MORE ON FAMILY LIMITED PARTNERSHIPS
— by Neil E. Harl*

Three recent Tax Court cases\(^1\) have provided significant insights into the treatment of family limited partnerships.\(^2\) While the Internal Revenue Service took an aggressive stance in challenging family limited partnerships or FLPs in 1997 and 1998,\(^3\) particularly where the only purpose behind the formation of a family limited partnership was to depress asset values with nothing of substance changed as a result of the formation,\(^4\) the recent cases have focused on the possibility of a gift on formation of the FLP\(^5\) and on whether a business purpose must be shown for a FLP to be recognized for tax purposes if properly formed under state law.\(^6\)

Possible gift on formation

In a case decided October 26, 2000, Shepherd v. Commissioner,\(^7\) leased timber land and bank stock were transferred to a general family partnership in which the donor held a 50 percent interest (and each son a 25 percent interest). The taxpayer initially contributed $10 and each son $5 to the partnership. On the same day, the taxpayer transferred land to the partnership and, about a month later, transferred bank stock to the firm. Under the terms of the agreement, ownership of the property was allocated among the partners in accordance with their initial percentages (50 percent to the taxpayer and 25 percent to each son). The court viewed the transaction as an indirect gift to each son of 25 percent of the land and bank stock, not as gifts of 25 percent of the partnership. Accordingly, the gifts could not be discounted as minority ownership interests and for lack of marketability and lack of control. The only discounts allowed were a 15 percent fractional interest discount and a 15 percent minority interest discount.\(^8\) Had the land and bank stock been first transferred to a valid partnership or LLC with the sons then brought in as partners, the larger discounts should have been available.

Necessity for business purpose

In Estate of Strangi v. Commissioner,\(^9\) the Tax Court rejected the IRS position that, under the business purpose and economic substance doctrines, the limited partnership at issue should be disregarded in valuing assets in the decedent’s estate. The taxpayer had formed a family limited partnership and transferred assets, including securities, real estate, insurance policies, annuities and partnership interests to the entity in return for a 99 percent limited partnership interest. While the court was skeptical of the estate’s claims of business purpose for the formation, the court found that the family limited partnership was validly formed under state law. The court agreed that the partnership “had sufficient substance to be recognized for tax purposes.”\(^10\)

The Internal Revenue Service also argued that I.R.C. § 2703(a)(2) applied and

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See the back page for details about the 2001 Agricultural Tax and Law Seminars
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supported the argument that the limited partnership should be disregarded for transfer tax purposes. That subsection deals with restrictions on the right to sell or use property which reduce the value of a decedent’s assets for federal estate tax purposes. The court said neither the statute nor the regulations support the IRS interpretation. The court, citing Kerr v. Commissioner, concluded that Congress did not intend that partnership assets be treated as if they were assets of the estate where the legal interest owned by the decedent at the time of death was a limited partnership (or corporate) interest.

A discount of 31 percent was allowed (eight percent for minority interest, 25 percent for lack of marketability) as to the limited partnership interest and 19 percent for the general partnership interest (five percent minority interest and 15 percent lack of marketability).

The third case, Knight v. Commissioner, involved the question of whether a family limited partnership interest should be recognized for federal gift tax purposes. The Tax Court observed that all requirements of state law were met. A discount of 15 percent was allowed for minority interest and lack of marketability.

As for the IRS argument that I.R.C. § 2704(b) applied, which makes reference to an “applicable restriction,” the court noted that the restrictions were not more restrictive than the limitations that would apply to partnerships under state law and, therefore, the Section 2704(b) provisions do not apply. Under that subsection, restrictions required or imposed by state or federal law are not included in “applicable restrictions.”

In conclusion

The picture has become more clear with the three recent Tax Court decisions. Certainly the family limited partnership is under less of a cloud as a result but it is vital that FLPs be set up carefully to avoid challenges of the type raised in Shepherd v. Commissioner.

FOOTNOTES


3 Ltr. Rul. 9719006, Jan. 14, 1997 (only purpose for partnership was to depress value of partnership assets through decedent’s gross estate into control of children; Ltr. Rul. 9725002, March 3, 1997 (partnership formed from assets held in revocable trust two months before death at time when taxpayer incompetent; partnership disregarded for property valuation purposes as serving no business purpose and not bona fide arm’s length arrangement); Ltr. Rul. 9723009, Feb. 24, 1997 (transfer of decedent’s two residences and personal property in exchange for 98 percent limited partnership interest followed by transfer of partnership interest to revocable trust for distribution to son treated as single testamentary transaction; IRS believed nothing of substance was intended by partnership arrangement); Ltr. Rul. 9730004, April 3, 1997 ($400,000 of farmland exchanged for 99 percent limited partnership interest; unsuccessful attempt to value partnership 54 days later for federal estate tax purposes with 40 percent discount); Ltr. Rul. 9842003, July 2, 1998 (sole or primary purpose was reduction of federal estate tax for transfer within six weeks of death; existence of family limited partnership disregarded) FSA Ltr. Rul. 200049003, Sept. 1, 2000 (same).

4 Id.


7 115 T.C. No. 30 (2000).

8 Id.

9 115 T.C. No. 35 (2000).

10 Id.

11 I.R.C. § 2703(a)(2).


14 Id.


CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

Chapter 12-ALM § 13.03[8].* DISMISSAL. The debtor participated in a horse farm in Ohio with the debtor’s aunt and mother. The operation encountered financial difficulties and one creditor attempted to sell some horses at a sheriff’s sale. Before the sale could commence, the debtor filed for Chapter 13 in order to stop the sale. The creditors decided to continue the sale, and prior to dismissing the Florida case, the debtor filed for Chapter 12 in Ohio. The court held that the Chapter 12 case was to be dismissed for cause because (1) the debtor was not qualified for Chapter 12, (2) the debtor failed to prove that the horses were estate property, (3) the petition was filed solely to halt the sale of the horses, (4) the debtor did not list the horses as estate property and did not timely file the bankruptcy schedules, and (5) the debtor’s schedules demonstrated that the debtor had minimal debt and did not need reorganization. In re Burger, 254 B.R. 692 (Ohio S.D. 2000).

FEDERAL TAX-ALM § 13.03[7].* EARNED INCOME CREDIT. The debtor filed for Chapter 7 in 1996 but did not make the election to terminate the tax year on the date of the petition. The debtor filed the 1996 tax return in

*Agricultural Law Manual (ALM).
1997 and claimed a refund based on an earned income credit. The trustee sought to include in the bankruptcy estate a proportional part of the EIC which accrued after the bankruptcy petition. The court held that the EIC which accrued after the petition and before the end of 1996 was bankruptcy estate property. In re Montgomery, 2000-2 U.S. Tax Cas. (CCH) ¶ 50,865 (10th Cir. 2000), aff’g, 219 B.R. 913 (Bankr. 10th Cir. 1998).

**FEDERAL AGRICULTURAL PROGRAMS**

**APPLES.** THE FSA has adopted as final regulations implementing Special Apple Loan Program enacted as part of the Agricultural Risk Protection Act of 2000. *65 Fed. Reg. 76115 (Dec. 6, 2000).*

**BRUCELLOSIS.** THE APHIS has issued interim regulations amending the brucellosis regulations by changing South Dakota from a Class A to Class Free state. *65 Fed. Reg. 75581 (Dec. 4, 2000).*

**COTTON.** The plaintiff was a cotton broker which had entered into an Upland Cotton Domestic User/Exporter Agreement (the Agreement) with the CCC. Under the Upland Cotton User Marketing Certificate Program, exporters received payments for cotton exported under such Agreements. The program had limited funding, however, and the Kansas City Commodity Office (KCCO) issued a memorandum that it would accept only complete and accurate applications as eligible for payments until the appropriation was expended. The plaintiff had submitted several timely applications before the funding ran out, but the applications were denied for omissions and inconsistencies. The plaintiff argued that the denial of the applications was arbitrary and capricious because the KCCO memorandum changed the application requirements in violation of the regulations and Agreement. The court held that the memorandum did not change the application requirements but only restated the basic requirements and highlighted the need for complete applications in time before the funding ran out. The court also held that, although the applications were returned for somewhat technical corrections, all of the corrections were required by the Agreement; therefore, the KCCO did not act arbitrarily or capriciously in not accepting the applications in time for funding. *Production Marketing v. Commodity Credit Corp., 108 F. Supp.2d 1294 (M.D. Ala. 2000).*

**FEEDLOTS.** The EPA has written draft regulations which would add more restrictions on large animal feedlot operations in order to decrease the air and water pollution possible from these operations. The draft regulations would (1) expand the permit process to include smaller feedlots currently exempted from permit regulation; (2) place more controls on discharge of waste from lagoons and on to fields and (3) hold corporations responsible for waste disposal on contract farms. The proposed regulations have not yet been published in the Federal Register.

**NATIONAL ORGANIC PROGRAM.** THE AMS has adopted as final regulations establishing the National Organic Program under the Organic Foods Production Act of 1990 (OFPA). The regulations establish national standards for the production and handling of organically produced products, including a national list of substances approved and prohibited for use in organic production and handling. The regulations establish a national-level accreditation program to be administered by AMS for state officials and private persons who want to be accredited as certifying agents. Under the program, certifying agents will certify production and handling operations in compliance with the requirements of this regulation and initiate compliance actions to enforce program requirements. The regulations include requirements for labeling products as organic and containing organic ingredients. The regulations also provide for importation of organic agricultural products from foreign programs determined to have equivalent organic program requirements. The AMS has a web page devoted to the NOP: http://www.ams.usda.gov/nop For a summary of the provisions, see 11 Agric. L. Dig. 52 (2000). *65 Fed. Reg. 80547 (Dec. 21, 2000), adding 7 C.F.R. Part 205.*

**PERISHABLE AGRICULTURAL COMMODITIES ACT-ALM § 9.05.** The U.S. Supreme Court has denied certiorari in the following case. The plaintiff sold produce to the defendants who later filed for bankruptcy. The plaintiff sought payment for the produce from the PACA trust fund. The defendants were a corporation which developed, owned and operated restaurants and a subsidiary corporation which operated its own restaurants. Both defendants argued that they were not dealers in produce, under 7 U.S.C. § 499a(b)(6), subject to PACA. The Bankruptcy Court noted that the statute was unambiguous and included retailers with purchases of commodities over $230,000 per year. The facts demonstrated that the defendants purchased the produce from a wholesaler, the plaintiff, for use in the restaurants and both defendants had annual purchases of commodities exceeding $230,000. The defendants argued that they were not retailers but were consumers of the produce. The Bankruptcy Court held that the defendants were subject to PACA as retailers because the defendants enhanced the produce by cooking and other preparation for serving to customers. The appellate court affirmed the original Bankruptcy Court decision that the defendants were subject to PACA as dealers. *Matter of Magic Restaurants, Inc., 121 S. Ct. 56 (2000), denying cert., 205 F.3d 108 (3d Cir. 2000), rev’g urep. D. Ct. dec., rev’g 204 B.R. 862 (Bankr. D. Del. 1997).*

**SEEDS.** THE FSA has adopted as final regulations implementing Emergency Loan for Seed Producers Program enacted as part of the Agricultural Risk Protection Act of 2000. *65 Fed. Reg. 76115 (Dec. 6, 2000).*

**TOBACCO.** The 2000 marketing quota for burley tobacco was 247.4 million pounds and the price support level was 180.5 cents per pound. *65 Fed. Reg. 78405 (Dec. 15, 2000).*

**FEDERAL ESTATE AND GIFT TAX**

**CHARITABLE DEDUCTION.** The decedent’s will provided a bequest to the decedent’s brother in trust with a remainder to a charitable organization. The trust was not a qualified charitable trust since the brother had the power to invade the trust without limit. However, after receiving only $33,000, the brother died before the estate filed its tax return. The other heirs challenged the will and agreed to drop the contest in exchange for receiving the right to seek a charitable deduction for the estate, thus increasing
the remainder estate which passed to these heirs. The court held that I.R.C. § 2055(e)(3)(F) applied to the trust. Under section 2055(e)(3)(F) the trust became reformed upon the death of the brother because the brother’s death fixed the amount passing under the trust to the charity; therefore, the amount passing under the trust was eligible for the charitable deduction. The IRS has argued that the brother's receipt of funds from the trust removed the trust from application of section 2055(e)(3)(F), but the court held that the statute contained no exception for cases where the trust beneficiary receives a portion of the trust before dying.

**Harbison v. United States, 2000-2 U.S. Tax Cas. (CCH) ¶ 60,389 (N.D. Ga. 2000).**

**GENERATION SKIPPING TRANSFERS.** There have been numerous private letter rulings regarding the effect that a proposed modification or construction will have on an exempt trust for GST tax purposes. In rulings in this area, the IRS has held that a modification will not cause the trust to lose its exempt status if the modification does not result in any change in the quality, value, or timing of any beneficial interest under the trust. Although the statute does not specifically address modifications to trusts that are exempt under section 1433(b)(2) of the TRA, the IRS has ruled that a trust that is modified such that none of the beneficial interests change can be viewed as the same trust that was in existence on September 25, 1985. The IRS has adopted as final regulations adopting a liberal standard with respect to changes that may be made to the trust without the loss of exempt status. In addition, the regulations clarify the application of the effective date provisions when the exercise or lapse of a general power of appointment over an otherwise grandfathered trust results in property passing to a skip person.

Under the regulations, a court order in a construction proceeding that resolves an ambiguity in the terms of a trust instrument will not cause the trust to lose its exempt status. The judicial action, however, must involve a bona fide issue and the court's decision must be consistent with applicable state law that would be applied by the highest court of the state. Construction proceedings determine a settlor's intent as of the date the instrument became effective, and, thus, a court order construing an instrument that satisfies these requirements does not alter or modify the terms of the instrument. Under the regulations, a court-approved settlement of a bona fide controversy relating to the administration of a trust or the construction of terms of the governing instrument of a trust will not cause a trust to lose its exempt status. This will be the case, however, only if the settlement is the product of arm's length negotiations, and the settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement.

The regulations also address the situation in which a trustee distributes trust principal to a new trust for the benefit of succeeding generations. In some cases, the governing instrument grants the trustee broad discretionary powers to distribute principal to or for the benefit of the trust beneficiaries, outright or in trust. Under these circumstances, distributions by the trustee to trusts for the benefit of trust beneficiaries will not cause the original trust or the new trusts to lose exempt status provided the vesting of trust principal is not postponed beyond the perpetuities period applicable to the original trust. Finally, under the regulations, a trust may be modified and remain exempt for GST purposes. The modification, however, must not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation, as defined in I.R.C. § 2651, than the person or persons who held the beneficial interest prior to the modification and must not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

The regulations clarify that the transfer of property pursuant to the exercise, release, or lapse of a general power of appointment created in a pre-September 25, 1985 trust is not a transfer under the trust, but rather is a transfer by the powerholder occurring when the exercise, release, or lapse of the power becomes effective, for purposes of Section 1433(b)(2)(A) of the TRA. 65 Fed. Reg. 79735 (Dec. 20, 2000), adding Treas. Reg. § 26.2601-1(b)(1)(i).

The decedent was the beneficiary of a testamentary trust established by the decedent’s predeceased spouse. The trust provided for distribution of income and discretionary distribution of corpus. The decedent also had a testamentary power of appointment over the trust corpus remaining at the decedent’s death. The decedent exercised that power for a portion of the trust in favor of several grandchildren and left the remainder to pass as directed by the trust. The court held that the exercise of the power of appointment removed the pre-1986 trust from the grandfather clause of I.R.C. § 1433(b)(2). The court rejected the reasoning of Simpson v. United States, 183 F.3d 812 (8th Cir. 1999) that the exercise of the power of appointment was not a substantive modification of the trust. The court stated that the grandfather clause purpose would be violated to allow a beneficiary to extend the clause to new generation-skipping transfers resulting from exercise of the power of appointment. The court concludes with the final regulations discussed supra. Bachler v. United States, 2000-2 U.S. Tax Cas. (CCH) ¶ 60,390 (N.D. Calif. 2000).

**FAMILY LIMITED LIABILITY COMPANY.** In a field service advice, the IRS discussed the various challenges to the gift and estate tax discount of valuation of interests in family limited liability companies. The facts included a family limited liability company formed by the decedent and funded with cash and marketable securities. The ruling is unclear as to the contributions made by the other family members. The decedent made several gifts of interests in the company to the family members, discounting the value of the gifts for minority interests and lack of marketability. At the decedent’s death, the decedent’s remaining interest passed to the other family members and its value was also discounted as a minority interest and for lack of marketability. The rulings discusses the numerous valuation issues. The IRS concluded that the discounts should be challenged because the decedent had no sufficient business purpose to overcome the tax purpose of the creation of the limited liability company. The IRS also ruled that I.R.C. § 2704 would apply because a restriction on liquidation of the company should be disregarded. FSA Ltr. Rul. 200049003, Sept. 1, 2000.

**REVOCABLE TRANSFERS.** The decedent had executed a power of attorney in favor of a son and daughter and had made them joint account holders of the decedent’s checking account. Prior to the decedent’s death, the children wrote several checks on the account as gifts to the decedent’s heirs. The estate acknowledged that the power of attorney did not specifically grant the children authority to make gifts for the decedent; however, the estate argued that the children, as joint account owners, had the authority to write the checks and make the gifts. The court held that, under Washington banking law, the decedent, as the original contributor of the funds in the bank account had the right to revoke and recover the checks written on the account by the joint owners. Therefore, the gifts were revocable at the decedent’s
death and remained in the decedent’s estate. Estate of Christensen, T.C. Memo. 2000-368.

RECIPIROCAL GIFTS. The decedent and brother each owned a portion of two agricultural businesses. The decedent and brother agreed that one business should pass to the decedent’s heirs and the other business pass to the brother’s family. The decedent transferred stock in one company to the brother’s heirs. The brother transferred stock in the other corporation to the decedent’s heirs. The decedent’s estate argued that the gifts were valid because they had a business purpose of passing the separate businesses to separate families. The court characterized the gifts as reciprocal and not eligible for the annual exclusion. The court also held that the transfers did not have a business purpose because the parties’ interests in the businesses were not changed substantially by the transfers. Estate of Schuler v. Comm’r, T.C. Memo. 2000-392.

TRUSTS. The IRS has issued proposed regulations under which qualified revocable trusts can elect to be treated as part of a decedent’s estate. The regulations replace the procedures established by Rev. Proc. 98-13, 1998-1 C.B. 370. 65 Fed. Reg. 79015 (Dec. 18, 2000).

The taxpayer formed two irrevocable Grantor Retained Annuity Trusts (GRATs) funded with corporate stock. Under each GRAT, the taxpayer was to receive an annuity amount equal to 49.35 percent of the initial trust value for the first 12-month period of the trust term and 59.22 percent of such initial value for the second 12-month period of the trust term. In the event that the taxpayer's death intervened, the annuity amounts were to be paid to the taxpayer's estate. The sums were payable on December 31 of each taxable year but could be paid up through the date by which the federal income tax return for the trust was required to be filed. The payments were to be made from income and, to the extent income was not sufficient, from principal. Any excess income was to be added to principal. Upon completion of the 2-year trust term, the remaining balance was to be distributed to the designated remainder beneficiary. Each trust also prohibited additional contributions, specified that the grantor's interest was not subject to commutation, and mandated that no payment be made during the trust term to any person other than the grantor or the grantor's estate. The taxpayer and remainder beneficiary were the trustees of each trust. The annuity payments over the two years exceeded the trust principal so no principal remained after the last payment. The taxpayer filed a gift tax return for the year the trust was started and claimed a zero value for the remainder interests. The IRS argued that each trust created two noncontingent annuity interests, the taxpayer’s right to receive the annuity payments and the taxpayer’s estate’s right to receive the payments if the taxpayer died before the end of the two years. The IRS position was based on Treas. Reg. § 25.2702-3(e), Example 5. The court held that the interests of the taxpayer and the taxpayer’s estate in the annuity payments was not two interests but only one and that this combined interest was a qualified annuity interest. The value of the remainder interest gift was the value of the stock used to fund the trust less the value of the annuity payments due over the two year term. Walton v. Comm’r, 115 T.C. 41 (2000).

FEDERAL INCOME TAXATION

ACCOUNTING METHOD. The IRS has issued updated procedures under which the IRS will except a qualifying taxpayer with average annual gross receipts of $1,000,000 or less from the requirements to account for inventories and to use an accrual method of accounting for purchases and sales of merchandise. The IRS also amended the procedures by which a qualifying taxpayer may obtain automatic consent to change to the cash receipts and disbursements method of accounting. Rev. Proc. 2001-10, I.R.B. 2001-2, ___ , modifying and superseding Rev. Proc. 2000-22, I.R.B. 2000-20, 1008.

CAPITAL EXPENSES. The taxpayer purchased residential property and made substantial improvements and repairs before offering the property for rent as a summer vacation home. The taxpayer made several operating expenditures, repairs and improvements over the next ten years before selling the property. The taxpayer argued that the taxpayer was in the business of buying and selling renovated homes; therefore, the improvements and operating expenses had to be capitalized in the basis of the property, resulting in a loss from the sale. The court held that the taxpayer purchased the property for investment and was required to capitalize only the repairs and improvements that increased the value of the property. Ashley v. Comm’r, T.C. Memo. 2000-376.

DISASTER PAYMENTS. On November 9, 2000, the president determined that certain areas in Hawaii were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of severe storms and flooding beginning on October 28, 2000. FEMA-1348-DR. On November 27, 2000, the President determined that certain areas in Oklahoma were eligible for assistance under the Act as a result of the severe storms and flooding beginning on October 21, 2000. FEMA-1349-DR. Accordingly, a taxpayer who sustained a loss attributable to the disasters may deduct the loss on his or her 1999 federal income tax return.

EMPLOYMENT TAXES. Under previous rules, if an employer had $1,000 or more of quarterly withheld employment taxes, the employer was required to make monthly deposits. The IRS has issued temporary and proposed regulations which increase the $1,000 amount to $2,500. If an employer has less than that amount due, the entire amount can be paid at the time of filing for the taxes. 65 Fed. Reg. 76152 (Dec. 6, 2000).

HOBBY LOSSES. The taxpayer owned a successful insurance company and was fully employed in operating that company. The taxpayer purchased a 40 acre rural property for a primary residence and gradually increased the land to almost 2000 acres. The taxpayer operated a cattle ranch on the property which incurred only losses. The court held that the cattle ranch was not operated for profit because the taxpayer (1) did not maintain separate records for the ranch, (2) did not have a business plan to make the operation profitable, (3) spend little time on the activity, and (4) never achieved a profit nor had any expectation of obtaining profitability. The court noted that it was extremely difficult to create a profitable cattle operation from scratch. Stonecipher v. Comm’r, T.C. Memo. 2000-378.
**INSTALLMENT REPORTING.** President Clinton on December 28 signed the Installment Tax Correction Act of 2000 (HR 3594). The new law reinstates the use of the installment method of accounting for accrual method taxpayers.

A cash basis partnership sold its sole asset in an installment sale and instructed its accountant to report the gain on the installment method. The accountant, however, reported all of the gain on the next partnership return. The partnership discovered the error three months later and sought permission to revoke the election out of installment reporting. The IRS ruled that the partnership could revoke the election as inadvertent. Ltr. Rul. 2000050009, Sept. 11, 2000.

**LIKE-KIND EXCHANGES.** The taxpayer owned real property and sold the property to the taxpayer’s children under a property exchange agreement. However, the taxpayer deeded the property directly to the children in exchange for a promissory note, which was held in escrow. The taxpayer then found replacement property and the children wrote checks to cover the purchase price of the replacement property which was deeded directly to the taxpayer. The checks were held by a law firm hired by the taxpayer until the purchase closed. The IRS ruled that the transaction did not qualify for like-kind, nonrecognition of gain treatment because the checks were in the constructive possession of the taxpayer when held by the law firm. The IRS also ruled that the escrow agent was not a qualified intermediary because the replacement property was never held by the agent, but was deeded directly to the taxpayer. The children sold portions of the original property within two years after the exchange. The IRS ruled that the sales made the transactions unqualified for related party exchange rules under I.R.C. § 1031(f). FSA Ltr. Rul. 200048021, Aug. 29, 2000.

**LOAN TO QUALIFYING CARE FACILITY.** The IRS has announced the inflation-adjusted amount that a taxpayer 65 years old or older may lend to a qualifying care facility without incurring imputed interest as allowed under I.R.C. § 7872(g)(2). For 2001 the amount is $144,111. Rev. Rul. 2000-56, I.R.B. 2000-52, ___.

**LODGING.** The taxpayer was self-employed as a researcher and writer. The taxpayer lived in a ranch but also maintained an apartment in a nearby city for use by the taxpayer and an assistant while doing research in the city. The taxpayer claimed a business expense deduction for the rent of the apartment, although the taxpayer did not keep any records of the use of the apartment. The taxpayer argued that the deduction could be based on the per diem rates under Rev. Proc. 92-17, 1992-1 C.B. 679, and Rev. Proc. 93-21, 1993-1 C.B. 529. The court held that the per diem rates were available only for employees who were paid per diem expenses. Christian v. Comm’r, T.C. Memo. 2000-385.

**MEDICAL EXPENSES.** The taxpayer’s spouse suffered from Multiple Chemical Sensitivity syndrome and the physician recommended that the taxpayer build a house of steel, concrete and other special components. The house was constructed over four tax years, 1992-1995, and the taxpayer claimed a deduction for all of the special medical-related construction costs in the last year, 1995, the year the house was completed. The IRS allowed a deduction for 1995 only for the costs paid in 1995. The court held that all of the medical-related costs were deductible only in the last year, the year the house became inhabitable by the wife. Zipkin v. United States, 2000-2 U.S. Tax Cas. (CCH) ¶ 50,863 (D. Minn. 2000).

**PARTNERSHIPS-ALM § 7.03.** CONTRIBUTION OF MORTGAGED PROPERTY. The partnership had four equal partners. One partner contributed property in exchange for additional interests in the partnership. The property was subject to a mortgage which the partnership assumed. However, the contributing partner also signed a guarantee of the mortgage which allowed the creditor to seek repayment from the partner first. The partner also agreed to indemnify the partnership if it was required to satisfy the debt. This agreement was not further explained in the ruling and would appear to apply only if the partnership had to pay the debt early. The IRS ruled that the mortgage was a recourse liability and that no gain was recognized from the contribution of the property to the partnership. Ltr. Rul. 2000050032, Sept. 15, 2000.

**ELECTION TO BE TAXED AS CORPORATION.** The taxpayer, a domestic limited partnership, was not classified as a corporation under Treas. Reg. § 301.7701-2(b)(1), (3), (4), (5), (6), (7), and (8) and was considered a partnership if it did not elect to be taxed as a corporation. The taxpayer intended to make the election under Treas. Reg. § 301.7701-3(a) to be taxed as a corporation but failed to make the election. The IRS granted the taxpayer 60 days to make the election. Ltr. Rul. 200051029, Sept. 21, 2000.

**LIMITED LIABILITY COMPANIES.** The taxpayer, a foreign limited liability company, was not classified as a corporation under Treas. Reg. § 301.7701-2(b)(1), (3), (4), (5), (6), (7), and (8) and was considered a corporation if it did not elect to be taxed as a partnership. The taxpayer intended to make the election under Treas. Reg. § 301.7701-3(a) to be taxed as a partnership but failed to make the election. The IRS granted the taxpayer 60 days to make the election. Ltr. Rul. 200051020, Sept. 21, 2000.

**PASSIVE ACTIVITY LOSSES.** The taxpayers owned and operated a heavy-equipment leasing company. The taxpayer individually purchased items of heavy equipment and entered into leases with the company which subleased the equipment to customers. The company agreed to maintain and repair the equipment. The taxpayers reported the rental income from the equipment but had net losses from the depreciation deductions. The court held that the losses were passive activity losses because the taxpayer did not meet the exceptions of Treas. Reg. §§ 1.469-1T(e)(3)(ii)(B) and (C). The first exception was for leases less than 30 days. The second exception applied where the lease between the taxpayers and the company was for a term longer than 30 days so the first exception did not apply. The second exception applied where the lessee performed extraordinary personal services in the leasing of the property to customers. The court held that the second exception did not apply because the company performed all of the major services required for maintaining and leasing the equipment. Hairson v. Comm’r, T.C. Memo. 2000-386.


**QUALIFIED DEBT INSTRUMENTS.** The IRS has announced the 2001 inflation adjusted amounts of debt instruments which qualify for the 9 percent discount rate limitation under I.R.C. §§ 483 and 1274:

<table>
<thead>
<tr>
<th>Year of Sale</th>
<th>1274(a)(b)</th>
<th>1274(a)(c)(2)(A)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>$4,085,900</td>
<td>$2,918,500</td>
</tr>
</tbody>
</table>

* Agricultural Law Manual (ALM).
The $4,085,900 figure is the dividing line for 2001 below which (in terms of seller financing) the minimum interest rate is the lesser of 9 percent or the Applicable Federal Rate. Where the amount of seller financing exceeds the $4,085,900 figure, the imputed rate is 100 percent of the AFR except in cases of sale-leaseback transactions, where the imputed rate is 110 percent of AFR. If the amount of seller financing is $2,918,500 or less (for 2001), both parties may elect to account for the interest under the cash method of accounting. **Rev. Rul. 2000-55, I.R.B. 2000-52.**

**RETURNS.** The IRS has announced the release of revised Publication 51 (Revised January 2001), Circular A, Agricultural Employer's Tax Guide. The IRS has released Publication 583 (Rev. December 2000), Starting a Business and Keeping Records; Publication 590 (2000), Individual Retirement Arrangements (IRAs) (Including Roth IRAs and Education IRAs); Form 1041, Schedule K-1 (2000), Beneficiary's Share of Income, Deductions, Credits, etc.; Form 1041-A (Rev. December 2000), U.S. Information Return Trust Accumulation of Charitable Amounts; Form 990-C (2000), Farmers' Cooperative Association Income Tax Return. These documents are available at no charge (1) by calling the IRS's toll-free telephone number, 1-800-829-3676; (2) via the internet at http://www.irs.gov/prod/cover.html; (3) through FedWorld; or (4) by directly accessing the Internal Revenue Services bulletin board at (703) 321-8020.

The IRS has announced that it will not impose penalties under I.R.C. §§ 6721, 6722 on certain taxpayers for failure to file information returns or furnish payee statements under I.R.C. § 6050P for discharges of indebtedness occurring prior to the first calendar year beginning at least two months after the date that appropriate guidance is issued. This rule applies only to taxpayers who were made subject to I.R.C. § 6050P by Section 533(a) of the Ticket to Work and Work Incentives Improvement Act of 1999, Pub. L. No. 106-170, 113 Stat. 1860 (1999). Section 533(a) of the Act amended I.R.C. § 6050P by expanding the types of entities that are required to report discharges of indebtedness to include any organization “a significant trade or business of which is the lending of money.” The IRS did not indicate when guidance would be issued. **Notice 2001-8, I.R.B. 2001-__**.

The IRS has released a revenue procedure that provides the requirements for electronically filing Form 940, Employer’s Annual Federal Unemployment Tax (FUTA) Return, in the Form 940 E-File Program. The procedure is effective for tax years after Dec. 31, 1999.

**S CORPORATIONS-ALM § 7.02[3][c].***

ACCOUNTING METHOD. I.R.C. § 444(d)(3) and Temp. Treas. Reg. § 1.444-2T generally prohibit an S corporation that is a member of a tiered structure from making an election under section 444 for taxable years beginning after December 31, 1986. An S corporation is considered to be a member of a tiered structure if the S corporation owns any portion of a deferral entity, or a deferral entity owns any portion of an S corporation. Temp. Treas. Reg. § 1.444-2T(b)(2) defines deferral entity to include any entity that is a trust with the exception of certain grantor trusts (including qualified subchapter S trusts within the meaning of I.R.C. § 1361(d)(1)(A)). The IRS has issued temporary regulations which provide that solely with respect to an S corporation shareholder, an electing small business trust and a trust that is described in I.R.C. § 401(a) or § 501(c)(3) and is exempt from taxation under I.R.C. § 501(a) is not a deferral entity for purposes of Temp. Treas. Reg. § 1.444-2T. **65 Fed. Reg. 82926 (Dec. 29, 2000).**

### SAFE HARBOR INTEREST RATES

<table>
<thead>
<tr>
<th></th>
<th>January 2001</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Annual</td>
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<tr>
<td><strong>Short-term</strong></td>
<td></td>
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<tr>
<td>AFR</td>
<td>5.90</td>
</tr>
<tr>
<td>110 percent AFR</td>
<td>6.50</td>
</tr>
<tr>
<td>120 percent AFR</td>
<td>7.10</td>
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<tr>
<td><strong>Mid-term</strong></td>
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<tr>
<td>AFR</td>
<td>5.61</td>
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<tr>
<td>110 percent AFR</td>
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<tr>
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<tr>
<td><strong>Long-term</strong></td>
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<td>AFR</td>
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<tr>
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<td>6.37</td>
</tr>
<tr>
<td>120 percent AFR</td>
<td>6.96</td>
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</tbody>
</table>


**SALE OF REAL PROPERTY.** The taxpayers operated a sole proprietorship which purchased and sold residential real estate. The properties were sold under a contract for deed and the contracts gave the buyers possession of the property during the agreement term. The contracts also required the buyers to pay property taxes from the date of execution, to keep fire insurance in force during the payment term, to perform maintenance and prevent deterioration, and to assume all liabilities as if they held fee simple title. Moreover, the instruments allowed the buyers to accelerate the agreement and prematurely obtain a warranty deed by tendering the full amount owing under the related promissory note. The contracts provided termination of the contract upon default of any payment by the buyers and allowed the taxpayer to retain any payments made as liquidated damages. The taxpayers argued that gain from the sale was not recognized until the year the contracts were completed, because the contracts were voidable, executory agreements. The court held that, under state law, the sales were complete upon execution of the contracts because sufficient rights and burdens of ownership passed to the buyers. **Because the taxpayers were on the accrual method of accounting,** the gain from the sales was recognized in the year of the contract execution and not the year of contract completion. No installment reporting of the gain was discussed, possibly because the taxpayers could be considered as dealers in real estate. **Keith v. Comm’r,** 115 T.C. No. 42 (2000). Neil Harl will publish commentary on this important case in an upcoming ALD issue.

**TAX RATES.** The standard deductions for 2001 are $7,600 for joint filers, $6,650 for heads of households, $4,550 for singlefilers and $3,800 for married individuals who file separately. The personal exemption is $2,900. The income limit for the maximum earned income tax credit is $4,760 for taxpayers with no children, $7,140 for taxpayers with one child, and $10,020 for taxpayers with two or more children. The IRS also announced the inflation adjusted tax tables and other inflation adjusted figures for 2001. **Rev. Proc. 2001-13, I.R.B. 2001-__**.

**CITATION UPDATES**

Benci-Woodward v. Comm’r, 219 F.3d 941 (9th Cir. 2000) (court awards and settlements) see p. 117 supra.
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MORE ON MIZELL

— by Neil E. Harl*

In a decision handed down by the Eighth Circuit Court of Appeals on December 29, 2000, additional light was cast on how to avoid self-employment tax on rents for those renting land to an entity in which the lessor is materially participating, taking into account the activities of the taxpayer as lessor and the involvement as partner or employee or in any other status. The problem, which arose with the 1995 Tax Court case of Mizell v. Commissioner, applies only to those producing agricultural or horticultural commodities.

**Reasoning in Mizell and other authorities**

In Mizell v. Commissioner, the taxpayer had formed a general partnership with three sons, each with a 25 percent general partnership interest. The father, the taxpayer, had retained 731 acres of land which were rented to the general partnership under a non-material participation crop share lease. The father did not report the rents as self-employment income and did not pay self-employment tax on the rental amounts.

On audit, the Internal Revenue Service asserted that 15.3 percent self-employment tax was due on the rents because the taxpayer was materially participating "under an arrangement involving the general partnership and the partnership was engaged in the production of "agricultural or horticultural commodities."

The Tax Court agreed with the I.R.S. position and upheld the SE tax levy. The case was not appealed (although, interestingly, it was appealable to the Eighth Circuit Court of Appeals).

The following year, 1996, I.R.S. ruled that the same analysis applied to the cash rental of land and personal property to a corporation. In that ruling, a husband and wife as officers and directors of a ranching corporation had self-employment income from the rental of property to the corporation.

Three Field Service Advice rulings, issued in 1998, were in accord with the position in Mizell v. Commissioner. In three cases decided by the Tax Court in 1999 (which factually resembled the three FSA rulings in 1998), I.R.S. prevailed using basically the same arguments as had been used successfully in Mizell v. Commissioner. In the first of the three cases, Bot v. Commissioner, the wife was renting land to her husband's sole proprietorship. She was deemed to be materially participating in the husband's farming operation and so the Tax Court held that she was liable for self-employment tax on the rental amounts.

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.

See the back page for details about the 2001 Agricultural Tax and Law Seminars by Dr. Neil Harl and Prof. Roger McEowen.
payments. The second case, *Hennen v. Commissioner*, was factually similar. In the third case, *McNamara v. Commissioner*, the husband and wife, owners of the land in joint tenancy, cash rented their land to the husband's farm corporation. The Tax Court determined that the husband and wife, as lessors, were liable for self-employment tax on the rents inasmuch as they were materially participating in the farming operation.

The three 1999 Tax Court cases were all appealed to the Eighth Circuit Court of Appeals.\(^6\)

**The Eighth Circuit Decision**

The Eighth Circuit Court of Appeals, examining the question for the first time, was not impressed by the taxpayers' argument that Section 1402(a)(1) only applies to "rental payments derived from sharecropping or share-farming."\(^7\) The Eighth Circuit, not surprisingly, also gave short shrift to the argument that the instructions to Form 4835 (on which non-material participation share rent income and expenses are reported) contradicted the statute and should override Section 1402(a)(1).\(^8\)

The appellate court also stated that it could not say that the Tax Court erred in holding that the taxpayer in the three cases had materially participated under the respective arrangements. However, the Eighth Circuit was impressed by another argument, that the lessor-lessee arrangements should stand on their own, apart from any employment relationship, and that if the rentals were "consistent with market rates for agricultural land" the rents were not "derived under an arrangement" and, therefore, self-employment tax was not due.\(^9\) The appellate court was looking at the "nexus" between the rents received by the lessor and the "arrangement" that requires material participation for self-employment tax to be due.\(^10\) As the court pointed out, "the mere existence of an arrangement requiring and resulting in material participation in agricultural production does not automatically transform rents received" into self-employment income.\(^11\) The court pointed out that rents consistent with market rates "very strongly suggest" that the rental arrangement stands on its own as an independent transaction and cannot be said to be part of an arrangement for participation in agricultural production.\(^12\)

The court proceeded to remand the cases to the Tax Court to provide an opportunity for I.R.S. to show a connection between the rents and the "arrangement."\(^13\)

**In conclusion**

Until the Tax Court has re-examined the facts, particularly in light of whether the rents were "fair market rental" rents, it is imperative that taxpayers potentially subject to challenge set the rental rates in keeping with rates in the area for comparable land. Moreover, it is important that evidence of rental rates be preserved for use in any later audit.

**FOOTNOTES**


2 I.R.C. § 1402(a)(1).

3 Id. See Mizell v. Comm'r, T.C. Memo. 1995-571.

4 T.C. Memo. 1995-571.


6 T.C. Memo. 1995-571.

7 See I.R.C. § 1402(a)(1).

8 Id.

9 T.C. Memo. 1995-571.

10 Ltr. Rul. 9637004, May 1, 1996.

11 FSA Ltr. Rul. 9917005, Dec. 10, 1998 (husband rented farmland from wife who was involved in husband's farming operation; self-employment tax imposed on rents); FSA Ltr. Rul. 9917006, Dec. 10, 1998 (same); FSA Ltr. Rul. 9917007, Dec. 10, 1998 (husband and wife rented land to corporation owned by husband where both were involved in farming operation; self-employment tax imposed).

12 T.C. Memo. 1995-571.

13 T.C. Memo. 1999-256.

14 T.C. Memo. 1999-306.

15 T.C. Memo. 1999-333.


17 2001-1 U.S. Tax Cas. (CCH) ¶ 63,004 (8th Cir. 2000).

18 Id.

19 Id.

20 Id.

21 Id.

22 Id.

23 Id.

24 Id.
BANKRUPTCY

GENERAL-ALM § 13.03.*

EXEMPTIONS

MOTOR VEHICLE. The debtors, husband and wife, filed a joint Chapter 7 petition and each claimed an exemption in a pickup truck as a business tool. The truck, however, was titled only in the husband’s name and the trustee objected to the wife’s exemption claim. The court held that the tool of the trade exemption applied to the individual debtor’s interest in property; therefore, the wife could not claim an exemption because the wife had no ownership interest in the pickup. In re Miller, 255 B.R. 221 (Bankr. D. Neb. 2000).

Chapter 12-ALM § 13.03[8].*

NOTE: The Bankruptcy Reform Bill was vetoed by President Clinton; therefore, there is no statutory authorization for Chapter 12, which expired on June 30, 2000.

DISCHARGE. The debtor served as executor for the debtor’s parent’s estate which included a farm. The debtor farmed the land during the administration of the estate without paying rent to the estate. In addition, the debtor wrote one check on the estate account for the debtor’s personal use. An action was brought in state probate court and the debtor was ordered to repay the check and pay the fair market rent for use of the farm. The estate filed a claim for the probate court judgment amount and sought a ruling that the claim was nondischargeable as a fraud or defalcation while the debtor was a fiduciary. The initial issue was whether the probate court order had any preclusive effect as to the dischargeability of the judgment. The court held that, although the probate court did not consider the bankruptcy effect of the case, the fact determinations were entitled to preclusive effect and those facts demonstrated that the debtor had committed fraud while serving in a fiduciary capacity. The court held that the probate judgment claim was non dischargeable. In re Nelson, 255 B.R. 314 (Bankr. D. N.D. 2000).

FEDERAL TAX-ALM § 13.03[7].*

ADMINISTRATIVE EXPENSES. The debtor’s Chapter 7 estate incurred administrative expenses during the administration of the estate. The trustee filed an income tax return for the estate and claimed the administrative expenses as a deduction from gross income of the estate, resulting in no income tax owed by the estate. The IRS disallowed the deduction except as a miscellaneous deduction, limited to the amount in excess of 2 percent of gross income. The IRS argued that, because the debtor would not be allowed a deduction from gross income for bankruptcy administrative expenses, the bankruptcy estate should not be allowed such a deduction. The court held that I.R.C. § 1398(h)(1) specifically allows bankruptcy estates deductions not otherwise disallowed. The court then looked to I.R.C. § 67 which allows estates and trusts to deduct administrative expenses from income. The court held that I.R.C. § 67 applied to bankruptcy estates. A similar case, In re Sturgill, 217 B.R. 291 (Bankr. D. Or. 1998), held that bankruptcy administrative expenses were not deductible as trade or business expenses. The court noted that I.R.C. § 67 was not raised or discussed in that case. See Harl, “Expenses in Bankruptcy” 11 Agric. L. Dig. 81 (2000). In re Miller, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,137 (Bankr. E.D. Tex. 2000).

ESTATE PROPERTY. The debtor owned interests in several employee pension plans and was receiving monthly distributions when the debtor filed for Chapter 13. The IRS filed a claim for taxes which exceeded the value of the debtor’s property. Tax liens had been filed pre-petition and the issue was whether the pension plan payments were included in bankruptcy estate property so as to be considered as part of the property securing the IRS claim. The pension plans had clauses restricting assignment or attachment of the plan distributions or principal. The court held that the pension plan payments were subject to the tax liens; therefore, the plan restrictions were not effective under nonbankruptcy law and the pension plan payments were included in estate property. The court held that the present value of the monthly payments was part of the security for the tax claim. In re McIver, 255 B.R. 281 (D. MD. 2000).

FEDERAL AGRICULTURAL PROGRAMS

ANIMAL WELFARE. The APHIS has adopted as final regulations allowing APHIS to place animals confiscated from situations detrimental to the animals' health and well-being with a person or facility that is not licensed by or registered with the APHIS, if the person or facility can offer a level of care equal to or exceeding that required by the regulations. 66 Fed. Reg. 236 (Jan. 3, 2001).

DISASTER PAYMENTS. The Livestock Indemnity Program for Contract Growers was originally enacted in 2000 to provide payments for contract livestock producers who suffered losses in 1999. Final regulations implementing that program were issued in June 2000, 65 Fed. Reg. 36550 (June 8, 2000). All of the funds for that program were not used so the program has been extended to cover losses through February 7, 2000. The CCC has issued final regulations implementing the extension of the program. 65 Fed. Reg. 82892 (Dec. 29, 2000).

FARM LOANS. The FSA has issued interim regulations which amend the regulations governing the FSA’s direct operating loan program by simplifying the application process.
for certain farmers requesting assistance of $50,000 or less and for certain recurring operating loan applicants. 66 Fed. Reg. 1570 (Jan. 9, 2001).

MEAT AND POULTRY PRODUCTS. The AMS has adopted as final regulations providing a voluntary, user-fee-funded program under the provisions of the Agricultural Marketing Act of 1946 to inspect and certify equipment and utensils used to process livestock and poultry products. Livestock and poultry processing equipment and utensils inspected and certified by AMS to voluntary consensus standards for sanitary design will provide a third party assurance that they meet minimum requirements for cleanliness, suitability of materials used in construction, durability and inspectability. 66 Fed. Reg. 1189 (Jan. 5, 2001).

Secretary Glickman has announced that the pork checkoff program has been rejected in a referendum of pork producers and will be terminated.

MILK. The AMS has issued a notice of the availability of revisions to the U.S. Standards for Grades of Nonfat Dry Milk (Spray Process), the U.S. Standards for Instant Nonfat Dry Milk, and the U.S. Standards for Grades of Dry Buttermilk and Dry Buttermilk Product. The changes reduce the Standard Plate Count (bacterial estimates) for U.S. Extra Grade nonfat dry milk (spray process) and instant nonfat dry milk to a maximum of 10,000 per gram for U.S. Extra Grade dry buttermilk and dry buttermilk product to a maximum of 20,000 per gram, and for U.S. Standard Grade dry buttermilk and dry buttermilk product to a maximum of 75,000 per gram. 66 Fed. Reg. 350 (Jan. 3, 2001).

PEANUTS. The CCC has adopted as final regulations amending the regulations for the peanut price support program to ease conditions for marketing Segregation 3 peanuts by allowing the peanuts to be reconditioned and regraded in certain limited instances. Peanuts are graded as "Segregation 3" peanuts when they are found by visual inspection to have Aspergillus flavus (A. flavus) mold. This rule would allow a farmer whose peanuts were found at a buying point inspection to have the mold to reclean those peanuts at the buying point and have them visually reinspected within 24 hours. The farmer could obtain such a re-inspection only once for any given lot. 66 Fed. Reg. 1807 (Jan. 10, 2001).

FEDERAL INCOME TAXATION

C CORPORATIONS-ALM § 7.02[3].

DEFINITION. The IRS has issued proposed regulations under I.R.C. § 7701 that address the federal tax classification of a business entity wholly owned by a foreign government and provide that a nonbank entity that is wholly owned by a foreign bank cannot be disregarded as an entity separate from its owner (disregarded entity) for purposes of applying the special rules of the IRC applicable to banks. The IRS also issued proposed regulations under I.R.C. § 892 that provide that a partnership can be a controlled commercial entity for purposes of I.R.C. § 892(a)(2)(B). 66 Fed. Reg. 2854 (Jan. 12, 2001).

DISTRIBUTIONS. The IRS has issued proposed regulations which apply the rules of I.R.C. § 357(d), involving the treatment of liabilities assumed by a shareholder, to distributions under I.R.C. § 301. The proposed regulations provide that the amount of a distribution under Section 301 will be reduced by the amount of any liability that is treated as assumed by the distributee within the meaning of Section 357(d)(1) and (2). 66 Fed. Reg. 723 (Jan. 4, 2001).

EMPLOYEE STOCK OWNERSHIP PLAN. A corporation had two classes of common stock, non-voting and voting. Both classes had identical dividend rights. The stock was eligible for trading on the over-the-counter bulletin board but neither was regularly traded. The IRS ruled that the stock was not considered "publicly traded" for purposes of I.R.C. §§ 409(l)(1), 1042(c)(1)(A) which require stock in an ESOP be "readily tradable on an established securities market." Ltr. Rul. 200052014, Sept. 27, 2000.

CASUALTY LOSSES. The taxpayers purchased two parcels of property on which to operate a nursery. The taxpayers made improvements to the road on the property costing $6,840. The existing road and improvements were severely damaged in floods and the taxpayer claimed a casualty loss which equaled the tax basis of the property. The court noted that the taxpayers had treated, for income tax purposes, the road as separate property, since the improvement costs were not capitalized into the land basis and the taxpayer had claimed a depreciation deduction for the road improvement costs. The court held that the road was a separate improvement on the land, was subject to separate depreciation, and had a basis equal only to the cost basis demonstrated by the taxpayers of $6,840. The court noted that the taxpayers had not presented any evidence of the portion of the land purchase price which was allocated to the existing road. The appellate court affirmed in a decision designated as not for publication. Cziraki v. Comm’r, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,141 (9th Cir. 2000), aff’g, T.C. Memo. 1998-439.

CHARITABLE DEDUCTION. The IRS has adopted as final regulations governing the character of certain distributions from a charitable remainder trust. In these transactions, a taxpayer typically contributes highly appreciated assets to a charitable remainder trust having a relatively short term and relatively high payout rate. Rather

FEDERAL ESTATE AND GIFT TAXATION

TRUSTS. The taxpayer was a trustee which incurred fees for its trust for investment strategy advice provided by private investment advisors and accounting, tax preparation, and management services. The court held that the fees were not deductible under I.R.C. § 67 because the fees "would not have been incurred if the property were not held in ... trust." Mellon Bank, N.A. v. United States, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,153 (Fed. Cls. 2000).

*Agricultural Law Manual (ALM).
or more of the following individuals may be used as measuring lives: the donor, the donor's spouse, and a lineal ancestor of all the remainder beneficiaries. However, this limitation regarding permissible measuring lives does not apply in the case of a charitable guaranteed annuity interest or unitrust interest payable under a charitable remainder trust described in I.R.C. § 664. An interest payable for a specified term of years can qualify as a guaranteed annuity or unitrust interest even if the governing instrument contains a “savings clause” intended to ensure compliance with a rule against perpetuities. The savings clause must utilize a period for vesting of 21 years after the deaths of measuring lives who are selected to maximize, rather than limit, the term of the trust. For example, a guaranteed annuity or unitrust interest that will terminate on the earlier of 30 years or 21 years after the death of the last survivor of the descendants of any grandparent of the donor living on the date of the creation of the interest will be treated as payable for a specified term of years. 66 Fed. Reg. 1040 (Jan. 5, 2001).

COURT AWARDS AND SETTLEMENTS. The taxpayer owned a corporation which purchased and operated an automobile dealership. The dealership eventually failed and the taxpayer sued the manufacturer’s region sales division for breach of contract, promissory fraud, violations of the Alabama Motor Vehicle Franchise Act, felonious injury, interference with business relations, misrepresentations and suppression of facts, and violation of RICO. Although the taxpayer suffered mental distress from the dealings with the defendant, the taxpayer did not allege any personal injury or any injury to the taxpayer’s personal business reputation. The parties reached a large settlement which the taxpayer sought to exclude from income. The court held that the taxpayer could not exclude the settlement because no portion of the pleadings alleged a personal injury claim. The court also held that the portion of the settlement paid to the taxpayer’s attorneys under a contingent fee arrangement was excludible from income under Cotnam v. Comm’r, 263 F.3d 119 (5th Cir. 1959).

Griffin v. Comm’r, T.C. Memo. 2001-5.

