

Overview - Anti-Corporate Farming Restrictions.

Presently, nine states prohibit corporations from engaging in agriculture to various degrees. The restrictions grew out of rising concern across the country that several key sectors of the U.S. economy were becoming controlled by a few large firms and multi-state corporations. While the laws are not designed to slow down or prevent structural change in agriculture, they are designed to control the organizational form of farming operations based on ownership arrangements. Until recently, no appellate-level court at either the state or federal levels had ever held a state anti-corporate farming law unconstitutional.

Initiative 300.

The Nebraska anti-corporate farming law (I-300) was added to the state Constitution in 1982 by voters through the initiative and referendum process. The law

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Handbook updates

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

County Loan Rates – A1-34 (2 pages)

Cost of Livestock Production – B1-20 (24 pages)

Please add these files to your handbook and remove the out-of-date material.

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Inside . . .

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prohibits a corporation or syndicate from acquiring or obtaining an interest in any title to real estate used for farming or ranching in Nebraska, or from engaging in farming or ranching in the state. A syndicate is defined as a limited partnership other than a limited partnership in which the partners are members of a family or a trust created for the benefit of a member of the family, related to one another within the fourth degree of kindred (first cousins) or their spouses, at least one of whom is a person residing on or actively engaged in the day-to-day labor and management of the farm or ranch. Numerous exceptions exist, but the major one is for family farm or ranch corporations (defined as a majority of the voting stock held by members of the family) or a trust created for the benefit of a member of the family. The majority shareholders must be related to each other within the fourth degree of kindred (or be the spouse of a family member), and at least one family member must either reside on the farm or be actively engaged in the day-to-day labor and management of the farm.

Jones, et al. v. Gale, et al.

The plaintiffs were engaged in agricultural activities to a certain degree. They all claimed that I-300 barred their proposed activities and challenged the law on the basis that it violated the "dormant commerce clause," the Privileges and Immunities Clause and the Equal Protection Clause of the U.S. Constitution. Two of the plaintiffs were disabled and claimed that I-300 also violated the ADA because of the requirement that at least one family member be "a person residing on or actively engaged in the day to day labor and management of the farm or ranch."

The "Dormant Commerce Clause."

The Commerce Clause of the U.S. Constitution forbids discrimination against commerce, which repeatedly has been held to mean that state and localities may not discriminate against the transactions of out-of-state actors in interstate markets even when the Congress has not legislated on the subject. The overriding rationale of the commerce clause was to create and foster the development of a common market among the states and to eradicate internal trade barriers. Thus, a state may not enact rules or regulations requiring out-of–state commerce to be conducted according to the enacting state's terms. So, states have the power to regulate economic activity within their borders, but cannot do so in a discriminatory manner. If the state has been motivated by a discriminatory purpose, the state bears the burden to show that it is pursuing a legitimate purpose that cannot be achieved with a nondiscriminatory alternative. However, if the state regulates without a discriminatory purpose but with a legitimate purpose, the provision will be upheld unless the burden on interstate commerce is clearly excessive in relation to the benefits that the state derives from the regulation. In essence, a state is free to regulate economic transactions occurring within its borders in the manner it deems appropriate as long as it is done in a nondiscriminatory fashion, but is not free to regulate economic conduct occurring elsewhere.

The court's "dormant commerce clause" analysis.

The court held that I-300 was facially discriminatory because it "was conceived and born in protectionist fervor," and that the ballot title and language of I-300 clearly indicated that Nebraskans would be given "favored treatment" on the basis that it would be more economically feasible for those living in close proximity to Nebraska farm and ranches to provide "day-to-day physical labor and management." As such, the court continued down the path established by the Eighth Circuit in two earlier cases involving anti-corporate farming laws from South Dakota and Iowa, where the court did not examine the actual impact on economic conduct by in-state and out-of-state firms, instead relying on statements of legislators and ballot titles to find discrimination against interstate commerce. But, the court appeared to go even further when it stated, "When it is apparent from the *language* of a …state constitutional amendment…that its *effect* is to burden out-of state economic interests and benefit in-state economic interests, the party challenging it should not be required to bear the burden of an evidentiary hearing to prove the obvious" [emphasis added]. Unfortunately, the court did not provide any explanation as to how the text of I-300, by itself, can have a discriminatory impact on interstate commerce. While the court was correct to examine the text of I-300, the text clearly

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applies to any corporation or syndicate "organized under the laws of any state of the United States." The provision does not provide preferential treatment for Nebraska firms as compared to out-of-state firms. All firms wishing to engage in agricultural activities in Nebraska are subject to an identical set of rules, as far as I-300 is concerned. Consequently, an appropriate question is whether I-300 burdens interstate commerce excessively in relation to the benefits that the state derives from I-300. That is not likely to be the case, particularly since I-300 does not contain any prohibition against agricultural contracting activities.