DISASTER PAYMENTS. On December 18, 2000, the president determined that certain areas in Alabama were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of severe storms and tornadoes on December 16, 2000. FEMA-1352-DR. On December 28, 2000, the President determined that certain areas in Arkansas were eligible for assistance under the Act as a result of severe winter ice storms beginning on December 12, 2000. FEMA-1354-DR. On December 29, 2000, the President determined that certain areas in North Dakota were eligible for assistance under the Act as a result of severe winter storms and tornadoes beginning on November 1, 2000. FEMA-1353-DR. On December 28, 2000, the President determined that certain areas in Oklahoma were eligible for assistance under the Act as a result of severe winter ice storms beginning on December 25, 2000. FEMA-3158-EM. On December 13, 2000, the President determined that certain areas in Wyoming were eligible for assistance under the Act as a result of severe winter storms beginning on October 31, 2000. FEMA-1353-DR. Accordingly, a taxpayer who sustained a loss attributable to the disasters may deduct the loss on his or her 1999 federal income tax return.

EMPLOYEE BENEFITS. The IRS has issued guidance on “split-dollar” life insurance arrangements between employers...
and employees. The IRS will generally accept the parties' characterization of the employer's payments under a split-dollar arrangement, provided that (i) such characterization is not clearly inconsistent with the substance of the arrangement, (ii) such characterization has been consistently followed by the parties from the inception of the arrangement, and (iii) the parties fully account for all economic benefits conferred on the employee in a manner consistent with that characterization. Notice 2001-10, I.R.B. 2001-__.

EXCISE TAX. The IRS has announced that the excise tax on sales of luxury passenger vehicles during 2001 is reduced to 4 percent of the sales price in excess of $38,000. The domestic segment tax portion of the tax on amounts paid for personal air travel during 2001 is $2.75 per segment. The excise tax on use of international air travel facilities during 2001 increased to: $12.80 per person for flights that begin or end in the United States and $6.40 per person for domestic segments that begin or end in Alaska or Hawaii (applies only to departures). The IRS also announced the excise tax rates as well as credit and refund rates for gasohol. IRS Newsstand, "What's Hot in Tax Forms." http://www.irs.gov.

IRA. The taxpayer owned interests in two IRAs and was less than 59 years old. The taxpayer had been divorced and as part of the divorce proceedings was required to pay the former spouse $29,000 in property settlement. The taxpayer failed to make that payment and was eventually ordered by a court to make the payment or face incarceration. The taxpayer had few other liquid assets and had to withdraw the funds from the IRAs. The taxpayer argued that the exception of I.R.C. § 408(d)(6) applied to exclude the early withdrawals from the taxpayer's gross income as withdrawals made incident to a divorce. The court held that withdrawals were included in gross income because the divorce decree did not require the withdrawal of IRA funds, only the payment of the fixed sum. Czepiel v. Comm'r, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,134 (1st Cir. 2000), aff'd, T.C. Memo 1999-289.

LETTER RULINGS. The IRS has issued its annual list of procedures for issuing letter rulings. Rev. Proc. 2001-1, I.R.B. 2001-__.

The IRS has issued its annual list of procedures for furnishing technical advice to District Directors and Chiefs, Appeals Offices. Rev. Proc. 2001-2, I.R.B. 2001-__.

The IRS has issued its annual list of tax issues for which the IRS will not give advance rulings or determination letters. Rev. Proc. 2001-3, I.R.B. 2001-__.

The IRS has issued its annual list of procedures for issuing letter rulings on employee plans. Rev. Proc. 2001-4, I.R.B. 2001-__.

LIKE-KIND EXCHANGES. The taxpayers, husband and wife, purchased a residence and used it as their primary residence for several years. The taxpayers purchased another residence and converted the first residence into a rental property. The fair market value of the property was much less than the taxpayers' adjusted basis in the property at the time of the conversion. The rental property was then exchanged for another rental property. The fair market value of the taxpayers' property was almost double the fair market value of the property received. The court held that (1) the taxpayers' basis in the first rental property was the fair market value at the time of the conversion, (2) the adjusted basis of the exchanged property was the adjusted basis of the first property less the difference in fair market value, considered boot, between the exchanged properties. Bundren v. Comm'r, T.C. Memo 2001-2.

PARTNERSHIPS-ALM § 7.03.* CONTRIBUTIONS OF STOCK OF A PARTNER. The IRS has issued proposed regulations governing situations where a corporation acquires an interest in a partnership that holds stock in that corporation (or the partnership subsequently acquires stock in that corporation in an exchanged basis transaction), the partnership does not have an election under I.R.C. § 754 in effect for the year in which the corporation acquires the interest, and the partnership later sells or exchanges the stock. In these situations, the increase (or decrease) in the corporation's adjusted basis in its partnership interest resulting from the sale or exchange of the stock equals the amount of gain (or loss) that the corporate partner would have recognized (absent the application of I.R.C. § 1032) if, for the taxable year in which the corporation acquired the interest, a section 754 election had been in effect. The purpose of these proposed regulations cannot be avoided through the use of tiered partnerships or other arrangements. For example, the proposed regulations provide that if a corporation acquires an indirect interest in its own stock through a chain of two or more partnerships (either where the corporation acquires a direct interest in a partnership or where one of the partnerships in the chain acquires an interest in another partnership), and gain or loss from the sale or exchange of the stock is subsequently allocated to the corporation, then the bases of the interests in the partnerships included in the chain shall be adjusted in a manner that is consistent with the purpose of the proposed regulations. 66 Fed. Reg. 315 (Jan. 3, 2001), adding Treas. Reg. § 1.705-2.

PENSION PLANS. For plans beginning in December 2000, the weighted average is 5.93 percent with the permissible range of 5.34 to 6.23 percent (90 to 106 percent permissible range) and 5.34 to 6.52 percent (90 to 110 percent permissible range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). Notice 2001-3, I.R.B. 2001-__.

The IRS has issued a revenue procedure which provides guidance for complying with the user fee program of the Internal Revenue Service as it pertains to requests for letter rulings, determination letters, etc., on matters under the jurisdiction of the Commissioner, Tax Exempt and Government Entities Division; and requests for administrative scrutiny determinations under Rev. Proc. 93-41, 1993-2 C.B. 526. Rev. Proc. 2001-8, I.R.B. 2001-__.

RETURNS. The IRS has issued a revised list of the filing locations for corporation, S corporation and partnership returns. The new locations are listed in the instructions to the income tax returns.

The IRS has announced that Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, due for decedents domiciled in the following states and Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, due for tax year 2000 with the donors living in the following states should be filed at the Cincinnati Service...
DISCHARGE OF INDEBTEDNESS. The taxpayer was a shareholder in an S corporation which was a partner in a joint venture which realized discharge of indebtedness income in 1991. The taxpayer increased the basis of the taxpayer’s S corporation stock by the taxpayer’s share of the discharge of indebtedness income passed through the S corporation. At the time of the discharge of the indebtedness, the S corporation was insolvent and had net operating losses. The increase in the stock basis enabled the taxpayer to deduct the carried-over losses in a later year. The IRS argued that the discharge of indebtedness income was not an item of income for purposes of determining stock basis because discharge of indebtedness income was excluded under the insolvency exclusion rule of I.R.C. § 108. The Tax Court held that, because the corporation was insolvent, I.R.C. § 108 caused an exclusion of the discharge of indebtedness income at the corporation level which was offset by reduction in tax attributes of the corporation, leaving no tax consequences to flow to the shareholders such as would increase the shareholders’ basis in stock. The Supreme Court reversed, holding that discharge of indebtedness income was a pass-through item of corporation income which was applied first to increase the shareholders’ basis, second to any shareholder losses, and finally to offset any tax attributes. In this case, the shareholders had sufficient losses to use up the entire discharge of indebtedness income. 

The Agricultural Law Press presents

2001 AGRICULTURAL TAX AND LAW SEMINARS

by Neil E. Harl and Roger A. McEowen

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GOOD NEWS AND BAD NEWS FOR INSTALLMENT REPORTING BY ACCRUAL ACCOUNTING TAXPAYERS

— by Neil E. Harl*

In one of the great ironies of the age, on the very day President Clinton signed the widely criticized near-ban on installment reporting of gain by taxpayers on the accrual method of accounting,1 December 28, 2000, the U.S. Tax Court delivered more bad news on installment reporting of gain to accrual accounting taxpayers.2 If not reversed on appeal, the Tax Court decision could promise to be a barrier to installment. Certainly, the Tax Court decision is a more serious problem for taxpayers disposing of property “used or produced in the business of farming.”3

The statutory ban

In legislation effective on December 17, 1999, the Congress passed a ban on installment reporting of gain for taxpayers “on an accrual method of accounting” with three enumerated exceptions for gain from—(1) residential lots; (2) timeshares; and (3) the disposition of any property “used or produced in the trade or business of farming.”4,5 It was believed that the farming exception meant that an accrual accounting landlord could use installment reporting of gain for eligible capital assets or assets used in the business provided the assets were “used or produced” under a crop share or livestock share lease with substantial involvement in management.6 Whether such a landlord could use installment reporting for the sale of farm commodities7 turned on whether the accrual accounting landlord was required to report the commodities in inventory8 which presumably would be the case for someone on classic accrual accounting.9 If inventories were being used, eligibility for installment reporting of commodities would be denied; however, if the taxpayer was using a hybrid method of accounting10 which did not involve inventories, installment reporting would be available.

As noted above,10 the repeal of the statutory ban on installment reporting of gain by taxpayers on an accrual method of accounting was signed by President Clinton on December 28, 2000.11

Keith v. Comm’r

On the same day, December 28, 2000, the U.S. Tax Court decided a case, Keith v. Comm’r,12 which involved the sale of residential real property sold under installment contract. Under the contract, the buyers obtained possession; paid the property taxes, insurance and maintenance; and were obligated to make monthly payments, with interest, toward the purchase price. After making full payment, the buyers would receive a warranty deed. If default occurred, the contracts would be voided and amounts paid would be retained as liquidated damages. The

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by Dr. Neil Harl and Prof. Roger McEowen
court concluded that the transaction produced income in the year of sale with the sale deemed completed in the year of contract execution for the seller which was on the accrual method of accounting. The Tax Court pointed out that the seller only had a security interest in the property.

Interestingly, the Tax Court acknowledged that the seller did not argue that the statutory authority for installment reporting of gain, I.R.C. § 453, applied. That may have been because of the dealer exception to the statutory authority for installment reporting, which arguably would have applied.

The Tax Court specifically noted that its 1967 decision, Baertschi v. Comm’r, would no longer be followed. That case had been reversed by the Sixth Circuit Court of Appeals in 1969. In the Tax Court decision in Baertschi v. Comm’r, the taxpayers had entered into an installment contract for the sale of a residence. The issue was whether the taxpayers were eligible for the rollover of gain under I.R.C. § 1034 (which was repealed in 1997). The Tax Court held that the contract did not constitute a “sale” of the property on the date entered into for purposes of the then-available statutory rollover of gain by reinvestment in a replacement residence. The Tax Court held that “sale” occurred later when final payment was made on the contract. Thus, the gain was eligible for rollover treatment. Five Tax Court judges dissented from the majority opinion in the court-reviewed decision.

The Sixth Circuit Court of Appeals, however, reversed the Tax Court and held that the sale transaction was consummated on the date benefits and burdens of ownership had passed to the buyers and the buyers had paid a substantial part of the sales price. The sellers at that point had “absolute right to title on payment of the full purchase price.” Accordingly, the taxpayers were not eligible for the rollover of gain inasmuch as they did not occupy the replacement property within 18 months, the statutory period at that time.

**In conclusion**

The Tax Court took the position, under the facts of the case of Keith v. Comm’r, that sale was consummated and income tax was properly imposed on the transaction in the year of contract execution. The decision leaves open an obvious question: is the opinion limited to accrual accounting taxpayers? Arguably, it is so limited. Certainly, I.R.C. § 453 constitutes clear authority for installment reporting of gain. An argument can be made that, with repeal of the ban on installment reporting by those on accrual accounting, Congress intended for accrual taxpayers to be eligible for installment reporting as well.

Unfortunately, the application of I.R.C. § 453 was not argued in Keith v. Comm’r. If the Keith decision is limited to dealer reporting, the impact is likely to be modest.

**FOOTNOTES**


4. I.R.C. § 453(a), (l)(2)(A), (B).


7. *Id.*

8. See 4 Harl, supra note 6, § 25.03[2].

9. See 4 Harl, supra note 6 § 25.03[3].

10. See note 1 supra.


13. *Id.*

14. *Id.*


20. *Id.*

21. *Id.*


23. *Id.*

24. *Id.*


27. 115 T.C. No. 42 (2000).

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**CASES, REGULATIONS AND STATUTES**

by Robert P. Achenbach, Jr.
case in August 1990. However, the court held that the 1989 taxes were not dischargeable because the IRS did not have sufficient time to attempt to collect the taxes after the assessment, in May 1990, and before the filing of the first bankruptcy case and between the time of dismissal of the first case, in October 1994, and the filing of the current case in January 1995. In re Morgan, 255 B.R. 247 (Bankr. N.D. Ga. 2000), on rem. from 182 F.3d 775 (11th Cir. 1999).

ENVIRONMENTAL LAW

CLEAN WATER ACT. Several cities selected an old sand and gravel pit area as a landfill. The EPA ruled that the cities needed a permit in order to fill in the ponds and water-filled trenches on the property, citing the migratory bird rule that any body of water used by migratory birds was included as navigable waters under the Clean Water Act (CWA). The U.S. Supreme Court held that the migratory bird rule was not authorized by the CWA and the ponds and trenches were not navigable waters governed by the CWA. The Digest will publish an article by Roger A. McEowen on this case in a future issue. Solid Waste Agency, Inc. v. United States Army Corps of Engineers, No. 99-1178, 2001 U.S. LEXIS 640 (Jan. 9, 2001), rev’d, 191 F.3d 845 (7th Cir. 1999), aff’d, 998 F. Supp. 946 (N.D. Ill. 1998).

FEDERAL AGRICULTURAL PROGRAMS

FEEDLOTS. The EPA has published proposed regulations amending the National Pollutant Discharge Elimination System (NPDES) provisions that define which operations are concentrated animal feeding operations (CAFOs) and establish permit requirements, and the Effluent Limitations Guidelines for feedlots (beef, dairy, swine and poultry subcategories), which establish the technology-based effluent discharge standards for CAFOs The proposed regulations would add more restrictions on large animal feedlot operations in order to decrease the air and water pollution possible from these operations. The draft regulations would (1) expand the permit process to include smaller feedlots currently exempted from permit regulation; (2) place more controls on discharge of waste from lagoons and on to fields and (3) hold corporations responsible for waste disposal on contract farms. 66 Fed. Reg. 2959 (Jan. 12, 2001).

KARNAL BUNT. The APHIS has issued proposed regulation which amend the Karnal bunt regulations to provide compensation for certain growers, handlers, seed companies, owners of grain storage facilities, flour millers, and participants in the National Karnal Bunt Survey who incurred losses and expenses because of Karnal bunt in the 1999-2000 crop season. 66 Fed. Reg. 3505 (Jan. 16, 2001).

PERISHABLE AGRICULTURAL COMMODITIES ACT. The debtor was a corporation which operated a chain of restaurants. The debtor had received, but not paid for, produce from a produce supplier. The supplier sought to have some of the debtor’s assets declared to be part of the PACA trust from which the supplier’s claims should be paid. The debtor argued that PACA did not apply to the debtor because the debtor was not a dealer under the act. The statute, 7 U.S.C. § 499e(b)(6), defined a dealer as a person in the business of buying or selling wholesale or jobbing quantities of perishable agricultural commodities. The regulations, 7 C.F.R. § 46.2(x), defined “wholesale or jobbing quantities” as at least one ton of aggregate commodities in any one day. The debtor often received more than one ton of commodities in any given day. The court, however, declared the terms “wholesale or jobbing quantities” as ambiguous and found a statement of the USDA in the legislative history that the USDA did not consider restaurants to be dealers unless they purchased commodities for other entities. The lower courts held that the debtor, as a restaurant, was not intended by the law, as interpreted by the USDA, to be a dealer under PACA; therefore, no PACA trust existed to satisfy the claim of the supplier. The appellate court reversed, holding that the statutory definition of “wholesale or jobbing quantities” was not ambiguous; therefore, because the debtor purchased more than $230,000 in commodities per year and more than one ton in a single day, the debtor was a dealer under PACA. In re Old Fashioned Enterprises, Inc., No. 00-1745, (8th Cir. Jan. 5, 2001), rev’g, 245 B.R. 639 (D. Neb. 2000).

STORAGE FACILITIES. The CCC has adopted as final regulations implementing a farm storage facility loan program to provide financing for producers to build or upgrade farm storage and handling facilities. Specific eligibility requirements for applicants are a satisfactory credit rating as determined by CCC; no delinquent federal debt as defined by the Debt Collection Improvement Act of 1996; production of facility loan commodities; proof of crop insurance from FCIC or a private company; compliance with USDA provisions for highly erodible land and wetlands; ability to repay the debt resulting from the program; compliance with any applicable local zoning, land use and building codes for the applicable farm storage facility structures; and need for new or additional farm grain storage or handling capacity. 66 Fed. Reg. 4607 (Jan. 18, 2001), adding 7 C.F.R. Part 1436.

FEDERAL ESTATE AND GIFT TAX

ESTATE PROPERTY. The decedent owned a 390 acre ranch in which the decedent had conveyed title to a daughter. In the state court probate proceedings for the estate, the daughter sought to quiet title to the ranch and ranch equipment in her. The state court ruled that the ranch and equipment was not owned by the daughter but were held in a constructive trust for the estate. The state court specifically ruled that the daughter did not provide any consideration for the transfer of title and that the decedent did not intend to give the ranch to the daughter. The state court also ruled that the ranch and equipment were not owned by the estate. Estate of Chemodurow v. Comm’r, T.C. Memo. 2001-14.

MARITAL DEDUCTION. The decedent’s will provided for property passing in trust to the surviving spouse. The trust provided for an annuity for the life of the spouse with the remainder passing to the decedent’s children. The spouse filed a
petition in the state probate court to receive the surviving spouse’s elective share. The estate and spouse settled before trial and the spouse received a lump-sum payment in satisfaction of the elective share claim. The estate claimed a marital deduction for the settlement amount. The court held that a settlement amount was deductible by the estate only if the right to estate property was deductible. The court reasoned that the surviving spouse’s interest in the estate was either the annuity, a nondeductible terminable interest, or an annuity as part of the satisfaction of the elective share amount. Because the annuity was not eligible for the marital deduction, the settlement amount in lieu of the annuity was not deductible. The portion of the resulting settlement amount which exceeded the annuity was deductible. Although the estate cited Treas. Reg. § 20.2056(c)-2 and Waldrup v. United States, 499 F. Supp. 820 (N.D. Miss. 1980), the court based its holding on the argument that allowing a settlement to change the deductible nature of property received from an estate would create a loophole that would circumvent the estate tax. Davies v. United States, 2001-1 U.S. Tax Cas. (CCH) ¶ 60,391 (D. Me. 2000).

VALUATION. A C corporation had three shareholders and one class of stock, voting common stock with par value of one dollar per share. The bylaws governing the stock were adopted prior to October 9, 1990. The corporation amended the bylaws to recapitalize the stock by issuing nonvoting common stock which was issued as a dividend to the shareholders. The only difference between the stocks was the right to vote; however, the nonvoting and voting stock had the right to vote in certain major corporate decisions. The IRS ruled that the creation of the second class of stock did not result in more than a de minimis change of the bylaws under Treas. Reg. § 25.2703-1(c), and did not subject the stock to I.R.C. § 2703. Ltr. Rul. 200103038, Oct. 20, 2000.

FEDERAL INCOME TAXATION

ALTERNATIVE MINIMUM TAX. In a Chief Counsel Advice letter, the IRS has ruled that a taxpayer who uses the standard deduction in computing taxable income for regular income tax purposes may not use itemized deductions when computing alternative minimum taxable income for alternative minimum tax purposes. At issue was the provision in I.R.C. § 56(b)(1)(F) which states that the I.R.C. § 68 limitation on itemized deductions did not apply for AMT purposes. The IRS ruled that this provision did not provide authority that itemized deductions could be taken for AMT purposes when the standard deduction was taken for regular taxable income purposes. CCA Ltr. Rul. 2000103073, Dec. 15, 2000.

C CORPORATIONS-ALM § 7.02[3].*

DEDUCTIONS. The taxpayer corporation was owned by one shareholder. The shareholder and wife both worked for the corporation for several years. The shareholder and wife divorced but the wife continued to work for the corporation until their relationship interfered with the office operations. The corporation entered into an agreement with the wife to pay her a full salary for life with inflation adjustments and the taxpayer claimed the payments as a business expense. The court found that the agreement had no business purpose but was intended to resolve and meet the husband’s property and alimony obligations from the divorce; therefore, the corporation was not entitled to deduct payments for the husband’s personal obligations. WSB Liquidating Corp. v. Comm’r, T.C. Memo. 2001-9.

DEFINITION. The IRS has issued proposed regulations governing the income tax treatment of an election, the “check-the-box” election, by an association to be treated as a partnership or to be disregarded as an entity separate from its owner. The proposed regulations provide that an elective conversion of an association to a partnership is deemed to have the following form: the association distributes all of its assets and liabilities to its shareholders in liquidation of the association, and immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership. The proposed regulations also provide that an elective conversion of an association to an entity that is disregarded as an entity separate from its owner is deemed to have the following form: the association distributes all of its assets and liabilities to its single owner in liquidation of the association. 66 Fed. Reg. 3959 (Jan. 17, 2001).

DISTRIBUTIONS OF STOCK. The IRS has withdrawn proposed regulations 64 Fed. Reg. 46155 (Aug. 24, 1999), relating to recognition of gain on certain distributions of stock or securities of a controlled corporation in connection with an acquisition. The proposed regulations will be reissued. Ann. 2001-11, I.R.B. 2001-

EMPLOYEE STOCK OPTION PLAN. The taxpayer corporation maintained an ESOP funded with the taxpayer’s stock. Under the ESOP, if the taxpayer pays a dividend on the stock, the plan allocates the dividends (1) to each participant’s account, (2) to cash payments to the participants or (3) to repay loans to the participants from the plan. When participants terminate employment, the taxpayer distributes cash in exchange for the participant’s stock in the plan. The taxpayer argued that the payment of cash was an “applicable dividend” under I.R.C. § 404(k) and was deductible by the taxpayer. The IRS ruled that the distribution payments were not dividends and were not deductible by the taxpayer corporation. Rev. Rul. 2001-6, I.R.B. 2001-

COURT AWARDS AND SETTLEMENTS-ALM § 4.02[14]. The U.S. Supreme Court has denied certiorari in the following case. The taxpayers had filed a lawsuit in tort and contract against their employer for wrongful termination of employment and had received a jury award for compensatory and punitive damages. The taxpayers had agreed to pay their attorneys on a contingency fee basis and a portion of the award was paid to the attorneys. As in Coady v. Comm’r, 2000-1 U.S. Tax Cas. (CCH) ¶ 50,528 (9th Cir. 2000) (Alaska attorney fee lien), the court looked at the nature of the attorney’s lien created by statute in California and held that the lien did not create a sufficient property interest in the jury award to exclude the fees from the taxpayers’ income. See Harl, “Handling Legal Fees in Settlements,” 11 Agric. L. Dig. 129 (2000). Benci-Woodward v. Comm’r, 219 F.3d 941 (9th Cir. 2000).

DISASTER PAYMENTS. On January 12, 2001, the president determined that certain areas in Louisiana were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of severe ice storms and flooding beginning on December 11, 2000. FEMA-1357-DR. Accordingly, a taxpayer who sustained a loss attributable to the disaster may deduct the loss on his or her 1999 federal income tax return.

* Agricultural Law Manual (ALM).
**EARNED INCOME CREDIT.** The taxpayers were not married but lived in the same household with three children. The taxpayers filed separately. The male taxpayer had a larger modified adjusted gross income than the female taxpayer. One child was the child of both taxpayers and two children were the children of the female taxpayer. The male taxpayer listed the shared child in claiming the earned income credit and the female taxpayer listed the other two children in claiming the earned income credit. The IRS disallowed the female taxpayer’s earned income credit and notified the taxpayers that the male taxpayer was the only person eligible for the earned income credit and that all three children had to be listed on his return for purposes of the earned income credit. The court found that the statute, I.R.C. § 32(c)(1)(C) had been amended to include all eligible children on the return of the taxpayer with the highest modified adjusted gross income, whether or not they were identified on that taxpayer’s return; therefore, because the female taxpayer’s children were qualified children, as foster children, of the male taxpayer, they had to be included in calculating his earned income credit, even though they were not listed on his return. **Sutherland v. Comm’r,** T.C. Memo. 2001-8.

**EXCHANGES.** The IRS has issued a revised revenue procedure which provides for an election that will facilitate the substitution of some or all of the debt instruments from two or more outstanding issues of debt with debt instruments from a new issue. The new debt and the old debt must be publicly traded. Under the election, taxpayers can treat a substitution of debt instruments, in certain circumstances, as a realization event for federal income tax purposes even though it does not result in a significant modification under Treas. Reg. § 1.1001-3 (and, therefore, is not an exchange for purposes of Treas. Reg. § 1.1001-1(a)). Under this revenue procedure, taxpayers do not recognize any realized gain or loss on the date of the substitution. Instead, the gain or loss generally is taken into account as income or deductions over the term of the new debt instruments. **Rev. Proc. 2001-21, I.R.B. 2001-___.**

**HEDGES.** The IRS has issued proposed regulations which revise the hedging regulations to reflect changes made by the Ticket to Work and Work Incentives Improvement Act of 1999. **66 Fed. Reg. 4738 (Jan. 18, 2001), amending Treas. Reg. § 1.1221-2.**

**IRA.** The taxpayers, husband and wife, filed a joint return for 1997. The husband was employed but the employer did not provide any employee pension plan. The wife was also employed in 1997 and her employer provided an employee pension plan. However, the wife’s interest in the pension plan was not vested because the plan provided for vesting only after five years of employment. The husband contributed $2000 to an IRA and claimed the contribution as a deduction from gross income on the joint return which claimed adjusted gross income in excess of $50,000. The court held that the taxpayers were not entitled to the $2,000 deduction because the wife was enrolled in a qualified pension plan, even though the wife’s interest was not yet vested. Note, after 1997, the adjusted gross income amount limit for married taxpayers has been increased to $150,000. The case is reported as a Tax Court Summary opinion which is not reviewable by another court and cannot be used as precedent. See I.R.C. § 7463. **Brandkamp v. Comm’r,** T.C. Summary Op. 2001-5.

**PARTNERSHIPS-ALM § 7.03.**

**ADMINISTRATIVE ADJUSTMENTS.** The taxpayer had been a partner in a partnership which dissolved. The IRS audited the partnership’s final return as to discharge of indebtedness income. The partnership had not designated a tax matters partner; therefore, the IRS chose one partner as the TMP. That partner signed two extensions for tax assessments. The IRS eventually issued a Final Partnership Administrative Adjustment (FPAA) which assessed discharge of indebtedness income against the partnership. The taxpayer did not receive notice of the audit, TMP designation or FPAA and challenged the final assessment as time barred because of the failure to give notice of these proceedings. The Tax Court held that it did not have jurisdiction over this claim because the issues involved partnership level proceedings and this case was brought by the individual taxpayer. **Overstreet v. Comm’r,** T.C. Memo. 2001-13.

The taxpayer was a partner in a partnership and filed for bankruptcy. The taxpayer did not elect to end the taxpayer’s tax year on the date of the petition but the partnership split the taxpayer’s distributive share of partnership net operating losses between the taxpayer, for the part of the year prior to the filing for bankruptcy, and the bankruptcy estate, for that part of the year post-petition. The IRS disallowed the taxpayer’s share of the partnership NOLs, arguing that the NOLs were properly reported only by the bankruptcy estate. The taxpayer argued that the matter had to be handled in a partnership level proceeding. The court held that, because the partner and bankruptcy estate were essentially the same partner, the determination of the allocation of the NOLs was a partner-level matter which did not need a TEFRA administrative proceeding at the partnership level. The court also held that the taxpayer’s share of partnership NOLs was allocated entirely to the bankruptcy estate because the NOLs were considered distributed at the end of the partnership tax year which occurred after the filing of the bankruptcy petition. **Katz v. Comm’r,** 116 T.C. No. 2 (2001).

**TERMINATION.** A partnership terminates for tax purposes under I.R.C. § 708(b)(1)(B) as a result of the sale or exchange of 50 percent or more of the total interest in partnership capital and profits within a 12-month period. The regulations under Section 708(b) were modified in 1997 to provide that following the termination of a partnership, the terminated partnership is deemed to contribute all its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and, immediately thereafter, the terminated partnership distributes interests in the new partnership to the purchasing partner and the other remaining partners in proportion to their respective interests in the terminated partnership in liquidation of the terminated partnership. The IRS has stated that when a partnership terminates under I.R.C. § 708(b)(1)(B) and continues as a new partnership, the terminated partnership must file a short year final tax return for its taxable year beginning after the date of termination of the terminated partnership. The new partnership is required to file a return for its taxable year beginning after the date of termination of the terminated partnership. **Notice 2001-5, I.R.B. 2001-___.**

**PASSIVE ACTIVITY LOSSES.** The taxpayer was CEO and shareholder in a C corporation which provided physician networks for insurance companies. The taxpayer sold the stock and formed an LLC which provided networks of physicians who provided alternative medical care, also for insurance companies. The LLC was formed in November of 1994. The taxpayer treated the taxpayer’s share of LLC 1994 net operating losses as ordinary losses but the IRS argued that the losses were passive activity losses because the taxpayer had limited liability in the LLC. **Treas. Reg. § 1.469-5T(a) provides seven tests for**
If, at the end of the year following the year of the employee's death there is more than one designated beneficiary and the account or benefit has not been divided into separate accounts or shares for each of them, the beneficiary with the shortest life expectancy would be the designated beneficiary. The determination of the designated beneficiary and the calculation of the beneficiary's life expectancy are generally contemporaneous with the commencement of the required distributions to the beneficiary. Prior beneficiary designations are irrelevant for distributions from individual accounts unless the employee takes advantage of a lifetime distribution period measured by the joint life expectancy of the employee and a surviving spouse more than 10 years younger than the employee.

For an employee with a designated beneficiary, the same rules apply for distributions after the employee's death regardless of whether the death occurred before or after the employee's required beginning date. For an employee who elects or defaults into recalculation of life expectancy and dies without a designated beneficiary, the requirement is eliminated that the employee's entire remaining account balance must be distributed in the year after death. Instead, a distribution period equal to the employee's remaining life expectancy recalculated immediately after death applies. The default rule is changed in the case of death before the employee's required beginning date for a nonspouse designated beneficiary from the five-year rule of I.R.C. § 401(a)(9)(B)(ii) to the life expectancy rule of I.R.C. § 401(a)(9)(B)(iii). Prop. Treas. Reg. § 1.401(a)(9)-3, Q&A 1. Absent a plan provision or election of the five year rule, the life expectancy rule applies in all cases in which the employee has a designated beneficiary.

The designated beneficiary for determining the distribution period for annuity payments generally is the beneficiary as of the annuity starting date, even if that date is after the required beginning date. Prop. Treas. Reg. § 1.401(a)(9)-6. A beneficiary of a trust is allowed to be an employee's designated beneficiary for purposes of required minimum distributions when the trust is named as the beneficiary of a retirement plan or IRA if the requirements are met. Prop. Treas. Reg. § 1.401(a)(9)-4(c), Q&A 5. Documentation of the underlying trust beneficiaries must be provided in a timely manner to the plan administrator. Id.

A former spouse to whom all or a portion of the employee's benefit is payable pursuant to a QDRO is treated as a spouse, including a surviving spouse, of the employee for purposes of the minimum distribution incidental benefit. The proposed regulations clarify that the surviving spouse of a deceased IRA owner could elect to treat an inherited IRA as the spouse's own IRA. Except for the required minimum distribution for the year of the individual’s death, the spouse is permitted to roll over the post-death required minimum distribution for a year if the IRA rollover account is established in the spouse’s name as owner. If the surviving owner is age 70 1/2 or older, the minimum lifetime distribution would have to be made for the year and, as a required minimum distribution, the amount would be ineligible for rollover.

The proposed regulations are applicable for calendar years beginning on or after January 1, 2002. For 2001, taxpayers may rely on the new or old regulations. 66 Fed. Reg. 3954 (January 17, 2001).

RETURNS. The IRS has published a revised Publication 51, Circular A, Agricultural Employer’s Tax Guide. This document is available at no charge (1) by calling the IRS's toll-free
SALE OF LEASED LAND. The defendants leased farm land under a lease which terminated in December 1996. The lease permitted the defendants to harvest, in the summer of 1997, a winter wheat crop planted in the fall of 1996. The landlord had granted a security interest in the farm which was foreclosed after the landlord defaulted on the underlying loan. The farm was sold at a foreclosure sale to the plaintiffs who were not aware of the lease. The defendants harvested the winter wheat and the plaintiffs sought recovery of the crop. The court held that the foreclosure sale terminated the lease because the plaintiffs were not aware of the lease when they purchased the farm. The defendants, however, were allowed to receive so much of the crop as would compensate them for the planting, cultivating and harvesting the crop. Elrick v. Merrill, 10 P.3d 689 (Colo. Ct. App. 2000).

SAFEGUARD HARBOR INTEREST RATES February 2001

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TAX SHELTERS. The taxpayer, a professor of international marketing and an owner of several businesses, invested in a partnership which developed and operated jojoba farms. The taxpayer claimed tax losses more than double the initial investment in the first tax year and additional losses in following years. The losses were disallowed because the partnership was held to be a sham tax shelter. The issues in this case were whether the taxpayer was liable for the negligence component of the accuracy-related penalty and whether the IRS should have waived the understatement of tax component of the accuracy-related penalty. The court ruled that the taxpayer had sufficient business acumen that it was unreasonable for the taxpayer to not have sought expert tax advice before claiming substantial and accelerated tax losses more than double the initial investment. The taxpayer also failed to provide any substantial authority for their claim of losses. Harvey v. Comm’r, T.C. Memo. 2001-16; Hunt v. Comm’r, T.C. Memo. 2001-15.

WITHHOLDING TAXES. The taxpayer’s employer withheld FICA and income tax from the taxpayer’s wages during 1992 but did not pay that amount to the IRS. The taxpayer was assessed the taxes plus interest and penalties and filed for a refund. The court held that the taxpayer was entitled to credit for the amounts withheld but not paid and was entitled to the refund of the taxes, interest and penalties paid. Winter v. United States, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,182 (S.D. Tex. 2000), aff’d, 2000-2 U.S. Tax Cas. ¶ 50,780 (Magis. D. Tex. 2000).

LANDLORD AND TENANT

SALE OF LEASED LAND. The defendants leased farm land under a lease which terminated in December 1996. The lease

SECURED TRANSACTIONS

CONSERVATION RESERVE PROGRAM. The debtor had granted a creditor a security interest in all “contracts, and all other general intangibles, including but not limited to Government Diversion, Deficiency, & CRP payments.” The debtor argued that the CRP payments for a portion of the debtor’s farm were not covered by the security interest because the CRP payments were rent. The court held that the CRP payments were accounts or contracts rights and not rent because none of the usual indicia for a landlord/tenant relationship were involved. The case did not discuss why the specific mention of CRP payments in the security agreement and financing statement was not sufficient to create a security interest in the CRP payments. In re Isenbart, 255 B.R. 62 (Bankr. D. Kan. 2000).

COOPERATIVE RETAIN CERTIFICATES. The debtor was a member of a cooperative and owned capital retain certificates in the cooperative. The certificates were restricted as to redemption in that the cooperative board of directors determined when the certificates would be paid to the members. The cooperative bylaws also prohibited granting a security interest in the certificates without prior permission of the cooperative board of directors. The debtor had granted a security interest in the debtor’s accounts, chattel paper, general intangibles and farm products and equipment. Under New Mexico law, N.M. Stat. § 55-9-318(4), an account debtor may not prohibit by contract the granting of a security interest in a general intangible for money due or become due. The court held that the cooperative was an account debtor and that the capital retain certificates were general intangibles; therefore, the prohibition in the bylaws against granting security interests in the certificates was void and the security interest attached to the certificates. In re Van Tol, 255 B.R. 57 (Bankr. 10th Cir. 2000).

CITATION UPDATES

Benci-Woodward v. Comm’r, 219 F.3d 941 (9th Cir. 2000) (court awards and settlements) see p. 117 supra.

The Agricultural Law Press presents

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by Neil E. Harl and Roger A. McEowen

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DEPRECIATING THE RESIDENCE
— by Neil E. Harl*

Since enactment of the Tax Reform Act of 1986,¹ which enacted the Modified Accelerated Cost Recovery System (MACRS),² questions have been raised about the proper recovery period for farm and ranch residences; the portion of the residence used for business purposes, such as for an office in the home; and the recovery period for residences on a farm or ranch which are occupied by individuals not associated with the farm or ranch operation.¹ To date, no rulings have been issued or cases decided which would provide guidance as to recovery period beyond the general rules published in 1987.⁶

The general rule for farm “buildings”

Under the MACRS rules, farm buildings are depreciable over 20 years.² The category of 20-year property includes property with an ADR midpoint life of 25 years or more or other than depreciable real property with an ADR midpoint life of 27.5 years or more.⁶ Farm buildings have a 25-year midpoint life by virtue of Rev. Proc. 87-56⁷ so depreciable farm buildings are 20-year property.⁶ Property in the 20-year class may be depreciated under the 150 percent declining balance method over 20 years, switching to straight line, in accordance with a half-year convention.⁹ The term “building” is not defined in the statute although the term was defined for investment tax credit purposes (buildings were not eligible for investment tax credit) as follows—

“The term ‘building’ generally means any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, packing, display or sales space.”¹⁰

That definition would seem to embrace the farm residence, particularly in light of the reference to “shelter or housing”¹¹ although it would appear that the most likely classification for the farm or ranch residence is as “residential rental property.”¹²

Residential rental property

Depreciable residential rental property is depreciable over 27.5 years in accordance with a mid-month convention at a maximum of straight line depreciation.¹³ The term “residential rental property” is defined as “any building or structure if 80 percent or more of the gross rental income from such building or structure for the year is rental income from dwelling units….¹⁴” The term “dwelling units” is defined as “a house or an apartment used to provide living accommodations in a building or structure but

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* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
does not include a unit in a hotel, motel, inn or other establishment more than one-half of the units in which are used on a transient basis." In light of those two definitions, it would seem doubtful that an owner-occupied farm or ranch residence would be considered to be "residential rental property.”

However, the statute goes on to state that if any portion of a building or structure is occupied by the taxpayer, the gross rental income from the property includes the rental value of the portion so occupied. That provision coupled with the definitions of “residential rental property” and “dwelling units” would suggest that an owner-occupied farm or ranch residence would seem to be a 27.5-year property and a business use (assuming the eligible business use does not exceed 20 percent of the total residence) would be depreciable over 27.5 years, at a straight line rate with a mid-month convention.

An important issue is whether a tenant-occupied farm or ranch residence would be similarly classified where the tenant does not pay rental for the right of occupancy. Since the residence is not occupant-owned, the provision imputing the rental value of the portion so occupied as gross rental income from the property would not apply and the definition of “residential rental property” would seem not to apply because 80 percent or more of the gross rental income from the building or structure would not be gross rental income from the building or structure. It is noted that the Internal Revenue Service has ruled that occupancy of a dwelling by a tenant does not produce income for the tenant.

Therefore, if a farm or ranch residence occupied by a non-rent paying tenant is not “residential rental property,” as would appear to be the case, the property must either be “nonresidential real property,” a farm building or seven-year property (because it is not classified elsewhere). It would seem that status as a farm building (depreciable over 20-years) would be the most likely.

In conclusion

Additional guidance from the Internal Revenue Service would be helpful in resolving the question of the proper classification of the farm or ranch residence under various factual circumstances.

FOOTNOTES

6. Id.
8. Hart v. Comm’r, T.C. Memo. 1999-236 (tobacco barn was 20-year property; not eligible for expense method depreciation and not single purpose agricultural or horticultural structure).
10. Treas. Reg. § 1.48-1(e)(1), (2).
11. Id.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ADVERSE POSSESSION

FENCE. The disputed land was located on an island created by two forks of a river. When the parties' predecessors in interest owned the properties, the island was swamp land. The plaintiff's predecessor in interest constructed a fence on the bank of the southern fork of the river to prevent cattle from reaching the swamp land. When the plaintiff and defendant purchased their neighboring properties, the island had become dry land. The island was included in the plaintiff's title description but the plaintiff's predecessor did not use the land because it was too wet. The defendant was told that the fence was the true boundary between the properties but the plaintiff believed that the fence existed only because of its historical use. The defendant argued that the open possession and use of the disputed land for many years established title by adverse possession. The plaintiff argued that the fence was merely a fence of convenience and could not be the basis of title by adverse possession. The trial court had granted the defendant summary judgment on the issue but the appellate court reversed, holding that the plaintiff had provided enough evidence of the existence of the fence of convenience to require a trial on the issue. Hovendick v. Ruby, 10 P.3d 1119 (Wyo. 2000).
BANKRUPTCY

GENERAL-ALM § 13.03.*

EXEMPTIONS

PENSION PLAN. The debtor owned an interest in a simplified employee pension plan (SEP) provided by the debtor’s employer. The debtor claimed the interest as exempt under Ohio Rev. Code § 2329.66(A)(10)(c) as an individual retirement plan. The court held that the Ohio exemption was intended to apply only to individual retirement plans, such as IRAs, and not to pension plans provided by employers or that exceeded the restrictions on individual plans; therefore, the SEP was not eligible for the Ohio exemption. The court noted that another section, Ohio Rev. Code § 2329.66(A)(10)(b), provided for other pension plans but limited the exemption amount to that necessary for the support of the debtor. Because the debtor did not claim any right to that exemption, no holding was made under that exemption. In re Schreiner, 255 B.R. 545 (Bankr. S.D. Ohio 2000).

FEDERAL TAX-ALM § 13.03(7).*

CLAIM. The debtor filed for Chapter 7 on May 9, 1997 and did not elect to end the tax year on the day before the filing. The debtor timely filed and paid the 1997 taxes but filed a claim in the bankruptcy case for the 1997 taxes. The court held that the 1997 taxes could not be included as a claim because the debtor paid the taxes and the estate was not liable for the taxes because the debtor did not make the election to end the tax year under I.R.C. § 1398(d). In re McCready, 255 B.R. 834 (Bankr. M.D. Tenn. 1999).

DISCHARGE. The debtors filed for Chapter 7 in April 1996 and received a discharge of all dischargeable debts in November 1996. In March 1997, the IRS assessed the debtors for 1993 taxes, filed notices of tax liens and sought levy against the debtors’ social security payments. The debtors argued that the IRS actions violated the discharge injunction. The court held that the 1993 taxes were not dischargeable in the Chapter 7 case because the tax return was filed less than three years before the filing of the Chapter 7 petition and the taxes were still assessable during the case because the automatic stay tolled the assessment period. In re Khoe, 255 B.R. 581 (E.D. Cal. 2000).

SETOFF. The debtor filed for Chapter 7 on May 19, 1998 and the debtor owed taxes from 1993. The case was considered a no asset case so no tax claim was filed by the IRS. The debtor filed and paid 1997 taxes in August 1998, claiming a refund. The debtor was granted a discharge, including the 1993 taxes, in September 1998. The IRS accepted the 1997 tax return but applied the refund to the 1993 taxes. The debtor sought to reopen the Chapter 7 case and listed the tax refund as exempt property. The debtor argued that the tax refund, as exempt property, was not subject to the IRS’s right of setoff. The issue was whether Section 522, excluding exempt property from liability for pre-petition debts, or Section 553, allowing setoff of pre-petition debts, controlled where a setoff involved exempt property. The court acknowledged a split of decisions on this issue and held that Section 553 had precedence over Section 522, although the court did not explain the reason for this decision. Therefore, the IRS setoff of the refund against the discharged pre-petition taxes was allowed. The basic reasoning is that, because Section 553 lists several exceptions to the setoff rule and does not include Section 522, the Congress did not intend Section 522 to be an exception to the right of setoff. United States v. Luongo, 255 B.R. 424 (N.D. Tex. 2000).

CONTRACTS

BREACH. The plaintiff was a potato processor and purchased potatoes from the defendant over several contracts. The first three contracts were fully delivered by the defendant but the plaintiff failed to make timely payment on any of the contracts and failed to fully pay for the third contract at the time delivery began under the fourth contract. The defendant started to make deliveries under the fourth contract but stopped when the plaintiff refused to make the delinquent payments on the third contract and to make timely payments on the potatoes delivered so far under the fourth contract. At this time, there was still sufficient time remaining under the contract for the defendant to timely deliver the remaining potatoes if the plaintiff had made timely payment for the potatoes already delivered. The plaintiff purchased potatoes from third parties to cover the remaining potatoes on the fourth contract and sued the defendant for breach of contract. The plaintiff argued that the defendant waived the timely payment requirement by accepting late payments on the first two contracts and continuing to deliver potatoes when past shipments were still not paid for. The court held that no waiver occurred in that the plaintiff provided no evidence of detrimental reliance on the waiver. The court also held that, even if a waiver occurred, the amount of delinquent payments had become so large that it justified stopping deliveries until more payments were made. The plaintiff also argued that it was justified in repudiating the contract and seeking cover once the defendant refused to make further deliveries. The court held that the plaintiff was not justified in repudiating the contract because the plaintiff failed to seek assurance of delivery before repudiation. The court also held that, under Idaho Code § 28-2-609(1), the plaintiff could not justifiably repudiate the contract while delinquent in payment. Magic Valley Foods v. Sun Valley Potatoes, 10 P.3d 734 (Idaho 2000).

COMMERCIAL REASONABLENESS OF RESALE OF GOODS. The defendant had agreed to purchase popcorn from the plaintiff when the popcorn was still growing. The popcorn became contaminated with corn smut on the surface of the stored corn. The parties discussed the situation for several months after which the defendant rejected the popcorn. The plaintiff then attempted to resell the popcorn by sending samples of the popcorn to various buyers. The samples were taken from the worst part of the stored crop. The plaintiff received some offers at half of the original contract price and gave the defendant an option to purchase the popcorn at the highest bid price. The defendant refused
and the plaintiff sold the popcorn to another buyer. The plaintiff then sued for the difference between the contract price and the actual price at which the popcorn was sold. The plaintiff argued that the defendant failed to timely reject the popcorn and the defendant countered that the plaintiff did not resell the popcorn in a commercially reasonable manner. The court held that the plaintiff followed standard commercial practice in taking bids and in sending samples of popcorn in the worst condition. The evidence demonstrated that popcorn buyers generally want to see the poorest quality sample in making a bid. The court upheld the jury instruction for timely rejection, holding that the determination of reasonableness of the time and manner of rejection is a fact issue for the jury. Smith v. Paoli Popcorn Co., 618 N.W.2d 452 (Neb. 2000). See also 587 N.W.2d 660 (Neb. 1999).

**THIRD PARTY BENEFICIARY.** The plaintiff ordered two grain dryer systems from a third party which ordered the dryers from the defendant manufacturer. The plaintiff alleged that the dryers were defective and sued the seller and manufacturer. The plaintiff settled with the seller and sought damages in this case from the manufacturer. The plaintiff argued that it was a third party beneficiary of the contract between the seller and the manufacturer based upon two elements: (1) the seller specifically entered into the contract in order to provide the dryers for the plaintiff and (2) the manufacturer required the plaintiff to pay for the dryers by a check made out jointly to the seller and manufacturer. The court held that, under Oklahoma law, these facts were insufficient to impose third party beneficiary rights on the plaintiff as to the contract between the seller and the manufacturer. Midwest Grain Products v. Productization, Inc., 228 F.3d 784 (7th Cir. 2000).

**FEDERAL AGRICULTURAL PROGRAMS**

**ANIMAL WELFARE ACT.** The defendant was charged with violation of 7 U.S.C. § 2156 for serving as a referee at a dog fight. The defendant argued that Section 2156 did not apply because the dogs were not transported in interstate commerce, (2) Congress did not have the authority under the Commerce Clause to make the defendant’s conduct criminal, and (3) the statute violates the Tenth Amendment to the U.S. Constitution in that it regulates an area reserved to the states. The court upheld the jury instruction for timely rejection, holding that the determination of reasonableness of the time and manner of rejection is a fact issue for the jury. Smith v. Paoli Popcorn Co., 618 N.W.2d 452 (Neb. 2000). See also 587 N.W.2d 660 (Neb. 1999).

**CROP INSURANCE.** The plaintiff obtained a multi-peril crop insurance policy from the defendant which was reinsured by the FCIC. The plaintiff filed a claim for a crop loss but the defendant denied the claim. The plaintiff brought an action in a state court and the defendant removed the case to the federal court. The plaintiff sought remand back to the state court for lack of a federal question or other federal jurisdictional requirement. The defendant argued that the Federal Crop Insurance Act (FCIA) preempted all state court actions. The court examined the FCIA and found that the act provided for exclusive jurisdiction in the federal courts only for actions brought against the FCIC or USDA under the FCIA, even for actions involving denial of claims by reinsurers. Therefore, the court held that the FCIA did not completely preempt state court actions against reinsurers under the FCIA. The court examined the legislative history of the FCIA and noted that the original bill of the 1994 amendments had included exclusive jurisdiction for actions against reinsurers but that provision was omitted from the final statute. The court noted that the District Court for the Southern District of Texas held to the contrary in Brown v. Crop Haul Management, Inc., 813 F. Supp. 519 (S.D. Tex. 1993) although the District Court for the Eastern District of Texas held no preemption in Bullard v. Southwest Crop Ins. Agency, Inc., 984 F. Supp 531 (E. D. Tex. 1997). The court also held that jurisdiction could not be based on a federal question solely from the need to interpret federal regulations and statutes in the case. Halfmann v. USAG Ins. Services, Inc., 118 F. Supp.2d 714 (N.D. Tex. 2000).


**FEDERAL ESTATE AND GIFT TAX**

**APPEALS.** The administrator of a decedent’s estate attempted to file a petition with the Tax Court involving a notice of estate tax deficiency. The petition was sent by private delivery service on the 87th day after the deficiency notice was received, three days before the 90 limitation period expired. The petition was sent on a Friday by overnight delivery but was erroneously marked “hold Saturday.” The delivery service held the petition at one of its offices without informing the Tax Court that the package was being held for pickup. The package was held for 12 days and returned to the administrator. The administrator immediately placed the petition in a new envelope and resent the petition to the Tax Court with an explanation for the delay. The Tax Court held that the second mailing would not invalidate the first mailing if the first mailing was properly sent and the first mailing was not improperly addressed because the administrator incorrectly marked the package as “hold Saturday.” The Tax Court held that the administrator...
had submitted the package with sufficient postage, a correct address and sufficient time to be delivered on time to the Tax Court and that the delays were not caused by the administrator’s failure to properly send the package; therefore, the petition was held to have been timely filed. 

**Estate of Cranor v. Comm'r, T.C. Memo. 2001-27.**

**MARITAL DEDUCTION.** The decedent and surviving spouse owned a house as tenants by the entirety. The property had an outstanding mortgage on the decedent’s date of death and the decedent and surviving spouse were jointly and severally liable for the loan. The house passed to the surviving spouse. Under state law, upon the death of the decedent the decedent’s estate became jointly and severally liable for the loan with the spouse. Therefore, the IRS ruled that (1) one-half of the fair market value of the house was included in the decedent’s estate, (2) the estate could deduct one-half of the loan balance, and (3) the marital deduction equaled the value of the house included in the estate less one-half of the outstanding balance on the loan. *Ltr. Rul. 200104008, Oct. 17, 2000.*

**POWER OF APPOINTMENT.** The decedent and predeceased spouse had established an inter vivos trust, under which at the death of the predeceased spouse, the decedent became the sole trustee and income beneficiary. The trust provided that the decedent as trustee had the power to distribute trust corpus for the decedent’s “happiness, health, support and maintenance.” The IRS argued that the term “happiness” created a general power of appointment in the decedent; therefore, the trust corpus was included in the decedent’s estate. The estate argued that an ascertainable standard existed under Kansas law which governed the decedent’s distribution of corpus. Both sides based their arguments on *United States v. Powell, 307 F.2d 821 (1962)* which interpreted the term “happiness” under Kansas law. The estate argued that happiness was a sufficient ascertainable standard unless the trust contained language which expanded the meaning of the term. The IRS argued that the *Powell* court held that the term “happiness” was insufficient unless the trust provided language which limited the meaning of “happiness” to produce an ascertainable standard. The court agreed with the IRS and held that, because the trust here did not have any limiting language, the decedent had a general power of appointment over the trust corpus sufficient to include the trust corpus in the decedent’s estate. The estate argued that the trust had limiting language in that (1) happiness was tied to health, support and maintenance, (2) the trust provided for remainder beneficiaries, and (3) the trust had a spendthrift clause. The court held that these provisions did not place any limitation on the “happiness” provision sufficient to hold the decedent to an ascertainable standard in distributing trust corpus. *Forsee v. United States, 76 F. Supp.2d 1135 (D. Kan. 1999).*

**TRUSTS.** The taxpayers, husband and wife owned a photography business for which the husband was the sole employee. The taxpayers established an asset management trust and transferred all their assets to the trust. The trust also established several sub-trusts, including a charitable trust, a vehicle trust and a business trust. None of the trusts operated any business or investments and the taxpayers, as trustees, maintained the same control over the assets as before the transfers. The taxpayers funneled all their income through the trusts and deducted their personal expenses from the trust income. The court held that the trusts were shams and that income from the taxpayers’ business was taxable to the taxpayers. The court also disallowed the deductions claimed for the expenses for establishing the trusts, for purchasing the trust kits and for management fees paid to the trust promoters. *Muhich v. Comm’r, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,199 (7th Cir. 2001).*

**VALUATION OF STOCK.** The taxpayers owned a holding company which owned the stock of a bank corporation. The taxpayers transferred blocks of stock to their children representing a 13 percent interest in the holding company. The court adopted the taxpayers’ expert’s valuation of the fair market value of the stock, using the net asset value basis method. The taxpayers’ expert applied the Quantitative Marketability Discount Model proposed by Z. Christopher Mercer in *Quantifying Marketability Discounts* for determining the minority interest and lack of marketability discount but the court rejected that method as unreliable. The court held that the fair market value of the stock would be discounted 40 percent for the minority interest and 40 percent for lack of marketability. *Janda v. Comm’r, T.C. Memo. 2001-24.*

The decedent was the major shareholder in a family corporation and was 92 years old when the family decided to change the decedent’s interest so as to protect the family ownership of the corporation. The decedent agreed to transfer all the stock to a trust for the decedent with remainders to family members. The stock was valued at $100 for gift tax purposes and gift tax returns were filed for the gifts of the remainder interests. The donees also agreed to pay any additional gift tax if the value of the gifts were increased by the IRS and to pay any additional estate tax if the gifts were included in the decedent’s estate. The IRS did increase the value of the gifts and the gifts were included in the decedent’s estate because the decedent died within three years after the gifts were made. The additional gift tax and estate tax liability of the donees reduced the value of the stock. The court held that the liability for the gift and estate taxes was too contingent to affect the value of the stock at the time the gifts were made. The court also noted that the gift and estate tax liability was illusory because the donees did not pay the additional taxes. *Armstrong v. United States, 2001-1 U.S. Tax Cas. (CCH) ¶ 60,392 (W.D. Va. 2001).*

**FEDERAL INCOME TAXATION**

**BUSINESS EXPENSES.** The taxpayer was the sole shareholder of a trucking business. The taxpayer claimed a business expense deduction for Christmas time gifts of gift certificates to business clients, gift nut baskets to employees and to business clients and $100 bonuses to employees. The
court held that the deduction for the gift certificates was limited, under I.R.C. § 274(d), to $25.00 each because the certificates were given to specific individuals and not to the general business entity for use as it determines. However, the court held that the gifts of nut baskets to employees were not limited to $25.00 because the baskets were not gifts, under I.R.C. § 274(d), since the baskets were not excludible from the employees’ income under I.R.C. § 102(c)(1). The court also held that the $100 bonuses were deductible as compensation. Leschke v. Comm’r, T.C. Memo. 2001-18.

DISCHARGE OF INDEBTEDNESS. The taxpayers operated a dairy farm and owed the FmHA (now FSA) on two mortgages but were unable to make the payments. The taxpayers applied for loan restructuring but were denied. However, the FmHA offered to allow the taxpayers to purchase the loan for the net recovery value (current value of the assets less costs of foreclosure) if they agreed to sign a recapture agreement for the remaining balance of the loans. Under the recapture agreement, the FmHA retained a mortgage on the farm property for 10 years, under which the FmHA retained the right to repayment of the lesser of the fair market value of the property or the remainder on the original loan if the taxpayers sold the property during the next 10 years. The remainder amount was fixed at the time of the agreement and did not increase with interest. The taxpayers argued that no discharge of indebtedness occurred upon the purchase of the mortgage at the net recovery value because the taxpayers remained obligated on the remainder amount. The court characterized the repurchase agreement as a replacement obligation and held that the recapture agreement was too contingent to function as a replacement for the original debt, in that the taxpayers had control over whether the obligation would ever arise, no interest was charged and no date was set on which the obligation would be due. Therefore, the court held that, upon the purchase of the original loan at the net recovery value, the taxpayers had discharge of indebtedness income equal to the difference between the total loan balance less the amount paid to purchase the loan. Note: This was not a case involving a shared appreciation agreement which requires payment of a portion of all appreciation during the term of the agreement whether or not the property is sold. The Digest will publish an article by Neil Harl on this case in a later issue. Jelle v. Comm’r, 116 T.C. No. 6 (2001).

DISASTER PAYMENTS. On January 18, 2001, the president determined that certain areas in Vermont were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of severe storms and flooding on December 16, 2000. FEMA-1358-DR. On January 17, 2001, the President determined that certain areas in Indiana were eligible for assistance under the Act as a result of record snow beginning on December 10, 2000. FEMA-3163-EM. Accordingly, a taxpayer who sustained a loss attributable to the disasters may deduct the loss on his or her 1999 federal income tax return.

IRA. The taxpayer received distributions from an IRA included in the taxpayer’s father’s estate. The father’s will provided that the heirs would not be liable for any income or estate taxes from distributions from the estate. The taxpayer argued that the distributions were not included in gross income because the distributions represented nondeductible contributions made by the father. The court held that the distributions were included in gross income because the taxpayer did not present any evidence to prove that the father made any nondeductible contributions to the IRA. In addition, the court held that the will provisions did not control the liability for the taxes, at least as between the IRS and the taxpayer. This case is a Tax Court summary decision which cannot be cited as precedent. Spuler v. Comm’r, T.C. Sum. Op. 2001-8.

INSTALLMENT METHOD OF REPORTING. The taxpayer sold stock in another corporation. The purchaser paid in cash and a promissory note. The sales agreement required the purchaser to obtain a line of credit sufficient to pay the balance of the note but allowed the taxpayer to draw on the line of credit only if the purchaser defaulted on any installment payment. The IRS ruled that the line of credit did not represent a constructive receipt of the full purchase price in the year of sale because the taxpayer was not fully entitled to withdraw from the line of credit. Ltr. Rul. 200105061, Sept. 22, 2000.

RETURNS. The IRS has announced that the required use of revised Form W-9, Request for Taxpayer Identification Number and Certification (Rev. December, 2000), is optional until July 1, 2001. The major change appearing on the revised form is that a payee must certify that he or she is a U.S. person (including a U.S. resident alien). A foreign person may not use Form W-9 to furnish his or her taxpayer identification number to a payor after December 31, 2000. Rather, foreign payees must use the appropriate Form W-8. Ann. 2001-15, I.R.B. 2001-__.

The IRS has announced the release of Publication 547, revised December 2000. The publication explains the tax treatment of casualties, thefts and losses on deposits. This document is available at no charge (1) by calling the IRS’s toll-free telephone number, 1-800-829-3676; (2) via the internet at http://www.irs.gov/prod/cover.html; (3) through FedWorld; or (4) by directly accessing the Internal Revenue Information Services bulletin board at (703) 321-8020.

SALE OF RESIDENCE. The taxpayer’s former spouse had owned a house which was purchased prior to their marriage. During the marriage, the spouse retained title to the property, although the taxpayer paid the mortgage, insurance, taxes and maintenance expenses. The couple divorced and the divorce decree awarded the possession of the house to the spouse but required the house to be sold within eight years and the taxpayer to receive one-half of the net proceeds. The divorce decree stated that title was to remain in both parties’ names, although no transfer of title was ordered or accomplished. The taxpayer was also ordered to continue to make the payments for the mortgage, insurance and taxes on the house until it was sold. The IRS argued that the proceeds paid to the taxpayer were capital...
gains from the sale of a residence because the taxpayer had an ownership interest in the house, evidenced by the terms of the divorce decree. The court held that the taxpayer did not own an interest in the residence because no portion of the title was transferred to the taxpayer by the divorce decree. 


This letter ruling involves I.R.C. § 121 before amendment in 1997. The taxpayer owned a house which was transferred to a trust. The trust provided that the taxpayer could use the house as a residence or sell the house for replacement property. The trust also allowed the taxpayer to withdraw each year up to $5,000 or 5 percent of the aggregate market value of trust corpus. The withdrawal right was non-cumulative. The IRS ruled that the taxpayer was considered to be the owner of so much of the trust as the taxpayer has refused to withdraw each year. The ownership interest was not increased by the right to occupy or sell the house because the taxpayer could not transfer the house or proceeds to the taxpayer. Therefore, if the trust sold the house, that portion of the gain allocated to the taxpayer’s accumulated interest in the trust would be eligible for the Section 121 exclusion if the taxpayer was age 55 or older. 


Simplified Employee Plan. The taxpayer was a shareholder in an S corporation which provided consulting services. The other shares were owned by family members. They filed only one income tax return, in 1987. During the tax years involved in this case, the corporation did not file any returns and the taxpayer performed consulting services free for charitable organizations. The corporation maintained a SEP for the taxpayer and the taxpayer claimed deductions for contributions to the SEP in the tax years involved here. The taxpayer also claimed self-employed health insurance deductions. The court held that the taxpayer was not entitled to either deduction because the taxpayer was not self-employed during the tax years involved because the corporation did not have any income. This case is a Tax Court summary decision which cannot be cited as precedent. 


Tax Shelters. These cases involved taxpayers who invested in a partnership which developed and operated jojoba farms. The taxpayer claimed tax losses more than double the initial investment in the first tax year and additional losses in following years. The losses were disallowed because the partnership was held to be a sham tax shelter. The issues in this case were whether the taxpayer was liable for the negligence component of the accuracy-related penalty and whether the IRS should have waived the understatement of tax component of the accuracy-related penalty. The court ruled that the taxpayer had sufficient business acumen that it was unreasonable for the taxpayer to not have sought expert tax advice before claiming substantial and accelerated tax losses more than double the initial investment. The taxpayer also failed to provide any substantial authority for their claim of losses. 

Robnett v. Comm’r, T.C. Memo. 2001-17.
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“REVERSE STARKER” LIKE KIND EXCHANGES
— by Neil E. Harl* 

The 1979 decision of Starker v. United States 1 revolutionized the world of like-kind exchanges 2 by allowing the replacement property to be acquired months or even years after the disposition of the property disposed of in the exchange. 3 While the Congress later limited the Starker exchange approach by imposing limits on the identification of the replacement property (on or before 45 days after the date of transfer of the property given up in the exchange) 4 and on the time within which the replacement property must have been received (the earlier of 180 days after the date of transfer of the taxpayer’s property or the due date, including extensions, of the transferor’s tax return for the tax year in which the transfer occurred), 5 neither the Congress nor the Internal Revenue Service had officially addressed the possibility of a “reverse Starker” like-kind exchange 6 until publication of Rev. Proc. 2000-37 7 in September of 2000. So-called reverse-Starker exchanges commonly involve acquiring the replacement property before relinquishing the property to be disposed of in the exchange.

The reverse-Starker safe-harbor

In publishing Rev. Proc. 2000-37, 8 the Internal Revenue Service has issued guidelines for a “safe harbor” for reverse like-kind exchanges that involve “parking” the desired replacement property with an accommodation party until such time as the taxpayer arranges for the transfer of the relinquished property to the ultimate transferee in a simultaneous or deferred exchange. 9 Once such a transfer is arranged, the taxpayer transfers the relinquished property to the accommodation party in exchange for the replacement property and the accommodation party then transfers the relinquished property to the ultimate transferee. 10

The guidelines state that IRS will not challenge the transaction if the property is held in a “qualified exchange accommodation arrangement” (QEAA). 11 Property is considered to be held in a QEAA if all of the following requirements are met—

• Qualified indicia of ownership of the property is held by a person (the “exchange accommodation title holder or EAT”) who is not the taxpayer or a disqualified person and either the EAT is subject to income tax or if the EAT is a partnership or S corporation for tax purposes, more than 90 percent of its interests or stock are owned by partners or shareholders who are subject to income tax.

• At the time the qualified indicia of ownership of the property is transferred to the EAT, it is the taxpayer’s bona fide intent that the property represent either replacement property or relinquished property in an exchange that is intended to qualify for

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See the back page for details about the
2001 Agricultural Tax and Law Seminars
by Dr. Neil Harl and Prof. Roger McEowen
The plaintiff was injured while riding on a practice sled pulled by two horses used in pulling competitions. The plaintiff fell off the sled when the horses suddenly started to move after the sled had been halted. The plaintiff sued for negligence in the design and maintenance of the sled. The defendant argued that the defendant was not liable for the injury under the equine immunity statute, Wis. Stat. § 895.481 and the recreational immunity statute, Wis. Stat. § 895.52. Only the first statute was applied in this case. The defendant argued that (1) the equine immunity statute applied only to equine professionals and (2) that an exception applied because the equipment was defective. The court held that the statute did not limit its application to professionals. The court also held that the statute applied to the accident involved in this case because there is an inherent risk that horses will move suddenly and without warning. The court held that the claim of a defect in the design and maintenance of the sled did not bar non-recognition treatment.

1. No later than five business days after the transfer of qualified indicia of ownership of the property to the EAT, the taxpayer and the EAT enter into a QEA providing that the EAT is holding the property for the benefit of the taxpayer in order to facilitate a like-kind exchange and the taxpayer and the EAT agree to report the acquisition, holding and disposition of the property as provided in Rev. Proc. 2000-37.12

6. The revenue procedure15 states that property will not fail to be treated as held in a QEA as a result of legal or contractual arrangements enumerated in Rev. Proc. 2000-37.16 Also, property will not fail to be treated as being held in a QEA merely because the accounting, regulatory or state, local or foreign tax treatment of the arrangement between the taxpayer and the EAT is different from the treatment in Rev. Proc. 2000-37, § 4.02(3).17

Effective date
The procedure is effective for QEAAs entered into on or after September 15, 2000. There is, however, no inference intended for those entered into prior to that date.18

FOOTNOTES
2. I.R.C. § 1031.
3. Starker v. United States, 602 F.2d 1341 (9th Cir. 1979).
4. I.R.C. § 1031(a)(3)(A). See Smith v. Comm’r, T.C. Memo. 1997-109, aff’d, 97-2 U.S. Tax Cas. (CCH) ¶ 50,928 (4th Cir. 1997) (no proof that replacement properties identified within 45 days after sale dates); Dobrich v. Comm’r, 99-2 U.S. Tax Cas. (CCH) ¶ 50,826 (9th Cir. 1999) (failure to identify replacement property within 45 days; also, taxpayers in constructive receipt of income). I.R.C. § 1031(a)(3)(B); Treas. Reg. § 1.1031(k)-1(b)(2)(ii). See St. Laurent v. Comm’r, T.C. Memo. 1996-150 (replacement property transfer not completed within 180-day period; replacement property not like-kind); Christensen v. Comm’r, T.C. Memo. 1996-254, aff’d, 98-1 U.S. Tax Cas. (CCH) ¶ 50,352 (9th Cir. 1998) (transfers not completed within specified period; argument unsuccessful that four month extension of time to file could have been obtained).

The preamble to the final regulations on like-kind exchanges stated that the deferred exchange rules under I.R.C. § 1031(a)(3) do not apply to reverse-Starker exchanges (where the replacement property is acquired before the relinquished property is transferred) and that the final regulations do not apply to such exchanges. T.D. 8346, 1991-1 C.B. 150, 151. The preamble to the final regulations stated that the Department of the Treasury and the Internal Revenue Service would continue to study the applicability of the like-kind exchange rules to such transactions. Id.


I.R.B. 2000-40, 308 (allows accommodation party to be treated as owner of the property for tax purposes, enabling transactions to qualify as like-kind exchange).

I.D.

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The revenue procedure (Rev. Proc. 2000-37, I.R.B. 2000-40, 308) does not address why the safe harbor provisions do not state that the property must be received by the earlier of 180 days after the date of transfer of the taxpayer’s property or the due date, including extensions, of the transferor’s tax return for the tax year in which the transfer occurred. I.R.C. § 1031(a)(3)(B).


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%Agricultural Law Manual (ALM).
application of the statute because the plaintiff failed to allege how any defect in the sled caused the plaintiff to fall. Kangas v. Perry, 620 N.W.2d 429 (Wis. Ct. App. 2000).

**BANKRUPTCY**

**GENERAL-ALM § 13.03.**

**ABANDONED PROPERTY.** The debtor filed for chapter 7 and the estate included a parcel of real property. The property remained in the estate for 26 months before the trustee abandoned the property back to the debtor. The debtor sought to charge the estate with the real estate taxes which accrued on the property during the administration of the estate until the property was abandoned. The trustee argued that the estate should not be held liable for the taxes because the estate did not benefit from the property. The court held that the estate was liable for the real estate taxes because the debtor had no control over the property while it was in the estate. The court noted that the trustee had 26 months to determine whether the property was beneficial to the estate and could have abandoned the property and reduced the tax burden much earlier. The court also noted that the trustee provided no reason for the delay in abandoning the property. In re Mailman Steam Carpet Cleaning, Inc., 256 B.R. 240 (Bankr. D. Mass. 2000).

**DISCHARGE.** The debtor needed to purchase farm supplies on credit and filled out a credit application form provided by a supplier. The debtor understated the debtor’s liabilities and overstated the debtor’s assets on the form and failed to correct the amounts when the final loan documents were signed several days later. The loan was approved by a computerized scoring system, based entirely on the information on the loan application. The lender sought to have the loan balance declared nondischargeable under Section 523(a)(2)(B) as obtained with false information. The court held that (1) the asset and liability figures were materially false because the figures portrayed the debtor as having a positive net worth when the debtor had a negative net worth; (2) the lender reasonably relied on the figures because the application and the computerized scoring system were the regular method of making loan decisions; and (3) the debtor intended to deceive the lender because the debtor knew the figures were false and would be used by the lender to decide whether to make the loan. The court held that the loan balance was nondischargeable as obtained using false financial statements. In re Webb, 256 B.R. 292 (Bankr. E.D. Ark. 2000).

**EXEMPTIONS**

**HOMESTEAD.** The debtors, husband and wife, filed for Chapter 7 and claimed their residence as an exempt homestead under Iowa Code § 561.16. The residence was purchased in 1998 and the schedules showed that at least some of the outstanding debts were incurred prior to the purchase of the residence. The trustee objected to the homestead exemption because, under Iowa Code § 561.21, a homestead was subject to execution to the extent that the debtors’ debts were incurred prior to the purchase of the residence. The debtors argued that Section 522(c) preempted the Iowa exemptions to the homestead exemptions because Section 522(c) exempts property from debts which arose prior to the bankruptcy petition. The court noted that In re Weinstein, 164 F.3d 677 (1st Cir. 1999), cert. denied, 527 U.S. 1036 (1999), held that Section 522(c) preempted state law exceptions to exemptions, but the court declined to follow that decision and held that the debtors’ residence was not exempt from debts which arose prior to the debtors’ purchase of the residence. In re Norkus, 256 B.R. 298 (Bankr. S.D. Iowa 2000).

**FEDERAL TAX-ALM § 13.03[7].**

**DISCHARGE.** The debtors filed their 1992 tax return on October 15, 1993 without paying the taxes. The debtors made a few small payments on the taxes but then filed for Chapter 13 in May 1996. The 1992 taxes were included in the case and the case was voluntarily dismissed in March 1997 on the same day that the debtors filed for a new Chapter 7 case. The debtors argued that the 1992 taxes were dischargeable because they were filed more than three years before the Chapter 7 bankruptcy case. The court held that the three year period in Section 523(a)(1) was tolled during the Chapter 13 case; therefore, the taxes were nondischargeable. In re Young, 233 F.3d 56 (1st Cir. 2000).

**CORPORATIONS**

**DISSOLUTION.** The plaintiff owned one-third of the stock of a family farm corporation, with the other two thirds owned by the plaintiff’s brother and sister. The corporation’s certificate of incorporation included a provision that a supermajority vote of 75 percent of the shareholder interests was required for several actions by the corporation, including dissolution. The parties began to disagree on corporate management and the plaintiff sought a dissolution of the corporation by filing an action in state court. The corporation argued that the certificate of incorporation controlled to require a vote by 75 percent of the shareholder interests to dissolve the corporation. Under Oklahoma law, 18 Okla. Stat. § 1006(B), shareholders could agree to increase the votes needed for any corporate action. However, 18 Okla. Stat. § 953(D) permits a minority shareholder to bring an action for judicial dissolution of a corporation. The court found that the certificate of incorporation provision requiring the supermajority affected only actions of the corporation and did not affect the right of a minority shareholder to bring a judicial action for dissolution. Therefore, the court held that the plaintiff was not barred by the certificate of incorporation from bringing an action for dissolution. Sutter v. Sutter Ranch Corp., 14 P.3d 58 (Okla. 2000).

**FEDERAL AGRICULTURAL PROGRAMS**

**ANNOUNCEMENT**

A one-day conference, “Fixing the Fair Act,” will be held at the National Press Club, Washington, D.C. on March 27, 2001. The conference is sponsored by Schnittker & Associates and the Iowa State University Center for International Agricultural Finance (Neil E. Harl is the Center Director). This is an opportunity to interact with some of the leading thinkers on the various dimensions of farm policy. Complete information may be obtained from John Schnittker, 1637 Calzada Avenue, Santa Ynez, California 93460, Tel. 805-686-5260 or via e-mail at jasjad@silcom.com.
produce. The Administrative Law Judge ruled that the plaintiff did violate PACA and recommended the revocation of the plaintiff’s PACA license. The ALJ presented an oral decision and stated that the decision would be final in 35 days after service of the opinion unless an appeal was filed. A written opinion was filed later. The hearing clerk sent the written opinion to the plaintiff with a letter which stated that the plaintiff had 30 days after receipt of the opinion in which to appeal the decision. The plaintiff filed an appeal within 30 days after receiving the written opinion but more than 35 days after the oral opinion. The Judicial Officer refused to hear the appeal as untimely filed. The plaintiff argued that the USDA Rules of Practice, found at 7 C.F.R. §§ 1.142(c)(4), 1.145(a), were so inconsistent as to fail to provide adequate notice of the proper appeal time requirement. Section 1.142(c)(4) provided that an appeal must be filed within 35 days after issuance of an oral opinion. Section 1.145(a) provided that an appeal must be filed within 30 days after receipt of service of a judge’s opinion. The court noted that the regulations do not state that “issuance” of an opinion was equivalent to “receipt of service” of an opinion. The court held that the regulations were so inconsistent as to fail to provide adequate notice of the appeal time requirement and ordered the Judicial Officer to hear the appeal because the plaintiff did file an appeal within the time allotted by one of the regulations. **PMD Brokerage v. USDA, 234 F.3d 48 (D.C. Cir. 2000).**

**FEDERAL ESTATE AND GIFT TAX**

**LEGISLATION.** Legislation has been introduced which would increase to $10,000,000 the maximum estate tax deduction for family-owned business interests. **H.R. 585.** Legislation has also been introduced which would repeal the estate, gift and generation-skipping transfer taxes. The legislation would also repeal the step-up of basis of estate property received from a decedent. **S. 333.**

**MARITAL DEDUCTION.** The IRS has issued proposed regulations (see also infra under TRUSTS) governing the definition of trust income for purposes of QTIP. The proposed regulations provide that a spouse’s interest satisfies the income standard set forth in Treas. Reg. §§ 20.2056(b)-5(f), 25.2523(e)-1(f) if the spouse is entitled to income as defined under a state statute that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of Treas. Reg. § 1.643(b)-1(a). As the examples under Treas. Reg. § 1.643(b)-1(a) make clear, reasonable apportionment can be accomplished through a unitrust definition of income or by giving the trustee the power to make equitable adjustments between income and principal. **66 Fed. Reg. 10396 (Feb. 16, 2001), amending Treas. Reg. §§ 20.2056(b)-5(f), 20.2056(b)-7(d).**

The taxpayer was the surviving spouse of a decedent. The decedent’s will provided for passing of a portion of the estate in trust to the taxpayer. However, two trusts existed because the second trust did not terminate or supersede the first trust; therefore, a dispute arose among the taxpayer and other heirs as to which trust controlled. The parties reached a settlement which used the second trust as determining the property passing to the taxpayer but provided for distribution of the estate outside of the trusts. As part of the agreement, the taxpayer disclaimed a portion of the marital trust share and disclaimed any right to recover gift taxes which could arise from the disclaimers. The IRS ruled that the amount received by the taxpayer under the settlement was eligible for the marital deduction because the taxpayer’s interest in the original trusts was QTIP. The IRS also ruled that the taxpayer made a gift of the disclaimed interest in the marital trust and the gift taxes which the taxpayer could have recovered as a result of the disclaimer. **Ltr. Rul. 200106029, Nov. 13, 2000.**

**GENERATION SKIPPING TRANSFERS.** The IRS has issued proposed regulations which provide that the administration of a pre-September 25, 1985 trust in conformance with a state law that defines income as a unitrust amount, or permits equitable adjustments between income and principal to ensure impartiality, and that meets the requirements of Treas. Reg. § 1.643(b)-1(a) will not be treated as a modification that shifts a beneficial interest to a lower generation beneficiary, or increases the amount of a generation-skipping transfer, subjecting the trust to GSTT. See also infra under TRUSTS. **66 Fed. Reg. 10396 (Feb. 16, 2001), amending Treas. Reg. § 26.2601-1(b).**

**INCOME IN RESPECT OF DECEDE NT.** The decedent’s will bequeathed property to the surviving spouse which was QTIP. The decedent also had substantial income in respect of decedent and the issue was how to calculate the deduction for IRD, under I.R.C. § 691, while allowing for the marital deduction. The court held that the proper calculation of the deduction was first to calculate the estate tax on the entire amount (including therein the ordinary consideration of marital share), and then to recalculate the estate tax by removing the IRD from the taxable estate (including therein a recomputation of the marital share). The difference in estate tax was the Section 691 deduction. **Estate of Cherry v. United States, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,223 (W.D. Ky. 2001).**

**TRANSFERS WITH RETAINED INTERESTS-ALM § 5.02[3].** In 1951, the decedent and parent owned most of the stock of a family corporation. In order to meet the inheritance and control desires of the shareholders, the decedent and parent entered into an agreement for the transfer of the parent’s stock at death to the decedent in trust for life with remainder to the parent’s grandchildren. The decedent agreed to transfer the decedent’s stock by will to the same trusts. The IRS argued that, although the agreement was reached in bona fide bargaining and the decedent did provide some consideration for the agreement, the consideration was not full and adequate; therefore, the stock in the trusts was included in the decedent’s gross estate. The IRS argued that the consideration had to equal the value of the entire property transferred; whereas, the estate argued that the consideration only had to equal the value of the remainder interest transferred. The Tax Court held that the value of the decedent’s future contribution of stock was not sufficient consideration for the parent’s agreement to transfer stock to the trusts; therefore, the decedent’s interest in the trust was not received for adequate consideration. The Tax Court included the value of the stock in the trusts in the decedent’s gross estate, decreased by the value of the decedent’s stock contributed to the trusts. The appellate court reversed, holding that the property would not be included in the decedent’s estate if the decedent’s consideration equaled the value of the remainder interest.
transferred by the parent. The case was remanded for a determination of values. The appellate court also held that the valuation date was the date of the original agreement. On remand, the Tax Court held that the value of the life estate received by the decedent under the agreement was less than half the value of the remainder interest in the stock transferred to the decedent’s children; therefore, the decedent did not receive full and adequate consideration of the transfer of stock and the value of the stock was included in the decedent’s estate. Estate of Magnin v. Comm’r, T.C. Memo. 2001-31, on rem from, 184 F.3d 1074 (9th Cir. 1999), rev’d, T.C. Memo. 1996-25.

TRUSTS. The IRS has issued proposed regulations which amend the definition of income under Treas. Reg. § 1.643(b)-1 to take into account certain state statutory changes to the concepts of income and principal. Under the proposed regulations, trust provisions that depart fundamentally from traditional concepts of income and principal (that is, allocating ordinary income to income and capital gains to principal) will generally continue to be disregarded, as they are under the current regulations. However, amounts allocated between income and principal pursuant to applicable state law will be respected if state law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, taking into account ordinary income, capital gains, and, in some situations, unrealized appreciation. Similarly, a state law that permits the trustee to make equitable adjustments between income and principal to fulfill the trustee’s duty of impartiality between the income and remainder beneficiaries is a reasonable apportionment of the total return of the trust. In addition, the proposed regulations provide that an allocation of capital gains to income will be respected if directed by the terms of the governing instrument and applicable local law. Similarly, if a trustee, pursuant to a discretionary power granted to the trustee by local law or by the governing instrument (if not inconsistent with local law), allocates capital gains to income, the allocation will be respected, provided the power is exercised in a reasonable and consistent manner. The proposed changes to the regulations will permit trustees to implement a total return investment strategy and to follow the applicable state statutes designed to treat the income and remainder beneficiaries impartially. At the same time, the limitations imposed by the proposed regulations ensure that the provisions relying on the definition of income under I.R.C. § 643(b) are not undermined by an unlimited ability of the trustee to allocate between income and principal.

Under the proposed regulations, capital gains will be included in distributable net income under certain circumstances that are directed by the terms of the governing instrument and applicable local law. Thus, any capital gain that is included in the I.R.C. § 643(b) definition of income is included in distributable net income. Similarly, any capital gain that is used to determine the amount or the timing of a distribution to a beneficiary is included in distributable net income. Capital gains are also included in distributable net income if the fiduciary, pursuant to a discretionary power granted by local law or by the governing instrument (if not inconsistent with local law), treats the capital gains as distributed to a beneficiary, provided the power is exercised in a reasonable and consistent manner. Thus, if a trustee exercises a discretionary power by consistently treating any distribution in excess of ordinary income as being made from realized capital gains, any capital gain so distributed is included in distributable net income. 66 Fed. Reg. 10396 (Feb. 16, 2001), amending Treas. Reg. §§ 1.643(a)-3, 1.643(b)-1, 1.651(a)-2.

FEDERAL INCOME TAXATION

LEGISLATION. Legislation has been introduced which would treat payments under the Conservation Reserve Program as rentals from real estate. S. 315. Legislation has been introduced which would (1) increase the deduction for health insurance for self-employed persons to 100 percent, (2) exclude gain from the sale of farmland just as gain is excluded from the sale of a residence, (3) allow farmers to use the lesser tax produced by either income averaging or alternative minimum tax, and (4) allow a deduction for FARM accounts. S. 333.

BAD DEBTS. The taxpayer had made loans to the taxpayer’s father but the loans were not evidenced by written notes and had no stated interest or repayment schedule. The taxpayer also failed to show that any payments were made. The taxpayer claimed that the debt became worthless when the father’s business burned down; however, the taxpayer provided no evidence of the father’s net worth or other financial status in the tax year when the loan was claimed as a bad debt deduction. The court held that the deduction was not allowed because the taxpayer failed to show the existence of a bona fide debt or that the debt was worthless in the tax year of the claimed deduction. Flood v. Comm’r, T.C. Memo. 2001-39.

BUSINESS EXPENSES. The taxpayer operated a laundry business and claimed business deductions for travel, meals, entertainment, office, rent, utilities and automobile repair expenses. The deductions were disallowed, except to the extent allowed by the IRS, for lack of substantiation because the taxpayer did not have full and accurate records to distinguish the expenses from personal expenses. The taxpayer also claimed deductions associated with a home office. The deductions were disallowed because the taxpayer’s primary business location was at the laundry. Clark-Hernandez v. Comm’r, T.C. Summary Op. 2001015.

DISASTER PAYMENTS. On January 5, 2001, the President determined that certain areas in Oklahoma were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of a severe winter ice storm on December 25, 2000. FEMA-1355-DR. On January 8, 2001, the President determined that certain areas in Texas were eligible for assistance under the Act as a result of a severe winter ice storm beginning on December 12, 2000. FEMA-1356-DR. On January 10, 2001, the President determined that certain areas in Michigan were eligible for assistance under the Act as a result of a severe winter ice storm beginning on December 11, 2000. FEMA-1356-DR. On January 10, 2001, the President determined that certain areas in Florida were eligible for assistance under the Act as a result of severe freezing beginning on December 1, 2000. FEMA-1359-DR. Accordingly, a taxpayer who sustained a loss attributable to the disasters may deduct the loss on his or her 1999 federal income tax return.

IRA. The taxpayer established an IRA in 1976 and made only deductible contributions over several years. In 1997 when the taxpayer was 56 years old, the taxpayer encountered financial difficulties and withdrew $6,000 from the IRA. The taxpayer did not use the money for any of the purposes entitled to an exception under I.R.C. § 72(t)(2) but used the money for personal
expenses. The taxpayer argued that the withdrawal should not be included in gross income and should not be subject to the 10 percent additional tax because the money was withdrawn when the taxpayer was having financial difficulties. The court held that there was no financial difficulties exception under I.R.C. § 72(t); therefore, the taxpayer had to include the withdrawn money in income and pay an additional 10 percent tax on that amount. **Gallagher v. Comm’r, T.C. Memo. 2001-34.**

**INSTALLMENT METHOD OF REPORTING.** The IRS has announced that, consistent with the change in law effected by the Installment Tax Correction Act, an accrual method taxpayer that entered into an installment sale on or after December 17, 1999, and filed a federal income tax return by April 16, 2001, reporting the sale on an accrual method (and, thus, an amount realized equal to the selling price) has the consent of the Secretary to revoke its effective election out of the installment method, provided the taxpayer files, within the applicable period of limitations, amended federal income tax return(s) for the taxable year in which the installment sale occurred, and for any other affected taxable year, reporting the gain on the installment method. Thus, a taxpayer may not revoke its effective election out of the installment method if the taxable year in which any payment on the installment obligation was received has closed. **Notice 2001-22, I.R.B. 2001-___.**

**MILEAGE RATE.** The IRS has informed CCH that there will be no change in the standard mileage rate of 34.5 cents per mile for 2001. See **Rev. Proc. 2000-48, I.R.B. 2000-49, 570.** The announcement was in response to questions about the new administration’s review of regulations and letters from members of Congress suggesting that the increase in gas prices justified a larger mileage rate. See http://www.irs.ustreas.gov. **PARTNERSHIPS-ALM § 7.03**

**DEFINITION.** The decedent had farmed with the decedent’s brother in an oral partnership for several years. The decedent had been more active in the farm and, after disagreements between them arose, the decedent excluded the brother from the farm. Several years later, during the tax years involved in this case, the brother sued for dissolution of the partnership. A state court ruling found that a partnership existed but that the decedent’s capital account far exceeded the brother’s. The court ordered the 50 percent split of partnership income after repayment of the capital accounts. The partnership property was sold with all proceeds used to repay the decedent. The decedent’s estate owned S corporation stock by the LLC and limited partnership, both disregarded entities, therefore, the the taxpayer had to include the withdrawn money in income and should not be subject to the 10 percent additional tax because the money was withdrawn when the taxpayer was having financial difficulties. The court held that there was no financial difficulties exception under I.R.C. § 72(t); therefore, the taxpayer had to include the withdrawn money in income and pay an additional 10 percent tax on that amount. **Gallagher v. Comm’r, T.C. Memo. 2001-34.**

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**SAFE HARBOR INTEREST RATES**

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*Note: The CCH published Mid-term rates are identical to the February mid-term rates and may be in error. We will publish any correction in the next issue. Rev. Rul. 2001-12, I.R.B. 2001-___.

**SALE OF JOINTLY OWNED PROPERTY.** The taxpayer had been married and during that marriage, the taxpayer and former spouse had purchased as joint tenants a townhouse which was used as a rental property. The couple decided to sell the property and the property was sold at a gain. The sale proceeds were issued in a single check, although the taxpayer had requested separate checks because the couple were in the process of divorcing. The couple disagreed on how the proceeds were to be split and the taxpayer refused to endorse the check. The former spouse then deposited the check in an old joint checking account, used some of the proceeds to satisfy an old joint debt and slowing transferred the remainder to the spouse’s individual account. The divorce decree ordered the former spouse to pay the taxpayer the taxpayer’s one-half share of the proceeds. The taxpayer did not include the taxpayer’s share of the gain in income, arguing that the taxpayer did not receive the proceeds until the next tax year. The court held that the taxpayer was liable for one-half of the gain from the sale of the property because the taxpayer was entitled to one-half of the proceeds, even though the taxpayer failed to protect the taxpayer’s rights to the proceeds until the divorce decree. **Zimmerman v. Comm’r, T.C. Memo. 2001-37.**
SALE OF RESIDENCE. This case involved tax law in effect prior to amendments in 1997. On October 30, 1995, the taxpayers, husband and wife, sold their residence for $310,000. The taxpayers purchased a vacant lot on May 2, 1996 for $111,000 and, on July 7, 1997, entered into a contract to build a residence on the lot for a cost of $388,000. During the construction, the taxpayers lived on the lot in a mobile home set on concrete pillars. The new residence was completed on August 19, 1998 and the taxpayers moved in after October 30, 1998. The court held that the taxpayers were not allowed to rollover the gain from the sale of their first residence under I.R.C. § 1034 because the taxpayer failed to purchase a replacement residence of equal or greater value within two years after the sale of the first residence. The court noted that, even if the residence in the mobile home on the lot was considered a new residence, the cost of the lot and mobile home was less than the proceeds to the sale of the first residence and rollover of gain would still not be allowed. Swarthout v. Comm’r, T.C. Summary Op. 2001-16.

The taxpayer operated a trucking business and had purchased a residence in New Jersey. The taxpayer discovered that the taxpayer could earn sufficient annual income by driving the truck in the winter in Florida. The taxpayer purchased rental property in Florida and used an apartment while working in Florida. The taxpayer obtained a Florida driver’s license, a Florida registration for the truck and stopped paying New Jersey income tax. The New Jersey residence was still used in the spring and summer by the taxpayer as a residence. The New Jersey residence was sold in 1996 and the taxpayer permanently moved to Florida. The IRS argued that the taxpayer had changed residence to Florida prior to the sale of the residence and was not eligible for the exclusion of gain from the sale. The court held that the taxpayer had not abandoned the New Jersey residence and had lived there for at least 36 months of the five years before the sale; therefore, the taxpayer was eligible to the exclude the gain from the sale of the residence. Taylor v. Comm’r, T.C. Summary Op. 2001-17.

TAX RATE. The IRS has announced that it has issued Publication 533 which includes the adjusted 2001 tax-rate schedules for use in determining estimated taxes for 2001. The tax rates are lower than those included with the 2001 Form 1040-ES package. Taxpayers may use either set of tables for paying estimated taxes but must use Pub. 533 for all other purposes. See http://www.irs.ustreas.gov.

STATE TAXATION

USE TAXES. The plaintiff was a dairy cooperative which marketed the milk produced by its members. The Michigan Department of Treasury (the Department) assessed use taxes against the plaintiff’s machinery, equipment and supplies used to test the members’ milk as required by federal and state laws and regulations. The plaintiff argued that the property was exempt from use tax, under Mich. Stat. § 7.555(4)(f), as property used in agricultural production. The Department ruled that the agricultural production of milk ended when the milk was put into storage tanks. The Department argued that the testing was part of the marketing of the milk and not the production of the milk. The court held that the testing equipment, machinery and supplies were exempt from use tax because the testing of the milk was a part of the production process because the testing was required in order for the milk to be suitable for sale. The court also held that the exemption did not require that the plaintiff be directly involved with the milk production, only that the services provided by the plaintiff be a part of the milk production process. Milk Producers v. Treasury Department, 618 N.W.2d 917 (Mich. Ct. App. 2000).

The taxpayer was a producer, processor and marketer of fresh shell eggs and maintained a flock of over 1.3 million laying hens. The taxpayer purchased day-old chicks and raised them in brooder houses which contain an automatic feeding, watering and ventilation system. The system used cages which were similar to the cages used for the laying hens in order to decrease the stress when the chickens are transferred to the laying cages. The plaintiff sought an exemption from use tax under Or. Stat. § 307.400(5)(e) as equipment used for producing fresh shell eggs. The court held that the exemption was properly denied because the raising of the chickens was not directly related to the production of eggs. The court noted that other use tax exemptions allowed for other agricultural uses did not contain the “directly related” language in order to qualify for the exemption; therefore, the court held that the legislature wanted to limit the exemption only to equipment used in the egg laying process. Willamette Egg Farms, Inc. v. Department of Revenue, 14 P.3d 609 (Or. 2000).

WORKERS’ COMPENSATION

EMPLOYER. The plaintiff was injured while employed by a professional S corporation wholly-owned by an orthodontist. The plaintiff sought damages from the corporation for assault, battery, intentional infliction of emotional distress and negligence. The corporation argued that the plaintiff was limited to claim only workers’ compensation benefits as an employee of the individual orthodontist. The plaintiff argued that the actual employer was the corporation. The court held that an employer does not lose the protection of the workers’ compensation statute by using the corporate form of business organization; therefore, the plaintiff was limited to claims under the workers’ compensation statute. Gunderson v. Harrington, 619 N.W.2d 760 (Minn. Ct. App. 2000).

ZONING

AGRICULTURAL AREA. The county had adopted a comprehensive land use plan under the Washington Growth Management Act and designated 40,000 acres in three Agricultural Production Districts (ADPs) for exclusive agricultural use. The county needed land for soccer fields and other recreational use and amended the land use plan to provide for temporary use of the ADP land for recreational uses. The amendments specified that the land would revert to agricultural use if needed. The county argued that the GMA allowed exceptions to the ADP exclusive use requirement. The court acknowledged that the GMA did promote the recreational use of land, but the court held that the GMA required agricultural land to be held exclusively for agricultural use if the land was suitable for agriculture. The court noted that all of the land involved in this case was prime farm land; therefore, the ADP land could not be used for nonagricultural purposes. King County v. Central Puget Sound, 14 P.3d 133 (Wash. 2000).
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by Neil E. Harl and Roger A. McEowen

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“MIGRATORY BIRD RULE” SHOT DOWN

— by Roger A. McEowen*

In a major decision important to farmers and ranchers with isolated wet areas on their land or private ponds, the U.S. Supreme Court, in early January 2001, reversed the opinion of the Seventh Circuit Court of Appeals and held that the federal government’s assertion of jurisdiction over an intrastate wetland pursuant to the so-called “migratory bird rule” exceeded its authority under the Clean Water Act.1

Section 404 of the Clean Water Act

Section 404 of the Clean Water Act (CWA) makes illegal the discharging of dredge or fill material into the “navigable waters of the United States” without obtaining a permit from the Secretary of the Army acting through the Corps of Engineers (COE).  Until 1975, the Corps construed the term “navigable waters” to mean waters that were actually navigable. In accordance with regulations promulgated in 1975, the COE expanded its jurisdiction to “other waters” of the United States, including streams, wetlands, playa lakes, and natural ponds if the use, degradation or destruction of those areas could affect interstate commerce.2

A series of court decisions beginning in the mid-1970s also contributed to the COE’s increasing jurisdiction over wetlands.3 In 1983, the Fifth Circuit Court of Appeals held that the term “discharge” may reasonably be understood to include “redeposit” and concluded that the term “discharge” covered the redepositing of soil taken from wetlands such as occurs during mechanized land clearing activities.4 In 1987, the COE’s permit jurisdiction was held to extend to wetlands created by irrigation and flood control structures.5

Isolated and Nonadjacent Wetlands

Since 1975, the COE and the Environmental Protection Agency (EPA) have defined “waters of the United States” such that the agencies assert regulatory authority over isolated wetlands or wetlands not adjacent to “waters of the United States” if a link exists between the waterbody and interstate commerce.6 This interpretation has been upheld by the courts. For example, in 1979, the Seventh Circuit Court of Appeals held that COE jurisdiction exists over all waters, and adjacent wetlands within the COE’s constitutional reach under the Commerce Clause.7

The “Migratory Bird Rule”

In 1985, an EPA internal memorandum concluded that CWA jurisdiction could be extended to include isolated wetlands that were or could be used by migratory birds or endangered species.8 In 1986, the COE issued memoranda to its districts explaining that the use of waters by migratory birds could support the CWA’s jurisdiction.9 A 1992 case from the federal district court for North Dakota held that protection of waters utilized

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See the back page for details about the 2001 Agricultural Tax and Law Seminars

by Dr. Neil Harl and Prof. Roger McEowen

*   *   *   *   *

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primarily for bird and wildlife habitat was within the Congress’ intent as expressed in the CWA. In this case, the county had cleared a lengthy drainage ditch through a vast shallow water area that was frequented by tens of thousands of migratory waterfowl for feeding, resting and breeding. The area was also utilized by interstate travelers for recreation, hunting and bird watching. The court held that the isolated wetlands were jurisdictional waters under the CWA. However, also in 1992, the Seventh Circuit Court of Appeals held that the EPA’s regulatory definition of “other waters” whose destruction could adversely impact interstate commerce did not include isolated wetlands and was invalid. But, in a highly unusual move, the court granted the EPA’s petition for a rehearing, vacated its earlier decision and referred the case to a senior court attorney for settlement negotiations. The court was informed in early 1993 that a settlement could not be reached. In a final decision, the court held that isolated wetlands actually used by migratory birds presented a sufficient connection to interstate commerce to give the EPA and COE jurisdiction under the CWA. The court held likewise in a subsequent decision and the Supreme Court agreed to hear the case.

The Solid Waste Agency Case
In the case, the plaintiff was a consortium of suburban Chicago municipalities that selected for a 410-acre solid waste disposal site a 533-acre abandoned sand and gravel pit containing excavation trenches that had become permanent and seasonal ponds. The ponds and small lakes had become home to approximately 121 species of birds, including many endangered, water-dependent, and migratory birds. Because the proposal for the site required filling in some of the ponds, the plaintiff contacted the COE to determine if a landfill permit was required under Section 404 of the CWA. The COE, asserting jurisdiction under the “migratory bird rule,” refused to issue a permit in 1991 and 1994, citing a need to protect the habitat of the migratory birds. When the municipalities challenged the COE’s jurisdiction, the District Court granted the COE’s motion for summary judgment, and, on appeal, the Seventh Circuit held that the Congress had authority under the Commerce Clause to regulate intrastate waters and that the “migratory bird rule” was a reasonable interpretation of the CWA.

On January 9, 2001, in a 5-4 opinion, the Supreme Court reversed the Seventh Circuit and held that the “migratory bird rule” exceeded the authority granted to the COE under §404 of the CWA. Accordingly, the Court held that the COE did not have jurisdiction over ponds that are not adjacent to open water. Because the Court found the “migratory bird rule” invalid, it did not address the scope of the CWA’s jurisdiction under the commerce clause of the U.S. Constitution. The court stated that the “migratory bird rule” raised significant constitutional questions and would significantly impinge upon traditional states’ power over land and water use. Since, there was no clear congressional intent to do so, the court interpreted the act to avoid raising the constitutional and federalism issues created by the COE’s interpretation of its jurisdiction.

Impact of the Decision
The Supreme Court’s decision seems to indicate rather strongly that the COE does not have a legal basis under the CWA to regulate isolated waters that do not have a substantive connection to interstate commerce. While there is perhaps room remaining to argue over navigability, the opinion does appear to remove federal jurisdiction over private ponds and seasonal or ephemeral waters where the only connection with interstate commerce is migratory waterfowl. Indeed, in early March 2001, the EPA and COE eliminated their regulatory definition for isolated, solely intrastate water bodies.

It is also believed that the opinion will have a particularly significant impact on agricultural activities in the prairie pothole region of the Dakotas, and other areas that experience seasonal flooding.

**FOOTNOTES**

2. By the early 1990s, the term “waters of the United States” was defined to mean “all waters which are currently used or were used in the past, or may be susceptible to use in interstate or foreign commerce…” 33 C.F.R. §328.3(b).
3. See, e.g., United States v. Holland, 373 F. Supp. 665 (M.D. Fla. 1974) (CWA held to manifest clear intent to break from Rivers & Harbors Act limitations); United States v. Ashland Oil & Transportation Co., 504 F.2d 1317 (6th Cir. 1974) (CWA held to extend to any tributary of any navigable stream); Natural Resources Defense Council v. Calloway, 392 F. Supp. 685 (D. D.C. 1975) (CWA held to extend Section 404 permit jurisdiction to all waters of United States); United States v. TGR Corp., 171 F.3d 762 (2d Cir. 1999) (phrase “waters of the United States” broadly defined to include nonnavigable tributaries of navigable waterways, and includes everything from “intrastate lakes” to “prairie potholes”).
6. The CWA has also been held to apply to the discharge of fill material into wetlands that are connected to navigable waters only via groundwater. See, United States v. Banks, 115 F.3d 916 (11th Cir. 1997), cert. denied, 118 S. Ct. 852 (1998); Mutual Life Insurance Co. of New York v. Mobil Corp., No. 96-CV-1781, 1998 U.S. Dist. LEXIS 4513 (N.D. N.Y. Mar. 31, 1998) (term “navigable waters” included groundwater hydrologically connected to surface water such as wetland with discharge of pollutants therein requiring permit).
7. United States v. Byrd, 609 F.2d 1204 (7th Cir. 1979) (Corps has jurisdiction over wetlands adjacent to inland lakes if lakes visited by interstate travelers for recreational purposes).
11. Hoffman Homes, Inc., v. EPA, 961 F.2d 1310 (7th Cir. 1992) (only adjacent wetlands are within the CWA’s jurisdiction).
a tax liability secured by a tax lien. However, if the tax is not paid, the tax lien is not extinguished in the bankruptcy case, and if the debtor is later found to have sufficient assets subject to the lien, the IRS ruled that it has the authority to increase the debtor’s tax assessment without issuing a new assessment, because the Section 6404(c) abatement does not characterize the original assessment as improper, just financially unreasonable to collect. CC-2001-014.

**TAX LIEN.** The debtor failed to file or pay federal income taxes for several years and the IRS filed a tax lien for its estimation of the taxes owed. The debtor argued that the debtor was not subject to any federal tax because the debtor was a “natural sovereign individual” or “freeman.” The court held that the debtor, as a resident citizen of the United States was subject to federal income taxation; therefore, the assessed taxes were sufficient to support the tax lien. *In re Lesonik*, 256 B.R. 441 (Bankr. W.D. Pa. 2000).

**CONTRACTS**

**ARBTRATION CLAUSE.** The debtor was a farmer and had entered into several hedge-to-arrive contracts with a grain cooperative. The debtor defaulted on three of the contracts and the cooperative demanded damages from the debtor. The contracts contained provisions requiring arbitration before the National Grain & Feed Ass’n (NGFA). The debtor refused to submit to arbitration and the cooperative obtained a state court order forcing arbitration. In the arbitration proceeding the debtor claimed that the contracts were void as illegal off-exchange futures contracts. The arbitrators ruled that the contracts were valid cash forward contracts and awarded damages to the cooperative. The debtor filed for bankruptcy and the cooperative filed a claim for the damage award. In the bankruptcy case, the debtor attempted to attack the validity of the arbitration proceeding as biased because of the predominance of grain dealers on the arbitration panel. The court held that the debtor failed to provide sufficient evidence of bias in the arbitration process. The court also held that the arbitration award was due preclusive effect, barring the Bankruptcy Court from relitigating the validity of the contracts. *In re Robinson*, 256 B.R. 482 (Bankr. S.D. Ohio 2000).
FEDERAL AGRICULTURAL PROGRAMS

APPLES. The CCC has issued final regulations implementing the Apple Market Loss Assistance Payment Program. 66 Fed. Reg. 13839 (March 8, 2001).