The court also found a discriminatory effect associated with the requirement that a family member provide (as the court referred to it) "day-to-day physical labor and management." The actual language of I-300 requires that a family member of a qualified entity be a "person residing on or actively engaged in the day-to-day labor and management of the farm or ranch…" The test is one of *active engagement* and not, as the court put it, the provision of "day-to-day physical labor and management." While the court relied on *Hall v. Progress Pig, Inc.*, for its reasoning, that case involved the construction of the terms "labor" and "management" and did not directly address the question of the meaning of "active engagement" in the context of the provision of labor and management. There is authority for the notion that "active engagement" requires much less than actually rendering labor and management on the premises. For example, under USDA payment limitation rules, one of the requirements that a farmer (or otherwise eligible entity) must satisfy to be eligible for federal farm program payments is the active engagement test. As part of the active engagement test, the individual (or entity) must make a significant contribution of active personal labor or active personal management (or a combination thereof). While hired services do not count, it is clear that active personal management need not be performed on the farm to satisfy the test – a person can contribute active personal management while living in a distant town. Active engagement in labor activities can be achieved via contract. In any event, under I-300, the mere fact that the shareholder resides on the farm negates the requirement that the shareholder be actively engaged in the day to day labor and management of the farm.

The ADA Claim.

The Court also found that I-300 was invalid under the Constitution's Supremacy Clause because it conflicted with the ADA on the basis that two of the plaintiffs were disabled and could not perform the daily physical labor that the court believed I-300 required. The ADA provides that "no qualified individual with a disability shall, by reason of such disability, be excluded from participation in or be denied the benefits of the services, programs, or activities of a public entity, or be discriminated by any such entity." While the court noted that "public entity" has been construed broadly to apply to all actions of state and local governments, the court did not address the point that I-300 did not involve the action of a governmental body. Instead, I-300 was the result of the initiative and referendum process and was approved by Nebraska voters. No action or activity of government was involved. The court also did not address the applicability of the ADA to Nebraska farming operations. The ADA only applies to "employers" that have 15 or more employees for each working day in each of 20 or more calendar weeks in the current or preceding calendar year.

Conclusion.

The court's opinion appears to be seriously flawed in several respects. However, it is questionable whether the opinion will be reversed on appeal. Except for its opinion in *Hampton*, the Eighth Circuit has not shown much willingness to analyze deeply the dormant commerce clause issue. If the decision stands, it will have a dampening effect on a state's efforts to ensure competitive markets for agricultural products and a level playing field for independent agricultural producers. Increased pressure could also be placed on the Congress to address the anti-competitive effects of concentrated agricultural markets and vertically integrated agricultural production supply chains.

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In the agricultural "whodunit," subsidies may not be the prime suspect

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One of the most gripping story lines of recent years is the one in which after a crime is committed, law enforcement officials become so focused on "the obvious suspect" that they ignore evidence that may point them toward other suspects. After the suspect is convicted, it has often taken decades before new forensic tools free "the obvious suspect" and identify someone else as responsible for the crime.

A similar story line is being played out in the debate over trade and the US farm program. Many of those looking for the reason for low commodity prices are so focused on "the obvious suspect" (increased production resulting from US subsidies) that they ignore evidence that may lead them to consider other causes for the low prices.

The argument asserts that US subsidies have stimulated US farmers to produce a considerably greater crop volume than they would have without the subsidies. The result of this "overproduction" is lower prices that are harming farmers in other countries. In addition, many are authoritatively asserting that eliminating subsidies will result in lower production on the part of US producers and higher prices for all farmers. Based on this reasoning the argument calls either for putting out a contract (in the Godfather sense) on all subsidies or reassigning subsidies to a World Trade Organization (WTO) approved "good-works" environmental and other "multifunctional" projects.

Over the last three columns we have presented evidence challenging both the methodology and focus of a case that has the potential to be played out before a WTO disputes panel. The potential WTO case that has been laid out in several forms would involve a challenge by a soybean, corn, wheat, or exporting country asserting that US subsidies have encouraged overproduction resulting in lower prices.

Our first response was that in examining the impact of subsidies, one needs to take the lack of price responsiveness on the part of both producers and consumers into account. Because farmers are price-takers and not price-makers, most of them will tell you that they have every incentive to try to maximize production in order reduce the per-unit cost of production. That allows farmers to spread the high fixed costs out over a greater amount of production, as long as the price is above the variable cost of production.