FARM CREDIT SYSTEM. The U.S. Supreme Court held that banks that are part of the Farm Credit System are subject to state income taxation. The court stated that Congress was silent as to whether the banks were subject to state income tax and, accordingly, the banks were subject to state income tax. Director of Revenue of Missouri v. CoBank ACB, et al., No. 99-1792, 531 U.S. ____ (Feb. 20, 2001).

LIVESTOCK INDEMNITY PROGRAM. The CCC has issued proposed regulations implementing the livestock indemnity program for 2000 for losses due to disasters or wild fires in areas covered by a qualifying disaster declaration issued by the President or Secretary of Agriculture. For 2000, losses due to anthrax are also included. 66 Fed. Reg. 13681 (March 7, 2001).

LOAN DEFICIENCY PAYMENTS. The CCC has issued final regulations providing for grazing payments in lieu of LDPs for the 2001 crop year for acreage planted to wheat, barley or oats where the producer elects to use the acreage for grazing instead of harvest. 66 Fed. Reg. 13402 (March 6, 2001).

PERISHABLE AGRICULTURAL COMMODITIES ACT. The plaintiff was held to have violated PACA commercial bribery provisions for making payments to purchasing agents of several produce buyers. The court upheld the Judicial Officer’s use of a four part test for commercial bribery: (1) payment or offer of payment to a purchasing agent; (2) the payment or offer was intended to induce the purchasing agent to purchase produce; (3) the payment or offer was more than de minimis; and (4) the purchasing agent’s employer was not aware of the payment or offer of payment. The court held that there was sufficient evidence to support a finding of the commercial bribery provision of PACA and that the four part test was valid. The court noted that the test still allowed such permissible “benefits” to purchasing agents as dinners, promotional allowances and rebates so long as the purchasing agent’s employer is informed about the benefit. JSG Trading Corp. v. U.S.D.A., 235 F.3d 608 (D.C. Cir. 2001).

WOOL AND MOHAIR. The CCC has issued final regulations implementing the Wool and Mohair Market Loss Assistance Payment Program. 66 Fed. Reg. 13839 (March 8, 2001).

FEDERAL ESTATE AND GIFT TAX

DISCLAIMER. The taxpayer was the nephew of the decedent. The taxpayer held a contingent remainder interest in a trust established by the decedent prior to 1977, although the taxpayer did not learn about the interest until the death of another contingent remainder holder who had become the beneficial interest holder in the trust upon the death of the decedent. At the death of the other contingent remainder holder, a question arose as to whether the taxpayer received an interest in the trust as an heir of the decedent or by a power of appointment exercised by the other contingent interest holder. A settlement was reached which essentially acknowledged that the taxpayer received estate property as an heir of the decedent. The taxpayer then disclaimed a portion of the bequest within nine months after learning about the taxpayer’s contingent interest in the trust. The IRS ruled that the disclaimer was timely made. The IRS also held that the taxpayer’s efforts to enforce rights under the decedent’s trust was not considered an acceptance of the benefits of the interest in the trust. Ltr. Rul. 200109041, Dec. 4, 2000.

GIFTS. The decedent formed a partnership with the taxpayer’s son, with each transferring property to the partnership in exchange for a corresponding interest in the partnership. The decedent also formed a similar partnership with the decedent’s daughters. In each case, the decedent owned a substantial majority of the partnership. The decedent then transferred most of the decedent’s interest in the partnerships to the other partners. The decedent valued gifts of the transferred interests at a discount for lack of marketability, minority interests and built-in capital gains. The IRS argued that if the decedent transferred property to the partnership with a value greater than the partnership interest received in return, a gift must have occurred when the property was transferred to the partnership. The court held that, as in Strangi v. Comm’r, 115 T.C. 478 (2000), no gift occurred upon transfer of the property to the partnership. However, the value of the gift of the decedent’s interest in the partnerships to the other partners was the value of the underlying assets less a 40 percent discount for lack of marketability and lack of control. A discount of an additional eight percent was allowed for possible litigation over forced liquidation. No discount was allowed for the built-in capital gains. Estate of Jones v. Comm’r, 116 T.C. No. 11 (2001).

TAX BENEFIT RULE. The taxpayer established a trust for the taxpayer funded with an inheritance. The decedent’s estate was assessed a deficiency which included interest. The interest was paid by the trust which claimed the payment as a deduction on the trust return. Because the trust was a grantor trust, the interest deduction passed to the taxpayer. The IRS later refunded the entire interest payment assessed to the estate and the refund was passed on to the trust. The court held that, because the taxpayer received the tax benefit from the interest deduction, the return of the interest was included in the taxpayer’s taxable income. The appellate court affirmed in a decision designated as not for publication. Hornberger v. Comm’r, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,234 (4th Cir. 2001), aff’d, T.C. Memo. 2000-42.

TRUSTS. The IRS has issued proposed regulations under which qualified revocable trusts can elect to be treated as part of a decedent’s estate. The regulations replace the procedures established by Rev. Proc. 98-13, 1998-1 C.B. 370. 65 Fed. Reg. 79015 (Dec. 18, 2000). The IRS has announced that estates and qualifying revocable trusts of decedents who die after December 31, 1999, and before the effective date of the final I.R.C. § 645 regulations, may choose to use either the election and reporting procedures set forth in Rev. Proc. 98-13, or the election and

The taxpayer established a trust intended to qualify as a personal residence trust. The taxpayer transferred two parcels of property to the trust. The parcels were contiguous and were used as a personal vacation home. The property included a residence, garage, a one bedroom cabin, a tennis court and a Jacuzzi. The property was not used for commercial purposes and was not used by anyone but the taxpayer and family. A part-time maintenance worker lived in an apartment above the garage when working on the property. A conservation easement prohibited division of the property. The IRS ruled that the property was a personal residence under I.R.C. § 2702(a)(3)(A)(ii). Ltr. Rul. 200109017, Nov. 27, 2000.

The taxpayers, husband and wife, established a trust after attending a week-long seminar sponsored by a trust promoter. The taxpayers transferred their home, business and other assets to the trust, although their use of those assets did not change. The taxpayers used a professional tax return preparer but did not give the preparer all information about the trust. The IRS had ruled that the trust was to be disregarded, resulting in the taxpayers being personally liable for income tax, and that the taxpayers were liable for the penalty for the accuracy-related penalty for negligent disregard of the income tax rules and regulations. The taxpayers argued that they were not liable for the penalty because they relied on the professional advice of the income tax preparer. The court held that the taxpayers could not rely on the advice of the preparer because the taxpayers did not give the preparer all the information about the trust and because the taxpayers failed to provide any evidence of the preparer's expertise. Bowen v. Comm'r, T.C. Memo. 2001-47.

VALUATION. The decedent had won a state lottery and, at the decedent’s death was eligible for 18 annual installment payments of the prize. Although the estate acknowledged that the remaining prize payments were included in the decedent’s estate, the estate argued that the installments should be valued under a fair market test. The court held that the installments were an annuity for federal estate tax purposes and had to be valued using the actuarial tables of I.R.C. § 7520. The second part of the holding is contrary to the holding of Estate of Shackleford v. United States, 99-2 U.S. Tax Cas. (CCH) ¶ 60,356 (E.D. Cal. 1999). Estate of Gribauskas v. Comm’r, 116 T.C. No. 12 (2001).

FEDERAL INCOME TAXATION

BUSINESS EXPENSES. The taxpayer claimed deductions for depreciation, legal expenses, and business travel, entertainment and meal expenses. The taxpayer failed to provide full and accurate records of the expenses sufficient to demonstrate the business purpose for each expense; therefore, the court upheld the IRS determination of those deductions. Burris v. Comm’r, T.C. Memo. 2001-49.

COURT AWARDS AND SETTLEMENTS. The taxpayer sued an insurance company for fraud, conversion and breach of fiduciary duty. The petition made no claim for personal injury other than to claim that the taxpayer had suffered mental anguish. The parties reached a settlement with no allocation of the payment as to the various claims made in the suit. The court held that the settlement proceeds were included in the taxpayer’s income because none of the proceeds were for personal injury claims. Dickerson v. Comm’r, T.C. Memo. 2001-53.

The taxpayer sued a former employer for race discrimination in termination of employment. The suit asked only for back pay and attorneys’ fees as damages. The parties reached a settlement which characterized the payments as for personal injury to the taxpayer. The court held that the character of the settlement proceeds was determined by the pending claims made in the lawsuit; therefore, the settlement proceeds were for back pay and attorneys’ fees and were included in the taxpayer’s income. Banks v. Comm’r, T.C. Memo. 2001-48.

DEPRECIATION-ALM § 4.03[4]. The IRS has issued tables detailing the (1) limitations on depreciation deductions for owners of passenger automobiles first placed in service during calendar year 2001, including separate limitations on passenger automobiles designed to be propelled primarily by electricity and built by an original equipment manufacturer (electric automobiles); (2) the amounts to be included in income by lessees of passenger automobiles first leased during calendar year 2001, including separate inclusion amounts for electric automobiles; and (3) the maximum allowable value of employer-provided automobiles first made available to employees for personal use in calendar year 2001 for which the vehicle cents-per-mile valuation rule provided under Treas. Reg. § 1.61-21(e) may be applicable.

For automobiles (other than electric automobiles) placed in service in 2001 the depreciation limitations are as follows (the amounts are identical to 2000):

<table>
<thead>
<tr>
<th>Tax Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st tax year</td>
<td>$3,060</td>
</tr>
<tr>
<td>2d tax year</td>
<td>4,900</td>
</tr>
<tr>
<td>3d tax year</td>
<td>2,950</td>
</tr>
<tr>
<td>Each succeeding year</td>
<td>1,775</td>
</tr>
</tbody>
</table>

For electric automobiles placed in service in 2001 the depreciation limitations are as follows:

<table>
<thead>
<tr>
<th>Tax Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st tax year</td>
<td>$9,280</td>
</tr>
<tr>
<td>2d tax year</td>
<td>14,800</td>
</tr>
<tr>
<td>3d tax year</td>
<td>8,850</td>
</tr>
<tr>
<td>Each succeeding year</td>
<td>5,325</td>
</tr>
</tbody>
</table>


DISASTER PAYMENTS. The IRS has issued a list of areas which were declared by the President in 2000 to be adversely affected by disasters of sufficient severity and magnitude to warrant assistance by the Federal Government under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of natural disasters in 2000. Accordingly, a taxpayer who sustained a loss attributable to the disasters may deduct the loss on his or her 1999 federal income tax return. Rev. Rul. 2001-15, I.R.B. 2001-13.

On February 23, 2001, the President determined that certain areas in Mississippi were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of a severe storms and tornadoes on February 16, 2001. FEMA-1360-DR. On March 1, 2001, the President determined that certain areas in Washington were eligible for
assistance under the Act as a result of an earthquake on February 28, 2001. FEMA-1361-DR. Accordingly, a taxpayer who sustained a loss attributable to the disasters may deduct the loss on his or her 2000 federal income tax return.

**DISCHARGE OF INDEBTEDNESS.** The taxpayer was in the fishing business and purchased a fishing boat using a loan. The taxpayer defaulted on the loan and the boat was sold at a foreclosure sale. The proceeds of the sale were used to pay off most of the loan, with the remainder forgiven by the lender. At the time of the loan forgiveness, the taxpayer was solvent, with most of the taxpayer’s assets in a commercial fishing permit. The taxpayer did not include the discharge of indebtedness income from the loan forgiveness in income because of the insolvency exception of I.R.C. § 108(d)(3). The taxpayer argued that assets which would be exempt from the claims of creditors should not be included in calculating the taxpayer’s solvency. The taxpayer claimed that the fishing permit was exempt from creditors’ claims under Alaska law. The court held that all assets, exempt or not, were to be included in determining a taxpayer’s solvency for purposes of discharge of indebtedness income. The court stated that the exempt assets exclusion rule established by Cole v. Comm’r, 42 B.T.A. 1110 (1940) was eliminated by Congress by the enactment of I.R.C. § 108. An article by Neil Harl will appear in a future issue of the Digest Carlson v. Comm’r, 116 T.C. No. __ (2001).

The taxpayer had borrowed money from the FmHA (now FSA) for the taxpayer’s farming operation and had defaulted on the loans. The FmHA foreclosed against the security for the loans and, in 1990, forgave the remaining indebtedness, giving rise to $32,000 in discharge of indebtedness income. The taxpayer excluded that amount from income under the qualified farm indebtedness exception. The IRS argued that the discharge of indebtedness income was not qualified farm indebtedness because the taxpayer did not have more than 50 percent of income from farming for the three years prior to receiving the discharge of indebtedness income. The taxpayer failed to provide any direct evidence of the taxpayer’s farm and nonfarm income; therefore, the court held that the taxpayer was not eligible for the qualified farm indebtedness exception. Campbell v. Comm’r, T.C. Memo. 2001-51.

**EARNED INCOME CREDIT.** The taxpayer had claimed an earned income credit based on self-employment income. The court found that the taxpayer was not employed at a business and received money from the taxpayer’s parents for work done in the home. The court held that the taxpayer was not eligible for earned income credit because the taxpayer had no earned income. Akhter v. Comm’r, T.C. Summary Op. 2001-20.

The taxpayer was a prison inmate who worked for a private company on a work-release program and received wages for the work. The work was performed outside of the prison but the taxpayer was required to return to prison at the end of each work period. The court held that the taxpayer was barred by I.R.C. § 32(c)(2)(B)(iv) from eligibility for earned income credit while incarcerated. Tramble-Bey v. Comm’r, T.C. Summary Op. 2001-23.

**EMPLOYEE BENEFITS.** The taxpayer was a towboat captain and the taxpayer’s employer provided insurance plans for the taxpayer as an employee. The taxpayer made contributions to the insurance plan but not to the long-term disability coverage. The employer paid for the long-term disability coverage with funds which were not included in the taxpayer’s wage income; therefore, the taxpayer did not pay any tax on the employer’s contributions. The taxpayer suffered a work-related disability and received benefits under the long-term disability plan. The court held that the benefits were included in the taxpayer’s income. Duplantis v. Comm’r, T.C. Summary Op. 2001-24.

**ENVIRONMENTAL CLEANUP COSTS.** The taxpayer purchased commercial property which had been used as a dry cleaning business. The previous owners had allowed chemicals to be dumped on the land. The taxpayers continued to use the property for the same business but eventually closed the business and stored remaining chemicals and equipment on the property. The taxpayer was ordered to clean up the contaminated soil several years later. The IRS ruled that, because the land was contaminated when the taxpayer purchased the property, the clean up costs had to be capitalized. Ltr. Rul. 200108029, Nov. 24, 2000.

**FUEL CREDIT.** The taxpayer was a corporation which operated a crop chemical application business. The chemicals were applied using tractors pulling the applicators. The taxpayer filed a claim for a credit for federal tax paid on the fuel used in the tractors but did not obtain formal waivers from its customers. The taxpayer argued that it is entitled to the fuel credit because Form 4136, Credit for Federal Tax Paid on Fuels was properly filled out and none of the customers filed for the credit. The taxpayer also argued that the waivers were not required by the instructions to Form 4136. The court held that the controlling rule was found in Treas. Reg. § 48.6420-4(d)(2) which required the formal waivers; therefore, the taxpayer could not claim the credit without first obtaining the waivers from its customers. Crop Care Applicators, Inc. v. Comm’r, T.C. Summary Op. 2001-21.

**INTEREST RATE.** The IRS has announced that, for the period April 1, 2001 through June 30, 2001, the interest rate paid on tax overpayments is 8 percent (7 percent in the case of a corporation) and for underpayments at 8 percent. The interest rate for underpayments by large corporations is 10 percent. The overpayment rate for the portion of a corporate overpayment exceeding $10,000 is the federal 5.5 percent. Rev. Rul. 2001-16, I.R.B. 2001-__.

**INVESTMENT TAX CREDIT.** The taxpayers owned two corporations, one of which purchased buses which were leased to the other corporation. In 1985, when the ITC was still available, the first corporation purchased seven buses with useful lives of nine years. The buses were leased to the other corporation for 49 months. At the end of that lease, another lease was executed for another 19 months. The court held that the leases were to be aggregated to a total of 68 months, which was more than 50 percent of the useful life of the buses; therefore, the first corporation could not claim ITC for the buses. The second corporation was also barred from claiming the investment tax credit because it is entitled to the building credit because it is entitled to the building credit because the building was destroyed by a fire and the taxpayer received insurance proceeds. The lease on the second building had a provision which allowed the taxpayer to purchase the building and the taxpayer used the insurance proceeds plus

* Agricultural Law Manual (ALM).
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additional funds to purchase that building. The first hardware business was terminated but the second business continued in the purchased building. The IRS ruled that the investment of the insurance proceeds in the second building was in sufficiently similar property to qualify for Section 1033 nonrecognition of gain from the transactions. Ltr. Rul. 200109005, Nov. 20, 2000.

LIMITED LIABILITY COMPANIES. A corporation decided to convert to a limited liability company and made the election to be classified as an association taxable as a corporation for federal tax purposes. The IRS ruled that the conversion and election would not cause the LLC to be taxed as an entity other than a corporation. Ltr. Rul. 200109019, Nov. 29, 2000.

PASSIVE ACTIVITY LOSSES. The taxpayer was a shareholder in two professional corporations, both of which provided accounting services. The taxpayer was also a partner in a partnership which owned a commercial building which was leased to both the corporations which occupied distinct portions of the building. Both leases originated prior to 1988 and had automatic renewal clauses. However, the rent amount in each lease was substantially changed after 1988 and new lease contracts were executed. The court held that the change in the rent amount and execution of new contracts after 1988 subjected the partnership’s rent income to the Treas. Reg. § 1.469-2(l)(6) recharacterization rules. The IRS had determined that the two leases constituted one business activity and that the rental income was not passive activity income. The court upheld the IRS determination because the taxpayer failed to demonstrate that the leases were treated as separate business activities and that the partnership did not materially participate in the business. Kucera v. Comm’r, T.C. Summary Op. 2001-18.

PENSION PLANS. The IRS has issued a Supplement to Publication 575, Pension and Annuity Income and a Supplement to Publication 590, Individual Retirement Arrangements, which take into account proposed regulations and substantially simplify the calculation of minimum required distributions from qualified plans, individual retirement arrangements and other related retirement savings vehicles. Ann. 2001-23, I.R.B. 2001-10, 74.

S CORPORATIONS-ALM § 7.02[3][c].

BUSINESS EXPENSES. The taxpayer was the sole shareholder of an S corporation which through which the taxpayer operated a law practice. The taxpayer owned three motorboats which were leased to the corporation for use in entertaining clients. The taxpayer included the rent paid as income and deducted the associated expenses of operating the boats. The S corporation claimed deductions for the lease payments. The lease deductions were disallowed to the corporation because the boats were used for personal and business entertainment. The court held that the taxpayer could not also decrease the amount of rent included in taxable income because the payments came from a separate entity, the S corporation. Catalano v. Comm’r, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,233 (9th Cir. 2001), aff’d, T.C. Memo. 1998-447.

SHAREHOLDER BASIS. The taxpayers were shareholders of an S corporation who had claimed pass-through loss deductions. The shareholders claimed to have made capital contributions and loans to the corporation which increased their bases in their stock. The taxpayers evidence of capital contributions and loans was only a disorganized collection of checks and business records. The court noted that even if the checks were loans or contributions to the corporation, the taxpayers failed to provide any evidence that the loans were still outstanding at the end of the tax year or that the contributions had not been repaid; therefore, the IRS disallowance of the loss deduction was upheld. Guerrero v. Comm’r, T.C. Memo. 2001-44.

SALE OF RESIDENCE. The taxpayer had purchased a New Jersey residence in 1969 and lived there continuously until 1991 when the taxpayer began operating the taxpayer’s trucking business in Florida in the winter. The taxpayer maintained the original residence but also used an apartment in an investment property owned by the taxpayer in Florida during the winter. The taxpayer stopped working in New Jersey but returned to the residence each summer. The New Jersey residence was sold in 1996 and the taxpayer excluded the gain from income. The IRS argued that the taxpayer had abandoned the New Jersey home as a principal residence before the sale and was not eligible for the gain exclusion. The court held that the gain was excludible because the taxpayer had demonstrated that the New Jersey home was used as a residence for at least 36 months of the five years before the sale of the property. Taylor v. Comm’r, T.C. Summary Op. 2001-17.

THEFT LOSS. The taxpayer was a partnership which claimed a theft loss deduction for 1991 based upon a claim of conversion. The court denied the deduction because the taxpayer did not discover the loss until 1992 and the loss was not shown to be unrecoverable in 1991. The court noted that, in 1991, the taxpayer was still pursuing litigation against the persons who the taxpayer alleged committed the conversion. Venture Funding, Ltd. v. United States, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,240 (E.D. Mich. 2001).

TRESPASS

TIMBER The plaintiff owned 18 acres of undeveloped land. The defendant was hired by the neighboring land owner to harvest trees from the neighbor’s property; however, the defendant unintentionally removed trees from the plaintiff’s property. The plaintiff sought a jury instruction at trial that the amount of damages included loss for use of the land and for discomfort and annoyance to the land owner. The trial court refused both additions and the appellate court affirmed, holding that the instructions were not allowed because the plaintiff failed to provide any evidence of loss of use of the land or discomfort and annoyance to the plaintiff from the loss of the trees. The court also held that the plaintiff was not entitled to treble damages because the trespass was unintentional. Hartle v. Nelson, 15 P.3d 484 (Mont. 2000).

CITATION UPDATES

McNamara v. Comm’r, 236 F.3d 410 (8th Cir. 2000) (rent as self-employment income) see Harl article p. 9 supra.

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CAN COMMODITIES INITIALLY HELD FOR SALE LATER BE HELD FOR INVESTMENT?

— by Neil E. Harl

Frequently, the question is raised whether farm taxpayers who enter retirement with substantial amounts of commodities in storage can transform the commodities into capital assets held for investment.1 In general, the answer from IRS has been no, with the courts upholding the IRS position.2

IRS position

The regulations specify that a farmer on the cash method of accounting is to include in gross income “the amount of cash and the value of other merchandise or other property received during the taxable year from the sale of livestock and other produce which he raised.”3 The regulations do not acknowledge that a farmer could transform stored commodities into property held for investment.

In Rev. Rul. 80-19,4 a wheat farmer on the cash method of accounting placed a wheat crop under Commodity Credit Corporation (CCC) loan. The farmer had elected to treat CCC loan proceeds as income.5 The following year, the loan was repaid and the crop pledged as collateral was redeemed.6 Several months later, the redeemed crop was sold at a price in excess of the amount of the CCC loan (which gave the crop a basis).7

The ruling notes that property “held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business” is not a capital asset.8 The ruling then points out that the determination of whether property is held primarily for sale in the ordinary course of business is a factual matter that must be resolved on a case-by-case basis.9 The ruling takes the position that the election to treat CCC loan proceeds as income does not determine whether the redeemed crop is held as a capital asset in the hands of the taxpayer. Accordingly, the crop continued to be held primarily for sale in the ordinary course of business.10

Shumaker v. Commissioner

In the 1979 Tax Court case of Shumaker v. Commissioner,11 which was upheld on appeal to the Ninth Circuit Court of Appeals,12 the taxpayer was a wheat farmer in Washington State who retired and sold his land and machinery. The last crop before retirement was stored and sold the following year with the proceeds reported as long-term capital gain.

The Tax Court acknowledged that while “…it is perhaps theoretically possible for a wheat farmer to produce and hold wheat for investment, the quantum of proof which

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See the back page for details about the 2001 Agricultural Tax and Law Seminars by Dr. Neil Harl and Prof. Roger McEowen
need by [sic] adduced to prove such investment intent has
not been met here." The court added, “indeed, we can find
no credible evidence at all in the record which would justify
a finding…that petitioner held his stored wheat for
investment.” The court then noted that “…it is taxpayer’s
status when he earned the income, not when he received it,
that is determinative.” The court agreed that the taxpayer’s
status might have changed upon retirement but the character
of the income did not.

The case was affirmed on this point by the Ninth Circuit
Court of Appeals. The Ninth Circuit observed that the
taxpayer “…was not precluded from holding wheat as a
capital asset merely because he had been engaged in the
business of raising and selling it.” The Ninth Circuit then
proceeded to explain that “the determining factor is the
taxpayer’s purpose in holding the property.” The court
concluded that the taxpayer presented no evidence that he
intended to hold the wheat for investment; an intent to
discontinue the business does not convert stock in trade into
a capital asset.

Asmussen v. United States

Three years after the appellate decision in Shumaker v.
Commissioner, the case of Asmussen v. United States was
decided by the United States District Court in South
Dakota. The facts are similar to those outlined in Rev. Rul.
80-19.

In the Asmussen case, the taxpayers placed their 1971 rye
crop under CCC loan. The taxpayers had made the election
to treat the loan proceeds as income. The rye crop was
later redeemed and held three years before sale by the
taxpayers. The court noted that “because the rye was raised on the
plaintiff’s farm, without the CCC redemption, there could be
no capital gains treatment. The rye would properly be held
by the plaintiffs ‘primarily for sale to customers in the
ordinary course of [their] trade or business,’ and plaintiffs
would not be entitled to a refund despite the presence of
other facts indicative of investment intent.” The court then
proceeded to hold that “the taxpayers had a subjective intent
to treat the rye as an investment.” In support of that
conclusion, the court cited three factors—(1) the crop was
segregated from the taxpayer’s trade or business property
the crop was stored in 23 bins); (2) the difference between
the redemption price and the market price was slight at the
time of redemption; (3) the plaintiff’s accountant had
advised that capital gain treatment would be available on
later sale; and (4) the redemption and subsequent holding of
the crop were “isolated” transactions.

The court did not cite the case of Shumaker v.
Commissioner which had been decided more than three
years earlier.

In conclusion

Both the Shumaker court and the Asmussen court agree
that intent is the key factor in determining whether a crop
can be held for investment as a capital asset. Anyone
wanting to lay the foundation for capital gains treatment
needs to develop a factual basis supporting a showing of
intent to hold the crop for investment rather than for sale
to customers in the ordinary course of business.

FOOTNOTES

1 See generally 4 Harl, Agricultural Law § 27.02[2] (2000);
3 See notes 3-10 infra.
4 Treas. Reg. § 1.61-4(a)(1).
5 1980-1 C.B. 185.
6 I.R.C. § 77(a).
8 Id.
9 I.R.C. § 1721(a)(1).
10 Gamble v. Comm’r, 242 F.2d 586 (5th Cir. 1957).
12 T.C. Memo. 1979-71.
13 See Shumaker v. Comm’r, 648 F.2d 1198 (9th Cir.
15 Id.
16 Id.
17 Schumaker v. Comm’r, 648 F.2d 1198 (9th Cir. 1981).
18 Id.
19 Id.
20 Id.
21 648 F.2d 1198 (9th Cir. 1981).
24 Asmussen v. United States, 603 F. Supp. 60 (D. S.D.
1984).
25 Id.
26 Id.
27 648 F.2d 1198 (9th Cir. 1981).
28 See note 23 supra.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ANIMALS

DOGS. The plaintiff owned two dogs which wandered on
to the defendant’s property. The defendant had recently lost
some sheep to an animal attack and was watching the flock
the next night when the defendant saw the plaintiff’s dogs in
with the sheep. Although the defendant did not see the dogs
attack the sheep and the defendant was able to capture the
dogs easily, the defendant claimed that the dogs were
chasing the sheep. The defendant knew the dogs belonged to the plaintiff but did not attempt to contact the plaintiff. The defendant declined a sheriff’s offer to take the dogs to an animal shelter. Instead, the defendant visited two veterinarians over three hours in an attempt to euthanize the dogs. The second veterinarian agreed to euthanize the dogs but only after the defendant claimed that the dogs belonged to the defendant. The court noted that the defendant’s sheep were attacked again several nights later. The plaintiff sued for the loss of the dogs and the defendant cited Mo. Rev. Stat. § 273.030 as allowing the defendant to kill the dogs because they attacked the defendant’s sheep. The court held that the trial court had sufficient evidence to support the award for the plaintiff because the defendant failed to demonstrate that the dogs were chasing or attacking the sheep when they were killed. The court noted that the defendant was easily able to remove the dogs from the sheep area and control them. The court also upheld the trial court’s award of punitive damages for the defendant’s extreme efforts to have the dogs killed without any evidence that the dogs attacked the sheep and without any attempt to contact the dogs’ known owner. Propes v. Griffith, 25 S.W.3d 544 (Mo. Ct. App. 2000).

FEDERAL AGRICULTURAL PROGRAMS

CONSERVATION RESERVE PROGRAM. The CCC has issued proposed regulations amending the Conservation Reserve Program (CRP) regulations to provide, under certain conditions, for equitable relief to producers who violated their contract based on a good faith reliance on the action or advice of certain USDA representatives, or while attempting to comply with their contract. It will also provide that CRP contracts will not be terminated for failure to plant cover when that failure was due to excess rainfall or flooding. 66 Fed. Reg. 15048 (March 15, 2001).

CROP INSURANCE. The plaintiff had purchased federal crop insurance from the defendant and filed a claim for crop losses. The defendant denied the claim on the basis that the land involved had not been planted and harvested in any of the three years before the year of the claimed loss. The plaintiff filed suit for breach of contract, misrepresentation, suppression, bad faith, negligent and wanton distribution of information and negligent and wanton supervision of agents. The defendant argued that the claims were subject to mandatory arbitration under the insurance contract and preempted by the Federal Crop Insurance Act (FCIA). The court held that the arbitration provision was enforceable and binding on the plaintiff as to factual determinations such as whether the plaintiff had planted and harvested a crop in the three previous years on the land involved but that, once the arbitration decision was reached, the remaining claims could be reviewed by a court. The court held that only actions against the Risk Management Agency (formerly FCIC) or USDA were subject to the exclusive jurisdiction of the federal courts. Nobles v. Rural Community Ins. Services, 122 F. Supp.2d 1290 (M.D. Ala. 2000).


GENETICALLY MODIFIED ORGANISMS. The plaintiff granted a license to the defendant to sell genetically modified soybean seeds using the plaintiff’s technology and claimed that the license ended when the defendant was merged into a subsidiary of another company. The court agreed with the plaintiff and granted the plaintiff’s motion for summary judgment on the license termination issue. However, the court granted the defendant’s motion for summary judgment on the issue of damages, ruling that the plaintiff was not entitled to any damages for alleged breach of the license agreements. The defendant is expected to file an appeal on the license termination issue with the U.S. Court of Appeals for the Federal Circuit. Monsanto Co. v. Pioneer Hi-Bred International, Inc., No. 4:99CV1917-DJS (E.D. Mo. Mar. 20, 2001).

“MAD COW” DISEASE. In 1997, the FDA adopted 21 C.F.R. § 589.2000 which prohibited the feeding of protein derived from mammals to cattle and other ruminants. It is

BANKRUPTCY

CHAPTER 12-ALM § 13.03[8].*

Note: Chapter 12 authorizing law expired on June 30, 2000, although renewal legislation is pending.

MODIFICATION OF PLAN. The debtors had filed for a previous individual Chapter 12 case but were in default of the plan provisions for failure to make a scheduled plan payment and to pay real estate taxes on their property. The debtors filed a second Chapter 12 case as a partnership before the individual Chapter 12 case was dismissed. A creditor objected to the second filing as an attempt to modify the debtors’ obligations covered by the first plan. The court held that the second case was dismissed for cause because the debtors could not modify the first plan and could not use a second filing to circumvent the first plan. In re Harry & Larry Maronde Partnership, 256 B.R. 913 (Bankr. D. Neb. 2000).

FEDERAL TAX-ALM § 13.03[7].*

TAX LIEN. The debtor was an attorney and the estate included the law practice assets, including work in progress. The debtor purchased these assets from the bankruptcy estate. The IRS had filed a claim for unpaid taxes and argued that the law practice assets were subject to a tax lien filed pre-petition for the tax claim. The trustee argued that the lien did not attach to the work in progress because the value was too contingent. The court held that, under California law, the work in progress was a property interest of the debtor and was subject to the tax lien. In re Herreras, 257 B.R. 1 (C.D. Calif. 2000).
suspected that Bovine Spongiform Encephalopathy (‘‘Mad Cow’’ disease) can be spread by feeding protein from infected animals to other animals. Livestock packers, auctions and other cattle handlers are requiring producers to certify that their cattle have been fed in compliance with the regulations. With the seizure of a flock of sheep in Vermont believed to be infected with the disease, certification efforts are expected to increase and stricter regulatory compliance will be required from producers. A sample certificate of compliance provided by the Dunlop, Iowa, Livestock Auction follows:

“The undersigned certifies that, to the best of his/her/its knowledge, as of the date of shipment or delivery, none of the livestock shipped to or delivered to Ipswitch Livestock Auction, Ipswitch, IA, will be, on such date, adulterated within the meaning of the Federal Food, Drug and Cosmetic Act (i.e., none of the cattle or other ruminants will have been fed any feed containing protein derived from mammalian tissues, e.g., meat and bone meal, as that term is defined in 21 C.F.R. § 589.2000 and none of the livestock will have an illegal level of drug residues). This certificate shall remain in full force and effect until revoked in writing by the undersigned seller and such revocation is delivered to Ipswitch Livestock Auction, Ipswitch, IA.

Date: __________________ Seller:___________________”

MARKETING ASSISTANCE. The CCC has adopted as final regulations implementing provisions of the Agriculture, Rural Development, Food and Drug Administration, and Related Agencies Appropriations Act, 2001, related to the Dairy and Cranberry Market Assistance Programs, the Honey Marketing Assistance Loan and LDP Program, the Sugar Program and payment limitations for marketing loan gains and loan deficiency payments. 66 Fed. Reg. 15171 (March 15, 2001).

MILK. The AMS has issued a notice of revisions to the United States Standards for Grades of Dry Whole Milk. The changes will: (1) lower the maximum bacterial estimate to not more than 10,000 per gram for U.S. Extra Grade and not more than 50,000 per gram for U.S. Standard Grade, (2) include protein content as an optional test, (3) incorporate maximum titratable acidity requirements, (4) expand the “Test methods” section to allow product evaluation using the latest methods included in the Standard Methods for the Examination of Dairy Products, in the Official Methods of Analysis of the Association of Official Analytical Chemists, and in standards developed by the International Dairy Federation, (5) reference the Food and Drug Administration's standards of identity for dry whole milk, and (6) relocate information concerning the optional oxygen content determination. 66 Fed. Reg. 14874 (March 14, 2001).

The CCC has issued final regulations implementing provisions of the Agriculture, Rural Development, Food and Drug Administration, and Related Agencies Appropriations Act, 2001, related to the Dairy Price Support, Dairy Recourse Loan, Livestock Assistance, American Indian Livestock Feed, and Pasture Recovery Programs. Dairy price support is extended through calendar year 2001 and dairy recourse loans are postponed until January, 2002. The LAP and PRP are being extended to cover disaster-related losses that occurred in calendar year 2000 and the AILFP was given additional funding. 66 Fed. Reg. 15537 (March 19, 2001).

**DISASTER PAYMENTS.** On March 5, 2001, the President determined that certain areas in Alabama were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of a severe storms and flooding on February 16-17, 2001. FEMA-1362-DR. On March 13, 2001, the President determined that certain areas in Arkansas were eligible for assistance under the Act as a result of a severe storms and flooding on February 14, 2001. FEMA-1363-DR. Accordingly, a taxpayer who sustained a loss attributable to the disasters may deduct the loss on his or her 2000 federal income tax return.

**HOBBY LOSSES.** The taxpayers purchased an 85 acre farm which was covered with trees. The taxpayers cleared most of the farm, built a residence on the property and started a tree farm. The taxpayers had nonfarm income from wages and a pension. The court held that the tree farm was not operated with an intent to make a profit because (1) the taxpayers did not keep full and accurate records sufficient to determine the profitability of the operation and did not make any attempts to change the business to make it profitable; (2) the taxpayers did not have or seek expert advice as to making the tree farm profitable; (3) although the taxpayers spent a considerable amount of time and work on the farm, most of the effort was not involved with the tree raising or selling part of the operation; (4) the taxpayers failed to prove how much appreciation in the property and trees had occurred or would occur to offset the losses; and (5) the taxpayers had not successfully operated any other similar business. The other factors of Treas. Reg. § 1.183-2(b) were held to be neutral on this issue. Zarins v. Comm’r, T.C. Memo. 2001-68.

**INCOME.** The taxpayer received a portion of the taxpayer’s wages in payments made directly from the taxpayer’s employer to the taxpayer’s landlord for rent. The employer did not withhold any taxes from these payments. The taxpayer claimed these rent payments as nontaxable earned income. The taxpayer argued that the taxpayer should not have to pay any taxes on the payments because no tax was withheld by the employer. The court held that the taxpayer was liable for the tax on the wages, whether or not any amounts were withheld by the employer. Zarichias v. Comm’r, T.C. Memo. 2001-67.

The taxpayer was self-employed as a cosmetologist. The IRS assessed an income tax deficiency for underreported income based upon deposits made to the taxpayer’s bank accounts. The taxpayer did not produce full and accurate records of the business to support the income reported on the income tax return. Except for an adjustment for interaccount transfers, the IRS determinations based on the bank account deposits were upheld by the court. Hintze v. Comm’r, T.C. Memo. 2001-70.

**IRA.** During 1995, the taxpayer was employed by an employer which provided a pension plan. The employer sold the business to another company which terminated the pension plan in 1996. The taxpayer rolled over the vested amount in the plan to an IRA in 1996. The taxpayer made contributions to the IRA in 1995 and claimed a deduction for the contributions. The taxpayer argued that the taxpayer had orally terminated participation in the employer’s plan in 1995 but the court did not believe the taxpayer and held that the taxpayer was an active participant in the employer’s pension plan and was ineligible for a deduction for contributions to an IRA. Hodder v. Comm’r, T.C. Summary Op. 2001-33.

**INSTALLMENT PAYMENT OF TAX.** The taxpayer had entered into an agreement to pay back taxes in monthly installments. As part of that agreement, the taxpayer agreed to pay 20 percent of income monthly as estimated tax payments for each year. The agreement provided that if the 20 percent payments exceeded the actual amount owed for a tax year, the excess payments were applied against the back taxes. In 1997, the taxpayer made the 20 percent payments and filed a timely return, claiming a refund. However, the IRS audit produced a tax liability for 1997. The taxpayer argued that the 20 percent payments were sufficient to cover the increased tax liability for 1997. The IRS, however, had applied the excess to the back taxes based on the taxpayer’s original return. The court held that, under the installment agreement, once the taxpayer filed a return, the amount of excess estimated tax payments was determined and applied to the back taxes. The court also held that the taxpayer could not recover the excess estimated payments to pay the current tax liability once the excess payments were applied to the back taxes. McKoin v. Comm’r, T.C. Memo. 2001-62.

**INTEREST.** The taxpayers entered into a lease of a residence and the lease contained an option for the purchase of the residence. A portion of the lease payments was to be credited toward the purchase price if the option was exercised. The taxpayers decided not to exercise the option because of repairs which the owner failed to complete. However, the taxpayers continued to pay the monthly lease amounts. Eventually, the taxpayers purchased the residence by assuming the mortgage. The taxpayers claimed mortgage interest deductions for the time the residence was leased to them. The court held that the interest was not deductible because the taxpayers were not obligated on the mortgage until it was assumed as part of the purchase. Blanche v. Comm’r, T.C. Memo. 2001-63.

**LEGAL EXPENSES.** The taxpayer had claimed various legal expenses as business deductions. The IRS recharacterized the expenses as capital expenses and disallowed the current deduction for the expenses. The court held that the legal expenses were to be capitalized because the taxpayer failed to provide evidence of the nature and purpose of the expenses. Bello v. Comm’r, T.C. Memo. 2001-56.

**LIKE-KIND EXCHANGES.** The taxpayer owned land which was to be sold to a nonprofit conservation organization. The organization agreed to participate in a like-kind exchange using a third party accommodator. The accommodator purchased the replacement property using borrowed funds and funds provided by the taxpayer. While the accommodator held the property, the property was leased to the taxpayer until the exchange was authorized by the organization. The main issue was whether the accommodator was an agent of the taxpayer such that the exchange would not qualify for like-kind exchange treatment. The IRS used
the six factors of *National Carbide Corp. v. Commissioner*, 336 U.S. 422 (1949) to determine the status of the accommodation as to the taxpayer. The IRS ruled that the accommodation was not the agent of the taxpayer because the accommodation (1) operated a separate business, (2) was not contractually authorized to bind the taxpayer by any action of the accommodation, (3) did not transfer money to the taxpayer; (4) had a written lease with the taxpayer; (5) was not owned by the taxpayer; and (6) had a business purpose separate from the exchange of the properties. *Ltr. Rul. 200111025, Dec. 8, 2000.*

**PENSION PLANS.** For plans beginning in February 2001, the weighted average is 5.89 percent with the permissible range of 5.30 to 6.19 percent (90 to 106 percent permissible range) and 5.30 to 6.48 percent (90 to 110 percent permissible range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). *Notice 2001-20, I.R.B. 2001-1.*

The taxpayer was a retired teacher. During employment as a teacher, the taxpayer made after-tax contributions to a pension plan. These contributions formed a tax basis in the pension plan which was allocated ratably to each year distributions were made after the taxpayer’s retirement. The taxpayer argued that the basis from these contributions should be increased to reflect the amount of inflation which occurred after the contributions were made. The court held that the taxpayer’s basis in the pension plan could not be increased for inflation because there was no authority in the statute or regulations for increasing basis because of inflation. *Nordtvedt v. Comm’r*, 116 T.C. No. 13 (2001).

**RETURNS.** The IRS has announced the use of automatic telephone and e-filing extension requests and approval. The phone requests can be made at 1-888-796-1074 and requires information from the taxpayer’s 1999 return. The e-filing request can be made through e-filing services and also requires information from the 1999 return. *IR-2001-37.*

**S CORPORATIONS-ALM § 7.02[3][c].**

**DISCHARGE OF INDEBTEDNESS.** The taxpayer held a 25 percent interest in an S corporation which had discharge of indebtedness income. The corporation was insolvent and filed for bankruptcy; therefore, the discharge of indebtedness income was excluded from the corporation’s income under I.R.C. § 108(a). The taxpayer increased the stock basis by the taxpayer’s share of the discharge of indebtedness income. The Tax Court cited its holding in *Nelson v. Comm’r*, 110 T.C. 114 (1998), to hold that discharge of indebtedness income excluded from an S corporation’s income was not passed through to the shareholders to increase the basis of stock. The appellate court discussed the several decisions on both sides of the issue and held that an S corporation must first use any untaxed discharge of indebtedness income to reduce tax attributes at the corporate level before passing through any remaining discharge of indebtedness income to shareholders. In this case, the corporation had suspended losses which completely offset the discharge of indebtedness income, leaving no discharge of indebtedness income to pass through to the shareholders. In addition, the offset suspended losses were not passed through to the shareholders. After ruling in *Gitlitz v. United States*, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,147 (S. Ct. 2001), see p. 15 *supra*, the U.S. Supreme Court granted certiorari, vacated and remanded this case. This case has been further remanded by the Circuit Court of Appeals for decision in light of *Gitlitz*. *Gaudiano v. Comm’r*, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,278 (6th Cir. 2001), on rem. from __ S. Ct. __ (2001), rem’g and vac’g, 2000-2 U.S. Tax Cas. (CCH) ¶ 50,559 (6th Cir. 2000), aff’g, T.C. Memo. 1998-408.

**SHAREHOLDER BASIS.** The taxpayers were the shareholders of an S corporation which wanted to build a new furniture showroom. The corporation applied to a bank for a construction loan but was unable to provide sufficient collateral for the loan. The taxpayers provided a guarantee of the corporation’s loan by providing personal assets as additional collateral. The taxpayers argued that, because the bank would not have made the loan to the corporation without the guarantee, the loan, in substance, was made to the taxpayers and reloaned to the corporation. The taxpayer sought to include the loan in their basis in the corporation in order to claim pass-through operating losses. The court refused to recharacterize the loan as made to the taxpayers because the taxpayers failed to show that the corporation had no ability to repay the loan. *Jackson v. Comm’r*, T.C. Memo. 2001-61.

**SAFE HARBOR INTEREST RATES**

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<td>6.35</td>
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</table>

**TRANSFER OF PROPERTY INCIDENT TO DIVORCE.** The taxpayer received an interest in real property under a property settlement as part of a divorce. The divorce decree required the taxpayer to pay a sum of money to the ex-spouse and that monetary award was secured by the real property received by the taxpayer under the divorce decree. The taxpayer sold the property and used most of the proceeds to satisfy the monetary obligation to the former spouse. The taxpayer did not include any of the gain from the sale in income, arguing that the sale was made “on behalf of” the former spouse and excludible under Treas. Reg. § 1.1041-1T(c), Q&A-9. The court noted that the former spouse had no obligation to the purchaser of the taxpayer’s property; therefore, the sale was of no benefit to the spouse but was used by the taxpayer solely to satisfy an obligation of the taxpayer to the former spouse. The court held that the gain from the sale was included in the taxpayer’s income. *Olsen v. Comm’r*, T.C. Summary Op. 2001-32.

**TRAVEL EXPENSES.** The IRS has released the applicable terminal charges and the Standard Industry Fare...
Level (SIFL) mileage rates for use in determining the value of noncommercial flights on employer-provided aircraft taken from January 1, 2001, through June 30, 2001. The terminal charge is $35.84, and the SIFL mileage rates are: up to 500 miles, $0.1961 per mile; 501-1,500 miles, $0.1495 per mile; and over 1,500 miles, $0.1437 per mile. Rev. Rul. 2001-13, I.R.B. 2001-__.

NEGLIGENCE

LEVEE. The plaintiff’s decedent had drowned when the decedent’s car became trapped in flood waters on a highway near the defendants’ farms. The defendants had constructed levees near the road to prevent flooding of their farms during heavy rains. When the accident occurred several inches of rain had fallen and the decedent was driving at night. The levees were constructed higher than the road surface such that the road would flood before the farms. The defendants argued that the levees were reasonable in that the levees were needed to prevent flooding. The evidence demonstrated, however, that in most years levees built to a height just below the road surface would have protected the land. The court held that building the levees above the roadway was not reasonable because the defendants could easily foresee that the levees would cause road flooding which would be dangerous to drivers. The court held that it was not reasonable to value crops and land over human life. The defendants also argued that the heavy rains on the evening of the accident were an intervening cause of the plaintiff’s decedent’s death. The court applied a “but for” test in holding that, but for the levees, the water would not have covered the highway when the decedent was driving on it; therefore, the levees were a direct and foreseeable cause of the accident and the decedent’s death. Robinson v. State Highway & Transportation Comm’n, 24 S.W.3d 67 (Mo. Ct. App. 2000).

DAIRY. The plaintiff had purchased an operating dairy located in the defendant city. The city’s residents near the plaintiff complained about offensive odors coming from the dairy and the plaintiff constructed a waste water treatment facility in the dairy but the odors and complaints continued. The defendant eventually refused to reissue the plaintiff’s business license on the basis that the dairy was a nuisance under the defendant’s nuisance ordinance. The plaintiff argued that Utah Code § 78-38-5 protected it from any actions for nuisance. The court held that the statute protected manufacturing operations which had been in operation for more than three years, which were not nuisances when begun and which had not changed their operation before the nuisance complaints were raised. Because the plaintiff had not changed its operations and had not been in operation for three years before the nuisance complaints, the court held that the statute did not protect the plaintiff from nuisance claims. The court also upheld the defendant’s authority to establish a nuisance ordinance. Dairy Product Services v. City of Wellsville, 13 P.3d 581 (Utah 2000).

PRODUCT LIABILITY

HERBICIDE. The plaintiff was a cotton farmer with a farm neighboring the defendant’s farm. The defendant purchased herbicide and hired another defendant to apply the herbicide by air. The plaintiff argued that the herbicide was negligently applied so as to drift on to the plaintiff’s fields and damage the plaintiff’s crops. The neighbor argued that the action was pre-empted by FIFRA but the court held that the neighbor was not a supplier or manufacturer; therefore, the neighbor was not protected by FIFRA from negligence suits. In addition, the court held that the action did not involve the label of the herbicide but was concerned with the application as directed by the label. The neighbor also argued that the applicator was an independent contractor; therefore, none of the claimed negligence could be attributed to the neighbor. The plaintiff argued that an exception to the independent contractor rule applied because the application of herbicide was inherently dangerous. The court held that aerial crop spraying is inherently dangerous in circumstances where spray drift may occur. The court held that the neighbor was liable for negligence of the applicator because the neighbor was aware that the weather conditions would make the aerial spraying dangerous for the plaintiff’s crops. The amount of damages was calculated using USDA crop reports from the area. Foust v. Estate of Walters, 21 S.W.3d 495 (Tex. Ct. App. 2000).

TRESPASS

TIMBER. The parties owned neighboring rural land and a dispute arose over the boundary line when the plaintiff constructed a home on the plaintiff’s property. The parties agreed to have the properties surveyed using the plaintiff’s deed, although the defendant disagreed with the resulting survey. The defendant then proceeded to have another survey done using the defendant’s deed. The survey produced a different boundary line and, based on that survey, the defendant removed trees from the disputed area between the properties. The plaintiff sued for the loss of the trees and the trial court awarded double the value of the trees removed from the plaintiff’s property. The appellate court affirmed the award, holding that the plaintiff’s surveyor used more reliable monuments and deed descriptions in surveying the properties. The court also held that the plaintiff was not entitled to treble damages because the defendant reasonably relied on the second survey and had no intention of removing trees belonging to the plaintiff. Mix v. Miller, 27 S.W.3d 508 (Tenn. Ct. App. 1999).

CITATION UPDATES

The Agricultural Law Press presents

2001 AGRICULTURAL TAX AND LAW SEMINARS

by Neil E. Harl and Roger A. McEowen

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• Federal estate tax, including 15-year installment payment of federal estate tax, co-ownership discounts, alternate valuation date, special use valuation, family-owned business deduction (FOBD), marital deduction planning, disclaimers, planning to minimize tax over deaths of both spouses, trusts, and generation skipping transfer tax.
• Gifts and federal gift tax, including problems with future interests, handling estate freezes, and “hidden” gifts.
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USING COMMODITY CERTIFICATES TO REDEEM CROPS FROM CCC LOAN
— by Neil E. Harl*

In the late 1980s, the authorization for paying federal benefits in the form of commodity certificates in the Food Security Act of 1985 led to practices where the certificates were used to redeem commodities from a Commodity Credit Corporation (CCC) loan in what came to be known as “PIK and Roll” maneuvers. In the era of “PIK and Roll,” commodity certificates were taxable on receipt at face value with later gain or loss on disposition of the certificates either in an exchange transaction for cash or in paying off a CCC loan.

Re-emergence of certificates

In recent months, commodity certificates have emerged once again, driven this time by a desire to avoid the payment limitations imposed on “persons.” In 2000, the limits were raised from $75,000 to $150,000 per “person” for the 2000 crop year. Low commodity prices in recent years have boosted the percentage of farm income coming from government payments and increased the pressure to avoid the payment limitations. CCC loans redeemed with commodity certificates are not subject to the payment limitations as to market assistance loan gains.

Income tax treatment

In the 1980s, as noted above, commodity certificates were taxable on receipt at face value. Further gain was triggered when a certificate was used to redeem a loan exceeding the face value of the certificate. If the taxpayer had not made the election to treat CCC loan amounts as income, the amount of gain was the difference between the face value of the certificate (which was the income tax basis in the certificate) and the amount of CCC loan redeemed and was taxed as ordinary income. In the event the taxpayer had made the election to treat CCC loan amounts as income, the gain on a commodity certificate could be deducted from the income tax basis of the crop under CCC loan with the result that the further gain on the commodity certificate (above its face value) could be deferred until the commodity under CCC loan was sold or exchanged in a taxable transaction.

The income tax consequences from transactions involving certificates issued as part of an arrangement to avoid the “person” payment limitations are different from those encountered in the “PIK and Roll” era.

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
imposed strict liability on dog owners. The court refused to
The defendant noted that the state had a statute which
stable owners strictly liable for injuries caused by the horses.
The court should change the case law precedents and hold
was invited to the stables by another child whose parents
visiting riding stables owned by the defendant. The plaintiff
belonged to the stable association. The defendant argued that
was reported in 2000 with the balance reported in 2001.
$2.12, the same as in
Example 1. Corn is placed under CCC loan in the amount
of $1.87 per bushel in 2001. In 2001, the commodity is
redeemed when the county posted price is $1.50 per bushel.
The corn is sold later in 2001 for $1.75. If the taxpayer had
not made the I.R.C. § 77(a) election, the taxpayer would have
no income to report in 2000 but would have $1.75 per bushel
gain on the crop itself in 2001 plus $.37 per bushel of
marketing loan gain. The commodity certificate used to
redeem the corn from the CCC loan would be treated the
same as money with the certificate worth $1.50 per bushel
(and having an income tax basis equal to $1.50 per bushel)
used to pay off the CCC loan which requires payment of
$1.50 per bushel either in cash or certificate. The net amount
of income per bushel is $1.75 + .37 or $2.12 per bushel.

Example 2. Assuming the same facts as in Example 1
except that the taxpayer has elected to treat CCC loan
amounts as income, the taxpayer would have $1.87 per
bushel of gain in 2000, the year the CCC loan is taken out.
That would become the income tax basis of the crop. On
redemption at $1.50 per bushel in 2001, the taxpayer would
trigger a marketing assistance loan gain of $.37 per bushel.
When the crop is sold later in 2001 for $1.75 per bushel, the
taxpayer would have a loss of $.12 per bushel (basis of $1.87
per bushel and a selling price of $1.75 per bushel). The net
gain to the taxpayer, over both years, is $1.87 + $.37 - $.12 or
$2.12, the same as in Example 1. However, $1.87 would be
reported in 2000 with the balance reported in 2001.

The argument has been made, based in part on the 1987
revenue ruling that taxpayer should be allowed to deduct
the marketing assistance loan gain ($ .37 per bushel in the
above example) from the income tax basis per bushel ($1.87)
rather than to report the $.37 currently (in 2001). That would
enable the marketing assistance loan gain to be deferred until
the crop is sold (which would be a benefit if the crop were
sold after 2001).

The Internal Revenue Service has been asked to allow the
deduction of the marketing assistance loan gain from the
income tax basis of the crop (where CCC loan proceeds are
-treated as income). No decision has been made on the matter
as of press time.

**FOOTNOTES**

   *Agricultural Law* ch. 91 (2000); Harl, *Agricultural Law Manual*
   § 10.03 (2000).
   1401.4 (2000).
10. See note 5 supra.
15. See I.R.C. § 77(a).
17. *Id.*

**CASES, REGULATIONS AND STATUTES**

by Robert P. Achenbach, Jr.

**ANIMALS**

**HORSES.** The plaintiff was injured by a horse bite while
visiting riding stables owned by the defendant. The plaintiff
was invited to the stables by another child whose parents
belonged to the stable association. The defendant argued that
the court should change the case law precedents and hold
stable owners strictly liable for injuries caused by the horses.
The defendant noted that the state had a statute which
imposed strict liability on dog owners. The court refused to
extend the dog owner’s law to horse owners, noting that the
legislature could have included horse owners in the strict
liability statute. The court held that the defendant was not
liable for the injury because the defendant was not aware
that children of the association members were inviting
friends to the stables and feeding the horses. For the same
reason, the court refused to held that the stable was an
attractive nuisance as a basis for the defendant’s liability. In
addition, the court noted that the injured child testified that
the child was well aware of the dangers of feeding the horses
and knew the proper way to feed the horses by hand. *Pullan v.
Steinmetz, 16 P.3d 1245 (Utah 2000).*
BANKRUPTCYY

FEDERAL TAX-ALM § 13.03[7].

ADMINISTRATIVE EXPENSES. The IRS has ruled, in a Chief Counsel Advice letter, that post-petition taxes in a chapter 13 case are not eligible for administrative expense status because the bankruptcy estate is not a separate taxable entity. CCA Ltr. Rul. 200113027, Feb. 8, 2001.

DISCHARGE. The debtor, a surgeon, failed to file and pay income taxes for 10 years, during which the debtor suffered from alcoholism. The court found that the debtor did no affirmative acts to avoid payment of the taxes but that the debtor was merely indifferent to paying the taxes, a condition caused by the alcoholism. Once the debtor sought treatment for the alcoholism, the debtor fully cooperated with the IRS and filed all of the unfiled returns. The Bankruptcy Court held that the taxes were dischargeable because the debtor did not willfully attempt to evade payment of the taxes. The Bankruptcy Court reiterated the holding in In re Haas, 48 F.3d 1153 (11th Cir. 1997) that the mere failure to file and pay taxes when able to do so was not sufficient to render the taxes nondischargeable. The appellate court reversed, holding that the debtor’s failure to file and pay taxes was sufficient conduct to make the taxes nondischargeable where the debtor knew that the taxes and returns were due. The court noted that the debtor had sufficient control over the debtor’s alcoholism to perform surgery; therefore, the alcoholism was insufficient to make the failure to file and pay the taxes less than willful. In re Fretz, 2001-U.S. Tax Cas. (CCH) ¶ 50,470 (11th Cir. 2001), rev’g unrep. D. Ct. dec. aff’g, 239 B.R. 605 (Bankr. N.D. Ala. 1999).

FEDERAL AGRICULTURAL PROGRAMS

CONFERENCES. A conference, “Fixing the Farm Bill,” was held at the National Press Club, Washington, DC, on March 27, 2001. The conference was organized by John A. Schnittker, Schnittker Associates, Santa Ynez, California, and Neil E. Harl, Director, Center for International Agricultural Finance, Iowa State University. For access to the papers see web site: http://www.econ.iastate.edu/faculty/harl/FFB/fib.html.

GENETICALLY MODIFIED ORGANISMS. The Washington Post has reported that a Canadian canola farmer was successfully sued by Monsanto Co. for failing to pay licensing fees for the use of canola seeds produced by plants pollinated by genetically modified canola in neighbors’ fields. The result means that farmers who plant non-GMO crops near GMO crops cannot save any seeds for replanting without paying the licensing fee to the GMO patent owner. M. Kaufman, “Court Says Canadian Used Company’s Plants,” Washington Post, March 30, 2001.

FEDERAL ESTATE AND GIFT TAX

LEGISLATION. The U.S. House of Representatives has passed legislation which would replace the unified credit with an exemption ($700,000 in 2002-2003, $850,000 in 2004, $950,000 in 2005 and $1,000,000 in 2006 and later). The legislation would also repeal I.R.C. § 1014 (new basis of estate property at death) after 2010; provide for up to $1,300,000 basis increase thereafter for each estate with $3,000,000 in additional maximum basis increase for surviving spouses; and increase from 15 to 45 the number of partners/shareholders allowable for 15-year installment payment of federal estate tax. H.R. 8.

Legislation has been introduced in the U.S. House of Representatives which would eliminate the limit on the family-owned business deduction. H.R. 1210. Legislation has been introduced in the U.S. House of Representatives which would exclude the tax on any gain from the sale of a qualified family farm to a family member who continues to materially participate in the operation of the farm. H.R. 1179.

BELOW-MARKET INTEREST LOANS. A corporation was owned by many members of one family, none with a majority interest. The corporation made no-interest loans to several entities which were owned in part by the shareholders of the corporation and by nonshareholder family members. The IRS assessed taxes for interest income deemed earned by the taxpayers, under I.R.C. § 7872. The taxpayers argued that Section 7872 applied only for loans from a corporation to majority shareholders. The court held that the rules applied to below-market interest loans from the corporation to any shareholder or to entities owned by shareholders. The appellate court affirmed in a decision designated as not for publication. Rountree Cotton Co., Inc. v. Comm’r, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,316 (10th Cir. 2001), aff’g, 113 T.C. No. 28 (1999).

CHARITABLE DEDUCTION. The decedent’s will provided a bequest to the decedent’s brother in trust with a remainder to a charitable organization. The trust was not a qualified charitable trust since the brother had the power to invade the trust without limit. However, after receiving only $33,000, the brother died before the estate filed its tax return. The other heirs challenged the will and agreed to drop the contest in exchange for receiving the right to seek a charitable deduction for the estate, thus increasing the remainder estate which passed to these heirs. The court held that I.R.C. § 2055(e)(3)(F) applied to the trust. Under section 2055(e)(3)(F) the trust became reformed upon the death of the brother because the brother’s death fixed the amount passing under the trust to the charity; therefore, the amount passing under the trust was eligible for the charitable deduction. The IRS argued that the brother’s receipt of funds from the trust removed the trust from application of section 2055(e)(3)(F), but the court held that the statute contained no exception for cases where the trust beneficiary receives a portion of the trust before dying. On reconsideration, the
court held that the trust was not eligible for a charitable deduction because the reformation did not occur until after the brother had received distributions from the trust. Harbison v. United States, 2001-1 U.S. Tax Cas. (CCH) ¶ 60,398 (N.D. Ga. 2001), vac'g on reconsid., 2000-2 U.S. Tax Cas. (CCH) ¶ 60,389 (N.D. Ga. 2000).

CLAIMS. The decedent had received from a predeceased spouse an usufruct (life estate) in mineral rights in land, with the remainder passing to the decedent’s children. The decedent received the royalties over several years before death. The estate deducted the value of the royalties received as a claim of the children against the estate. The estate argued that the decedent was required to account for and repay any royalties received and retained during the usufruct. The court examined state law and the predeceased spouse’s will and held that the type of usufruct granted to the decedent did require the decedent to account for and repay any mineral royalties received during the usufruct; therefore, the children were entitled to repayment from the estate and the estate was entitled to a deduction for the amount paid. The appellate court affirmed in a decision designated as not for publication. Marshall v. Comm’r, 2001-1 U.S. Tax Cas. (CCH) ¶ 60,397 (5th Cir. 2001), aff’g, 99-2 U.S. Tax Cas. (CCH) ¶ 60,360 (E.D. La. 1999).

DEDUCTIONS. The decedent had redeemed stock received from the estate of a predeceased spouse. The decedent realized gain on the redemption, based on the basis in the stock established by the predeceased spouse’s estate for federal estate tax purposes. The decedent’s estate tax return claimed a deduction for the federal income tax paid on the stock redemption. The predeceased spouse’s estate tax return was audited and the value of the stock was increased, thus increasing the decedent’s basis in the stock and decreasing the income tax liability. The decedent’s estate filed for a refund which was allowed. The IRS then assessed a deficiency against the decedent’s estate tax because of a decrease in the deduction for federal income tax. The estate argued that post-death events should not be considered in determining the amount of a deduction which was valid on the date of the decedent’s death. The estate cited Propstrea v. United States, 680 F.2d 1248 (9th Cir. 1982) and Estate of Sachs v. Comm’r, 88 T.C. 769 (1987), rev’d, 856 F.2d 1158 (8th Cir. 1988) which did not allow changes based on post-death events. The Tax Court distinguished the current case on the basis that the estate here had requested the refund of income taxes, demonstrating that the income tax liability was contingent as of the decedent’s death. The Tax Court held that the income tax deduction for estate tax purposes had to be decreased by the amount of the refund. The Tax Court also held that the deduction for state income taxes was also decreased since the state tax liability was dependent upon the estate’s income tax liability. The appellate court reversed, holding that the post-death events cannot be considered in valuing a deduction. Est. of McMorris v. Comm’r, 2001 U.S. Tax Cas. (CCH) ¶ 60,396 (10th Cir. 2001), rev’d, T.C. Memo. 1999-82.

GROSS ESTATE. The decedent’s estate included an interest in a QTIP trust received from the decedent’s predeceased spouse. The trust owned 42 percent of farm land. The land was contributed to a limited partnership; however, the operation of the farm, including management of timber and peach orchards, was handled by a separate general partnership in which the trust was not a partner. The court held that the timber and orchard and other farm personal property was not included in the QTIP trust property because title were reserved by the decedent and predeceased spouse and contributed to the general partnership. Est. of Forbes v. Comm’r, T.C. Memo. 2001-72.

LIFE INSURANCE. The taxpayers, husband and wife, established a trust for the benefit of their parents and heirs. The trusts owned life insurance policies on the lives of the taxpayers. The trusts contributed the insurance policies to a limited partnership in exchange for limited partnership interests. The taxpayers were also limited partners in the partnership. The limited partnership also owned other investment properties. Under I.R.C. § 101(a)(1) gross income does not include amounts received under a life insurance contract, if such amounts are paid by reason of the death of the insured. However, under I.R.C. § 101(a)(2), if a life insurance contract or any interest therein is transferred for valuable consideration, the exclusion from gross income provided by Section 101(a)(1) is limited to an amount equal to the sum of the actual value of the consideration and the premiums and other amounts subsequently paid by the transferee. An exception to the Section 101(a)(2) rule is provided in I.R.C. § 101(a)(2)(B) for insurance contracts transferred to partnerships in which the insured is a partner. The IRS ruled that the trust’s life insurance policies were transferred for valuable consideration, the exchanged partnership interests, but that the exception applied because the taxpayers were limited partners in the receiving partnership. The IRS also ruled that the partnership held all the incidents of ownership such that the policies would not be included in the taxpayers’ estates. Ltr. Rul. 200111038, Dec. 15, 2000.

VALUATION. The decedent’s estate included an interest in a QTIP trust received from the decedent’s predeceased spouse. The trust owned 42 percent of farm land. The court held that the value of the land for federal estate tax purposes could be discounted by 30 percent of the fair market value. Est. of Forbes v. Comm’r, T.C. Memo. 2001-72.

The taxpayers established a trust for themselves, with remainders to their children. The taxpayers transferred to the trust a residence which included an 8.7 acre main lot, a one-seventh interest in a 16.7 wooded lot and easements granting access to the properties which ran between the two parcels. The IRS ruled that the entire property qualified as a personal residence and that the trust was a qualified personal residence trust. Ltr. Rul. 200112018, Dec. 15, 2000.

VALUATION OF STOCK. The decedent owned 19.86 percent of the stock of a family-owned S corporation, the largest block of stock owned by any one shareholder. The estate valued the stock at $29.77 per share, based upon a pre-death appraisal and two post-death sales of stock by other family members to another family member. The sales were made without negotiation and without any determination of the fair market value of the stock. The court held that the post-death sales were not determinative of the value of the
stock because the transactions were not negotiated and the number of shares sold was much smaller than the decedent’s holdings. The estate presented an expert appraiser’s appraisal of the stock in support of the $29.77 value but the Tax Court found that the appraiser’s valuation was defective because it was based solely upon sale of the stock to other shareholders, which was not required by the corporation’s bylaws. The Tax Court held that the IRS valuation of the stock was to be used because the estate failed to present sufficient evidence to rebut that valuation. The appellate court reversed, holding that the post-death sale of stock was representative of the fair market value because the sellers did not have to sell the stock, the buyers obtained an appraisal from a brokerage, and the buyers were not closely related to the sellers or the decedent. *Morrissey v. Comm’r*, 2001-1 U.S. Tax Cas. (CCH) ¶ 60,395 (9th Cir. 2001), rev’g sub. nom., Estate of Kaufman v. Comm’r, T. C. Memo. 1999-119.

The taxpayers had transferred by gift stock in a closely-owned corporation and had valued the stock at $175.24 per share for gift tax purposes. IRS had issued a deficiency notice based upon an income-based appraisal value of $260.13 per share. At trial both parties presented expert valuations, with the IRS expert valuing the stock at $260.61 per share on a market-based approach. The court held that the taxpayer’s expert’s valuation was flawed; therefore, because the taxpayer failed to provide evidence to support the taxpayer’s valuation of the stock, the IRS value in the notice of deficiency was presumed correct and upheld. *Wall v. Comm’r*, T.C. Memo. 2001-75.

**FEDERAL INCOME TAXATION**

**LEGISLATION.** CCH has published a report by the Joint Committee on Taxation on an overview of current and proposed taxation law for small business and agriculture. JCX-19-01.

**BUSINESS EXPENSES.** The taxpayer operated a financial planning business as well as maintained employment with a bank. The taxpayer claimed business deductions for depreciation, office expenses, meals and travel expenses. Most of the items were substantiated only by entries in a daily planner and credit card monthly statements. The court found that several of the daily planner entries were not clear as to the business purpose for the expense and held that only the expenses clearly substantiated as to date, amount and business purpose were allowed as deductions. *Bishop v. Comm’r*, T.C. Memo. 2001-82.

The taxpayer was not allowed business deductions for more than those allowed by the IRS because the taxpayer did not keep any records of the amounts, dates and purposes of the expenses. *Gapikia v. Comm’r*, T.C. Memo. 2001-83.

**COOPERATIVES.** The IRS has announced that it acquiesces in the following case. The taxpayer was a nonexempt agricultural cooperative which owned directly or through stock ownership oil and gas refinery businesses which provided petroleum products to the members of the taxpayer. The taxpayer sold the stock and properties when the businesses became nonproftable and the issue was whether the proceeds of the sales were patronage-sourced income. The court held that the proceeds were patronage-sourced income because the property was directly related to the taxpayer’s business with its members. The court rejected the IRS argument that all capital gain was nonpatronage-sourced income. *Farmland Indus., Inc. v. Comm’r*, T.C. Memo. 1999-388, acq., I.R.B. 2001-__

**COURT AWARDS AND SETTLEMENTS.** The taxpayer owned property neighboring a petroleum processing plant. The taxpayer complained about the odors and appearance of the plant and the plant owners agreed to purchase the taxpayer’s property for cash and 450 acres of property elsewhere. The taxpayer signed a release of all claims against the plant owners. The court held that, under Texas law, an action for emotional harm could not result from the lawful operation of the plant. The court also held that the taxpayer had made no claim in tort for personal harm but that the proceeds were paid in compensation for the property rights transferred to the plant owners; therefore, the proceeds were included in the taxpayer’s gross income to the extent they exceeded the taxpayer’s basis in the property. The appellate court affirmed in a decision designated as not for publication. *Holland v. United States*, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,465 (5th Cir. 2001), aff’d, 2000-1 U.S. Tax Cas. (CCH) ¶ 50,465 (S.D. Texas 2000).

The taxpayer was a former employee of an employer who was sued by class action for overtime compensation, liquidated damages, attorney fees and costs. The taxpayer was a member of the class but did not actively participate in the suit. The action was settled and the taxpayer received a portion of the settlement. The taxpayer did not include any of the proceeds in income, arguing that the proceeds represented compensation for personal injury from racial discrimination claims against the employer. The court noted that no racial discrimination claims were raised as part of the class action lawsuit or settlement negotiations. The court held that the proceeds were included in the taxpayer’s income as back pay, liquidated damages, attorneys’ fees and costs. The IRS acknowledged that the taxpayer was entitled to an itemized deduction for the attorneys’ fees and costs. *Waters v. Comm’r*, T.C. Summary Op. 2001-46; *Nelson v. Comm’r*, T.C. Summary Op. 2001-44.

**DISASTER PAYMENTS.** The IRS has issued additional guidelines for extensions for filing returns and paying estimated, income, gift and estate taxes for persons suffering losses from the 2000 Cerro Grande fire in New Mexico. IR-2001-42.

On March 20, 2001, the President determined that certain areas in Maine were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of near-record snow on March 5-7, 2001. FEMA-3164-EM. Accordingly, a taxpayer who sustained a loss attributable to the disasters may deduct the loss on his or her 2000 federal income tax return.

**MARKET SEGMENT TRAINING GUIDE.** The IRS has announced the publication of a revised Market Segment
Specialization Program Audit Technique Guide—IRC Section 183: Farm Hobby Losses with Cattle Operations and Horse Activities.

PENSION PLANS. For plans beginning in March 2001, the weighted average is 5.87 percent with the permissible range of 5.29 to 6.17 percent (90 to 106 percent permissible range) and 5.29 to 6.46 percent (90 to 110 percent permissible range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). Notice 2001-28, I.R.B. 2001-13, 944.

The taxpayer, an attorney who operated the practice through a professional corporation. The corporation provided a pension plan in which the taxpayer was the sole participant. The plan allowed loans of up to 50 percent of the vested interest in the plan for up to five years. The taxpayer borrowed money from the plan. The loan agreement provided for monthly payments of principal and interest over five years with a large balloon payment at the end of the term. The monthly payments would require 15 years to repay the loan. The court held that the loan was included in the taxpayer’s income in the year made because the loan exceeded I.R.C. §§ 72(p)(2)(B)(i) or 72(p)(2)(C) in that the loan either exceeded the five year limitation of Section 72(p)(2)(B) or the level amortization amount required of Section 72(p)(2)(C).

RETURNS. The IRS has released revised Publication 51 (Rev. January 2001), Circular A, Agricultural Employer’s Tax Guide (Including 2001 Wage Withholding and Advance Earned Income Credit Payment Tables) and Publication 1779, Independent Contractor or Employee (Rev. 12-99). These documents are available at no charge (1) by calling the IRS’s toll-free telephone number, 1-800-829-3676; (2) via the internet at http://www.irs.gov/prod/cover.html; (3) through FedExWorld; or (4) by directly accessing the Internal Revenue Information Services bulletin board at (703) 321-8020.

The IRS has announced that it will follow the holding of Weisbart v. United States, 222 F.3d 93 (2d Cir. 2000), rev’g. 99-1 U.S. Tax Cas. (CCH) ¶ 50,549 (E.D. N.Y. 1999), which held that, under I.R.C. § 7502(a), a claim for refund on a delinquent original return will be considered filed on the postmark date. This rule will apply to other tax returns as well. Final regulations have been issued which are consistent with this announcement. See Treas. Reg. § 301.7502-1(f), 66 Fed. Reg. 2257 (Jan. 11, 2001). CC-2001-019.

SALE OF RESIDENCE. The taxpayer, a certified public accountant, sold a residence in December 1993. In August 1995, a corporation wholly-owned by the taxpayer completed a residence. The taxpayer used the residence for temporary sleeping quarters but kept the taxpayer’s personal belongings in the taxpayer’s camper. The corporation accepted a third party offer to buy the house in November 1995. In early December, the corporation executed a quitclaim deed for the house to the taxpayer in exchange for an offset of debt owed to the taxpayer. On December 26, 1995, the taxpayer quitclaimed the title to the house back to the corporation which then sold it to the third party. The court held that the sale of the house to the taxpayer was not bona fide and did not qualify the taxpayer for deferment of gain from the sale of the first house. Because the purchase of the house was not bona fide and was made solely to qualify the taxpayer for the deferral of gain, the court upheld the IRS assessment of the accuracy-related penalty. Bare v. Comm’r, T.C. Memo. 2001-71.

INSURANCE

BAD FAITH. The plaintiff had obtained a real and personal property insurance policy from the defendant. Because the policy excluded coverage for loss of animals from freezing, the plaintiff purchased extra coverage for this loss. The plaintiff lost 297 cattle in two separate snow storms and filed for recovery of the loss from the defendant. The defendant refused to pay the loss until each animal had been necropsied, which required the plaintiff to thaw each animal and have it examined by a veterinarian for cause of death and then retain the animals. The defendant told the plaintiff that he would not pay to thaw and retain each animal because the policy did not cover the loss due to freezing. The plaintiff’s attorney had informed the defendant that the policy covered the loss due to freezing, and the defendant still refused to pay. The plaintiff then filed suit against the defendant for declaratory judgment, breach of contract, and bad faith. The plaintiff prevailed in the trial court and the defendant appealed. The court of appeals affirmed the judgment of the trial court.

*Source: Agricultural Law Manual (ALM).
plaintiff that the plaintiff had to prove the cause of death, even though the policy covered all losses. The defendant eventually refused to cover the losses because the plaintiff did not completely own the animals. The plaintiff had obtained investors who contributed money in exchange for a portion of the profits from the animals. The court found that the policy referred only to the insured as “owner” of the property but did not provide any definition of that term. The policy did not provide that partial ownership was not covered under the policy. The plaintiff received a jury verdict for actual, bad faith and punitive damages. The court rejected the defendant’s argument that the policy required 100 percent ownership of covered property. The court noted that the defendant was aware of the plaintiff’s partial interest in the cattle before and after the policy was purchased and failed to inform the plaintiff that the policy would not fully cover animals in which the plaintiff had a partial interest. The court held that the policy use of the word “owner” was ambiguous and would be interpreted against the defendant as the drafter of the document. The court also upheld the award for bad faith because the evidence demonstrated that the defendant attempted to discredit the plaintiff, attempted to hide facts, and placed an unreasonable demand on the plaintiff to have the cattle Necropsied and stored on the farm for several months. The evidence even included a tape recording of the defendant’s agents plotting how they could avoid paying on the claim. The court also upheld the punitive damages for the same reasons. Sawyer v. Farm Bureau Mut. Ins. Co., 619 N.W.2d 644 (S.D. 2000).

**PRODUCT LIABILITY**

HERBICIDE-ALM § 2.04.* The plaintiffs were wheat and barley farmers and applied to their crops herbicide manufactured by the defendant. For several weeks after the application, the nighttime temperatures were near or below freezing. A state Department of Agriculture expert told the plaintiffs that cold temperatures could cause damage to crops treated with the herbicide. The plaintiffs sued in negligence, breach of warranty and strict liability, claiming that the defendant was negligent in manufacturing, advertising and selling a product which could cause damage when applied at the normal time for application, in the spring when the nights were cold. The trial court dismissed all claims as preempted by FIFRA. The appellate court held that the negligence action was preempted by FIFRA because the action was based on the defendant’s failure to warn about the cold problem. The court held that the breach of warranty action was not necessarily preempted by FIFRA because the plaintiff alleged some representations were made by agents of the defendant during the sale of the herbicide. The court also allowed the strict liability claim to remain until discovery was completed by the parties to see if any actions by the defendant, outside of the label, gave rise to a strict liability claim. The court noted that the EPA approval of the herbicide label did not absolve the defendant of all liability where the product was advertised and sold in areas where the product would not work according to the label instructions. On remand to the trial court, a jury verdict was returned for the defendant manufacturer. The trial court had given a jury instruction which required that, for the defendant to be held strictly liable, the jury must find that the herbicide was in a “defective condition unreasonably dangerous.” The appellate court held that this instruction was improper in that the “unreasonably dangerous” language was superfluous and confusing because a herbicide which was defective was unreasonably dangerous as a matter of law. The plaintiffs also appealed the jury verdict on the basis that it should have been allowed to present evidence of the content of the herbicide label. The defendant argued that, even under the prior appellate holding of this case, FIFRA preempted all state law damage claims involving information on the label. The court held that, in Sleath v. West Mont, 16 P.2d 1042 (Mont. 2000), it reversed its prior ruling in this case; therefore, the label contents were admissible and the trial court’s refusal to allow the evidence was reversible error. Earlier case: McAlpine v. Rhone-Poulenc Ag. Co., 947 P.2d 474 (Mont. 1997), McAlpine v. Rhone-Poulenc Ag. Co., 16 P.3d 1054 (Mont. 2000).

The plaintiffs were peanut farmers who had applied on their crops a herbicide manufactured by the defendant. The plaintiffs filed suit for strict liability, breach of express and implied warranties, and violation of the Texas Deceptive Trade Practice-Consumer Protection Act. The defendant argued, and the trial court granted summary judgment on the grounds, that the suit was preempted by FIFRA. The plaintiffs claimed that the herbicide off-label advertisements and brochures stated that the herbicide could be mixed with another herbicide without damaging crops. In addition, the herbicide label stated that it could be mixed with another herbicide without damaging crops. The plaintiffs produced evidence that the damage to their crops resulted from mixing these two herbicides before applying them. The court noted that the EPA had issued Pesticide Regulation Notice 96-4 which stated that the EPA would no longer consider the efficacy of registered herbicides in the registration process. The court also noted that this notice was merely a restatement of a two decade practice by the EPA in not considering the efficacy of registered herbicides. Therefore, the court held that FIFRA did not preempt state court actions involving herbicide labeling where the action involved the ability of the herbicide to perform as indicated on the label. This case conflicts with several other state court cases, including cases which have discussed the effect of Notice 96-4. Geye v. American Cyanamid Co., 32 S.W.3d 916 (Tex. Ct. App. 2000).

**CITATION UPDATES**


Gitlitz v. United States, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,147 (S. Ct. 2001) on rem., 2001-1 U.S. Tax Cas. (CCH) ¶ 50,319 (10th Cir. 2001), vac’g, 182 F.3d 1143 (10th Cir. 1999), aff’g sub nom., Winn v. Comm’r, T.C. Memo. 1998-71 (discharge of indebtedness) see p. 15 supra.

Muhich v. Comm’r, 238 F.3d 860 (7th Cir. 2001) (trusts) see p. 29 supra.
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DISCHARGE OF INDEBTEDNESS ON FMHA (FSA) BUY-OUT?
— by Neil E. Harl*

Since enactment of the Agricultural Credit Act of 1987, in which Congress instructed the then Farmers Home Administration (now Farm Service Agency) and Farm Credit Services to avoid losses on loans with priority consideration to writing down the loan principal and interest and setting aside debt whenever those procedures would make it possible for a borrower to survive and remain on the farm or ranch, the question has been raised whether the write-down of loan balances produced discharge of indebtedness income.

Basic options

Under the legislation (which was signed on January 8, 1988), a borrower’s loans could be written down to the point that the “net recovery value” of the restructured debt was equal to or greater than the net recovery value of the collateral securing the debt. A new promissory note was executed for each note rescheduled or reamortized. A borrower was required to enter into a shared appreciation agreement for all write-downs involving real properties as collateral.

In the event a feasible debt restructuring plan could not be worked out with FmHA (or FSA), a debtor under the 1987 legislation is permitted to purchase the collateral at its net recovery value if the net recovery value of the secured property exceeds the net recovery value of a restructured loan supported by the debtor’s cash flow. Again, the debtor is required to execute a recapture agreement and to agree to pay in full the difference between the net recovery value of the property and the fair market value of the property (as of the date of the agreement) if within ten years the property is conveyed for an amount greater than the net recovery value.

Tax Court case

On January 31, 2001, the U.S. Tax Court decided a case, Jelle v. Commissioner, focusing on whether a buy-back of collateral at its net recovery value produced discharge of indebtedness income. An issue has existed, since enactment of the 1987 legislation, whether the debtor was discharged of liability under both the debt write-down program and the collateral buy-back program.

In Jelle v. Commissioner, a couple engaged in dairy farming in Wisconsin was advised by FmHA that they did not qualify for debt write-down but could avoid foreclosure by buying out the collateral (land) at its net recovery value. The taxpayers obtained a bank loan and purchased the collateral for $92,057 from FmHA. The agency then proceeded to write off the remaining $177,772.28 of indebtedness.

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See the back page for details about the 2001 Agricultural Tax and Law Seminars by Dr. Neil Harl and Prof. Roger McEown
As a condition of the buy-back, the taxpayers entered into a shared appreciation agreement which required repayment on a formula basis if the property were conveyed within 10-years. The recapture agreement commitment was secured by a secondary lien on the land. In the year of the buy-back, the Farm Service Agency of the U.S. Department of Agriculture (the successor to FmHA) issued a Form 1099-C showing “amount of debt cancelled” of $177,772.27. The taxpayers did not report the amount as discharge of indebtedness on their income tax return in the year of the buy-back.

The key issue before the court was whether the recapture agreement continued the taxpayer’s obligations to FmHA/FSA in a manner that there was no discharge of indebtedness in the year of the buy-back of collateral. As the court noted, the disagreement was over the contingency involved. The taxpayers argued that the cancellation itself was contingent, believing that the transaction merely generated an agreement to cancel their debt at a future time. On the other hand, IRS argued that the transaction involved a present cancellation with a contingent future obligation to pay.

The Tax Court took the position that the taxpayer’s indebtedness was discharged in the year of the buy-back of the collateral. The court’s reasoning was that “whether or when [the taxpayer] would ever be required to make any further payments to FmHA rested totally within their own control.” As the court explained, if the taxpayers chose to sell their property within 10-years, repayment would be required; if the taxpayers chose not to dispose of their property, nothing further would be due.

In conclusion

The decision in *Jelle v. Commissioner*[10] is consistent with the IRS position taken in a letter dated May 22, 1989 from IRS to the Farmers Home Administration[11] In that letter, the Chief Counsel stated “…the Recapture Agreement is not a substitute indebtedness for any of the FmHA debt in excess of the buyout amount. Thus, an FmHA borrower realizes discharge of indebtedness income to the extent the old FmHA debt balance exceeds the buyout amount even when a Recapture Agreement is part of the restructuring arrangement…”[12]

The IRS position has been that the same result applies to a debt write down.[13] Although *Jelle v. Commissioner*[14] involved only a buy-back at net recovery value,[15] the case provides support for the IRS position on a debt write-down as well.

FOOTNOTES

2. See 7 C.F.R. § 1951.909.
4. 7 C.F.R. § 1951.909(h)(3).
5. 7 C.F.R. § 1951.909(h).
7. 7 C.F.R. § 1951.909(e).
8. 7 C.F.R. § 1951.909(h).
10. Id.
11. Id.
12. Id.
13. Id.
14. Id.
17. Id.
19. Id. at 6.
20. 7 C.F.R. § 1951.909.
22. 7 C.F.R. § 1951.909(h)(3).

CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr.

**BANKRUPTCY**

**GENERAL-ALM § 13.03.**

**ADMINISTRATIVE CLAIMS.** The debtors had leased farmland from a creditor. The landlords’ liens were not perfected and were avoided by the Chapter 7 trustee. However, the debtors used the farms during the bankruptcy case, planting the crops just before filing for bankruptcy and harvesting the crops 142 days later. The landlords filed administrative claims for the rental of the properties during the bankruptcy case. The Bankruptcy Court had determined the rental value of the properties by multiplying the annual rent by a fraction equal to the number of days the property was used by the bankruptcy estate divided by 365. The appellate court remanded the case because the use of the number 365 failed to take into account the limited use and lower rental value of a farm during nonproductive months. The court noted that, in this case, the bankruptcy estate had the use of the farm during nearly the entire productive period of the farm for the year, from planting to harvest. The court required the fair rental value to be determined by the usefulness of the property during the bankruptcy case. *In re*
Wedermeier, 239 B.R. 794 (Bankr. 8th Cir. 1999), aff’d, 237 F.3d 938 (8th Cir. 2001).

SETOFF. The debtor was a wholesale distributor of food products which had contracted with a manufacturer of pickle products. The debtor placed the purchased pickle products in a warehouse for resale to retailers and the military. The debtor would bill the retailers directly and submit the proceeds to the manufacturer in payment for the pickles sold. However, when pickles were sold to the military, the manufacturer billed the military and credited the debtor’s account with the sale proceeds. At the time of the bankruptcy filing, the debtor owed the manufacturer for purchased pickle products and the manufacturer had credits against the debtor’s accounts from military sales. The manufacturer sought permission to offset the military sales credit against the debtor’s account. The manufacturer acknowledged that setoff was not allowed under the bankruptcy rules but argued that the doctrine of recoupment allowed the debtor’s account to be reduced by the military sales credit. The court held that the doctrine of recoupment was not available in this case because the debt and credit did not arise from the same transaction. The court held that the initial sale of the pickle products to the debtor was too distinct from the later sale of the products to the military. In re Affiliated, Inc., 258 B.R. 495 (Bankr. M.D. Fla. 2000).

ARTPA 

FEDERAL TAX-ALM § 13.03[7].

AUTOMATIC STAY. The stay did not apply for Chapter 13 in May 1996 and listed an unsecured IRS claim for $193. The debtors’ plan was confirmed in September 1996 without objection. The debtors filed their 1996 tax return in February 1997 and claimed a refund. The IRS imposed a freeze on the debtors’ tax account because the debtors were delinquent on their plan payments. The court adopted the holding of some prior cases that, upon confirmation, the estate property vested in the debtors but the estate includes all property acquired by the debtors post-confirmation; thus, the refund was estate property protected by the automatic stay. The court also held that the IRS refusal to pay the refund was a violation of the automatic stay and awarded the debtors $1000 in general damages, $12,000 in attorneys’ fees and $7000 in emotional distress damages. In re Holden, 258 B.R. 323 (D. Vt. 2000), aff’d, 236 B.R. 156 (Bankr. D. Vt. 1999).

SETOFF. The IRS had filed secured, unsecured priority and unsecured nonpriority tax claims in the debtor’s Chapter 13 case. The debtors claimed a pre-petition tax refund as exempt and the IRS sought permission to apply the refund against the unsecured nonpriority tax claim, reducing the dischargeable tax claims. The debtor argued that the tax refund could be used to offset only the unsecured priority claims, reducing the nondischargeable tax claims. The IRS argued that the right of setoff created an involuntary payment of taxes and the IRS could apply the refund as the IRS wanted. The court held that Section 522(c) excluded exempt property from liability for pre-petition taxes except nondischargeable taxes; therefore, the refund could be applied only to the priority tax claims and any remaining amount was to be returned to the debtor. This and the previous case represent the two main approaches to this issue, which is in need of resolution by the Supreme Court (or the Congress). In re Pace, 257 B.R. 918 (Bankr. W.D. Mo. 2000).

FEDERAL AGRICULTURAL PROGRAMS

BRUCELLOSIS. The APHIS has adopted as final regulations amending the brucellosis regulations by changing South Dakota from a Class A to Class Free state. 66 Fed. Reg. 19847 (April 18, 2001).

COTTON. On December 7, 2000, OSHA issued a direct final rule amending its occupational health standard for Cotton Dust, 29 CFR 1910.1043, to add cotton washed in a batch kier system to the other types of washed cotton that are partially exempt from the cotton dust standard. See 65 Fed. Reg. 76563. OSHA has stated that, because no negative comments were received, the amendment was effective April 6, 2001. 66 Fed. Reg. 18191 (April 6, 2001).

MEAT INSPECTION. The plaintiffs were federal meat and poultry inspectors, their union and a private organization. The plaintiffs sought to enjoin the USDA from instituting new meat inspection rules under which federal meat inspectors would no longer personally inspect the meat carcasses but would only oversee the inspection performed by employees of the meat packers. The plaintiff argued that the Federal Meat Inspection Act (FMIA), 21 U.S.C. § 604, required the federal inspectors to do the inspections. The USDA argued that the term “inspection” included observing others do the inspection but the court held that the plain meaning of the statute prohibited the USDA from allowing anyone but federal inspectors to do the inspection of processed meat. After the first appellate decision, the USDA modified the inspection procedure to have one inspector observe all carcasses and one inspector float throughout the line to oversee the other inspections. The plaintiffs argued that, although the modifications met the statutory requirements, the single inspector of the carcasses was insufficient to properly inspect the carcasses. The District Court, on remand, held that the modified rules met the statutory requirements. American Fed. Of Employees v. Glickman, 127 F. Supp. 2d 243 (D. C. 2001), on rem. from, 215 F.3d 7 (D.C. Cir. 2000).

POTATOES. The AMS has issued a proposed rule setting forth the terms of the Fresh Russet Potato Diversion Program for 2000. The proposed program will assist fresh Russet potato growers faced with oversupplies and low prices by diverting potatoes to charitable institutions, for livestock use, in donations to schools or for livestock use by employees of charitable institutions.
FEDERAL ESTATE AND GIFT TAX

GIFT. The decedent’s predeceased spouse had owned a corporation and served as chief executive officer. The spouse had given annual gifts of stock in the corporation to the spouse’s executive assistant. After the corporation was sold, the spouse gave money instead of stock. The spouse filed gift tax returns for the amounts given to the assistant. The decedent was advised to file amended gift tax returns which would treat the gifts as compensation but the decedent refused. After the decedent’s death, the advisor became the executor of the decedent’s estate and filed amended gift tax returns on behalf of the estate claiming that the stock and money transfers were actually compensation for services by the assistant. The estate argued that money and property transferred to an active employee could not be a gift. The court acknowledged that the employment relationship of the donor and donee could be a factor in determining the nature of a transfer. The court denied summary judgment for either party because the determination of a gift was dependent upon several fact issues to be determined by the trier of fact. **Estate of Powell v. United States, 2001-1 U.S. Tax Cas. (CCH) ¶ 60,327 (W.D. Va. 2001).**

Just prior to death, the decedent wrote several checks to relatives for under $10,000 each. The checks were delivered to the donees before the decedent’s death but were not paid until after the decedent’s death. The court ruled that the checks were incomplete gifts at the time of the decedent’s death because the gifts were revocable by the decedent’s ability to stop payment on the checks. Therefore, the amount of the checks was included in the decedent’s estate. **Rosano v. United States, 2001-1 U.S. Tax Cas. (CCH) ¶ 60,359 (2d Cir. 2001), aff’g 67 F. Supp. 2d 113 (E.D. N.Y. 1999).**

INSTALLMENT PAYMENT OF ESTATE TAX. The decedent owned and operated 82 residential rental properties. The decedent or the decedent’s employees performed all of the management and maintenance services for the properties. The decedent also had excess cash-on-hand from the rental properties, which was the insurance proceeds paid from the loss of one property by fire. The decedent had intended to use the money to replace the destroyed unit. The IRS ruled that the decedent’s interest in the rental properties was one business and was eligible for installment payment of estate tax as an interest in a closely held business. The IRS also ruled that the excess cash-on-hand was included in the value of the rental property business. **Ltr. Rul. 200114005, Dec. 15, 2000.**

MARITAL DEDUCTION. The decedent’s will created an annuity trust for the surviving spouse with an annuity amount of $100,000 annually. The trust also provided for an increase in the annuity to adjust for inflation. The decedent’s estate representative elected to treat the trust as QTIP and included the value of the annuity with the inflation provision in the value of the trust for marital deduction purposes. The court held that the marital deduction was limited to the amount of the trust needed to produce the annuity but that the inflation increases could not be considered because the increases were contingent upon any inflation occurring. **Estate of Sansone v. United States, 2001-1 U.S. Tax Cas. (CCH) ¶ 60,399 (C.D. Calif. 2001).**

VALUATION. The decedent’s house had been destroyed by fire and the decedent had obtained an agreement from the insurance company for the rebuilding of the original residence. The cost of rebuilding was far greater than the value of the original residence because of the historic nature of the building. At the decedent’s death, the building was only 57 percent completed, although the insurance company still was obligated to pay for reconstruction if the residence was completed. The decedent’s estate valued the residence, for estate tax purposes, as an incomplete building and deducted the cost of completing the reconstruction. The IRS sought to include the fair market value of the residence as completed because the estate was entitled to have the residence reconstruction completed and paid for by the insurance company. The court held that the date of death determined the point at which the estate property was to be valued; therefore, the residence was to be valued as an incomplete building with no consideration to future costs or reimbursements. The court held that the insurance company obligation was too contingent to be recognized as an asset of the estate on the decedent’s date of death. **Estate of Bull v. Comm’r, T.C. Memo. 2001-92.**

FEDERAL INCOME TAXATION

LEGISLATION. The Joint Committee on Taxation on April 19 released its “General Explanation of Tax Legislation Enacted in the 106th Congress,” which follows the chronological order of the tax legislation as signed into law. **JCS-2-01.**

BUSINESS EXPENSES. The taxpayer was a neurologist who owned 49 acres of rural property. The land consisted of six acres of hay fields, forest and open land. The property was also used as the taxpayer’s residence. The taxpayer purchased a tractor and fuel storage tank and claimed I.R.C. § 179 expense method depreciation deduction for the equipment. The tractor was used to cut the grass and weeds along the perimeter of the property and the fuel tank held fuel for the tractor. The court held that the taxpayer was not entitled to a depreciation deduction for the tractor and tank because the equipment was not used in the taxpayer’s farming business. **Solomon v. Comm’r, T.C. Summary Op. 2001-53.**

The taxpayer retired from the U.S. Air Force in 1989 as an engineer and began looking for civilian work in the same area. The taxpayer worked for a short time in 1991 but did not find permanent employment until 1999. The taxpayer claimed deductions for a home office, travel expenses and various other business expenses for 1995 and 1996 which

*Agricultural Law Manual (ALM).*
were disallowed by the IRS. The court acknowledged that job hunting expenses were generally deductible within a reasonable period but held that expenses incurred more than three years after employment in 1991 were not reasonable or deductible. **Ellis v. Comm’r, T. C. Summary Op. 2001-52.**

The taxpayer was employed by a state as an insurance examiner. The employment contract described the taxpayer as an independent contractor, although the state withheld and paid social security taxes on the amounts paid under the contract. The taxpayer sought unemployment insurance benefits after the contract was terminated but the state unemployment insurance commission ruled that the taxpayer was an independent contractor and not entitled to unemployment insurance. The taxpayer claimed deductions for travel, meals and other expenses associated with the taxpayer’s duties as an examiner. The taxpayer maintained an appointment log, credit card receipts and other receipts to substantiate the expenses; however, the court found much of the log to be unreliable because it was contradicted by the receipts. The IRS also argued that the taxpayer was not entitled to business deductions because the expenses were incurred during employment. The court held that the state unemployment insurance commission ruling that the taxpayer was an independent contractor was correct; therefore, the taxpayer was entitled to claim business expense deductions. The court disallowed the expenses claimed above those allowed by the IRS for lack of substantiation. **Goins v. Comm’r, T.C. Summary Op. 2001-55.**

**COURT AWARDS AND SETTLEMENTS.** The U.S. Supreme Court has denied certiorari in the following case. The taxpayer had filed a wrongful termination suit against an employer and received a judgment for back pay, front pay, and pension benefits. Under the taxpayer’s legal fee arrangement with the taxpayer’s lawyers, about two-thirds of the award was paid to the taxpayer’s attorneys. The court held that, under Alaska law, the lien for an attorney’s fees did not attach to an unrelated party under a grazing lease and used the proceeds to buy a farm. The farm was leased from another corporation owned by the taxpayer, which owned and operated a recycling business and a farm. The farm was used for poultry waste energy resources.

The inflation adjustment factor for calendar year 2001 is 1.7 cents per kilowatt hour on the sale of electricity produced from wind, closed-loop biomass, and renewable electricity production credit. These figures apply to calendar year 2001 sales of kilowatt hours of electricity produced in the United States or a possession from qualified energy resources. The inflation adjustment factor for calendar year 2001 is 1.641, and the reference prices are 2.57 cents per kilowatt hour for facilities producing electricity from wind energy resources and zero cents per kilowatt hour for facilities producing electricity from closed loop biomass and poultry waste. The renewable electricity production credit for calendar year 2001 is 1.7 cents per kilowatt hour on the sale of electricity, except as exempted by section 53(b) of the Act.

**HOBBY LOSSES.** The taxpayers owned an S corporation which owned and operated a recycling business and a farm. The farm was leased from another corporation owned by the taxpayers and the S corporation leased a portion of the farm to an unrelated party under a grazing lease and used the remaining portion for livestock and almond orchards. The court held that the S corporation did not operate the farm with the intent to make a profit because (1) the corporation did not
implement changes to the operations so as to make them profitable, (2) the taxpayers did not have expertise on how to operate a farm and the corporation failed to seek the advice of experts on how to make the farm profitable, (3) expenses were maximized and receipts minimized in the method of operating the farm, the corporation had high profits from the recycling business which were offset by the farm losses, (4) the losses increased each year, and (5) the taxpayer spent considerable time on the recycling business and not the farm business. O'Connor v. Comm'r, T.C. Memo. 2001-90.

IRA. The taxpayer was an attorney who operated a law practice through a professional corporation. The corporation provided a defined benefit, single-employer pension plan for the taxpayer and made all of the contributions to the plan. The taxpayer received a distribution from the plan and rolled the distribution over to an IRA. The taxpayer received an early distribution from the IRA but did not include the distribution in income. The IRS assessed taxes based on including the IRA distribution in the taxpayer’s income. The court held that the distribution was includible in the taxpayer’s income because the taxpayer failed to provide any evidence or argument to support the failure to include the distribution in income. Pena v. Comm'r, T.C. Memo. 2001-95.

INNOCENT SPOUSE DEFENSE. The taxpayer was married to a person who operated a cattle-raising activity. The taxpayer helped keep the records for the activity and knew that the activity was not profitable. The taxpayer testified that the spouse and taxpayer expected the activity to become profitable. The taxpayer separated from the spouse in 1993 and the couple was divorced in 1996. The taxpayer knew the spouse continued the cattle-raising activity in 1993 but did not participate in any aspect of the activity. The IRS disallowed deductions for expenses of the cattle-raising activity for 1993 in excess of income because the IRS ruled that the activity was not engaged in for profit. The taxpayer was assessed for the tax deficiency arising from the disallowed deductions. The taxpayer sought relief from the liability for the taxes under the innocent spouse defense. The court held that the IRS failed to prove that the taxpayer knew that the former spouse engaged in the cattle-raising activity without an intent to make a profit. King v. Comm’r, 116 T.C. No. 16 (2001).

INSTALLMENT REPORTING. The taxpayer owned a housing construction business. The taxpayer purchased land and built 58 homes on subdivided lots. The homes were sold through a third party real estate broker and the taxpayer accepted promissory notes for part of the purchase price. The taxpayer reported only the portion of the notes actually paid in each tax year, using the installment method of reporting the income from the notes. The court held that, under I.R.C. § 453(b)(2)(A), the taxpayer was not entitled to use the installment of reporting income from the notes because the taxpayer was a dealer in that the homes were held for sale to customers in the ordinary course of the taxpayer’s business. Raymond v. Comm’r, T.C. Memo. 2001-96.

The taxpayer, a trust, owned a meat packing business which was operated by the beneficiaries’ family for many years. The business had financial trouble and was sold to another company for cash and promissory note. The note provided for payments depending upon the net income of the business but also provided for full payment by a date certain. The company was later resold and the notes were modified as to the payment schedules. The taxpayers did not include the face value of the note in income for the year of the first sale. The taxpayers argued that the note had no ascertainable value in the first year as an open transaction because the payments were uncertain in that the payments depended upon the net income of the business. The court held that the open transaction rule was rarely applied because gain could be reported by the installment method of reporting. The court held that the notes had an ascertainable value in the year of sale because the business was well established and was reasonably expected to provide annual net income. Bernstein Patton Testamentary Trust v. United States, 2001 U.S. Tax Cas. (CCH) ¶ 50,332 (Fed. Cls. 2001).

The taxpayers owned an S corporation which manufactured, sold and leased farm irrigation equipment. The company provided financing to the buyers by taking promissory notes as part of the purchase price. The corporation reported the income from these sales on the installment method. The taxpayers agreed that dealers are not allowed the use of installment reporting of gain from the sale of personal property in the course of business. However, the taxpayers argued that the exception for farm property in I.R.C. § 453(l)(2)(A) applied to allow installment reporting because the irrigation equipment was used in farming by the purchasers. The court held that the exception applied only to farmers who sell personal property used by both the buyer and seller in a farming business; therefore, the taxpayer was not entitled by the exception to use the installment method of reporting. Thom v. United States, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,345 (D. Neb. 2001).

INTEREST. The IRS has ruled that interest or other fees imposed by credit card companies on tax payments made with a credit card are not deductible as interest. The IRS ruled that the interest is a personal interest expense. In addition, the IRS ruled that the prohibition of fees and charges, under Temp. Treas. Reg. § 301.6311-2T(a), for payment of taxes by credit card did not apply to credit card companies. CCA Ltr. Rul. 200115032, Feb. 12, 2001.

INVESTMENT INCOME. The taxpayer purchased silver coins using money borrowed specifically for the purchases. The taxpayer also owned residential rental properties which the taxpayer managed and maintained. The taxpayer sought to claim the interest paid on the silver coin purchase loans as an offset against the income from the rental properties. The court held that the income from the rental properties was not investment income because the taxpayer materially participated in that activity. The court also held that, because the taxpayer had no investment income from the silver coins or the rental properties, the investment interest from the silver coin loans was not deductible. Ritter v. Comm’r, T.C. Summary Op. 2001-57.

S CORPORATIONS-ALM § 7.02[3][e].

TERMINATION. An S corporation was administratively dissolved by the state because the corporation failed to file an annual report. The corporation was unaware of the dissolution for some time but took the necessary steps to reincorporate as soon as the state action was discovered. The
IRIS ruled that the administrative dissolution and reincorporation did not terminate the Subchapter S election or the corporation’s tax status as a corporation. Ltr. Rul. 200114029, Jan. 8, 2001.