We then argued that the effect of subsidies cannot be looked at one crop at a time because most US farmers grow more than one crop and a reduction in corn plantings does not mean that the land will be left idle. Instead, acres shifted out of corn will be planted to soybeans or another crop, leaving total acreage relatively unchanged – this is the low price responsiveness that we talked about. At most, the subsidies may be responsible for a three-tenths of one percent change in production. Looking at the crops one at a time runs afoul of the fallacy of composition.

Last week we argued that with low price responsiveness, it is not the subsidies per se that are responsible for the low prices, but rather the "market-oriented" Loan Deficiency Payment/Marketing Loan Gain (LDP/MLG) program. In fact the LDP/MLGs were designed to protect US producers while allowing the US price to drop to the world price. What the designers of this program failed to understand was that producers in other countries usually sell their crops for a discount off the US

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price. As a result, LDP/MLGs have allowed prices to fall below the loan rate with most of the benefits being picked up by integrated cattle feeders, importing countries, and the transporters and processors of grains and seeds.

Ignored in the discussion of trade distorting subsidies is the impact of government funded agricultural research and extension programs. In WTO parlance these payments are put in the green box and are considered non-trade distorting. We find it hard to understand how research programs which increase yield potential and decrease crop loss can be considered to have no impact on trade. By their very nature these programs result in increased production and, in the presence of weak price responsiveness, lower prices.

We are not arguing for the elimination of agricultural research and extension programs, but rather for recognition that the fruits of this research have had more impact on increasing the supply of food than farm subsidies. Since 1996, US corn and soybean yields have increased by 16 percent and much of this gain has its roots in basic research that can be tied to government funding.

If US subsidies are the cause of low prices, then we should see a different picture for those crops for which the US has no subsidies and no tariffs. Absent the presence of US programs these crops should have stable prices. Between 1980 and 2002, cocoa prices fell by 58 percent, coffee prices fell by 70 percent and pepper prices fell by 32 percent. Clearly US subsidies are not the cause of these low prices.

If both unsubsidized tropical crops and subsidized temperate zone crops have similar price/income problems, then maybe we should look at something other than "the obvious suspect:" subsidies. And that other suspect is the low price responsiveness for aggregate crop agriculture, both tropical and temperate.

More on handling CSP payments*

-by Neil E. Harl , Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University, Ames, Iowa. Member of the Iowa Bar, harl@iastate.edu

On June 24, 2005, the Federal Register (at page 36,557) carried a Notice of Determination by the Secretary of Agriculture that payments under the Conservation Security Program, under criteria specified in the USDA regulations, are ". . . primarily for the purpose of conserving soil and water resources or protecting and restoring the environment." The Secretary is charged with making such a determination in order for the payments to be eligible for the cost share exclusion available under federal income tax law. The Secretary of the Treasury is obligated to make a determination that the payments under the program do not increase ". . . substantially the annual income derived from the property."

The Secretary of Agriculture, in the June 24, 2005 notice, proceeded to state that ". . . this determination permits recipients to exclude from gross income, for Federal income tax purposes, all or part of the existing practice, new practice, and enhancement activity payments under the extent allowed by the Internal Revenue Service." However, as discussed in a November 18, 2005 Agricultural Law Digest article**, the exclusion provision is limited to "capital improvements." Cost-share payments for the adoption of land-based structural practices should be eligible for the exclusion from income if the practice is a capital improvement." Cost-share payments for the adoption or main-

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tenance of management or vegetative practices would not be excludible from income nor would "existing practice, new practice, and enhancement activity payments" necessarily be excludible from income. Those payments are very likely to be reportable as ordinary income except to the extent the payments are for capital improvements.

The misleading statement in the June 24, 2005 Notice has contributed to the belief by some taxpayers, augmented by statements from Natural Resource Conservation Service offices, that perhaps the entire amount of CSP payments could be excluded from income. That would only be possible if the entire payment amount were to be directed into capital improvements. Considering the nature of the CSP program, that is highly unlikely.

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*** This article appeared in the January issue of the Ag Decision Maker newsletter.*

Updates, continued from page 1

Internet updates

The following updates have been added to www.extension.iastate.edu/agdm.

How to Use Grants – C5-08 (3 pages)

Creating a Mission Statement, Setting Goals and Developing Strategies (action plans) – C5-09 (4 pages)

When to Do and How to Use a Feasibility Study – C5-64 (2 pages)

What is a Feasibility Study? – C5-65 (3 pages)

Feasibility Study Outline – C5-66 (4 pages)

Writing a Value-Added Business Plan – C5-68 (3 pages)

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