SAFE HARBOR INTEREST RATES

<table>
<thead>
<tr>
<th>May 2001</th>
<th>Annual</th>
<th>Semi-annual</th>
<th>Quarterly</th>
<th>Monthly</th>
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<tr>
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<tr>
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<td>6.53</td>
<td>6.43</td>
<td>6.38</td>
<td>6.35</td>
</tr>
</tbody>
</table>


TRAVEL EXPENSES. The taxpayer was self-employed in insurance sales. The business required the taxpayer to travel to other cities to meet with clients. The taxpayer maintained an appointment calendar which included the names of cities, the names of the people visited and the number of miles traveled. The court found that the listing of names was not credible evidence because the names were added after the IRS audited the taxpayer’s returns. The court also discredited the mileage figures because the figures were often clearly incorrect, based on the other information in the calendar. The court held that the mileage deductions were properly disallowed by the IRS for lack of substantiation.


WITHHOLDING TAXES. The taxpayer was a professional baseball team which was required to pay back wages under an employment settlement. The employees who received the payments did not work for the team in the year the back wages were paid. The Sixth Circuit Court of Appeals held that, under Bowman v. United States, 824 F.2d 528 (6th Cir. 1987), the wages were taxable under the FICA and FUTA rules in effect in the years the wages were earned, not when they were paid. The Sixth Circuit case was designated as not for publication. The U.S. Supreme Court reversed, holding that the back wages were to be taxed under FICA and FUTA tax rules in effect in the year the back wages were paid and not when the wages were earned.

Cleveland Indians Baseball Co. v. United States, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,341 (S. Ct. 2001), rev’g, 215 F.3d 1325 (6th Cir. 2000).

PRODUCT LIABILITY

PESTICIDE. The plaintiff purchased a pesticide for the control of weevils in stored peas. The pesticide was manufactured by the defendant. The plaintiff sought recovery for breach of express and implied warranty from statements on the package labels, and manuals and for negligent oral misrepresentations by the defendant’s employees. In the first case, the court held that the breach of warranty claims were preempted by FIFRA because the claims arose from information on the product’s labels. The plaintiff had plead two kinds of oral representations by the defendant’s employees. The first involved statements which reiterated the information on the product label. The second set of representations involved information comparing the product to other products. The court held that the first oral representations were not actionable because they involved information on the product label and were preempted by FIFRA. However, the court held that the claim arising from the second set of oral representations involving comparison of the product to other products was not preempted by FIFRA because the comparative representations involved information not found on the label and were voluntarily made for commercial advantage. M & H Enterprises v. Tri State Delta Chemicals, Inc., 984 S.W. 2d 175 (Mo. Ct. App. 1998). On remand, the trial court granted summary judgment to the defendant on the negligent misrepresentation claim because the court found that no false statements were made by the defendant and that any errors in the instruction manual or label were pre-empted by FIFRA because the instructions were approved by the EPA. The appellate court affirmed.


WITHHOLDING TAXES. The taxpayer was a professional baseball team which was required to pay back wages under an employment settlement. The employees who received the payments did not work for the team in the year the back wages were paid. The Sixth Circuit Court of Appeals held that, under Bowman v. United States, 824 F.2d 528 (6th Cir. 1987), the wages were taxable under the FICA and FUTA rules in effect in the years the wages were earned, not when they were paid. The Sixth Circuit case was designated as not for publication. The U.S. Supreme Court reversed, holding that the back wages were to be taxed under FICA and FUTA tax rules in effect in the year the back wages were paid and not when the wages were earned.

Cleveland Indians Baseball Co. v. United States, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,341 (S. Ct. 2001), rev’g, 215 F.3d 1325 (6th Cir. 2000).

CITATION UPDATES

Catalano v. Comm’r, 240 F.3d 842 (9th Cir. 2001), aff’g, T.C. Memo. 1998-447 (S corporation business expenses) see p. 47 supra.

Witzel v. Comm’r, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,339 (7th Cir. 2001), on rem. from, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,164 (S. Ct. 2001), rev’g, 200 F.3d 496 (7th Cir. 2000), aff’g in part, T.C. Memo. 1999-64, (discharge of indebtedness) see 11 Agric. L. Dig. 21.
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by Neil E. Harl and Roger A. McEowen

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CALCULATING SOLVENCY: A NEW DEVELOPMENT
— by Neil E. Harl*

In handling discharge of indebtedness for income tax purposes, a highly important question is whether the taxpayer involved is solvent or insolvent. Except for the
solvent farm debtor rule, the provision for real property business debt, and purchase
price adjustment, once a taxpayer becomes solvent, any further discharge of
indebtedness produces ordinary income except for taxpayers in bankruptcy. For an
insolvent taxpayer, discharge of indebtedness is excluded from income although the
taxpayer’s tax attributes and income tax basis of assets must be reduced.

General rules on determining solvency

The determination of solvency is made immediately before the discharge of
indebtedness. Insolvency is defined as an “excess of liabilities over the fair market
value of assets.” Both recourse and non-recourse liabilities are included in the insolvency computation although contingent liabilities are not included. To determine the fact and extent of insolvency, an appraisal of assets may be necessary. In a 1989 Tax Court case, debtors were not allowed to use the insolvency rules where they failed to prove they were insolvent prior to the discharge of indebtedness. The separate assets of a debtor’s spouse are not included in determining the extent of insolvency.

Exempt property

A major issue in recent months has been whether assets which are exempt from execution by creditors are included in the insolvency/solvency calculation.

Until 1999, the authority was compelling that exempt property was not included in the calculations of solvency or insolvency. Beginning with a 1940 decision by the Board of Tax Appeals (the predecessor to the Tax Court), and continuing through three more Tax Court decisions and two Internal Revenue Service private letter rulings, the authority clearly supported the exclusion of exempt property in calculating insolvency. However, in May of 1999, IRS signaled a change of position by revoking one private letter ruling and a Field Service Advice stating that the prior IRS position had been in error and that exempt property should be included in the calculations.

Tax Court decision

On February 23, 2001, the U.S. Tax Court decided a case upholding the new IRS position announced in May of 1999. In that case, Carlson v. Comm’r, the value of a

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by Dr. Neil E. Harl and Prof. Roger A. McEowen
fishing permit, which was exempt under Alaska law to commercial fishermen, was not excluded from the taxpayer’s assets in determining insolvency. The taxpayer had financed the purchase of a boat for $202,451, in 1988, with a bank loan. In 1993, when the loan balance stood at $137,142, the bank foreclosed on the boat. The boat was sold for $95,000 as part of the foreclosure. The bank discharged the remaining $42,142 on the loan. As a result of the foreclosure sale, the taxpayers realized capital gain of $28,621 and discharge of indebtedness income of $42,142.

In determining whether the discharge of indebtedness amount was income,\(^{21}\) the question was whether the taxpayer was solvent. The taxpayer had assets of $875,251 and liabilities of $515,930. However, the taxpayer’s “limited entry” fishing permit had a fair market value of $393,400 and was exempt from creditors under Alaska laws.\(^ {24}\)

The taxpayer argued that exempt property should not count as “assets” for purposes of the insolvency determination with the result that the taxpayer would be insolvent and the discharge of indebtedness income of $42,142 would not be includible in income.\(^ {25}\) The Internal Revenue Service took the position that the exclusion of exempt property from “assets” was a judicially-created exemption that had not been codified in I.R.C. § 108 when enacted as part of the Bankruptcy Tax Act of 1980.\(^ {26}\)

The Tax Court concluded that I.R.C. § 108(e)(1) (which states “there shall be no insolvency exception from the general rule that gross income includes income from the discharge of indebtedness” except as provided in I.R.C. § 108(a)(1)(B)), eliminated the judicially-created exception for exempt property.\(^ {27}\)

This decision has important implications for farm and ranch estates where the value of exempt property is often $60,000 or more.\(^ {28}\)

**FOOTNOTES**

2. I.R.C. § 108(g).
3. I.R.C. § 108(c).
10. Merkel v. Comm’r, 109 T.C. 463 (1997), aff’d, 192 F.3d 844 (9th Cir. 1999) (guarantee of partnership debt treated as contingent debt and not included in debts for purposes of insolvency determination).
22. Id.
25. Id.

**CASES, REGULATIONS AND STATUTES**

by Robert P. Achenbach, Jr.

**BANKRUPTCY**

**GENERAL-ALM § 13.03.**

**ADMINISTRATIVE EXPENSE.** The debtor leased farm equipment from a creditor and was three months behind in the lease payments when the debtor filed for Chapter 11. The debtor continued to possess the equipment post-petition but made no use of the equipment. The case was later converted to Chapter 7 and the lessor obtained an order to reject the lease. The lessor sought an administrative expense claim in the Chapter 7 case for the lease payments incurred during the post-petition period of the Chapter 11 case. The trustee argued that the lease payments could not receive administrative claim priority because the estate did not benefit from the use of the equipment. The court held that, under Section 365(d)(10), the debtor was required to perform under the lease; therefore, the post-petition lease...
payments were entitled to administrative expense priority even if the debtor did not use the leased property. The court also held that the administrative claim status of the lease payments continued after the case was converted to Chapter 7, although the claim would be subordinated to the administrative claims which arose after the conversion to Chapter 7. In re Eastern Agri-Systems, Inc., 258 B.R. 352 (Bankr. E.D. N.C. 2000).

EXECUTORY CONTRACTS. The debtor was a hog producer who entered into a contract to supply hogs to a processor. Under the contract the processor agreed to purchase the hogs at a set price. If the market price is less than the contract price when some hogs are delivered, the deficit is merely recorded. If the market price is above the contract price when hogs are delivered, the excess is first applied against the deficit account and then split between the parties, a so-called ledger contract. So long as the contract was not breached or repudiated by the debtor, the deficit account could not be collected from the debtor. When the debtor filed for Chapter 11 the deficit account had exceeded $5 million and the processor sought, under Section 365(c), to force the trustee to reject the contract so that the deficit account could be a claim against the estate. The processor argued that the contract could not be assumed under Section 365; therefore, it must be rejected. The court held that the contract could be assumed under Section 365 because (1) it was not a financing arrangement but a contract for goods and (2) the processor failed to prove that the contract could not be assigned. The court noted that the processor’s business significantly relied on the hogs produced by the debtor and had granted the deficit account feature to insure a steady supply of hogs. In re Neuhoff Farms, Inc., 258 B.R. 343 (Bankr. E.D. N.C. 2000).

EXEMPTIONS

HOMESTEAD. The debtor lived on a farm which was separated by a road from a farm owned by the debtor and two siblings, subject to a life estate held by the debtor’s parent. The debtor had farmed the parent’s property but had only raised hogs in several buildings during the years before the bankruptcy filing. At the time of the petition, the debtor was cleaning the buildings and not raising any hogs. The debtor claimed the debtor’s residence as exempt and also included the debtor’s interest in the parent’s farm as part of the homestead exemption. The court held that the debtor could not claim the interest in the parent’s farm as part of the homestead exemption because the debtor did not have any legal right to possession of the property, even though the debtor did operate part of the debtor’s business on the parent’s farm. In re Stenzel, 259 B.R. 141 (Bankr. 8th Cir. 2001).

FEDERAL TAX-ALM § 13.03[7].

DISCHARGE. The debtor filed a Chapter 7 case in December 1998 and received a discharge in March 1999. The debtor filed a Chapter 13 case in August 1999 which included tax claims for 1995 and 1996. The debtor argued that the tax claims were dischargeable because the returns were due more than three years before the filing of the Chapter 13 case. The IRS argued that the three year period of Section 507(a)(8)(i) was tolled by the prior Chapter 7 case. The court held that the three year period was not tolled by law but that the period would be tolled under the court’s equitable powers because the debtor used serial filings to prevent the IRS from collecting the taxes within the three years. In re Evoli, 258 B.R. 839 (Bankr. M.D. Fla. 2001).

The debtor did not file or pay 1991 income taxes. In 1993 the IRS prepared a substitute return and assessed the debtor for the taxes. In 1996 the debtor filed a return but did not include wages and IRA distributions that the IRS had included in its return and assessment. The debtor sought discharge of the taxes because the return was filed more than three years before the bankruptcy petition. The court held that the late filed return would not be considered a return for purposes of Section 523(a)(1)(B) because (1) the IRS prepared a substitute return first, (2) the debtor’s return did not include all income, and (3) the debtor did not provide any explanation as to why the debtor’s return excluded items of income. In re Shrenker, 258 B.R. 82 (Bankr. E.D. N.Y. 2001).

CONTRACTS

PRODUCTION CONTRACTS. The Oklahoma Attorney General has issued an opinion as to three issues involving farmer production contracts. These contracts generally provide for the raising of livestock, birds or crops with the farmer supplying the facilities and labor and the integrator supplying the livestock, birds or seeds and the feed or other supplies. The integrator generally retains title to the livestock, birds or crops and the contract generally establishes the amount paid to the farmer by the quantity and quality of the final product. The AG noted that many of these contracts are forms drafted by the integrator, with no terms negotiated by the parties. The AG opinion states that such contracts are contracts of adhesion and could be held to be void, depending upon whether the factual circumstances demonstrate unconscionability. The AG opinion notes that contracts of adhesion will be interpreted against the drafter. The AG opinion also states that the contracts would be governed by the laws of Oklahoma if the farmer’s property and activities take place in Oklahoma, unless a clear choice of law clause provides for the governance of the laws of another state. The AG opinion described a production contract which sets forth in detail the manner in which the livestock or crop is to be raised. The AG opinion states that in such circumstances the contract establishes an employment relationship because the integrator has significant control over the farmer’s activities. Okla. A.G. Opinion 01-17, April 11, 2001.

FEDERAL AGRICULTURAL PROGRAMS

BRUCELLOSIS. The APHIS has issued interim regulations amending the brucellosis regulations to change

CONSERVATION RESERVE PROGRAM. The CCC has issued final regulation amending the Conservation Reserve Program (CRP) regulations to implement provisions of Title XI of the Agriculture, Rural Development, Food and Drug Administration, and Related Agencies Appropriations Act, 2001, and provide for enrollment, in the States of Iowa, Minnesota, Montana, Nebraska, North Dakota, and South Dakota, of certain wetlands and buffer acreage on a pilot basis into the CRP under the Farmable Wetlands Pilot Program. 66 Fed. Reg. 22097 (May 2, 2001).

EDUCATION. The USDA has issued proposed regulations to implement the Outreach and Assistance for Socially Disadvantaged Farmers and Ranchers Program whereby the 1890 Land Grant Colleges, including Tuskegee University, Indian tribal community colleges and Alaska native cooperative colleges, Hispanic serving post-secondary educational institutions and/or other qualifying educational institutions and community-based organizations are eligible to compete for grants and cooperative agreements to provide outreach and technical assistance to socially disadvantaged farmers and ranchers. The program's objective is to reverse the decline of socially disadvantaged farmers and ranchers across the United States. 66 Fed. Reg. 21607 (April 30, 2001).

FOOT AND MOUTH DISEASE. "USDA will compensate livestock producers for their losses if efforts to keep the highly contagious foot-and-mouth disease out of the United States fail and animals have to be destroyed in order to contain the disease, Agriculture Secretary Ann Veneman told the House Appropriations subcommittee on agriculture last week. "She said USDA has studied the matter and is prepared to pay direct costs for the fair market value for any animals that must be destroyed. The department has not worked out the details of any 'associated costs' that also might arise but have not been identified.

"Veneman told the committee that a paper outlining the details of the compensation program is still being drafted and would be available soon. The department is having additional discussions on the matter with the White House Office of Management and Budget.

"Veneman said she wanted to reassure producers that there would be an underlying program to help farmers devastated by livestock losses if the disease should make its way into the United States. 'Producers have the assurance that they should report an outbreak,' because they will be compensated, she said." The Food Chemical News, April 30, 2001.

KARNAL BUNT. The APHIS has issued proposed regulations which establish new areas to be regulated because of the existence of Karnal bunt disease. The proposed regulations also remove other areas from regulation. 66 Fed. Reg. 20204 (April 20, 2001).

FEDERAL ESTATE AND GIFT TAX

CLAIMS. The IRS had assessed a decedent’s estate for an income tax deficiency resulting from the decedent’s improper claim for earned income credit. The executor of the estate argued that the IRS claim was not allowed because the claim was filed after the time period allowed for claims against a decedent’s estate under state law. The court held that the IRS was not subject to the state statute of limitations because no law or regulation has waived the IRS governmental immunity to the state statute. United States v. Stevenson, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,371 (M.D. Fla. 2001).

FAMILY-OWNED BUSINESS DEDUCTION. The IRS has issued a Chief Counsel Advice letter as to two issues involving FOBD. The first issue was whether and how the IRS could file a lien against personal property if there is insufficient real property to which a lien can attach to secure the possible recapture of FOBD benefits. The IRS ruled that, when a FOBD election is made, a lien against estate property arises under I.R.C. §§ 2057(i)(3)(P), 6324B. The IRS noted that guidance will be supplied by forthcoming regulations. The second issue was whether an estate can designate as subject to the FOBD lien only estate FOBD business interests sufficient to satisfy the recapture liability. The IRS ruled that all FOBD interests for which the election was made are subject to the lien. The IRS noted that the lien amount is limited to the recapture amount but that all FOBD interests remain subject to the lien until the recapture liability has ended. The Digest will publish an article on this ruling by Neil E. Harl in a future issue. CCA Ltr. Rul. 200116001, April 23, 2001.

GIFT. The decedent bequeathed property in trust to the surviving spouse. The surviving spouse disclaimed a portion of the trust, resulting in the trust property passing to the decedent’s children. The disclaimer was conditioned upon the donees paying the gift tax resulting from the disclaimer. The IRS ruled that the amount of the taxable gift would be reduced by the amount of gift tax paid by the donees. Ltr. Rul. 200116006, Dec. 14, 2000.

INSTALLMENT PAYMENT OF ESTATE TAX. The decedent’s estate had elected to pay the estate tax over 15 years. After the 15 years had expired, the IRS notified the estate that a substantial portion of the estate tax remained to be paid. The estate sent a payment with an offer in compromise, which was rejected by the IRS. The IRS then assessed the estate for the unpaid taxes. The estate filed an action under I.R.C. § 7422(j), claiming that the estate had paid all taxes due. The case does not identify the estate’s reason for contesting the tax amount. However, the estate admitted that it had not paid all the taxes and that it was not current in the installment payments. The court held that the court did not have jurisdiction, under I.R.C. § 7422(j), to hear the claim because the estate was not current on payment of all installments. Hansen v. United States, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,382 (8th Cir. 2001).
MARITAL DEDUCTION. The decedent’s will provided for an annuity trust for the surviving spouse, in which the surviving spouse received $100,000 annually with increases for inflation. The remainder was held by a charity. The executor elected QTIP status for the annuity trust interest passing to the spouse and claimed a marital deduction based on the $100,000 annuity amount. The estate argued that the value of the marital deduction should be increased to reflect the inflation provision. The court held that the marital deduction could not include the inflation provision because the inflation provision was defeasible upon the contingency that inflation not occur. *Estate of Sansone v. Commr*, 2001-1 U.S. Tax Cas. (CCH) ¶ 60,399 (C.D. Calif. 2001).

SPECIAL USE VALUATION-ALM § 5.03[2]. The IRS has issued the 2001 list of average annual effective interest rates charged on new loans by the Farm Credit Bank system to be used in computing the value of real property for special use valuation purposes:

<table>
<thead>
<tr>
<th>District</th>
<th>Interest rate</th>
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VALUATION. The taxpayer established a trust and transferred a vacation residence to the trust. The taxpayer claimed to use the residence for at least the greater of 14 days or 10 percent of the time the property is leased to others. The IRS ruled that the property was a qualified personal residence for purposes of I.R.C. § 2702. *Ltr. Rul. 200117021*, Jan. 25, 2001.

FEDERAL INCOME TAXATION

LEGISLATION. Legislation has been introduced in the U.S. House of Representatives which excludes from income the gain from the sale of livestock raised as part of an FFA or 4H project by minors. *H.R. 1599*.

CORPORATIONS-ALM § 7.02.*

CONTRIBUTIONS. The taxpayers were members of one family who had operated a farm as a joint venture. The taxpayers incorporated the farm, with each member contributing assets subject to liabilities. The corporation assumed the liabilities but the taxpayers retained personal liability for the liabilities assumed by the corporation. Because the assumed liabilities exceeded the taxpayers’ basis in each asset, the IRS assessed tax for the gain, measured by the difference between the basis of each asset and the liability assumed by the corporation for that asset. The gain was long-term or short-term, depending upon the holding period for each asset. The taxpayers argued that the gain should not be recognized because the taxpayers remained personally liable for the corporate debt. The taxpayers sought to characterize the personal liability as similar to a loan to the corporation from the shareholders. The court rejected this characterization and held that the taxpayers recognized gain from the contribution of property to the corporation with assumed liabilities in excess of the taxpayers’ basis. The Digest will publish an article on this case by Neil E. Harl in a future issue. *Seggerman Farms, Inc. v. Comm’r*, T.C. Memo. 2001-99.

COST-SHARING PAYMENTS. The USDA has determined that all state cost-share payments made to individuals as part of a Brownfields Grant by the Wisconsin Department of Commerce are made primarily for the purpose of restoring the environment, for the purposes of I.R.C. § 126. The determination permits recipients of these cost-share payments to exclude them from gross income to the extent allowed by the I.R.C. *66 Fed. Reg. 20965* (April 26, 2001).

COURT AWARDS AND SETTLEMENTS-ALM § 4.02[14]. The taxpayer’s employment was terminated and the taxpayer believed the termination was solely because the taxpayer knew too much about the employer’s environmental violations. The taxpayer’s lawyer negotiated a termination settlement which exceeded the normal termination payment by $280,000. The taxpayer excluded the entire settlement from gross income, arguing that the settlement was a payment for personal injuries. The District Court held that, although no suit was filed and the taxpayer made no personal injury claim to the employer, the settlement was paid, in part, to compensate the taxpayer for wrongful employment termination. The court allocated the settlement to the personal injury only to the extent the settlement exceeded the normal termination payment, $280,000. The appellate court affirmed the lower court’s holding that some of the payment above the normal termination amount was excludible from income as compensation for personal injuries. However, the appellate court remanded the case for a determination of the portion of the $280,000 which was compensation for the personal injuries. On remand, the trial court held that the entire $280,000 was excludible from income as payment for personal injuries. *Greer v. United States*, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,377 (E.D. Ky. 2001), *on rem from*, 207 F.3d 322 (6th Cir. 2000), *aff’d in part*, 98-2 U.S. Tax Cas. (CCH) ¶ 50,821 (E.D. Ky. 1998).

The taxpayer was employed for several years by a drugstore chain. The taxpayer experienced various physical and mental problems from the strain of working long hours and irregular hours. A class action suit was filed by other parties against the drugstore chain for unpaid overtime compensation. The taxpayer joined in the suit as a class member but did not assert any claims for physical or mental injuries. The drugstore agreed to a monetary settlement and the settlement mentioned that the taxpayer’s payment was for personal injuries. The taxpayer excluded the settlement payment from income as a payment for personal injuries. The court held that the payment was included in income because the class action petition made no mention of claims for personal injuries but sought damages only for unpaid compensation. *Fawcett v. Comm’r*, T.C. Summary Op. 2001-65.
**DISASTER PAYMENTS.** On April 10, 2001, the President determined that certain areas in Massachusetts were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of severe storms and flooding on March 5, 2001. *FEMA-1364-DR.* On April 10, 2001, the President determined that certain areas in Vermont were eligible for assistance under the Act as a result of record snow fall on March 5-7, 2001. *FEMA-3167-EM.* Accordingly, a taxpayer who sustained a loss attributable to the disasters may deduct the loss on his or her 2000 federal income tax return.

**EARNED INCOME CREDIT.** The U.S. Supreme court has denied certiorari in the following case. The taxpayer claimed welfare payments under AFDC and SSI programs, Social Security disability benefits, and gifts as wages on the taxpayer’s income tax return. No other wages or income were reported such that, after the standard deduction and exemptions, the taxpayer had zero taxable income. The taxpayer also claimed earned income credit. The Tax Court held that earned income does not include welfare payments such as AFDC and SSI, Social Security disability benefits or gifts. The appellate court affirmed in an opinion designated as not for publication. *Powers v. Comm’r,* T.C. Memo. 2000-5, *aff’d*, 2000-1 U.S. Tax Cas. (CCH) ¶ 50,838 (6th Cir. 2000), *cert. denied*, ___ U.S. ___ (2001).

**FUEL CREDIT.** The IRS has announced that the reference price that is to be used in determining the availability of the I.R.C. § 29 tax credit for the production of fuel from nonconventional sources for calendar year 2000 is $26.73. Since this amount does not exceed $23.50 multiplied by the inflation adjustment factor, the I.R.C. § 29(b)(1) phaseout of the credit will not occur for any qualified fuel based on the above reference price. *Notice 2001-31, I.R.B. 2001-17, 1093.*

**HOME OFFICE.** The taxpayer was a professional violinist who claimed a home office deduction for the living room in the taxpayer’s apartment which was used solely for practicing and storage of music. The taxpayer performed at several film studios. The court applied two tests from *Commissioner v. Soliman,* 506 U.S. 168 (1993), (1) the relative importance of the activities performed at each business location and (2) the amount of time spent at each location. The court held that the first test was inconclusive because the practice and performance activities had similar importance. The appellate court held that the taxpayer allowed a deduction for the living room as a home office because the taxpayer spent significantly more time practicing than performing. *Popov v. Comm’r,* 2001-1 U.S. Tax Cas. (CCH) ¶ 50,353 (9th Cir. 2001).

**IRA.** The taxpayer owned four IRAs and was required by a divorce decree to transfer ownership in two IRAs to the taxpayer’s former spouse. At the time of the transfer the taxpayer was receiving annual distributions from the IRAs. After the transfer, the total annual payments were less but the payments from the remaining IRAs were the same. The IRS ruled that the transfer of the two IRAs pursuant to the divorce decree was nontaxable. In addition, the reduction in total annual payments did not violate I.R.C. § 72(t)(4) as a substantial modification because the distributions from the remaining IRAs remained the same. *Ltr. Rul. 200116056, Jan. 26, 2001.*

**INNOCENT SPOUSE DEFENSE.** The decedent was married during the tax years involved. The decedent was predeceased by the spouse. The decedent’s spouse separately owned partnership interests in those tax years. After the decedent’s and spouse’s deaths, the IRS made administrative adjustments to the partnership tax items, resulting in assessments against the decedent and spouse. The decedent’s executor filed Form 8857, “Request for Innocent Spouse Relief” on behalf of the decedent as to the partnership-related assessment. In a Chief Counsel Advice letter, the IRS ruled that a executor could not make the election for innocent spouse relief but could only pursue the claim if the decedent had made the election while still alive. *CCA Ltr. Rul. 200117005, Jan. 12, 2001.*

**PASSIVE LOSSES.** The taxpayers owned the majority of the stock of an S corporation which provided management services for several partnerships in which the taxpayers owned an interest. The taxpayers actively participated in the management activities of the corporation but received passive income and losses from the partnerships. The taxpayers offset the passive income and nonpassive losses, arguing that was allowed by the legislative history of I.R.C. § 469 because the S corporation and partnerships were related entities with income and deductions arising from the same activities. The IRS argued that the offset was not allowed because the statute and regulations under the statute allowed such offset only for interest items by lenders. The Tax Court held that the failure of the IRS to promulgate regulations in keeping with the legislative history did not prevent the offset which was otherwise allowable under the letter and intent of the statute. The appellate court reversed, holding that the statute was plain and unambiguous in prohibiting the offset of passive income against nonpassive losses. *Hillman v. Comm’r,* 2001-1 U.S. Tax Cas. (CCH) ¶ 50,354 (4th Cir 2001), *rev’g*, 114 T.C. 103 (2000).

**PENSION PLANS.** For plans beginning in April 2001, the weighted average is 5.85 percent with the permissible range of 5.26 to 6.14 percent (90 to 106 percent permissible range) and 5.26 to 6.43 percent (90 to 110 percent permissible range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). *Notice 2001-32, I.R.B. 2001-18, 1146.*

**RETURNS.** The IRS has released revised Publication 969 (Rev. April 2001), Medical Savings Accounts. This document is available at no charge (1) by calling the IRS’s toll-free telephone number, 1-800-829-3676; (2) via the internet at http://www.irs.gov/prod/cover.html; (3) through FedWorld; or (4) by directly accessing the Internal Revenue Information Services bulletin board at (703) 321-8020.

**S CORPORATIONS-ALM § 7.02[3][c].**

**BASIS.** The taxpayer owned an S corporation formed for the purpose of acquiring another unrelated corporation. The funds for the acquisition were borrowed from a bank and structured in such a way as to include a personal loan by the taxpayer. However, the court found that, in substance, the taxpayer’s personal loan was actually a personal guarantee.
of the S corporation’s loan because the taxpayer did not receive any funds and was not required to make any payments on the loan unless the S corporation failed to make payments. The court held that the taxpayer could not increase the taxpayer’s basis in the corporation for the guarantee of the S corporation loan. This resulted in disallowance of the taxpayer’s share of corporate losses. Grojean v. Comm’r, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,355 (7th Cir. 2001), aff’g, T.C. Memo. 1999-425.

SALE OF RESIDENCE. A federal District Court held that the TRA 1997 provision amending the home sale rules does not violate the Constitution’s due process or equal protection clauses by being made retroactive to home sales occurring on or after May 7, 1997, and not to home sales occurring earlier that year. Buerer v. United States, No. 1:00CV269 (W.D. N.C. April 25, 2001).

SELF-EMPLOYMENT TAX. The taxpayer was self-employed as a sales representative. The taxpayer’s spouse was also self-employed in other business and did not participate in the taxpayer’s business. The taxpayer and spouse filed separate returns. The taxpayer was the resident of a community property state. The taxpayer filed a timely income tax return but claimed only one-half of the income from the sales representative business as taxable income. The taxpayer argued that, under the state community property rules, one-half of the taxpayer’s income belonged to the spouse. The court held that all of the income from the sales representative business was earned by the taxpayer and was taxable to the taxpayer. Landsberg v. Comm’r, T.C. Memo. 2001-105.

SOCIAL SECURITY BENEFITS. The taxpayer had begun receiving social security benefits at retirement at age 62 in 1992. The taxpayer was employed in 1997 but received full social security benefits. The SSA determined that the taxpayer had received excess benefits in 1997 because of the employment income and began withholding social security benefits until the excess was eliminated. The IRS assessed taxes for 1997 by including the social security benefits until the excess was eliminated. The court held that the excess social security benefits were included in income in 1997 because they were not a loan. The court noted that I.R.C. § 86(d) provided rules for mitigating the harsh effects of excess social security payments and that the mitigating calculations were properly applied here. Zavatto v. Comm’r, T.C. Summary Op. 2001-62.

THEFT LOSS. The taxpayer had owned a residence subject to a mortgage. When the taxpayer defaulted on the loan payments, the lender foreclosed and the property was sold at a foreclosure sale. The taxpayer challenged the foreclosure order in state court on procedural issues but the state trial and appellate courts held that the foreclosure order was properly made. The taxpayer claimed the value of the residence as a theft loss deduction, characterizing the loss as “judicial theft of real estate.” The court held that the foreclosure order was fully adjudicated in the state courts and was binding on the taxpayer; therefore, no theft occurred and the deduction was not allowed. Johnson v. Comm’r, T.C. Memo. 2001-97.

SECURED TRANSACTIONS

PRIORITY. The plaintiff loaned money to a farmer for operating expenses to grow a crop of corn in 1995. In March 1995, the farmer granted the plaintiff a security interest in the crop and other farm products. The security interest was perfected. In February 1995, the farmer had executed a contract to deliver 30,000 bushels of corn to the defendant. The plaintiff notified the defendant about the security interest in the corn. The farmer delivered a portion of the contracted corn but notified the defendant that no more corn would be delivered. The defendant purchased replacement corn and deducted the price from the amount paid to the farmer for the corn delivered. The case does not discuss why the setoff was not limited to the difference in price for the cover corn as against the contract price. The plaintiff argued that its security interest had priority over the defendant’s right to setoff the corn purchased to cover the contract. The court held that the defendant’s right of setoff did not affect the security interest since the plaintiff was not a party to the contract. Therefore, the court held that the security interest had priority and the defendant was required to pay the setoff amount to the plaintiff. Ag Services of America v. DeBruce Grain, 19 P.3d 188 (Kan. Ct. App. 2001).

STATE REGULATION OF AGRICULTURE

TUBERCULOSIS. The plaintiff had imported from Canada a herd of elk. Six of the elk responded positive to a tuberculosis test and were required to be destroyed in order to conduct a post-mortem test for tuberculosis. The issue was the value of the six elk for purposes of compensating the plaintiff under Mo. Stat. § 267.610. The plaintiff argued that the elk should have been valued as if they were disease free. The court held that the statute required an appraisal of the destroyed animal in its condition at the time of the appraisal, which included its condition as infected with tuberculosis. Carmack v. Missouri Dept. of Agriculture, 31 S.W.3d 40 (Mo. Ct. App. 2000).

CITATION UPDATES

Catalano v. Comm’r, 240 F.3d 842 (9th Cir. 2001), aff’g, T.C. Memo. 1998-447 (S corporation business expenses) see p. 47 supra.
The Agricultural Law Press presents

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by Neil E. Harl and Roger A. McEowen

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LAW AIMED AT BOLSTERING COMPETITIVE LIVESTOCK MARKETS IN MISSOURI UPHELD AS CONSTITUTIONAL

— by Roger A. McEowen* and Neil E. Harl**

In an opinion viewed as crucial to the continued viability of independent livestock producers in Missouri, the United States Circuit Court of Appeals for the Eighth Circuit in *Hampton Feedlot, et. al. v. Nixon*, upheld as constitutional provisions of the Missouri Livestock Marketing Law that the state legislature passed in 1999 preventing livestock packers that purchase livestock in the state of Missouri from discriminating against producers in purchasing livestock except for reasons of quality, transportation costs, or special delivery times. The law also requires any differential pricing to be published.

Packers and Stockyards Act.

In 1921, the Congress enacted the Packers and Stockyards Act (PSA) as a means of regulating the meatpacking industry. In 1917, President Wilson directed the Federal Trade Commission (FTC) to investigate the packing industry, and the FTC’s report documented widespread anti-competitive practices including the operations of stockyards and control of packing plants. In 1920, the five largest packers of the day (Swift & Co., Armour & Co., Morris & Co., Cudahy Packing Co. and Wilson & Co.) signed a consent decree in an attempt to ward off the PSA’s passage. Under the consent decree, the five packers were prohibited (among other things) from maintaining or entering into any contract, combination or conspiracy in restraint of trade or commerce, or monopolizing or attempting to monopolize trade or commerce. After passage of the PSA, the packers sued to have the decree either vacated or declared void, but in 1928 the Supreme Court upheld the consent decree. However, the decree was terminated on November 23, 1981. While the PSA was “the most far-reaching measure and extend[ed] further than any previous law into the regulation of private business with few exceptions,” and the powers given the Secretary of Agriculture were more “wide-ranging” than the powers granted to the FTC, the PSA was upheld as constitutional in several court cases from 1922-1934. Unquestionably, the PSA extends well beyond the scope of other antitrust law.

The PSA is administered by the Packers and Stockyards Administration, a part of the United States Department of Agriculture. Enforcement of the PSA is either by a civil

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See the back page for details about the 2001 Agricultural Tax and Law Seminars by Dr. Neil E. Harl and Prof. Roger A. McEowen
action, initiated by the person aggrieved by the violation of the PSA, or by an action taken by the U.S. Attorney upon request of the Secretary of Agriculture, with jurisdiction in the federal district courts. In recent years, however, the widespread belief has been that enforcement of the PSA has been less than vigorous. This has led to legislative attempts in several states to engraft some of the provisions contained in the PSA into state law with enforcement authority vested in the particular state Attorney General.

**The South Dakota Provision**

South Dakota enacted a price discrimination statute in 1999, but the legislation was declared unconstitutional because it applied to livestock slaughtered in South Dakota regardless of where the livestock was purchased. As such, the legislation violated the “dormant Commerce Clause” by requiring out-of-state commerce to be conducted according to South Dakota’s terms.

**The Missouri Act**

In *Hampton Feedlot, et. al. v. Nixon,* a consortium of packer interests filed a declaratory judgment action seeking to have the Missouri law declared unconstitutional. The federal district court agreed, and granted permanent injunctive relief before the statute took effect. On appeal, the Eighth Circuit reversed.

While the court noted that the Missouri Livestock Marketing Law closely resembled the South Dakota provision by requiring packers to disclose any price that they offer to pay or pay to sellers of livestock for slaughter unless the packers purchase livestock on a grade and yield basis, the court also noted that the Missouri provision does not eliminate any method of sale - it simply requires price disclosure. More importantly, however, the court noted that the Missouri statute, unlike the South Dakota provision, only regulates the sale of livestock sold in Missouri. As such, the extraterritorial reach that the court found fatal to the South Dakota statute is not present in the Missouri statute. The court reasoned that the statute was indifferent to livestock sales occurring outside Missouri and had no chilling effect on interstate commerce because packers could easily purchase livestock other than in Missouri to avoid the Missouri provision. The court also noted that Missouri had legitimate reasons for enacting a price discrimination statute, including preservation of the family farm and Missouri’s rural economy, and an improvement in the quality of livestock marketed in Missouri. The court opined that the Missouri legislature has the authority to determine the course of its farming economy and that the legislation was a constitutional means of doing so. Likewise, the court noted that the federal PSA supports such legislation at the state level.

**Implications of the decision**

Packer buying activity amounting to a boycott of Missouri livestock may be an initial reaction to the court’s opinion. However, such action would be highly suspect inasmuch as the refusal to buy livestock from particular sellers has been held to be a restraint of trade and an unfair discriminatory practice under the PSA. In any event, an attempt to avoid purchasing livestock in Missouri would likely be viewed as solid confirmation of price discriminatory conduct which could lead to prosecution under the PSA.

Undoubtedly, the Eighth Circuit's ruling provides other states a model to regulate anti-competitive practices in the livestock industry.

**FOOTNOTES**

7. 61 Cong. Rec. 1872 (1921).
10. The Commerce Clause of the U.S. Constitution (Art. I, §8) forbids discrimination against interstate commerce, which repeatedly has been held to mean that the states 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. See, e.g., Dean Milk Co. v. Madison, 340 U.S. 349 (1951) (holding as unconstitutional a city ordinance prohibiting the sale of milk in the city unless it had been bottled at an approved plant within five miles of the city); Hunt v. Washington State Apple Advertising Commission, 432 U.S. 333 (1977) (state statute requiring all closed containers of apples sold or shipped into the state to bear “no grade other than the applicable U.S. grade or standard” held an unconstitutional discrimination against interstate commerce). The overriding rationale of the commerce clause was to create and foster the development of a common market among the states and eradicate internal trade barriers.
12. Id.
14. The court found persuasive the testimony of a witness for the state that by providing an incentive for packers to buy livestock on the basis of quality through the grade and yield method, producers would make better genetic decisions, raise better quality animals and earn a better price. The court also noted that, under the current system, larger producers receive premiums for their livestock, giving them an economic advantage over smaller farmers. See, e.g., United States v. American Livestock Commission Co., et. al., 279 U.S. 435 (1929); Capitol Packing Co. v. United States, 350 F.2d 67 (10th Cir. 1965) (refusal to purchase livestock from a particular market agency for seven weeks).
15. See *In re Sterling Colorado Beef Co.,* 39 Agric. Dec. 184 (1980) (dual pricing system held to be unjustly discriminatory and undue or unreasonable preference or advantage violating PSA).
In re McIver, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,384 held that the District Court's ruling was the law of the case. Bankruptcy court's disagreement on this issue, but the court supported the Keyes, 255 B.R. 819 (Bankr. E.D. Va. 2000) Bankruptcy Court noted that the contrary holding in was part of the security for the tax claim. On remand, the Court held that the present value of the monthly payments were included in estate property. The District Court held that the pension plan payments were included in bankruptcy estate property so as to be considered as part of the property securing the IRS claim. The pension plans had clauses restricting assignment or attachment of the plan distributions or principal. The District Court held that the pension plan payments were subject to the tax liens; therefore, the plan restrictions were not effective under nonbankruptcy law and the pension plan payments were included in estate property. The District Court held that the present value of the monthly payments was part of the security for the tax claim. On remand, the Bankruptcy Court noted that the contrary holding in In re Keyes, 255 B.R. 819 (Bankr. E.D. Va. 2000) supported the Bankruptcy court's disagreement on this issue, but the court held that the District Court’s ruling was the law of the case. In re McIver, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,384 (Bankr. D. Md. 2001), on rem. from, 255 B.R. 281 (D. Md. 2000).

FEDERAL AGRICULTURAL PROGRAMS

“MAD COW” DISEASE. The APHIS has issued proposed regulations amending the livestock and meat importation regulations by adding Germany, Italy, and Spain to the list of regions where bovine spongiform encephalopathy exists because the disease has been detected in native-born animals in those regions. Germany, Italy, and Spain are currently listed among the regions that present an undue risk of introducing bovine spongiform encephalopathy into the United States. The effect of this action is a continued restriction on the importation of ruminants that have been in Germany, Italy, or Spain and meat, meat products, and certain other products of ruminants that have been in Germany, Italy, or Spain. 66 Fed. Reg. 22425 (May 4, 2001), amending 9 C.F.R. § 94.18.

FEDERAL ESTATE AND GIFT TAX

GROSS ESTATE. The decedent owned land which was leased to a corporation owned by the decedent which processed and marketed nuts produced by the decedent. The written lease had a term of 10 years and allowed the tenant to continue leasing at will. The lease had no provision for fixtures added to the property by the corporation. The court held that, under California law, a tenant had the right to remove business fixtures during the term of the lease. The court further held that the term of a lease did not include holdover tenancies. At the decedent’s death, the original term had expired and the corporation was leasing the property at will. Therefore, the court held that the business fixtures on the property belonged to the decedent and were included in the decedent’s gross estate. The appellate court reversed in a decision designated as not for publication. The appellate court held that the lease included an implied right to remove trade fixtures because the lease treated any holdover as an extension of the original lease terms, including the right to remove trade fixtures. The case was remanded for findings as to whether the fixtures involved were trade fixtures governed by the lease. Estate of Frazier v. Comm‘r, 2001-1 U.S. Tax Cas. (CCH) ¶ 60,404 (9th Cir. 2001), rev’g and rem’g, T.C. Memo. 1999-201.

SPECIAL USE VALUATION-ALM § 5.03[2].* In a Chief Counsel Advice letter, the IRS has ruled that the I.R.C.

BANKRUPTCY


FEDERAL TAX-ALM § 13.03[7].* DISCHARGE. The debtors had filed returns for 1992, 1993 and 1994 but had not paid the taxes owed. The debtors filed several bankruptcy cases in response to attempts by the IRS to levy for the taxes. The debtors filed the current bankruptcy case in 1998 such that all three tax returns were due more than three years before the petition filing. The IRS sought to have the taxes for all three years declared nondischargeable because the interim bankruptcy cases tolled the three year period of Sections 523(a)(1) and 507(a)(8). The court initially held that the three year period could be tolled by equitable considerations to allow the IRS sufficient time to attempt collection. The court held that the 1992 taxes were dischargeable because the IRS had over 1200 days to seek collection of the taxes. The court held, however, that the 1993 and 1994 taxes were nondischargeable because the IRS had only 798 and 311 days to collect those taxes. The court noted that the debtors had attempted to negotiate payment and had not attempted to evade payment of the taxes. In re Hamrick, 259 B.R. 224 (Bankr. M.D. Ga. 2000).

ESTATE PROPERTY. The debtor owned interests in several employee pension plans and was receiving monthly distributions when the debtor filed for Chapter 13. The IRS filed a claim for taxes which exceeded the value of the debtor’s property. Tax liens had been filed pre-petition and the issue was whether the post-petition pension plan payments were included in bankruptcy estate property so as to be considered as part of the property securing the IRS claim. The pension plans had clauses restricting assignment or attachment of the plan distributions or principal. The District Court held that the pension plan payments were subject to the tax liens; therefore, the plan restrictions were not effective under nonbankruptcy law and the pension plan payments were included in estate property. The District Court held that the present value of the monthly payments was part of the security for the tax claim. On remand, the Bankruptcy Court noted that the contrary holding in In re Keyes, 255 B.R. 819 (Bankr. E.D. Va. 2000) supported the Bankruptcy court’s disagreement on this issue, but the court held that the District Court’s ruling was the law of the case. In re McIver, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,384 (Bankr. D. Md. 2001), on rem. from, 255 B.R. 281 (D. Md. 2000).
§ 6324B lien on recapture of special use valuation benefits does not automatically expire and release 10 years after the death of the decedent. The IRS ruled that a recapture event during the 10 years could extend the lien beyond the 10 years; therefore, the lien should not be released after the 10 years until a determination has been made that no recapture event has occurred during the 10 years. CCA Ltr. Rul. 200119053, March 16, 2001.

TRUST. The decedent’s will created a trust prior to September 25, 1985, for each of three children with the remainders to pass in trust to the children of each child. One of the decedent’s children died and that child’s trust interest passed to that child’s three children. The trust obtained a local court order partitioning the trust into three separate trusts, with each trust retaining the same provisions as the original trust. The IRS ruled that the partitioning of the trust did not subject the trust to GSTT. Ltr. Rul. 200118038, Feb. 05, 2001.

The taxpayers, husband and wife, transferred all their personal and business property to a trust. The taxpayers continued to have complete control over the assets and made use of them as before transfer to the trust. The taxpayers, as co-trustees had discretionary authority to distribute income and principal. The trusts transferred no other beneficial interests to other persons. The taxpayers claimed that the trusts were not formed for tax benefits, but the court held that the trust was a sham without any economic substance. The court held that the taxpayers were liable for tax on income earned by the taxpayers’ business, which was also self-employment income. Castro v. Comm’r, T.C. Memo. 2001-115.

VALUATION. The decedent owned an interest in a marital trust established by a predeceased spouse for which the predeceased spouse’s estate claimed a marital deduction. The trust owned 44 percent of the stock of a corporation. The decedent also individually owned another 50 percent of the stock of the same corporation. The court held the decedent owned a general power of appointment over the stock. The IRS, in a field service advice, ruled that the 44 percent share and 50 percent share of the corporation must be aggregated in determining the value of the stock in the decedent’s estate. The ruling stated that a general power of appointment over property has been considered by Congress and the courts to be the equivalent of outright ownership of the property. FSA Ltr. Rul. 200119013, Feb. 6, 2001.

The taxpayers, husband and wife, owned 90 percent of the outstanding stock of a closely held corporation that developed, constructed, and sold single-family houses. Each taxpayer created a 15-year grantor retained annuity trust (GRAT) funded with stock in the company. Each GRAT provided a fixed annual annuity to the grantor based on the initial fair market value of the trust assets. The remaining passed first to the surviving spouse in trust and then to the descendants of each grantor. The taxpayers argued that the retained interests in the annuities should be valued as interests for the term of 15 years or for the lives of the grantor and spouse, whichever is shorter. The IRS argued that the interests in the annuities that were given to each grantor and spouse, whichever is shorter. The IRS argued that the interests in the annuities that were given to each grantor and spouse, whichever is shorter.

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The IRS argued that the interests in the annuities that were given to each grantor and spouse, whichever is shorter. The IRS argued that the interests in the annuities that were given to each grantor and spouse, whichever is shorter. The IRS argued that the interests in the annuities that were given to each grantor and spouse, whichever is shorter. The IRS argued that the interests in the annuities that were given to each grantor and spouse, whichever is shorter. The IRS argued that the interests in the annuities that were given to each grantor and spouse, whichever is shorter. The IRS argued that the interests in the annuities that were given to each grantor and spouse, whichever is shorter. The IRS argued that the interests in the annuities that were given to each grantor and spouse, whichever is shorter. The IRS argued that the interests in the annuities that were given to each grantor and spouse, whichever is shorter.

FEDERAL INCOME TAXATION

ACCOUNTING PERIOD. The IRS has issued proposed revenue procedures for approving changes in accounting period or method. The basic change in procedure is that the IRS will require “additional terms, conditions and adjustments” to neutralize any distortion of income resulting from the change of accounting method or period. The current procedure provides for denying changes if more than a de minimis distortion would result from the change in accounting method or period. Notice 2001-35, I.R.B. 2001-23; Notice 2001-34, I.R.B. 2001-23.

ALIMONY. The taxpayer’s divorce agreement provided that the taxpayer was to make weekly child support payments until the minor children reach age 18, die or become emancipated. The divorce agreement also provided for monthly payments to the former spouse until the child support payments cease. The court held that the payments to the spouse were not deductible from the taxpayer’s income as alimony because the payments were contingent upon the payments for the children. Bonar v. Comm’r, T.C. Summary Op. 2001-70.

BELOW-MARKET INTEREST LOANS. The taxpayers were the controlling shareholders of a horse farm corporation. The taxpayers made several loans totaling $2 million to the corporation which did not pay interest to the taxpayers. The loans were recorded on the corporation’s books but no repayment terms were written. The corporation’s tax returns indicated that the advances were interest-free advances. The taxpayers claimed that the loans were capital contributions but the court held that the loans were demand loans. The court found that the loans were intended by the taxpayers to be repaid. The court held that the loans were demand loans with a below-market interest rate; therefore, the taxpayers

* Agricultural Law Manual (ALM).
were considered to have income for the amount of uncharged interest. The appellate court affirmed in a decision designated as not for publication. *Estate of Hoffman v. Comm’r*, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,401 (4th Cir. 2001), aff’g T.C. Memo. 1999-395.

**COOPERATIVES.** Legislation has been introduced in the U.S. House of Representatives which would amend I.R.C. § 1388 to “reestablish the marketing aspects of farmers’ cooperatives in relation to adding value to a farmer’s product by feeding it to animals and selling the animals and to grant a declaratory judgment remedy relating to the status and classification of farmers’ cooperatives.” H.R. 1821.

The taxpayer was a cooperative which was originally organized as a corporation in one state. The taxpayer formed an LLC in another state which elected to be taxed as an association for federal income tax purposes. The taxpayer then merged with the LLC. The taxpayer continued to operate as a cooperative. Although the IRS ruled that it would not make a determination as to the tax-free status of the type F reorganization under I.R.C. § 368(a)(1)(F), the IRS ruled that the taxpayer would qualify as a cooperative under Subchapter T as an LLC because the taxpayer elected to be taxed as an association. *Ltr. Rul. 200119016, Feb. 6, 2001.*

**CORPORATIONS-ALM § 7.02.*

**COMPENSATION.** The taxpayer was a wholly-owned corporation which provided insurance adjusted services to insurance companies. The taxpayer was founded and owned by a person who was highly qualified and respected as a claims adjuster and who was indispensable to the business of the taxpayer. The shareholder’s compensation was tied to the gross receipts of the taxpayer. The compensation paid to the shareholder was held to be excessive, and the excessive portion was held to be dividends. The court noted that the compensation depleted nearly all of the taxpayer’s profits. *Eberl’s Claim Service, Inc. v. Comm’r*, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,396 (10th Cir. 2001).

**LOANS TO SHAREHOLDERS.** The IRS has posted a revised version of the Shareholder Loans Market Segment Specialization Program (MSSP) Audit Technique Guide (5-01) on its website, http://www.irs.gov. It addresses issues regarding loans to shareholders. It examines bona fide debt v. non-bona fide debt, the mechanics of bona fide debt, below-market loans, demand loans, the de minimis exception, computations and interest issues on market rate loans.

**REORGANIZATION.** A corporation merged with another corporation, with some shareholders receiving stock and others cash. After the merger, the first corporation sold 50 percent of its operating assets and retained the proceeds. The IRS ruled that, under Rev. Rul. 88-48, 1988-1 C.B. 117, the merger qualifies for Section 368 treatment because, although the corporation sold 50 percent of its assets after the merger, the corporation retained the proceeds. *Rev. Rul. 2001-25, I.R.B. 2001-22.*

**COURT AWARDS AND SETTLEMENTS-ALM § 4.02[14].** The taxpayer had sued an insurance company for fraudulently selling the taxpayer supplemental medicare insurance which the taxpayer could not use. The taxpayer was awarded compensatory and punitive damages and post-judgment interest. The taxpayer’s attorneys collected the award and paid the taxpayer one-half as arranged under their fee agreement. The court held that the punitive damage award and post-judgment interest were included in the taxpayer’s gross income and that the amount retained by the attorneys was eligible for the miscellaneous deduction for the taxpayer. *Foster v. United States, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,392 (11th Cir. 2001), aff’g on point, 106 F. Supp. 2d 1234 (N.D. Ala. 2000).*

**DISASTER PAYMENTS.** On April 17, 2001, the President determined that certain areas in Mississippi were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of severe storms and flooding on April 3-5, 2001. *FEMA-1365-DR*.

**DISCHARGE OF INDEBTEDNESS.** The taxpayers, husband and wife, negotiated with several creditors for full payment of several loans. As part of the payment agreement, a portion of the loans was discharged without payment. The debtors argued that the discharged loan amounts were not included in income because the taxpayers were insolvent at the time of the discharge. The taxpayer calculated their insolvency by excluding from their assets property which was exempt from the claims of creditors under state law. The court held that, under *Carlson v. Comm’r*, 116 T.C. 87 (2001), exempt assets could not be excluded in determining a taxpayer’s solvency at the time of discharge of indebtedness. See Harl, “Calculating Solvency: A New Development,” 12 Agric. L. Dig. 73 (2001). *Johns v. Comm’r*, T.C. Summary Op. 2001-67.

**ELECTRICITY PRODUCTION CREDIT.** The IRS has announced the 2001 inflation-adjusted electricity production credit of 1.7 cents per kilowatt-hour on the sale of electricity produced from wind, closed-loop biomass and poultry waste energy sources. *Notice 2001-33, I.R.B. 2001-19, 1155.*

Legislation has been introduced in the U.S. Senate which would include electricity produced from all animal waste as a renewable energy source eligible for the electricity production credit. S. 845.

**HOBBY LOSSES.** The taxpayer operated a volleyball club activity which sponsored volleyball camps, sold branded volleyball paraphernalia and provided consultation to volleyball teams. The court held that the activity was engaged in with the intent to make a profit because the taxpayer maintained sufficient records, sought advice as to how to make the activity profitable, was an expert at volleyball and spent a significant amount of time at the activity. *Nelson v. Comm’r*, T.C. Memo. 2001-117.

**IRA.** The taxpayer was a part-time teacher and was required to participate in the state sponsored pension plan, with mandatory contributions withheld from the taxpayer’s
wages. The taxpayer also contributed $2000 to an IRA and claimed a deduction for that contribution. The taxpayer argued that the taxpayer should not be considered an active participant in the state pension plan because the taxpayer’s interest would not vest within 10 years. The court held that taxpayer was an active participant in the state pension plan because the taxpayer made contributions to the plan. 

**LEASES.** The IRS has issued guidelines for advance ruling purposes in determining whether certain transactions purporting to be leases of property are leases for federal income tax purposes. The guidelines apply to transactions called “leveraged leases.” These are leases with a lease term that covers a substantial part of the useful life of the leased property and the lessee’s payments to the lessor are sufficient to discharge the lessor’s payments to the lender. The guidelines clarify the circumstances in which an advance ruling recognizing the existence of a lease ordinarily will be issued. Rev. Proc. 2001-28, I.R.B. 2001-19, 1156. A second revenue procedure provided the information and representations required to be furnished by a taxpayer in requesting a ruling on a leveraged lease. All parties to the lease must join in the ruling request. Rev. Proc. 2001-29, I.R.B. 2001-19, 1160.

**LIKE-KIND EXCHANGES.** The taxpayer was involved in a like-kind exchange under I.R.C. § 1031. The property to be acquired was owned by an LLC with one owner. The LLC did not elect to be taxed as an association for federal income tax purposes. The purchased real property was the sole asset of the LLC. Instead of acquiring the parcel of real property owned by the LLC, the buyer acquired the LLC in order to avoid real estate transfer fees. The IRS ruled that the LLC would be disregarded for purposes of I.R.C. § 1031 because the LLC had only one owner and did not elect to be taxed as an association. Ltr. Rul. 200118023, Jan. 31, 2001.

**NON-COMPETITION AGREEMENT.** The taxpayer purchased an interest in a car dealership. As part of the sales agreement, the seller agreed not to open or operate a car dealership within a certain distance. The initial agreement was entered into in 1990 but the sale did not close and no noncompetition agreement was executed because the seller did not receive payment for the agreement. The dealership was resold in 1993 under similar terms but the sales agreement expressly stated that the earlier sale contract was terminated. The taxpayer argued that the second sales agreement was an extension or amendment of the 1990 agreement; therefore, 1990 law applied and the noncompetition agreement was an extension or amendment of the 1990 agreement to be amortized over 15 years. Frontier Chevrolet, Inc. v. Comm’r, 116 T.C. No. 23 (2001); Burien Nissan, Inc., v. Comm’r, T.C. Memo. 2001-116.

**PENSION PLANS.** The taxpayer participated in an employer sponsored pension plan and made several loans from the plan. The repayments terms were for 999 biweekly payments, totaling 83.42 years. The taxpayer did not provide evidence that any of the loan proceeds were from nondeductible contributions. The court held that the loan proceeds were includible in income because the repayment period exceeded five years and because the taxpayer failed to demonstrate that any of the proceeds were allocated to nondeductible contributions to the plan. Campbell v. Comm’r, T.C. Memo. 2001-118.

**PREPRODUCTION EXPENSES.** The taxpayer was a corporation which operated a citrus orchard. The taxpayer instituted advanced techniques in planting, fertilizing and irrigating which minimized the growing period between planting and fruit production. The taxpayer was able to produce some fruit within two years, but not full production. Although the taxpayer was able to produce fruit within two years, the taxpayer did not provide evidence that the nationwide average preproduction period for citrus fruit was less than two years. The court found that the taxpayer had used special and advanced techniques which were not widely used. The IRS argued that the prohibition in I.R.C. § 263A(d)(3)(C) of citrus and almond growers from electing out of the capitalization rules for four years indicated Congressional intent that the preproduction period for citrus was longer than two years. The court held that the prohibition in I.R.C. § 263A(d)(3)(C) would be superfluous unless the preproduction period for citrus was intended to be at least four years. In addition, the court held that the taxpayer failed to demonstrate that even the taxpayer’s methods would produce a commercially viable harvest within two years; therefore, the taxpayer was required to capitalize the preproduction period expenses. The appellate court affirmed in an opinion designated as not for publication. Pelayez and Sons, Inc. v. Comm’r, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,395 (11th Cir. 2001), aff’g, 114 T.C. No. 28 (2000).

**RETURNS.** The taxpayer was not married but lived with a same sex partner. The taxpayer shared assets and income with the partner. The court ruled that the taxpayer was not entitled to file using married taxpayer status and that the filing status classifications of the Internal Revenue Code were constitutional. The appellate court affirmed in a decision designated as not for publication. Mueller v. Comm’r, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,391 (7th Cir. 2001), aff’g, T.C. Memo. 2000-132.

**S CORPORATIONS-ALM § 7.02[3][c].***

**DISCHARGE OF INDEBTEDNESS.** The taxpayer was a shareholder in an S corporation which realized discharge of indebtedness income. The taxpayer increased the basis of the taxpayer’s S corporation stock by the taxpayer’s share of the discharge of indebtedness income passed through the S corporation. At the time of the discharge of indebtedness, the S corporation was insolvent. The increase in the stock basis enabled the taxpayer to deduct carried-over losses in a later year. The IRS argued that the discharge of indebtedness income was not an item of income for purposes of determining stock basis because discharge of indebtedness income was excluded under the insolvency exclusion rule of I.R.C. § 108. The Tax Court held that, because the corporation was insolvent, I.R.C. § 108 caused an exclusion of the discharge of indebtedness income at the corporation level which was offset by reduction in tax attributes of the corporation, leaving no tax consequences to flow to the shareholders such as would increase the shareholders’ basis.
in stock. The case has been vacated in light of the holding in Gitlitz v. United States, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,147 (S. Ct. 2001). Eberle v. Comm’r, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,390 (9th Cir. 2001), vac’d, T.C. Memo. 1999-287.

SAFE HARBOR INTEREST RATES
June 2001

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SALE OF RESIDENCE. The taxpayers, husband and wife owned a residence. The title to the residence was transferred to a grantor trust established and owned by the taxpayers. The trust transferred the title to a partnership. The taxpayers each owned 1 percent of the partnership, with the trust owning the remaining 98 percent. The IRS originally ruled that the taxpayers would be treated as owning the residence at all times. The IRS has revoked this ruling as contrary to IRS views. Ltr. Rul. 200004022, Feb. 5, 2001, revoking, Ltr. Rul. 200004020, Oct. 28, 1999.

TRAVEL EXPENSES. The IRS has released revised Publication 1542 (Rev. March 2001), Per Diem Rates (For Travel Within the Continental United States). This document is available at no charge (1) by calling the IRS’s toll-free telephone number, 1-800-829-3676; (2) via the internet at http://www.irs.gov/prod/cover.html; (3) through FedWorld; or (4) by directly accessing the Internal Revenue Information Services bulletin board at (703) 321-8020.

PROPERTY

EMINENT DOMAIN. The defendant operated a manufacturing facility which produced various chemical products, including herbicides and water treatment chemicals. The defendant obtained a permit from the state of Louisiana to dispose of wastewater from the facility by injecting the water into underground sand areas between impermeable layers of rock. The plaintiffs were neighboring land owners who claimed that the wastewater migrated along the sand layers to areas under their property. The plaintiffs brought an action for unjust enrichment, trespass and governmental takings without compensation in violation of the Louisiana constitution. Only the third claim was involved in this case. The plaintiffs argued that the defendant had obtained governmental authority to contaminate their underground property without adequate compensation. The court held that the wastewater underground disposal permit did not make the defendant a “state actor” subject to the constitutional provision prohibiting takings without compensation. The court stated that the defendant had to have received express authority by statute or from the state agency in order for the takings provision to apply to the defendant. Mongrue v. Monsanto Co., No. 00-30052 (E.D. La. May 7, 2001).

IN THE NEWS

(a new service featuring items in newspapers and other secondary sources)

BANKRUPTCY. A Bankruptcy Court has ruled that former farmers could exempt livestock and farm equipment because the debtors intended to return to farming. The debtors had started a trucking business to pay farm debts and living expenses but were not engaged in farming when the bankruptcy petition was filed.

The debtor’s interest in a profit-sharing plan provided by the debtor’s employer was held to be estate property even though the profit-sharing payments did not vest until after the petition was filed. In re Booth, No. 00-8053 (Bankr. 6th Cir. March 16, 2001).

A debtor was allowed a full residence exemption for a residence in joint tenancy with two siblings. In re Abernathy, No. 00-6098EM (Bankr. 9th Cir. March 8, 2001).

INSURANCE. The Eighth Circuit Court of Appeals has ruled that heat damage from mold was covered under an insurance policy which covered damage from “ensuing fire.” Oakley v. Farmland Mutual, ___ F.3d ___ (8th Cir. 2001).

NUISANCE. A state trial court in Kentucky has allowed the residents of a town to sue a factory chicken farm located outside the town as odor nuisance under a town ordinance.

PENSION PLANS. The U.S. Supreme Court has ruled that an ex-spouse is the beneficiary of an insurance policy and pension plan owned by the deceased where the deceased failed to change the beneficiary after the divorce. Engelhoff v. Engelhoff, No. 99-1529 (S. Ct. March 21, 2001).

WATER RIGHTS. A federal District Court in Oregon has upheld a Bureau of Reclamation decision not to release water for irrigation in order to protect threatened coho salmon and to honor treaty obligations. Farmers from the Klamath Basin had sought an injunction because the Bureau’s decision left no water for irrigation for 90 percent of the 200,000 acres in the irrigated by the Klamath Project.

CITATION UPDATES


Est. of McMorris v. Comm’r, 243 F.3d 1254 (10th Cir. 2001), rev’g, T.C. Memo. 1999-82, (deductions) see p. 60 supra.
The Agricultural Law Press presents

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**by Neil E. Harl and Roger A. McEowen**

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ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001, H.R. 1836: SUMMARY OF SELECTED PROVISIONS
— by Neil E. Hart* and Roger A. McEowen**

Unified credit
The unified credit applicable exclusion amount was scheduled to increase from $675,000 in 2001, to $700,000 in 2002 and 2003, $850,000 in 2004, $950,000 in 2005 and $1,000,000 in 2006. I.R.C.§ 2010. Under the 2001 Act, the unified credit applicable exclusion amount for federal estate tax purposes rises to $1,000,000 in 2002, $1,500,000 in 2004, $2,000,000 in 2006 and $3,500,00 in 2009. Act Sec. 521(a), amending I.R.C. § 2010.

For federal gift tax purposes, the unified credit applicable exclusion amount remains at $1,000,000 in 2002 and thereafter. Act Sec. 521(b), amending I.R.C. § 2505(a).

The GST exemption amount for any calendar year is the same as the applicable exclusion amount under I.R.C. 2010(c). Act Sec. 521(c), amending I.R.C. § 2631(a). This GST provision is effective for estates of decedents dying and generation-skipping transfers after December 31, 2003.

Federal estate and gift tax rates
The top federal estate and gift tax rate has been 55 percent (of the excess over $3,000,000 of taxable estate) for deaths since 1983. I.R.C. § 2001(c) The 2001 Act drops the top rate to 50 percent in 2002, 49 percent in 2003, 48 percent in 2004, 47 percent in 2005, 46 percent in 2006 and 45 percent in 2007. Act Sec. 511, amending I.R.C. § 2001(c).

The maximum gift tax rate is reduced to the maximum individual rate of 35 percent after 2009 (35 percent of the excess over $500,000). Act Sec. 511(d), amending I.R.C. § 2502(a). This provision is effective for gifts after December 31, 2009.

A transfer in trust is treated as a taxable gift unless the trust is treated as wholly owned by the donor or donor’s spouse. Act Sec. 511(e), amending I.R.C. § 2511(c). This provision is effective for gifts made after December 31, 2009. Act Sec. 511(f)(3).

Estate and gift surtax
The five percent surtax rates (which phase out the benefit of the graduated rates) are repealed effective for deaths after December 31, 2001. Act Sec. 511(b), amending I.R.C. § 2001(c). This provision is effective for estates of decedents dying and gifts made after December 31, 2001.

Family-owned business deduction

See the back page for details about the 2001 Agricultural Tax and Law Seminars by Dr. Neil E. Harl and Prof. Roger A. McEowen

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
** Associate Professor of Agricultural Economics and Extension Specialist, Agricultural Law and Policy, Kansas State University. Member of Kansas and Nebraska Bars.
The 2001 Act provides that Chapter 11 of the Internal Revenue Code (federal estate tax) is not to apply to the estates of decedents dying after December 31, 2009. Act Sec. 501(a) enacting I.R.C. § 2210.

Likewise, Chapter 13 of the Internal Revenue Code (generation skipping transfer tax) is not to apply to generation-skipping transfers made after December 31, 2009. Act Sec. 501(a)(b), enacting I.R.C. §§ 2210, 2664.

State death tax credit
A credit has been allowed for a portion of state inheritance, estate, legacy or succession taxes paid based on the taxable estate. I.R.C. § 2011.

Under the 2001 Act, the maximum estate death tax credit is decreased to 75 percent of the amount in 2002, to 50 percent in 2003 and to 25 percent in 2004. Act Sec. 531(a), amending I.R.C. § 2011(b). This provision is effective for deaths after December 31, 2001. Act Sec. 531(b).

In 2005, the state death tax credit is repealed and a deduction will be allowed for any estate, inheritance, legacy or succession taxes paid to any state or the District of Columbia in respect of property included in the gross estate of the decedent. Such state taxes must have been paid and claimed before the later of (1) four years after the filing of the federal estate tax return or (2) 60 days after a decision of the U.S. Tax Court becomes final which determines the estate tax liability, (3) the expiration of the period of extension to pay estate taxes under I.R.C. § 6166 or (4) the expiration of the period of limitations in which to file a claim for refund or 60 days after a decision of a court in which such refund suit has been filed becomes final. Act Sec. 532(a), repealing I.R.C. § 2011, adding I.R.C. § 2011(g) and enacting I.R.C. § 2058.

New income tax basis at death
The provisions authorizing a new income tax basis at death, I.R.C. § 1014(a), have generally allowed a basis equal to the fair market value (or value used for federal estate tax purposes) as of the date of death or as of the alternate valuation date up to six months after death. In a community property state, the surviving spouse’s one-half share of community property held by the decedent and the surviving spouse generally is treated as having passed from the decedent and thus is eligible for a new basis at death. This rule applies if at least one-half of the whole of the community interest is included in the decedent’s gross estate.

Under the 2001 Act, no change in income tax basis at death is made until repeal of the federal estate tax, effective for deaths after December 31, 2009. Act Sec. 541, adding I.R.C. § 1014(f) (“This section shall not apply with respect to decedents dying after December 31, 2009.”)

Thereafter, the provisions authorizing a new income tax basis at death are repealed and a system of carryover basis is implemented. Act Sec. 542(a), enacting I.R.C. § 1022.

Recipients of property transferred at the decedent’s death will receive an income tax basis equal to the lesser of the adjusted income tax basis of the decedent or the fair market value of the property as of the date of the decedent’s death. Act Sec. 542(a), adding I.R.C. § 1022(a)(2).

Property acquired from the decedent is treated as if acquired by gift. Act Sec. 542(a), adding I.R.C. § 1022(a)(1).

The character of the gain on the sale of property received from a decedent’s estate is carried over to the heir. As the Committee Reports state as an example, “real estate that has been depreciated and would be subject to recapture if sold by the decedent will be subject to recapture if sold by the heir.”

Conf. Committee Report p. ___.

Allowable increase in basis. The 2001 Act allows an executor to increase the income tax basis of assets owned by the decedent and acquired by beneficiaries at death by designated amounts. Act Sec. 542(a), adding I.R.C. § 1022(b)(1).

The 2001 Act allows an executor to increase the income tax basis of eligible assets transferred by up to a total of $1,300,000. The $1,300,000 is increased by the amount of unused capital losses, net operating losses and certain “built-in” losses of the decedent. Act Sec. 542(a), adding I.R.C. §§ 1022(b)(2)(B), (C).

In addition, the income tax basis of property transferred to a surviving spouse can be increased by an additional $3,000,000. Act Sec. 542(a), adding I.R.C. § 1022(c). Thus, the total basis increase for an estate could be $4,300,000.

Non-residents who are not U.S. citizens are limited to an increase of basis of $60,000. Act Sec. 542(a), adding I.R.C. § 1022(b)(3).

The $60,000, $1,300,000 and $3,000,000 figures for basis increase are adjusted for inflation for decedents dying after 2011. Act Sec. 542(a), adding I.R.C. § 1022(d)(4).

Property eligible for increase in basis. To be eligible for a basis increase, the property must have been owned, or treated as owned, by the decedent at the time of the decedent’s death. Act Sec. 542(a), adding I.R.C. § 1022(d)(1)(A).

For property held in joint tenancy or tenancy by the entirety with the surviving spouse, one-half of the property is treated as having been owned by the decedent (the so-called “fractional share” rule under I.R.C. § 2040(b)) and is, therefore, eligible for an increase in basis. Act Sec. 542(a), adding I.R.C. § 1022(d)(1)(B)(i)(I).

For property held jointly with a person other than the surviving spouse, the portion of the property attributable to the decedent’s consideration furnished (the so-called “consideration furnished” rule under I.R.C. § 2042(a)) is treated as having been owned by the decedent and is eligible for a basis increase. Act Sec. 542(a), adding I.R.C. § 1022(d)(1)(B)(ii)(II).

The 2001 Act does not acknowledge the “Gallenstein” rule which allows the consideration furnished rule to be applied to joint interests created before 1976 where the owner dies after 1981. E.g., Gallenstein v. United States, 91-2 U.S. Tax Cas. (CCH) ¶ 60,088 (E.D. Ky. 1991), aff’d, 975 F.2d 286 (6th Cir. 1992) (entire value entitled to new income tax basis for husband-wife joint tenancy where husband provided consideration and preceded wife in death).

The decedent is also treated as the owner of property eligible for an increase in basis if the property was transferred to a qualified revocable inter vivos trust (as defined in I.R.C. § 645(b)(1)). Act Sec. 542(a), adding I.R.C. § 1022(d)(1)(B)(iii).

However, the decedent is not treated as owning property solely by reason of holding a power of appointment with respect to such property (even if it is a general power of appointment). Act Sec. 542(a), adding I.R.C. § 1022(d)(1)(B)(iv).

For community property, the decedent is treated as having owned the surviving spouse’s one-half share of community property, which is eligible for a basis increase if at least one-half of the property is owned by, and acquired from, the decedent. Act Sec. 542(a), adding I.R.C. § 1022(d)(1)(B)(v).

Therefore, both the decedent’s share and the surviving spouse’s share of community property are generally eligible for a basis increase.
Thus, the legislation continues the differential treatment for community property and property subject to common law treatment which has been criticized in recent years.

Property not eligible for basis increase. Several categories of property are not eligible for an increase in income tax basis including –

- Property that was acquired by the decedent by gift (other than from the spouse unless the spouse acquired the property by gift) during the three-year period ending on the date of the decedent’s death: Act Sec. 542(a), adding I.R.C. § 1022(d)(1)(C).
- Property that constitutes a right to receive income in respect of decedent (such assets do not receive a new basis at death under prior law): Act Sec. 542(a), adding I.R.C. § 1022(f).
- Stocks or securities of a foreign personal holding company; Act Sec. 542(a), adding I.R.C. § 1022(d)(1)(D)(i).
- Stock of a domestic international sales corporation (DISC) or former DISC: Act Sec. 542(a), adding I.R.C. §1022(d)(1)(D)(ii).
- Stock of a foreign investment company; and Act Sec. 542(a), adding I.R.C. § 1022(d)(1)(D)(iii).
- Stock of a passive foreign investment company (except for which a decedent-shareholder had made a qualified electing fund election with respect to the decedent. Act Sec. 542(a), adding I.R.C. § 1022(d)(1)(D)(iv).

Applying the basis increase to assets. In no event, can the basis of an asset be increased above the fair market value. Act Sec. 542(a), adding I.R.C. § 1022(d)(2). The basis increase is allocated on an asset-by-asset basis, apparently down to the level of a share of stock. Conference Committee Report, p. ___.

If the amount of available increase in basis is less than the potential adjustment in basis up to fair market value, the executor of the estate is to determine which assets are to receive an adjustment in basis and the extent to which each asset is to receive a basis increase.

Special rules for property passing to surviving spouses. Property passing to a surviving spouse is eligible for a basis increase if it is “outright transfer property” or “qualified terminable interest property.” Act Sec. 542(a), adding I.R.C. § 1022(c)(3).

The term “outright transfer property” means any interest in property acquired from the decedent by the surviving spouse but does not include an interest in property where, on the lapse of time, occurrence of an event or contingency or failure of an event or contingency to occur, the interest passing to the spouse will terminate or fail. Act Sec. 542(a), adding I.R.C. § 1022(c)(4)(A), (B).

This provision parallels the terminable interest rule for purposes of the federal estate tax marital deduction. I.R.C. § 2056(b). An interest passing to a surviving spouse is not considered an interest that will terminate or fail on the death of the spouse if the death will cause a termination or failure only if it occurs within a period not exceeding six months after the decedent’s death, or only as result of a common disaster, and the termination or failure does not occur. Act Sec. 542(a), adding I.R.C. § 1022(c)(4)(C).

This is similar to the rule in prior law. See I.R.C. § 2056(b)(3).

Reporting requirements

Effective for decedents dying and gifts made after December 31, 2009, new reporting requirements will apply. Act Sec. 542(b).

Lifetime gifts. A donor will be required to report to the Internal Revenue Service the income tax basis and character of any non-cash property transferred by gift with a value in excess of $25,000 (except for gifts to charitable organizations). Act Sec. 542(b)(2).

The donor is required to report to I.R.S. – (1) the name and taxpayer identification number of the donee; (2) an accurate description of the property; (3) the adjusted income tax basis of the property in the hands of the donor at the time of the gift; (4) the donor’s holding period for the property; (5) sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income; and (6) any other information the Treasury Secretary may prescribe. Act Sec. 542(b)(2)(B), adding I.R.C. § 6019(b).

Similar information is required to be provided to the recipients of the property. Id.

Transfers at death. For transfers at death of non-cash assets in excess of $1,300,000 and for appreciated property received by a decedent within three years of death, the executor of an estate or the trustee of a revocable inter vivos trust must report to IRS. Act Sec. 542(b)(1), adding I.R.C. § 6018.

The executor is to report to IRS – (1) the name and taxpayer identification number of the recipient of the property; (2) an accurate description of the property; (3) the adjusted basis of the property in the hands of the decedent and its fair market value as of death; (3) the decedent’s holding period for the property; (4) sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income; (5) the amount of basis increase allocated to the property; and (6) any other information the Secretary of the Treasury may prescribe. Act Sec. 542(b)(1), adding I.R.C. § 6018(c).

Penalties for failure to file. Any donor required to report the income tax basis and the character of any non-cash property with a value in excess of $25,000 who fails to do so will be liable for a penalty of $500 for each failure to report the information to IRS and $50 for each failure to report the information to a beneficiary. Act Sec. 542(b)(4), adding I.R.C. § 6716.

Any person required to report to the IRS transfers at death of non-cash assets in excess of $1,300,000 in value who fails to do so is liable for a penalty of $10,000 for the failure to report such information. Id.

Sunset provision

The 2001 Act, specifies that “all provisions of, and amendments made by the Act shall not apply . . . to estates of decedents dying, gifts made or generation-skipping transfers after December 31, 2010.” Act Sec. 901.

Therefore, unless amended further, the estate, gift and generation skipping transfer tax provisions will (1) be repealed after 2009 and (2) revert to the status of the provisions as of the date of enactment. It would appear that the unified credit applicable exclusion amount in 2011 would be $1,000,000 (the amount applicable after 2005) unless the sunset provision, Sec. 901 of the 2001 Act, is repealed. All of this means enormous uncertainty in estate planning for the next decade.

Tax benefits surviving repeal of federal estate tax

If an estate has claimed a tax benefit which is subject to recapture, the recapture provisions survive repeal of the federal estate tax (if that, in fact occurs). Conference Committee Report, p. ____.

Special use valuation. The recapture provisions applicable to special use valuation continue to apply so that those who had claimed the benefit prior to repeal are subject to recapture if a disqualifying event occurs causing payments after repeal. Id., I.R.C. § 2032A(c).

Family-owned business deduction. In a similar manner, the recapture provisions under the family-owned business deduction
Installment payment of federal estate tax

Number of owners. The 2001 Act increases from 15 to 45 the number of partners in a partnership or shareholders in a corporation (under the tests for what is an interest in a closely-held business) for purposes of so-called 15-year installment payment of federal estate tax. Act Sec. 571, amending I.R.C. § 6166(b). The provision is effective for deaths after December 31, 2001. Act Sec. 571(b).

Lending and financing business. The 2001 Act also expands the availability of the installment payment provisions by allowing an interest in a qualifying lending and financing business to be eligible for installment payment of federal estate tax. Act Sec. 572(a), adding I.R.C. § 6166(b)(10).

The installation payments (including both principal and interest) for the interest in a qualifying lending and financing business, can be made over five years with no deferral of principal for five years as under I.R.C. § 6166 generally. Act Sec. 572(a), adding I.R.C. § 6166(b)(10)(A)(i), (ii), (iii).

The term “lending and financing business” means a trade or business of making loans; purchasing or discounting accounts receivable, notes or installment obligations; engaging in rental and leasing of real and tangible personal property, including entering into leases and purchasing, securing and disposing of leases and leased assets; rendering services or making facilities available in the ordinary course of a lending or financing business; or rendering services or making facilities available in connection with the preceding list of activities by a corporation rendering services or making facilities available or by another corporation which is a member of the same affiliated group. Act Sec. 572(a), adding I.R.C. § 6166(b)(10)(B)(i).

A “qualifying lending and financing business” means a lending and financing business if – (1) there was substantial activity immediately before the decedent’s death in the lending and financing business or (2) during at least three of the five taxable years ending before the date of the decedent’s death, the business had at least one full-time employee substantially all of the services of whom were in the active management of the business, 10 full-time non-owner employees substantially all of the services of whom were directly related to the business and $5,000,000 in gross receipts from the lending and financing business. Act Sec. 572(a), adding I.R.C. § 6166(b)(10)(B)(i).

The provision is effective for decedents dying after December 31, 2001. Act Sec. 572(b).

Stock of holding companies. The 2001 Act clarifies that the installment payment provisions require only the stock of holding companies, not that of operating subsidiaries, to be non-readily tradable in order to qualify for installment payment. Act Sec. 572(a)*, amending I.R.C. § 6166(b)(8)(B).

The Act also specifies that an estate with a qualifying property interest held through holding companies that claim installment payment of federal estate tax (both principal and interest) for an interest held through a holding company can make the payments only over five years. Act Sec. 572(a)*, amending I.R.C. § 6166(b)(8)(B)(ii).

The provision is effective for deaths after December 31, 2001. Act Sec. 572(b)*.

*Agricultural Law Manual (ALM).

Installment payment of federal estate tax

Liability in excess of basis

The 2001 Act clarifies that, after 2009, gain is not recognized at the time of death if an estate or heir acquires from the decedent property as the principal residence, the decedent’s period of ownership and occupancy in determining whether the property was owned and occupied for two years as the principal residence.

The exclusion applies to property sold by a trust that was a qualified revocable trust (under I.R.C. § 645) immediately prior to the decedent’s death. The decedent’s period of occupancy as the principal residence can be added to an heir’s subsequent ownership and occupancy in determining whether the property was owned and occupied for two years as the principal residence.

The 2001 Act clarifies that after 2009, gain is not recognized at the time of death if an estate or heir acquires from the decedent property subject to a liability that exceeds the decedent’s income tax basis in the property. Act Sec. 542(a), adding I.R.C. § 1022(g).

Likewise, gain is not recognized by an estate on distribution of such property to a beneficiary of an estate by reason of the liability exceeding the basis. Id.

Conservation easements

The availability of qualified conservation easements is expanded by eliminating the requirement that the land be located within a designated distance from a metropolitan area, national park, wilderness area or Urban National Forest. Act Sec. 551(a), amending I.R.C. § 2031(c)(8)(A)(i).

Under the legislation, a qualified conservation easement can be claimed with respect to any land located in the United States or its possessions. Id.

The legislation also clarifies that the date for determining easement compliance is the date the donation is made. Act Sec. 551(b), amending I.R.C. § 2031(c)(2).

The changes are effective for decedents dying after December 31, 2000. Act Sec. 552(c).

Conservation easements. The additional tax that could become due on failure to execute an agreement to extinguish development rights continues to be due after repeal of the federal estate tax. Conf. Committee Report, p. ___. I.R.C. § 6166.

Exclusion on sale of residence

The income tax exclusion on sale of the principal residence ($250,000, $500,000 on a joint return) is extended to estates and heirs. Act Sec. 542(c), amending I.R.C. § 121(d)(9).

Gain can be excluded under the provision if the decedent used the property as the principal residence for two or more years during the five year period prior to sale. If an heir occupies the property as the principal residence, the decedent’s period of ownership and occupancy of the property as the principal residence can be added to the heir’s subsequent ownership and occupancy in determining whether the property was owned and occupied for two years as the principal residence.

The exclusion applies to property sold by a trust that was a qualified revocable trust (under I.R.C. § 645) immediately prior to the decedent’s death. The decedent’s period of occupancy as the principal residence can be added to an heir’s subsequent ownership and occupancy in determining whether the property was owned and occupied for two or more years as the principal residence, regardless of whether the residence was owned by the trust during the decedent’s occupancy. Act Sec. 542(c), adding I.R.C. § 121(d)(9). See Conf. Committee Report, p. ___. The provision is effective for deaths after December 31, 2009.

The 2001 Act clarifies that, after 2009, gain is not recognized at the time of death if an estate or heir acquires from the decedent property subject to a liability that exceeds the decedent’s income tax basis in the property. Act Sec. 542(a), adding I.R.C. § 1022(g).

Likewise, gain is not recognized by an estate on distribution of such property to a beneficiary of an estate by reason of the liability exceeding the basis. Id.

The inclusion of a qualifying conservation easement as a trade or business of making loans; purchasing or discounting accounts receivable, notes or installment obligations; engaging in rental and leasing of real and tangible personal property, including entering into leases and purchasing, securing and disposing of leases and leased assets; rendering services or making facilities available in the ordinary course of a lending or financing business; or rendering services or making facilities available in connection with the preceding list of activities by a corporation rendering services or making facilities available or by another corporation which is a member of the same affiliated group. Act Sec. 572(a), adding I.R.C. § 6166(b)(10)(B)(i).

A “qualifying lending and financing business” means a lending and financing business if – (1) there was substantial activity immediately before the decedent’s death in the lending and financing business or (2) during at least three of the five taxable years ending before the date of the decedent’s death, the business had at least one full-time employee substantially all of the services of whom were in the active management of the business, 10 full-time non-owner employees substantially all of the services of whom were directly related to the business and $5,000,000 in gross receipts from the lending and financing business. Act Sec. 572(a), adding I.R.C. § 6166(b)(10)(B)(i).

The provision is effective for decedents dying after December 31, 2001. Act Sec. 572(b).

Stock of holding companies. The 2001 Act clarifies that the installment payment provisions require only the stock of holding companies, not that of operating subsidiaries, to be non-readily tradable in order to qualify for installment payment. Act Sec. 572(a)*, amending I.R.C. § 6166(b)(8)(B).

The Act also specifies that an estate with a qualifying property interest held through holding companies that claim installment payment of federal estate tax (both principal and interest) for an interest held through a holding company can make the payments only over five years. Act Sec. 572(a)*, amending I.R.C. § 6166(b)(8)(B)(ii).

The provision is effective for deaths after December 31, 2001. Act Sec. 572(b)*.

*Agricultural Law Manual (ALM).
**CASES, REGULATIONS AND STATUTES**
by Robert P. Achenbach, Jr.

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**BANKRUPTCY**

**GENERAL-ALM § 13.03.*"**

**EXEMPTIONS**

HOMESTEAD. The debtor borrowed money to purchase farm land on which the debtor lived. The debtor executed mortgages to secure the loans but the mortgages did not include language required by Iowa Code § 561.22 for the waiver of homestead exemption rights. The debtor claimed the property as a homestead exemption in a bankruptcy proceeding and the bank sought to enforce the mortgage against the property. The court held that the failure of the mortgages to contain the language required by Iowa Code § 561.22 prevented the bank from asserting any waiver of the homestead exemption. *In re Wagner*, 259 B.R. 694 (Bankr. 8th Cir. 2001).

**CHAPTER 12-ALM § 13.03[8]."**

The current extension of Chapter 12 expired on May 31, 2001.

**RESIGNATION OF TRUSTEE.** The court received a notice that the U.S. Trustee had accepted the resignation of the standing Chapter 12 trustee for the court’s district. The UST did not file the letter with the court or provide any notice to the court, parties or attorneys involved in current Chapter 12 cases. The UST argued that, because the UST had the power to appoint the standing trustee and to appoint a successor trustee, the UST had the authority to remove the standing trustee. The court held that the standing trustee could be removed only after notice and a hearing as required by Section 324 and that the UST’s powers did not include the power to remove the standing trustee without court approval. *In re Brookover*, 259 B.R. 884 (Bankr. N.D. Ohio 2001).

**FEDERAL TAX-ALM § 13.03[7]."**

**DISCHARGE.** The debtor filed for Chapter 13 in February 2000 and the claims included taxes for 1993 which were assessed in 1998. The debtor had filed two previous bankruptcy petitions, in June 1997 and September 1998, both of which prevented collection by the IRS. The IRS argued that the previous bankruptcy cases tolled the 240 day provision in Section 507(a)(8)(A)(ii) to make the taxes nondischargeable. The court found that the debtor had not filed the previous bankruptcy petitions in order to intentionally use up the 240 days; however, the court held that the 240 day limitation was equitably tolled because the IRS was allowed only 108 days to collect the assessed taxes. *In re Hoppe*, 259 B.R. 852 (Bankr. E.D. Tax. 2001).

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**FEDERAL AGRICULTURAL PROGRAMS**

**FARM CREDIT SYSTEM.** The FCA has adopted as final regulations which expanded the eligible borrowers and use of loan proceeds to farmers, ranchers, aquatic producers and harvesters, processing and marketing operators, farm-related businesses, rural homeowners, cooperatives and rural utilities. The previous regulations were challenged in *Independent Bankers Assn' of Am. v. Farm Credit Admin.*, 986 F. Supp. 633 (D. D.C. 1997), rev'g, 164 F.3d 661 (D.C. Cir., 1999) as too broad because (1) the loans could be made to rural homeowners who did not reside in the rural home and (2) the regulations did not specifically limit FCS banks and associations that extend long-term mortgage credit to financing necessary capital structures, equipment, and initial working capital for eligible farm-related service businesses. The final regulations amend the original regulations to conform with the two rulings. *66 Fed. Reg. 28641 (May 24, 2001).*

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**FEDERAL ESTATE AND GIFT TAX**

**EQUITABLE RECOUPMENT.** The taxpayer had made gifts in several years and filed gift tax returns for the gifts. The amount of gift tax assessed and paid was less than the amount actually due because the IRS failed to account for previous gifts. By the time the decedent died, the statute of limitations on the gift tax for several years had elapsed. The estate claimed the “gift tax payable” for the gifts at the correct amount, i.e. the estate claimed a credit for more gift tax than was actually paid. In a field service advice letter, the IRS determined that it could not use the doctrine of equitable recoupment to reduce the “gift tax payable” to the amount of gift tax actually paid. The IRS reasoned that (1) the doctrine was available only as a defense against an otherwise valid tax claim by the IRS and (2) the Tax Court did not have sufficient equitable powers to use the doctrine. *FSA Ltr. Rul. 200118002, Dec. 15, 2000.*

**GIFT.** The decedent had created a revocable trust for the decedent’s life, with a remainder to various heirs. The decedent subsequently married and created an irrevocable trust for the spouse which was conditioned upon funding and qualification of the trust as QTIP. If the irrevocable trust was not fully established, the corpus reverted to the revocable trust established earlier. The decedent failed to timely file an election to treat the irrevocable trust as QTIP. The decedent’s estate filed an action in state court which determined that the transfer to the irrevocable trust was not completed; therefore, no gift occurred. The court noted that the state court judgment was not given full weight but held that the irrevocable trust was conditioned upon requirements which were not met by the time of the decedent’s death; therefore, no gift was completed for federal gift tax purposes. *First Security Bank v. United States, 2001-1 U.S. Tax Cas. (CCH) ¶ 60,406 (D. N.M. 2001).*

**NET OPERATING LOSSES.** The decedent was involved in a Chapter 11 bankruptcy case at the time of death. The decedent had net operating losses which passed to the estate and which were offset by discharge of indebtedness occurring during the bankruptcy case. The bankruptcy estate also incurred net operating losses. The bankruptcy case terminated after the death of the decedent. The decedent’s spouse filed a joint return for the
year of the decedent’s death and the issue was whether the spouse could claim on the joint return the net operating losses which passed to the decedent at the close of the bankruptcy case. In a field service advice letter, the IRS ruled that the net operating losses did not belong to the decedent at the decedent’s death; therefore, the decedent did not have any losses to include in the joint return, which covered the spouse’s entire tax year but only the decedent’s year up to the date of death. The IRS ruled that the net operating losses were passed from the bankruptcy estate to the decedent’s estate and would be included in the decedent’s estate’s income tax return. FSA Ltr. Rul. 2001118003, Dec. 26, 2000.

VALUATION OF STOCK. The decedent owned 18 of the outstanding 76,445 shares of the voting stock and 3,942,048 of the outstanding 141,288,584 shares of the nonvoting stock of a private, family-owned corporation. The remaining shares of outstanding voting stock were owned by the decedent’s three siblings. The voting stock was subject to a 360-day restriction on transferability or hypothecation. Both classes of stock were entitled to the same dividends on a per-share basis, if and when dividends were declared. Holders of the nonvoting stock were entitled to a liquidating preference. The Tax Court valued the stock by calculating the equity value of the corporation, adding a premium for voting privileges, and applying a 35-percent marketability discount to the voting stock and a 40-percent marketability discount to the nonvoting stock. The appellate court reversed as to the valuation of the voting stock, holding that the premium added for the voting stock was not based on any economic value to the decedent or any potential buyer. Est. of Simplot v. Comm’r, 2001-1 U.S. Tax Cas. (CCH) ¶ 60,405 (9th Cir. 2001), rev’g in part, 112 T.C. 130 (1999).

FEDERAL INCOME TAXATION

BAD DEBTS. The taxpayer was an attorney who owned a joint tenancy interest in a family corporation which operated a small retail store. The taxpayer provided some management assistance but received no income from the corporation. The corporation ceased business in 1993. The taxpayer made several loans to the corporation and deducted the amount of the loans as a bad debt in 1993. The taxpayer also paid some of the business expenses in 1993 and claimed those payments as a business expense deduction. The court held that the taxpayer was not entitled to a business bad debt deduction because the taxpayer was not in the lending business nor the retail business but made the loans as shareholders or family members. The court also denied the business expense deduction because the expenses were liabilities of the corporation. Martens v. Comm’r, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,416 (5th Cir. 2001), aff’d, T.C. Memo. 2000-46.

CORPORATIONS-ALM § 7.02.*

REASONABLE COMPENSATION. The taxpayer was an S corporation with one shareholder. Although the shareholder had been responsible for the taxpayer’s early success, the shareholder had been in failing health during the tax years involved and most of the income came from passive investments. The shareholder received compensation equal to 81 and 88 percent of the taxpayer’s adjusted taxable income and the court held that this was unreasonable because the shareholder’s efforts were no longer essential to the production of income. Metro Leasing & Development Corp. v. Comm’r, T.C. Memo. 2001-119.

COURT AWARDS AND SETTLEMENTS-ALM § 4.02.[14] The U.S. Supreme Court has denied certiorari in the following case. The taxpayer had received severance pay based on the taxpayer’s salary and length of service with the employer. The taxpayer excluded the payments from income, arguing that the taxpayer received physical injury from the early termination of employment and the employer knew about the injury when the payments were made. The court held, in an opinion designated as not for publication, that the payments were income because the payments were based on the taxpayer’s salary and length of service and were not made as compensation for the injuries. Cook v. United States, 2000-2 U.S. Tax Cas. (CCH) ¶ 50,770 (Fed. Cir. 2000), cert. denied, ___ S. Ct. ___ (2001).

The taxpayers received a jury award and accrued interest in a personal injury action. A portion of the award was paid to the taxpayers’ attorneys under a contingent fee contract. The taxpayers excluded the attorney fees from their reported gross income. The court held that the attorneys’ fees were properly excluded from income because the fees would be taxable to the attorneys. The court cited Estate of Clarks v. United States, 202 F.3d 854 (6th Cir. 2000) in support of its holding. The case is designated as not for publication. Brisco v. United States, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,420 (6th Cir. 2001).

The taxpayer was employed for several years by a drugstore chain. The taxpayer experienced various physical and mental problems from the strain of working long hours and irregular hours. A class action suit was filed by other parties against the drugstore chain for unpaid overtime compensation. The taxpayer joined in the suit as a class member but did not assert any claims for physical or mental injuries. The drugstore agreed to a monetary settlement and the settlement did not indicate that the taxpayer’s payment was for personal injuries. The taxpayer excluded the settlement payment from income as a payment for personal injuries. The court held that the payment was included in income because the class action petition made no mention of claims for personal injuries but sought damages only for unpaid compensation. Hamblin v. Comm’r, T.C. Summary Op. 2001-73.

The decedent and family had filed a suit against various sheetrock manufacturers for injury to the decedent from asbestos. The parties reached a settlement which stated that a portion of the award was paid to the sheetrock manufacturers for injury to the decedent from asbestos. The parties reached a settlement which stated that a portion of the award was paid to the sheetrock manufacturers for injury to the decedent from asbestos. The parties reached a settlement which stated that a portion of the award was paid to the sheetrock manufacturers for injury to the decedent from asbestos. The parties reached a settlement which stated that a portion of the award was paid to the sheetrock manufacturers for injury to the decedent from asbestos.

DISASTER PAYMENTS. On April 27, 2001, the President determined that certain areas in Kansas were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of severe storms, hail, tornadoes and flooding beginning on April 21, 2001. FEMA-1366-DR. On May 9, 2001, the President determined that certain areas in Illinois were eligible for assistance under the Act as a result of flooding beginning on April 18, 2001. FEMA-1368-DR. On May 16, 2001, the President determined that certain areas in Maine were eligible for assistance under the Act as a result of flooding on March 5-31, 2001. FEMA-1371-DR. On May 16, 2001, the President determined that certain areas in Minnesota were eligible for assistance under the Act as a result of severe winter storms, flooding and tornadoes beginning on March 23, 2001. FEMA-
On May 16, 2001, the President determined that certain areas in Nebraska were eligible for assistance under the Act as a result of severe storms, flooding and tornadoes on April 10-23, 2001. **FEMA-1370-DR.** On May 16, 2001, the President determined that certain areas in Puerto Rico were eligible for assistance under the Act as a result of severe storms, flooding and mudslides beginning on May 6, 2001. **FEMA-1372-DR.** On May 11, 2001, the President determined that certain areas in Wisconsin were eligible for assistance under the Act as a result of severe storms and flooding on April 10, 2001. **FEMA-1369-DR.** Accordingly, a taxpayer who sustained a loss attributable to the disasters may deduct the loss on his or her 2000 federal income tax return.

**EARNED INCOME CREDIT.** In a Chief Counsel Advice letter, the IRS discussed whether rental income was qualified income for earned income credit purposes where (1) unimproved land was leased to an unrelated party and (2) improved land was leased to a partnership in which the taxpayer was a partner. The IRS stated that, under I.R.C. § 32(i)(2)(C), EIC qualified income must come from the ordinary course of a trade or business and, under I.R.C. § 32(i)(2)(E), cannot be passive activity income as defined by I.R.C. § 469. The IRS ruled that, under both situations, the rental income was derived from the ordinary course of a trade or business. In addition, the IRS ruled that the rental income in the first situation was not qualified for EIC because the income was considered income from a passive activity under I.R.C. § 469. The main issue was whether, in the second situation, the self-rental recharacterization rule of I.R.C. § 469 applied for the purposes of EIC. Under the recharacterization rules, otherwise passive rental income from property leased to a related entity in which the lessor materially participates is recharacterized as nonpassive under I.R.C. § 469. The IRS ruled that the recharacterization rule did not affect the EIC definition of nonpassive activity because the recharacterization rule applied only to transform the income into nonpassive income and did not affect the definition of the passive activity. Thus, the IRS ruled that the rental income from the second situation was not qualified for EIC because the income came from a passive activity. See also Harl, “Recharacterization of Income: Treacherous Rules,” 11 Agric. L. Dig. 33 (2000). **CCA Ltr. Rul. 20012037, March 30, 2001.**

A similar ruling concerning a lease of improved real property to a C corporation wholly-owned by the lessor. In a Chief Counsel Advice letter, the IRS ruled that the rental income from the second situation was not qualified for EIC because the income came from a passive activity. As with the above ruling, the IRS ruled that the recharacterization rule did not apply to change the passive rental income activity into a nonpassive activity. **CCA Ltr. Rul. 200120036, March 28, 2001.**

**HOME OFFICE.** The taxpayer was a clinical psychologist who was employed by a clinic for at least eight hours each day. The taxpayer also provided counseling services at the taxpayer’s own office. The taxpayer lived in a small apartment and used an area in the entryway for scheduling appointments by phone call for the taxpayer’s private practice. The taxpayer also stored the business records in the apartment but did not meet any clients there. The court held that the taxpayer could not deduct any home office expenses relating to the costs of the apartment. **Mullin v. Comm’r, T.C. Memo. 2001-121.**

The taxpayer was the sole shareholder of an S corporation and leased a portion of the taxpayer’s residence to the corporation for use in its business. The taxpayer used this leased portion of the residence to carry on the business of the corporation. In a Chief Counsel Advice letter, the IRS ruled that the taxpayer could claim deductions for the leased portion for mortgage interest, real property taxes and personal casualty losses; however, I.R.C. § 280A(c)(6) prevented any deductions under I.R.C. §§ 162, 165(c)(1) 167 for business expenses, business casualty losses or depreciation for the leased portion of the residence. **CCA Ltr. Rul. 200121070, March 19, 2001.**

**INTEREST.** The taxpayer had obtained several student loans in obtaining a Ph. D. in psychology and was making payments on those loans. The court held that the taxpayer could not deduct the interest paid on the loans as a business deduction. **Mullin v. Comm’r, T.C. Memo. 2001-121.**

**LOSSES.** The taxpayer owned several related small corporations. The IRS assessed a deficiency against the taxpayer in 1987 and executed a levy at the taxpayer’s business operated by one corporation. The taxpayer claimed a loss deduction for the value of the taxpayer’s labor to the corporation which was lost due to the execution of the levy. The court held that the taxpayer could not claim a loss deduction for the loss of the taxpayer’s labor because the taxpayer had no tax basis in the labor. **Tonn v. Comm’r, T.C. Memo. 2001-123.**

**PENALTIES.** The IRS has issued a revenue procedure to inform taxpayers how to request an administrative appeal of the penalties imposed by I.R.C. § 6715 relating to the misuse of dyed diesel fuel and kerosene and I.R.C. §§ 4083(c)(3), 7342 relating to the refusal to admit entry for purposes of inspecting facilities and equipment and taking and removing fuel samples. **Rev. Proc. 2001-33, I.R.B. 2001---.**

**RETURNS.** The IRS has issued specifications for the submission of Forms 1098, 1099, 5498, and W-2G magnetically or electronically using magnetic tape, tape cartridges, or diskettes, or electronically through the IRS FIRE System. These guidelines govern the preparation of tax year 2001 information returns and information returns for tax years prior to 2001 that are required to be filed. The specifications are to be used to prepare current and prior year information returns filed beginning January 1, 2002, and received by the IRS Martinsburg Computing Center or postmarked by December 15, 2002. **Rev. Proc. 2001-32, I.R.B. 2001-21.**

The IRS has released an April 2001 revision of Publication 538, Accounting Periods and Methods and Form 8851 (2001), Summary of Archer MSAs. These documents are available at no charge (1) by calling the IRS’s toll-free telephone number, 1-800-829-3676; (2) through FedWorld; (3) via the internet at http://www.irs.gov/prod/cover.html; or (4) by directly accessing the Internal Revenue Information Services bulletin board at (703) 321-8020.

The IRS has requested comments regarding Form 4835, Farm Rental Income and Expenses. The form is used by landowners or sublessors to report farm income based on crops or livestock produced by a tenant when the landowner or sublessee does not materially participate in the operation or management of the farm. Written comments should be submitted on or before July 20, 2001, to Garrick R. Shear, IRS, Room 5244, 1111 Constitution Ave., NW., Washington, D.C. 20224.

The plaintiff was hired by the defendant and during the processing stage of the hiring, the plaintiff requested that the
defendant not use the plaintiff’s social security number (SSN) on the employment records. The plaintiff objected to the use of the SSN on religious grounds. The defendant fired the plaintiff as a result of the defendant’s refusal to use a substitute number. The plaintiff sought an injunction and reinstatement, arguing that the termination for refusal to use the SSN violated the Civil Rights Act of 1964. The court assumed that the plaintiff’s religious objection was bona fide and that the plaintiff’s employment was terminated solely because of the defendant’s refusal to allow the use of the SSN. The court held that the termination did not violate the Act because the termination resulted from the federal law requirement that an employer report withholding taxes using an employee’s SSN. Baltgalvis v. Newport News Shipbuilding Inc., 2001-1 U.S. Tax Cas. (CCH) ¶ 50,408 (E. D. Va. 2001).

SALE OF RESIDENCE. The taxpayer sold a residence on April 25, 1997 and failed to purchase a new home within two years so as to qualify for rollover of the gain from the sale of the first home. In 1997, the Congress amended the law for gain from the sale of a home to exclude up to $250,000 of gain but made the new law retroactive only to May 7, 1997. The taxpayer challenged the constitutionality of the retroactive date, arguing that the law should have been made retroactive to January 1, 1997 because the new law was being considered then. The court held that the choice of May 7, 1997 as the retroactive date of the new law was not unconstitutional because it served a legitimate congressional purpose. Buerer v. United States, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,424 (W.D. N.C. 2001).

SOCIAL SECURITY BENEFITS. The taxpayer received social security benefits because of a medical condition and excluded the benefits from income. The taxpayer argued that the benefits were nontaxable as health and accident insurance benefits under I.R.C. §§ 104(a)(3), 105(e). The court held that the social security disability payments were included in taxable income. The court noted that a provision excluding social security disability benefits from income was repealed in 1983, strongly indicating Congressional intent that social security benefits were taxable. The taxpayer also argued that the taxation of social security benefits violated the equal protection clause of the U.S. Constitution because other disability payments were not taxable. The court cited several cases which supported the holding that the taxation of social security benefits was constitutional. Thomas v. Comm’r, T.C. Memo. 2001-120.
ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001, H.R. 1836: SUMMARY OF SELECTED PROVISIONS–PART II
— by Roger A. McEowen* and Neil E. Harl**

Individual income tax rates
The act provides a new ten percent regular income tax bracket applicable to the first $6,000 of taxable income for single persons, $10,000 of taxable income for heads of households and $12,000 for married couples filing joint returns. The provision is made applicable for taxable years beginning after December 31, 2000. The $6,000 and $12,000 amounts increase to $7,000 and $14,000 respectively for 2008 and thereafter. The taxable income levels for the new low-rate bracket will be adjusted annually for inflation for taxable years beginning after 2008, and the bracket for single persons and married persons filing separately will be 50 percent of that of joint returns. Act. Sec. 101, amending I.R.C. § 1.

The Act adds a new provision creating a rate reduction credit for 2001 and which operates in lieu of the new 10 percent bracket for 2001. Taxpayers will be entitled to a credit in tax year 2001 of five percent of the amount of the income that would have been eligible for the new 10 percent rate. The Treasury is instructed to issue checks by October 1, 2001, to taxpayers who timely filed their 2000 returns. Act. Sec 101, adding I.R.C. § 6428.

The Act specifies that the 15 percent bracket is modified to begin at the end of the new 10 percent income tax bracket and ends at the same level as under present law. The present law regular income tax rates are reduced after June 30, 2001 as follows: the 28 percent rate is reduced to 27.5 percent in years 2001, to 27 percent in 2002 and 2003, to 26 percent in years 2004 and 2005, and 25 percent in 2006 and later. The 31 percent rate is reduced to 30.5 percent in 2001, to 30 percent in 2002 and 2003, 29 percent in 2004 and 2005, and 28 percent in 2006 and later. The 36 percent rate is reduced to 35.5 percent in year 2001, and 35 percent in 2002 and 2003, 34 percent in years 2004 and 2005 and 33 percent for year 2006 and later. The 39.6 percent rate is reduced to 39.1 percent in 2001, 38.6 percent in 2002 and 2003, 37.6 percent for 2004 and 2005, and 35 percent in 2006 and later. Act Sec. 101(a)(i)(2), amending I.R.C. § 1.

Phaseout of personal exemptions
The Act provides for a five-year phase-in of the repeal of the personal exemption.
phaseout, whereby the otherwise personal exemption phaseout is reduced by one-third in taxable years beginning in 2006 and 2007, and is reduced by two-thirds in taxable years beginning in 2008 and 2009. The repeal is fully effective for taxable years beginning after December 31, 2009. The effective date of the provision is for tax years beginning after December 31, 2005.  

**Act Sec. 102, amending I.R.C. § 151(d).**

### Phaseout of overall limitation on itemized deductions

A phased-in repeal of the overall limitations on itemized deductions for all taxpayers is provided as follows: the applicable overall limitation on itemized deductions is reduced by one-third in taxable years beginning in 2006 and 2007, and by two-thirds in taxable years beginning in 2008 and 2009. For taxable years beginning after December 31, 2009, the overall limitation is repealed. The provision is effective for tax years beginning after December 31, 2005.  

**Act Sec. 103, amending I.R.C. § 68.**

### Child tax credit

The Act increases the child tax credit to $1,000, effective for taxable years beginning after December 31, 2000. The increase is phased in as follows: $600 for calendar years 2001-2004; $700 for calendar years 2005-2008; $800 for 2009; and $1,000 for 2010 and later. The credit is refundable to the extent of ten percent of the taxpayer’s earned income in excess of $10,000 for calendar years 2001-2004 and the percentage is increased to 15 percent for calendar years 2005 and thereafter. The $10,000 amount is indexed for inflation starting in 2002. Families with three or more children are allowed a refundable credit for the amount by which the taxpayer’s social security taxes exceed the earned income credit, if that amount is greater than the refundable credit based on the taxpayer’s earned income in excess of $10,000. The refundable portion of the credit does not constitute income and will not be treated as resources for purposes of determining eligibility or the amount or nature of benefits or assistance under any federal program or state or local program financed with federal funds.  

**Act Sec. 201, amending I.R.C. § 24(a).**

### Adoption credit

The Act provides a credit against tax of $10,000 or a gross income exclusion of $10,000 for employer-provided adoption assistance. For the adoption of special needs children, the Act provides a credit against tax for qualified adoption expenses limited by an aggregate amount of $10,000 in qualified adoption expenses. The Act also provides for an income exclusion up to $10,000 for employer-provided adoption assistance. The Act increases the income limitation at which phase-out begins to $150,000 (from $75,000), and makes permanent the use of the credit against alternative minimum tax.  

**Act Sec. 202, amending I.R.C. § 23(a)(1).**

### Dependent care credit

The applicable dollar limit for dependent care credits is increased to $3,000 (for one qualifying person) and $6,000 (for two qualifying persons). The Act increases the applicable percentage to 35 percent (from 30 percent), but reduces the rate (but not below 20 percent) by one percentage point for each $2,000 (or fraction thereof) by which the taxpayer’s adjusted gross income for the taxable year exceeds $15,000 (from $10,000). The provision applies to taxable years beginning after December 31, 2002.  

**Act Sec. 204, amending I.R.C. § 21.**

### Employer expenses for child care assistance

A tax credit for employer-provided child care is provided equal to 25 percent of the qualified expenses for employee child care and 10 percent of the qualified expenses for child care resource and referral services, up to a limit of $150,000 per taxable year. The Act provides that such credits are subject to recapture for the first 10 years after the qualified child care facility is placed in service, reduced as a percentage of the credit over the 10-year period, if the taxpayer ceases operation of the facility as a qualified child care facility or disposes of its interest in the facility and the person acquiring the interest in the facility does not agree in writing to assume the taxpayer’s recapture liability. The provision is effective for taxable years beginning after December 31, 2001.  

**Act Sec. 205, amending I.R.C. §§ 38, 1016 and adding I.R.C. § 45F.**

### “Marriage penalty”

The size of the 15 percent bracket for a married couple filing jointly is increased to twice the size of the corresponding rate bracket for taxpayers filing as a single person by 2008. The increase is phased in over four years beginning in 2005. The Act specifies that the end point of the 15 percent bracket for a married person filing a separate return will be one-half of the end point of the 15 percent bracket for a married couple filing a joint return. The provision is effective for tax years beginning after 2004.  

**Act Sec. 302, amending I.R.C. § 1(f).**

### Earned income credit

Beginning in 2002, the amount of reduction of the earned income credit by the amount of the alternative minimum tax is repealed. The earned income amount used to calculate the EIC for married taxpayers filing jointly is increased to 110 percent of the amount for all other taxpayers eligible for the EIC. The definition of earned income for EIC purposes is amended to exclude nontaxable earned income amounts. The beginning and ending amounts of the EIC phase-out range for married taxpayers filing jointly is increased by $1,000 in taxable years beginning in 2002-2004, by $2,000 in taxable years beginning in 2005-2007, and by $3,000 in taxable years beginning in 2008. The $3,000 amount will be adjusted for inflation annually beginning in 2009. The definition of “qualifying child” for EIC purposes is expanded, and the calculation of the EIC is changed by replacing “modified adjusted gross income” with “adjusted gross income.”  

**Act Sec. 303, amending I.R.C. § 32.**

### Education IRAs

The annual limit on contributions to an education IRA is increased from $500 to $2,000. The definition of qualified education expenses that may be paid tax-free from an education IRA is expanded. The phase-out range for marrieds filing jointly is increased so that it is twice the range for single taxpayers, resulting in a phase-out range of $190,000 to $220,000 of modified adjusted gross income. The Act specifies that various age limitations do not apply to special needs beneficiaries, and clarifies that corporations and other entities are permitted to make contributions to education IRAs, regardless of the income of the corporation or entity during the year of the contribution. Taxpayers are allowed to claim a HOPE Credit or Lifetime Learning Credit for a tax year and to exclude from gross income amounts distributed (both the contributions and earnings portions) from an education IRA on behalf of the same student as long as the distribution is not used for the same educational expenses for which a credit was claimed. Repealed is the excise tax on contributions made by any person to an education IRA on behalf of a beneficiary during any taxable year in which any contributions are made by anyone to a qualified state tuition
program on behalf of the same student. The provision is effective for taxable years beginning after December 31, 2001. Act Sec. 401, amending I.R.C. § 530.

Qualified tuition programs

The Act expands the definition of “qualified tuition program” to include certain prepaid tuition programs established and maintained by one or more eligible educational institutions that satisfy the requirements of I.R.C. § 529. Distributions made in taxable years from qualified state tuition programs are excluded from gross income to the extent the distribution is used to pay for qualified higher education expenses. A taxpayer may claim a HOPE Credit or Lifetime Learning Credit for a tax year and can exclude from gross income amounts distributed from a qualified tuition program on behalf of the same student as long as the distribution is not used for the same expenses for which a credit was claimed. Eliminated is the penalty on distributions not used for higher education expenses. That provision is replaced with the same additional tax that applies to educational IRAs. Assets of qualified tuition plans of private institutions must be held in trust. The provision is effective for taxable years beginning after December 31, 2001, except that the exclusion from gross income for certain distributions from a qualified tuition program established and maintained by an entity other than a state is effective for tax years beginning after December 31, 2003. Act Sec. 402, amending I.R.C. § 529.

Student loan interest deduction

The phase-out ranges for eligibility for the student loan interest deduction are increased to $50,000- $65,000 for singles, and to $100,000-$130,000 for married taxpayers filing jointly. The phase-out ranges are adjusted annually for inflation after 2002. The Act also repeals both the limit on the number of months during which interest paid on a qualified education loan is deductible and the restriction that voluntary payments of interest are not deductible. The provision is effective for interest paid on qualified education loans after December 31, 2001. Act Sec. 412, amending I.R.C. § 221.

Deduction for higher education expenses

Taxpayers are permitted an above-the-line deduction for qualified higher education expenses paid by the taxpayer during tax years from 2002-2005. Qualified education expenses are defined in the same manner as for the HOPE credit. For years 2002 and 2003, a taxpayer with an AGI of not more than $65,000 ($130,000 for married filing jointly) is entitled to a maximum annual deduction of $3,000. In 2004 and 2005, the maximum deduction rises to $4,000. Taxpayers with higher incomes that do not exceed $80,000 ($160,000 for married filing jointly) may deduct a maximum of $2,000 per year. Taxpayers with incomes exceeding the limits receive no deduction and the deduction expires for tax years beginning after December 31, 2005. The deduction and the HOPE or Lifetime Learning Credit may not be taken in the same year for the same student. Likewise, a taxpayer may not claim a deduction for amounts taken into account in determining the amount excludable due to a distribution from an education IRA or the amount of interest excludable for education savings bonds. The provision is effective for education payments made in tax years beginning after December 31, 2001 and before January 1, 2006. Act Sec. 431, redesignating I.R.C. § 222 as § 223 and inserting a new § 222.

Modifications of IRA contribution limits

The maximum annual dollar contribution limit for IRA contributions is increased to $3,000 for 2002 through 2004, $4,000 for years 2005 through 2007, and $5,000 for 2008. For years beginning after 2008, the limit is adjusted annually for inflation in $500 increments. The otherwise maximum contribution limit (before application of the AGI phase-out limits) for an individual who had attained age 50 before the end of the taxable year is increased by $500 for 2002 through 2005, and is increased by $1,000 for 2006 and thereafter. The provision is effective for taxable years beginning after December 31, 2001. Act Sec. 601, amending I.R.C. §§ 219(b) and 408.

Defined benefit plans

The Act increases the $35,000 limit on annual additions to a defined contribution plan to $40,000 and indexes it in $1,000 increments. The $140,000 annual benefit limit under a defined benefit plan is increased to $160,000, and the dollar limit is reduced for benefit commencement before age 62 and increased for benefit commencement after age 65. The Treasury Secretary is to apply rules similar to those adopted in Notice 99-44 regarding benefit increases due to the repeal of the combined plan limit under former I.R.C. § 415(e), according to the Statement of Managers for Conference Agreement on H.R. 1836. The Act also increases the dollar limit on annual elective deferrals under I.R.C. § 401(k) plans, I.R.C. § 403(b) annuities and salary reduction SEPs to $11,000 in 2002. In 2003 and thereafter, the Act increases the limits in $1,000 annual increments until the limits reach $15,000 in 2006, with indexing in $500 increments thereafter. Also increased is the maximum annual elective deferrals that may be made to a SIMPLE plan to $7,000 in 2002, $8,000 in 2003, $9,000 in 2004, and $10,000 in 2005. The limit is indexed thereafter in $500 increments. The limit is twice the otherwise applicable dollar limit in the three years before retirement. The provisions are effective for years beginning after December 31, 2001. Act Sec. 611, amending I.R.C. §§ 402, 408, 415 and 457.

Sunset of provisions

All provisions of the Act are repealed and have no application to taxable, plan or limitation years beginning after December 31, 2010. Act Sec. § 901.

CORRECTION

On P. 83 of the last issue of the Digest, the following paragraphs should read (change in italics):

“Sunset provision

On P. 83 of the last issue of the Digest, the following paragraphs should read (change in italics):

“Sunset provision

The 2001 Act, specifies that “all provisions of, and amendments made by the Act shall not apply . . . to estates of decedents dying, gifts made or generation-skipping transfers after December 31, 2010.” Act Sec. 901.

Therefore, unless amended further, the estate, gift and generation skipping transfer tax provisions will (1) be repealed after 2009 and (2) one year later revert to the status of the provisions as of the date of enactment.”
returns and made an assessment, the debtor was no longer filed more than three years before the bankruptcy petition was filed in 1988 and 1989. The court noted that Section 523(a)(1)(B)(i) after filing the returns and argued that the plain language of assessments. The debtor filed for Chapter 7 more than three years not vary substantially from the IRS original substitute returns and debtor agreed to file returns. The returns filed by the debtor did levying against the debtor's property and, three years later, the any of the IRS assessments or requests for returns. The IRS began assessments based on those returns. The debtor did not respond to separate set of exemptions.

The court also held that each debtor was entitled to a customers. The court also held that the cattle were used as breeder cattle and not for sale to farming. The court noted that the debtors’ current employment in the trucking business was started as a means of saving the family farm operation. The court also noted that the families of both debtors had been in farming for several generations and that the debtors themselves had been farming for over 20 years. The court went so far as to hold that the debtors’ involvement in the trucking business demonstrated their sincere intention to reenter farming as soon as possible; therefore, the court held that the debtors were engaged in farming for purposes of claiming tools of the trade exemptions. The court held that the farm equipment qualified as tools of the trade because the equipment was useful primarily for farming and was essential to a farming operation. The court also held that the cattle were tools of the trade because the cattle were used as breeder cattle and not for sale to customers. The court also held that each debtor was entitled to a separate set of exemptions. In re Larson, 260 B.R. 174 (Bankr. D. Colo. 2001).

The debtor did not file timely returns for 1988 and 1989. The IRS construed substitute returns and made assessments based on those returns. The debtor did not respond to any of the IRS assessments or requests for returns. The IRS began levying against the debtor’s property and, three years later, the debtor agreed to file returns. The returns filed by the debtor did not vary substantially from the IRS original substitute returns and assessments. The debtor filed for Chapter 7 more than three years after filing the returns and argued that the plain language of Section 523(a)(1)(B)(i) allowed the discharge of the taxes for 1988 and 1989. The court noted that Section 523(a)(1)(B)(i) applied to discharge taxes for which a return was required and filed more than three years before the bankruptcy petition was filed. The court held that, once the IRS constructed the substitute returns and made an assessment, the debtor was no longer required to file a return; therefore, Section 523(a)(1)(B)(i) no longer applied to make the taxes nondischargeable. In re Walsh, 260 B.R. 142 (Bankr. D. Minn. 2001).

FINANCIAL INSTITUTIONS. Under 15 U.S.C. § 6809 of the Gramm-Leach-Bliley Act of 1999, is the definition of “financial institution” (which is required to disclose annually) as “. . . any institution the business of which is engaging in financial activities as described in section 1843(k) of title 12.” Section 1843(k)(4)(C) in Title 12 defines “activities that are financial in nature” as including “providing financial, investment, or economic advisory services, including advising an investment company . . . “ Except where a law firm or CPA firm is running some sort of advisory service, we do not believe that the firm would be subject to the Act. However, because there is some uncertainty about the scope of the act, firms may wish to give the required privacy notice.

The court also held that the nature of the debtors' business also included the debtors’ bona fide intent to return to farming. The court noted that the debtors’ current employment in their trucking business was started as a means of saving the family farm operation. The court also noted that the families of both debtors had been in farming for several generations and that the debtors themselves had been farming for over 20 years. The court went so far as to hold that the debtors’ involvement in the trucking business demonstrated their sincere intention to reenter farming as soon as possible; therefore, the court held that the debtors were engaged in farming for purposes of claiming tools of the trade exemptions. The court held that the farm equipment qualified as tools of the trade because the equipment was useful primarily for farming and was essential to a farming operation. The court also held that the cattle were tools of the trade because the cattle were used as breeder cattle and not for sale to customers. The court also held that each debtor was entitled to a separate set of exemptions. In re Larson, 260 B.R. 174 (Bankr. D. Colo. 2001).

DISCLAIMER. The decedent’s spouse died two years before the decedent. The couple had executed identical wills which bequeathed a fixed sum to their child and the remainder to the surviving spouse. The wills also established testamentary residuary trusts which would receive any property disclaimer by the surviving spouse. The couple had intended to allow some post-death estate planning by the survivor to minimize the estate tax over the death of the couple. The decedent had made a good deal of preparation for the disclaimer of the spouse's estate which passed to the decedent but had only managed to write down a list of the spouse’s assets before the decedent died. The decedent’s estate argued that the decedent had substantially complied with the disclaimer requirements because the list was intended to be used for the disclaimer. The court held that the list was not sufficient to be a qualified disclaimer because the list contained no language of an affirmative statement of disclaimer. The court noted that even the list did not fully comply with the estate’s claim of the decedent’s intent because the list did not contain enough assets to fully minimize the estate tax. The appellate court affirmed in a decision designated as not for publication. Estate of Chamberlain v. Comm’r, 2001-1 U.S. Tax Cas. (CCH) ¶ 60,407 (9th Cir. 2001), aff’d, T.C. Memo. 1999-181.

ESTIMATED TAX. For estates and trusts using Form 1041-ES, Estimated Income Tax for Estates and Trusts, and for tax-exempt trusts using Form 990-W, most of the 2001 income tax rates have been reduced. A Revised 2001 Tax Rate Schedule for Estates and Trusts is provided on the IRS web site (http://www.irs.gov) in the “Forms and Publications” section under “What's Hot,” “Tax Law Changes for 2001 Affecting Taxpayers Making Estimated Tax Payments.”

FAMILY-OWNED BUSINESS DEDUCTION. The decedent’s representative did not make a FOBD election when
filing the estate tax return because the representative had determined that the value of the business interests held by the decedent was insufficient to qualify the estate for FOBD. The IRS audited the return and determined that the value of the business interest was higher than claimed on the estate tax return. The new value was high enough to qualify the estate for FOBD. The representative sought an extension of time to file the FOBD election. The IRS granted the extension. \textit{Ltr. Rul. 200122012, Feb. 21, 2001.}

\textbf{GIFTS.} The taxpayers were four brothers, three of whom were married, who owned stock in a family business. The married couples gave stock to their own three children and to each of their nieces and nephews, with each gift valued at just below the annual exclusion amount of $10,000. Thus, each child received the same total amount of stock. The fourth brother gave stock to all the nieces and nephews, although that brother had no children. Each brother and wife claimed an annual exclusion for each gift.

The court held that the gifts were reciprocal gifts, causing the gifts from the aunt and uncle to be attributed to the parent of the donee nieces and nephews. Therefore, the gift of stock to each child from an aunt or uncle was combined with the gifts from their parents, causing the total amount of the gifts above $10,000 to be subject to gift tax. The court held that the nonreciprocal nature of the fourth brother’s gifts did not affect the reciprocal nature of the gifts made between the other families. \textit{Sather v. Comm’r, 2001-1 U.S. Tax Cas. (CCH) ¶ 60,409 (8th Cir. 2001), aff’g, T.C. Memo. 1999-309.}

\textbf{MARITAL DEDUCTION.} The IRS has issued a revenue procedure which provides relief for surviving spouses and their estates in situations where a predeceased spouse’s estate made an unnecessary qualified terminable interest property (QTIP) election under I.R.C. § 2056(b)(7) that did not reduce the estate tax liability of the estate. This revenue procedure describes the circumstances in which these QTIP elections will be treated as a nullity for federal estate, gift, and generation-skipping transfer tax purposes, so that the property will not be subject to transfer tax with respect to the surviving spouse. \textit{Rev. Proc. 2001-38, I.R.B. 2001-.}

\textbf{POWER OF APPOINTMENT.} The taxpayer received an interest in property in a trust from a deceased parent. The parent was not a U.S. resident or citizen and the trust assets were not subject to U.S. estate tax. The trust provided that the taxpayer could appoint the trust corpus by will to the taxpayer’s surviving spouse. The IRS ruled that the taxpayer did not have a general power of appointment over the trust property and that the property would not be included in the taxpayer’s estate. \textit{Ltr. Rul. 200123045, March 8, 2001.}

\textbf{TRUST.} The taxpayer established a trust for the taxpayer’s children with the taxpayer as the initial trustee. The trustee had the power to distribute trust income and principal for the health, education, support or maintenance of the beneficiaries. The beneficiaries had the annual power to demand distribution of gifts to the trust. The IRS ruled that transfers to the trust were gifts of present interests, unless there was an implied or express agreement or understanding that the beneficiaries would not exercise the right of withdrawal, and that the trusts would not be included in the taxpayer’s estate. \textit{Ltr. Rul. 200123034, March 8, 2001.}

\textbf{VALUATION.} The decedent’s will included a bequest in a charitable remainder unitrust to the surviving spouse with the remainder to a charity. The spouse was diagnosed with cancer five months after the death of the decedent and died about one year later. The charitable remainder interest was valued by valuing the spouse’s interest using the actuarial tables for a 67 year old man. The estate argued that the value of the spouse’s interest should be valued using the actual life span of the spouse because the cancer was in existence when the trust was created, even though the cancer was not discovered for five months thereafter. The court held that the valuation of the trust had to be made on the basis of information known at the time of the transfer; therefore, the spouse’s interest in the trust was properly valued using the actuarial tables. \textit{Estate of Burchell v. United States, 2001-1 U.S. Tax Cas. (CCH) ¶ 60,410 (S.D. N.Y. 2001).}

\section*{FEDERAL INCOME TAXATION}

\textbf{ACCOUNTING PERIOD.} The IRS has issued proposed regulations which re-propose temporary regulations under I.R.C. §§ 441, 442. Most of the substantive provisions of Reg. Sec. 1.441-1T have been retained, including the general rules for the period for computing tax, many definitions and the requirement that partnerships, S corporations, electing S corporations and personal service corporations generally must demonstrate a business purpose and obtain IRS approval to adopt or retain a tax year other than their required tax year. The proposed rules also define “required taxable year,” identify entities that have such a year and clarify the applicable exceptions. In addition, the proposed regulations clarify the meaning of the requirement to keep books for taxpayers using a fiscal year and provide that a tax year would be adopted by filing the first federal income tax return using that tax year. Filing an application for an employer identification number, filing an extension or making estimated tax payments indicating a particular tax year would not constitute an adoption of that year. \textit{66 Fed. Reg. 31850 (June 13, 2001).}

\textbf{BAD DEBT DEDUCTION.} The taxpayer made several advances to a corporation owned by the taxpayer’s father. The corporation operated a retail jewelry store. The court held that the advances were contributions to capital because, the taxpayer did not receive any note for the advances, did not receive any interest or repayments, and agreed to subordinate the repayment of the advances to other debt of the corporation. \textit{Levy v. Comm’r, T.C. Memo. 2001-136.}

\textbf{BUSINESS EXPENSES.} The taxpayer had claimed deductions for various business expenses but did not provide the business records to substantiate the expenses. The taxpayer claimed that the records were in the possession of an attorney who would not produce the records because of animosity toward the taxpayer from past legal proceedings. However, the taxpayer did not provide other evidence to reconstruct the missing records. The court disallowed the deductions for lack of substantiation. \textit{Blodgett v. Comm’r, T.C. Memo. 2001-147.}

The taxpayer had obtained a patent for an automotive oil filtration system. The taxpayer claimed deductions for expenses related to manufacturing and marketing the system. The taxpayer did not provide any records of manufacturing activity for marketing activity. The court disallowed the deductions for lack of proof of any trade or business activity related to the expenses. \textit{McMullen v. Comm’r, T.C. Summary Op. 2001-87.}
The taxpayer operated a painting business but did not keep separate records of income and expenses. Many of the payments received were in cash and were untraceable. The IRS reconstructed the taxpayer’s income based upon the expenditures of the taxpayer during each tax year. The court upheld the IRS income calculation because the taxpayer failed to provide any evidence to rebut the calculation. In addition, the court disallowed most of the business expense deductions for lack of any substantiation. Owens v. Comm’r, T.C. Memo. 2001-143.

CHARITABLE DEDUCTION. The taxpayer transferred business interests to trusts for the taxpayer’s children and a charitable organization. The business interests were assigned a value and then a portion of that value was transferred to the children’s trusts and the remainder transferred to the charity. The trusts provided that if the value of the business interests was increased by an IRS audit, the increase would be allocated to the charity. Six months after the funding of the trusts, the charity’s interest in the trust was redeemed by the children at appraised value, although the charity had no part in the appraisal. In a field service advice letter, the IRS ruled that the taxpayer would not be entitled to an additional charitable deduction for any increase in value determined by an IRS audit. FSA Ltr. Rul. 200122011, Feb. 20, 2001.

COOPERATIVES. Three cooperatives joined in forming a limited liability company to merge together common operating and manufacturing activities in order to obtain the benefits of larger scale operations. The IRS ruled that the resulting LLC would have patronage-sourced income from activities performed for member/patrons of the original cooperatives. Ltr. Rul. 200123033, March 7, 2001.

CORPORATIONS-ALM § 7.02.* DISREGARDING CORPORATE ENTITY. The taxpayer was employed as a consultant and started an export business on the side. The export business was incorporated but never made any sales. The taxpayer sought to claim the corporate expenses as personal business deductions. The court held that the expenses could be taken as a deduction only by the corporation because the corporation had sufficient activities to be recognized for federal income tax purposes. Most of the expenses were disallowed as deductions for lack of substantiation since the taxpayer did not keep records and receipts for the expenses. Verma v. Comm’r, T.C. Memo. 2001-132.

ESTIMATED TAX. The IRS has announced that corporations using Form 1120-W, Estimated Tax for Corporations, and tax-exempt corporations using Form 990-W, Estimated Tax on Unrelated Business Taxable Income for Tax-Exempt Organizations, the due date for any estimated tax payment that would otherwise be due in September 2001 has been changed to October 1, 2001. Due dates for all other estimated tax payments remain the same.

CONSTRUCTIVE RECEIPT. The taxpayer owned timberland for over 30 years. When the timber became harvestable, the taxpayer sold exclusive rights to harvest the timber to a third party. The proceeds of this contract were placed in escrow in 1994 to be purchased other timberland to be selected by the taxpayer. The taxpayer argued that no income was realized in 1994 because the taxpayer did not actually or constructively receive any property in 1994 for the harvest rights. The court held that the taxpayer had a bona fide intent to identify and receive replacement property; therefore, the harvest rights proceeds were not actually or constructively received by the taxpayer when paid to the escrow agent in 1994. Smalley v. Comm’r, 116 T.C. No. 29 (2001).

COURT AWARDS AND SETTLEMENTS-ALM § 4.02[14]. The taxpayer was employed for three years before the employment was terminated because the taxpayer refused a transfer. The taxpayer received a severance payment and signed a release of claims against the employer. The taxpayer was treated for injuries received during previous employment but made no claims for injuries against the employer. The court noted that the same severance payment and release were presented to several employees as part of the employer’s staff reduction program. The court held that the severance payment was included in the taxpayer’s gross income. Tritz v. Comm’r, T.C. Summary Op. 2001-76.

The taxpayer was discharged from employment and brought an action against the employer for wrongful termination as age and disability discrimination. The parties reached a settlement but the settlement payment was based upon the salary of the taxpayer. The court held that the settlement proceeds were included in income because the settlement was based primarily on the salary of the taxpayer and was not intended to compensate the taxpayer for any physical injury or sickness. Broedel v. Comm’r, T.C. Memo. 2001-135.

DEPRECIATION. The taxpayer owned several vehicles for use in the taxpayer’s business. The vehicles were purchased without tires because the taxpayers purchased tires in bulk for use on all vehicles, either as new tires or replacement tires. In a field service advice letter, the IRS ruled that, if the tires had a useful life beyond one year, the cost of the tires had to be capitalized as separate property with a recovery period of either five or eight years. Because the taxpayer had been currently deducting the cost of the tires, the change to capitalizing the cost was a change of accounting method. FSA Ltr. Rul. 200122002, Jan. 30, 2001.

DISASTER PAYMENTS. On May 17, 2001, the President determined that certain areas in Colorado were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of severe winter storms that began on April 11, 2001. FEMA-1374-DR. On May 17, 2001, the President determined that certain areas in South Dakota were eligible for assistance under the Act as a result of severe winter storms, flooding and ice jams beginning on March 1, 2001. FEMA-1375-DR. On May 28, 2001, the President determined that certain areas in North Dakota were eligible for assistance under the Act as a result of severe storms, flooding and ground saturation beginning on March 1, 2001. FEMA-1376-DR. On May 28, 2001, the President determined that certain areas in Montana were eligible for assistance under the Act as a result of severe winter storms beginning on April 8, 2001. FEMA-1377-DR. On June 3, 2001, the President determined that certain areas in West Virginia were eligible for assistance under the Act as a result of severe storms, flooding and land slides beginning on May 15, 2001. FEMA-1378-DR. On June 9, 2001, the President determined that certain areas in Texas were eligible for assistance under the Act as a result of tropical storm Allison beginning on June 5, 2001. FEMA-1379-DR. On June 11, 2001, the President determined that certain areas in Louisiana were eligible for assistance under the Act as a result of tropical storm Allison beginning on June 5, 2001. FEMA-1380-DR. Accordingly, a taxpayer who sustained a loss attributable to the disasters may deduct the loss on his or her 2000 federal income tax return.

EARNED INCOME CREDIT. The taxpayer claimed welfare payments under AFDC and SSI programs, Social Security disability benefits, and gifts as wages on the taxpayer’s income tax return. No other wages or income were reported such that, after the standard deduction and exemptions, the taxpayer had
zero taxable income. The taxpayer also claimed earned income credit. The court held that earned income does not include welfare payments such as AFDC and SSI, Social Security disability benefits or gifts. The appellate court affirmed in an opinion designated as not for publication. Powers v. Comm’r, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,838 (6th Cir. 2001), aff’d, T.C. Memo. 2000-5.

ESTIMATED TAX. The IRS has announced that individuals who use Form 1040-ES, Estimated Tax for Individuals, or Form 1040-ES(NR), U.S. Estimated Tax for Nonresident Alien Individuals, should not use the tax rate schedules shown in those forms or in Publication 553, Highlights of 2000 Tax Changes. The Revised 2001 Tax Rate Schedules can be found on the IRS web site at http://www.irs.ustreas.gov/graphic/estimpaynets.gif.

HOME OFFICE. The taxpayer operated a locksmith business out of the taxpayer’s home garage. Most of the work was performed at the customer’s site, with some customers bringing their locks to the garage. The garage was also used for the taxpayer’s personal storage. The court held that the taxpayer was not allowed deductions for expenses associated with the garage as a home office because the principal location of the business was outside of the garage. Krist v. Comm’r, T.C. Memo. 2001-140.

INCOME. The taxpayer was a corporation involved in the manufacture, sale, and distribution of health care marketing materials, health care educational materials, and clinical and infection control products. Petitioner’s client base consisted of dental offices, veterinary clinics, and other health care professional offices. The customers would often have positive balances in their accounts resulting from returns, overpayments and other adjustments. The customers had the option to receive refund checks, apply the credit to subsequent purchases or leave the credit in the account for future use. The IRS argued that the credit balances which existed for two years or more should be included in the taxpayer’s income. The court held that the credit balances were not included in income because the taxpayer and its customers recognized that the credit belonged to the customer and would either be repaid or applied to the price of future orders. Smarthealth, Inc. v. Comm’r, T.C. Memo. 2001-145.

INTEREST RATE. The IRS has announced that, for the period July 1, 2001 through September 30, 2001, the interest rate paid on tax overpayments is 7 percent (6 percent in the case of a corporation) and for underpayments at 7 percent. The interest rate for underpayments by large corporations is 9 percent. The interest rate paid on tax overpayments is 7 percent (6 percent in the case of a corporation) and for underpayments at 7 percent. The interest rate for underpayments by large corporations is 9 percent. The interest rate paid on tax overpayments is 7 percent (6 percent in the case of a corporation) and for underpayments at 7 percent. The interest rate paid on tax overpayments is 7 percent (6 percent in the case of a corporation) and for underpayments at 7 percent.

LEVY. The taxpayer was married to a dentist who failed to file returns for the children because the taxpayers failed to provide TINs for the children. The court held that the IRS demonstrated a sufficient nexus between the spouse and the ownership of the farm and insurance proceeds to levy against the insurance proceeds for the taxes owed by the spouse. Scoville v. United States, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,442 (8th Cir. 2001), aff’d, 2000-1 U.S. Tax Cas. (CCH) ¶ 50,163 (D. Mo. 2000).

PENSION PLANS. The IRS has released guidelines relating to the amendments made by Section 314(e) of the Community Renewal Tax Relief Act of 2000 (Pub. L. No. 106 554) (CRA) to I.R.C. §§ 403(b)(3), 414(s)(2), and 415(c)(3), which provide definitions of compensation that apply to qualified plans and I.R.C. § 403(b) annuities. The CRA amendments modify those definitions of compensation to change the amount of the compensation reduction elected for qualified transportation fringe benefits that is not includable in an employee's gross income pursuant to I.R.C. § 132(f)(4) elective reductions. Qualified plans must be operated in accordance with the CRA amendments for post-2000 plan and limitation years, and plan amendments necessitated by the CRA amendments must be adopted within the GUST remedial period and take effect no later than the first day of the first plan and limitation years beginning after 2000. Plan sponsors may adopt model amendments, and qualified plans will not be disqualified solely due to a failure to timely reflect the CRA amendments. Notice 2001-37, I.R.B. 2001-25.

PREPAID EXPENSES. The taxpayer was an S corporation which operated a turkey farm. The taxpayer purchased turkey feed in one tax year for use in the next tax year. The trial court had followed Rev. Rul. 79-229, 1979-2 C.B. 133, which required a valid business purpose for allowing a current deduction for prepaid expenses. The trial court and the appellate court affirmed that the taxpayer failed to demonstrate a valid business purpose for the prepayment of turkey feed and that the deduction was not allowed in the tax year prior to the tax year of the actual use of the feed. The appellate decision is designated as not for publication. Petersen Turkey Hatchery, Inc. v. United States, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,435 (8th Cir. 2001).

RETURNS. The taxpayers, husband and wife, did not obtain social security numbers for their children and did not include any taxpayer identification number for the children on their income tax returns. The court upheld denial of dependency exemptions for the children because the taxpayers failed to provide TINs for the children. The court also held that the TIN requirement was constitutional under the Free Exercise Clause of the First Amendment and the Due Process and the Equal Protection clauses of the Fourteenth Amendment to the U.S. Constitution. Cansino v. Comm’r, T.C. Memo. 2001-134.

SAFE HARBOR INTEREST RATES

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TAX SHELTERS. The IRS has announced that, effective immediately, the address for filing Form 8264, Application for Registration of a Tax Shelter, has changed to: Internal Revenue Service Center, Ogden, Utah 84201.

SECURED TRANSACTIONS

REMINDER—by Neil E. Harl

LANDLORD LIENS. The 1998 revisions to Article 9 of the Uniform Commercial Code contain one provision that demands attention before July 1, 2001, in most of the states that have enacted the revision. For many, many years, most liens, including landlord's liens, have enjoyed a position of priority over perfected security interests and, in the case of landlord's liens, in many states prevailed as against purchasers of commodities even though the landlord's lien was not recorded. Only in the event of tenant bankruptcy did the landlord's lien lose its priority status. In the 1998 revisions, a landlord's lien (and other liens) that are classified as agricultural liens must be perfected as security interests under the UCC in order to have priority. In order to perfect a landlord's lien on farm products, a landlord must file a financing statement. In general, a perfected lien in farm products has priority over a conflicting security interest or lien, including a security interest or lien that was perfected prior to the creation of the landlord's lien, if the landlord's lien is perfected prior to July 1, 2001, for existing leases, or when the debtor takes possession of the leased premises or within 20 days after the debtor takes possession of the leased premises for new leases. A financing statement filed to perfect a lien in farm products must include a statement that it is filed for the purpose of perfecting a landlord's lien. Therefore, landlords should consider, before July 1, 2001, whether the risks of non-collection of rent are great enough to justify filing a financing statement under the UCC before July 1. U.C.C.Rev. 9-308, subsection 2; for an example of an amendment to a landlord's lien statute, see Iowa Code Sec. 570.1 (2001).

CITATION UPDATES

Popov v. United States, 246 F.3d 1190 (9th Cir. 2001) (home office) see p. 78 supra.

* * * *

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by Neil E. Harl and Roger A. McEown

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DEBT IN EXCESS OF BASIS
— by Neil E. Harl*

One of the important objectives in the incorporation of a farm or ranch business is to accomplish a tax-free exchange of assets to the new entity.¹ With a low income tax basis for many of the assets in most farm and ranch businesses, the consequences of a taxable exchange can be very serious in terms of income tax liability on the gain involved.²

A recent Tax Court case, Seggerman Farms, Inc. v. Commissioner³ has focused attention once again on the need for careful planning.

Facts in Seggerman
In the facts of Seggerman Farms, Inc., a father and two sons formed a farm corporation with a transfer of individually owned assets to the corporation. The father, Ronald Seggerman, conveyed assets with a fair market value of $445,820 and basis of $66,201 to the corporation with the corporation assuming debt totaling $402,903. One son, Craig Seggerman, transferred assets with a fair market value of $156,340 and basis of $30,517 to the corporation with the corporation assuming debt totaling $121,911. The other son, Michael, conveyed assets totaling $156,340 in value with a basis of $30,517 to the corporation with the corporation assuming debt totaling $113,111. The transferors remained personally liable on the debts accompanying the assets to the new corporation.

Whether gain was triggered
Ordinarily a transfer of assets to a newly formed corporation, where the debt involved exceeds the basis, triggers gain to the extent the indebtedness exceeds the basis.⁵ The basis of stock received by the transferors is the basis of property transferred, less “boot” received and plus gain recognized, if any.⁶ If a corporation assumes a liability of the transferor or takes property subject to a liability, as for example a mortgage, the amount of the liability is treated as “money received” and reduces the basis of stock received.⁷ Therefore, since negative basis figures are not possible, the excess of indebtedness over basis is gain.⁸

In determining the amount of gain recognized when several assets are transferred to a corporation, each asset is considered separately in exchange for a portion of each category of consideration received.⁹

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.

See the back page for details about the 2001 Agricultural Tax and Law Seminars
Featuring discussion of EGTRRA 2001
by Dr. Neil E. Harl and Prof. Roger A. McEowen
The taxpayer argued that the excess of liabilities over basis (which totaled $510,690) should not be subject to income tax because the transferees remained personally liable on the debt obligations. The Tax Court pointed out that it has consistently held that debt in excess of basis was subject to tax on the gain involved even if the transferees remained personally liable on the debt obligations. The taxpayers relied on Lessinger v. Commissioner, where the difference between the basis of property and debt was recorded as a loan receivable from the taxpayer (to the corporation) and Peracchi v. Commissioner, where the transferor was relieved of liability (or portion), whether or not the transferor was relieved of liability. The transferee has agreed to, and is expected to, satisfy such liability. The court cited a Seventh Circuit Court of Appeals case, Testor v. Commissioner, which denied relief to a taxpayer with a gain on incorporation where the property is subject to liabilities for which the corporation did not assume liability. IRS, in response, took the position that the structure of the transactions in Lessinger and Peracchi was different from the way the transfer was handled in Seggerman Farms, Inc. In that the taxpayers in Seggerman did not contribute loan receivables or personal notes to the corporation to cover the difference between the transferred liabilities and the basis of the transferred property. The Tax Court agreed with the distinction urged by the Service. The court cited a Seventh Circuit Court of Appeals case, Testor v. Commissioner, which denied relief to a taxpayer with a gain on incorporation where indebtedness exceeded the basis. The case of Seggerman Farms, Inc. is appealable to the Seventh Circuit.

Recent legislation

In 1999, Congress enacted changes to I.R.C. § 357(c), effective for transactions after October 18, 1998. The amendment struck the words “plus the amount of liabilities to which the property is subject” from the statute and provided relief for taxpayers transferring assets subject to liabilities where the transferor remains personally liable on the debt but for which the corporation did not assume liability. The 1999 amendment also added I.R.C. § 357(d)(1)(A) which provides guidance in determining the amount of liabilities assumed and states that “a recourse liability (or portion thereof) shall be treated as having been assumed if...the transferee has agreed to, and is expected to, satisfy such liability (or portion), whether or not the transferor is relieved of such liability.”

The Tax Court pointed out that the 1999 amendment did not apply in the Seggerman case because the transaction was in 1993. In dictum, the court stated that even after the 1999 amendments, “...Congress has refrained from providing relief to taxpayers in petitioners’ situation.” Apparently in the belief that the debt obligations were assumed by the corporation.

In conclusion

It is clear that great care is needed in handling exchanges of property any time the indebtedness exceeds the income tax basis. The stakes can be high.

FOOTNOTES

3 T.C. Memo. 2001-99.
4 Id.
5 I.R.C. §§ 351, 358.
7 I.R.C. § 358(d).
8 Id. See Owen v. Comm’r, 881 F.2d 832 (9th Cir. 1989).
13 872 F.2d 519 (2d Cir. 1989), rev’g, 85 T.C. 824 (1985).
14 143 F.3d 487 (9th Cir. 1998), rev’g, T.C. Memo. 1996-191.
16 Id.
17 327 F.2d 788 (7th Cir. 1964), aff’d, 40 T.C. 273 (1963).
18 T.C. Memo. 2001-99.
20 Id.
21 Id., Sec. 3001(b), 113 Stat. 182 (1999).

CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-ALM § 13.03.*

EXEMPTIONS
ADDITIONAL CHILD TAX CREDIT. The debtor claimed an exemption for a portion of an income tax refund. The exemption was claimed under Idaho Code § 11-60394) for benefits received under federal, state or local public assistance legislation. The debtor claimed that a portion of the refund resulted from the additional child income tax credit allowed under I.R.C. § 24(d). The court applied a three part inquiry as to whether the tax credit was in the nature of public assistance: whether the credit had a public assistance purpose, whether the credit was refundable, and at what income level did the

* Agricultural Law Manual (ALM).
credit phase out. The court held that the additional child credit had the public assistance purpose to help families with three or more children and was refundable. However, the court held that the credit was not eligible for the exemption because the credit was available to higher income families, thus demonstrating that the credit was not intended to serve as public assistance legislation. In re Steinmetz, 261 B.R. 32 (Bankr. D. Idaho 2001).

CHAPTER 12-ALM § 13.03[8].

LEGISLATION. The President on June 26, 2001 signed H.R. 1914 (Pub. L. No 107-8) which retroactively extends Chapter for four months, from June 1 until October 1, 2001.

PLAN. The debtors owed two secured claims on their farm, a first mortgage to a bank and a second mortgage to the FSA. The FSA mortgage was only partially secured by the farm. The debtors had signed up their entire farm for CRP and were eligible for nine more years of CRP payments. The debtors’ plan provided for payment of the secured claims from nonfarm income and the CRP payments but listed the FSA claim as secured only by the farm. The FSA did not claim any right of setoff of the CRP payments but objected to the plan because it did not characterize the entire FSA claim as secured, in part by the farm and the remainder by the future CRP payments. The debtors also argued that the FSA had waived its setoff rights by not including them in it claim in the bankruptcy case. The court held that the plan could not be confirmed because the FSA right of setoff made the entire claim secured. The court also held that the right of setoff was not waived because the FSA objected to the plan. In re Krause, 261 B.R. 218 (Bankr. 8th Cir. 2001).

The debtors had challenged a secured claim based upon a mortgage as unenforceable. While that issue was being appealed, the debtors obtained the consent of the creditor for the confirmation of the plan. The confirmation agreement provided that if the mortgage claim was upheld, the claim would be paid in full. The plan did not make any provision for post-petition interest on the mortgage claim. The plan also contained a provision that the bankruptcy estate property would not re vest in the debtors upon confirmation of the plan. The mortgage claim was resolved in favor of the creditor several years after confirmation of the plan and the creditor sought post-petition interest on the claim. At the time the post-petition interest was sought, the estate had more than enough property to pay the claim and interest. There was uncertainty whether the excess estate property resulted from appreciation or the efforts of the trustee to maximize the property by selling the property in small lots. The debtors argued that the post-petition interest was not allowed because the debtors were insolvent at the confirmation date. The court held that post-petition interest was not allowed because (1) the debtors did not prove that they were insolvent on the confirmation date, (2) the confirmation agreement provided for payment “in full” of all secured claims, and (3) any post-petition appreciation of estate assets accrued to the estate because the property did not re vest in the debtors upon confirmation, as provided in the confirmation agreement. In re Ogle, 261 B.R. 22 (Bankr. D. Idaho 2001).

FEDERAL TAX-ALM § 13.03[7].

DISCHARGE. The taxpayer filed timely returns for 1989 through 1992 but did not pay the taxes when due. The returns improperly claimed deductions for residential mortgage interest and home office deductions because the residence was owned separately by the taxpayer’s spouse. The spouse and taxpayer had their returns prepared by third parties based on the information provided by the taxpayer and spouse. The court held that the taxpayer did not willfully attempt to evade payment of tax and did not intend to file fraudulent tax returns, but merely made negligent mistakes in claiming the improper deductions. The court held that the taxes were dischargeable. In re Frosch, 261 B.R. 181 (Bankr. W.D. Pa. 2001).

The debtor had filed a previous bankruptcy case in 1997 which included tax claims for 1995 and 1996. That case continued for over two years before being dismissed. The current case was filed in September 2000 and the debtor sought have the 1995 and 1996 taxes declared dischargeable as due more than three years before the filing of the petition. The court followed the majority of cases which hold that the three year period of Section 507(a)(8)(A)(i) was tolled during the previous bankruptcy case. In re Fiels, 260 B.R. 362 (Bankr. D. Md. 2001).

CONTRACTS

HEDGE-TO-ARRIVE CONTRACTS. The plaintiffs were grain producers who had entered into hedge-to-arrive (HTA) contracts with the defendants, a corporation which was an introducing broker. The defendants marketed the HTA contracts through a local agent who presented the HTA contract concept at seminars and programs for the plaintiffs. The contracts were marketed as low risk and a method of establishing a floor price for grain prior to sale. The plaintiffs brought suit against the defendants as the principals for the local agent, alleging that the HTA contracts were illegal off-exchange futures contracts and that the marketing of the contracts violated federal racketeering laws (RICO) for wire and mail fraud. The defendant sought and obtained a dismissal of the case in the District Court for lack of standing and for failure to properly plead mail and wire fraud under RICO. The court held that the plaintiff sufficiently plead the agency relationship between the corporations and the local agent, the possible violations of the Commodity Exchange Act if the HTA contracts were proven to include the sale of off-exchange futures, and the acts which would violate the wire and mail fraud provisions of RICO. The court did not discuss or rule on the merits of any of these issues. Abels v. Farmers Commodities Corp., No. 00-2045NI (8th Cir. July 3, 2001).

ENVIRONMENTAL LAW

CLEAN WATER ACT. The plaintiffs were nonprofit environmental organizations. The defendant irrigation district applied aquatic herbicide to its irrigation canals to control weeds. The herbicide contained a chemical which caused a massive fish kill and the plaintiffs sued the defendant for violation of the Clean Water Act for application of a pollutant...
without a National Pollution Discharge Elimination permit. The lower court had held that the herbicide was a pollutant and that the canals were waters of the U.S. but held that no permit was required because the herbicide was fully regulated by the EPA under FIFRA. The appellate court affirmed the first two holdings, noting that the canals were covered as waters of the U.S. also because the canals drained into several natural creeks and streams. The appellate court reversed on the third holding because it held that FIFRA did not regulate the application of herbicides into waters of the U.S. The court noted that the FIFRA and CWA had different purposes and jurisdictions; therefore, a regulated herbicide could be a pollutant under the CWA. Headwaters, Inc. v. Talent Irrigation District, 243 F.3d 526 (9th Cir. 2001).

FEDERAL AGRICULTURAL PROGRAMS

LEGISLATION. Legislation has been introduced in the U.S. House of Representatives to dedicate revenues from recent tobacco tax increases for use in buying out tobacco quotas. H.R. 2334.

ADVERTISING ASSESSMENTS. The U.S. Supreme Court has affirmed the following decision. The plaintiff was a mushroom grower and was assessed funds for the advertising of mushrooms as required under the Mushroom Promotion, Research and Consumer Information Act, 7 U.S.C. § 6101 et seq. The plaintiff argued that the assessment violated the First Amendment of the U.S. Constitution in that it required the plaintiff to participate in the advertisements which the plaintiff saw as against the plaintiff’s interest. The Court interpreted Glickman v. Wileman Bros. & Elliott, Inc., 521 U.S. 457 (1997) as upholding the constitutionality of advertising assessments only where the marketing within an industry was completely regulated (within the check-off statute) as was the fruit tree industry in Wileman. Because the marketing of the mushroom industry was not completely regulated, the assessments for compelled commercial speech violated the plaintiff’s First Amendment right to not participate in the commercial speech in the advertisements. The Digest will be publishing an article by Neil Harli on this case. United Foods, Inc. v. United States, No. 00-276 (S. Ct. June 25, 2001), aff’d, 197 F.3d 221 (6th Cir. 1999).

PERISHABLE AGRICULTURAL COMMODITES. The debtor had entered into a contract to sell tomatoes raised by the debtor. The buyer was a produce broker who agreed to arrange for the harvest, packing and sale of the tomatoes. The contract provided that the broker would receive a commission of 10 percent for the services and that the costs of harvest and packing would be deducted from the sales proceeds to be returned to the debtor. The broker also received a commission from the buyers of the tomatoes which was paid as a percentage of the purchase price. When other creditors sought to attach the proceeds from the sale, the broker placed the funds with the court. However, the broker reduced the proceeds by the 10 percent commission and the costs of harvest and packing. The trustee sought to include the commission fee in the amount deposited with the court because the commission represented a double charge in violation of 7 U.S.C. § 499e. The court held that the commission was not a double charge because the debtor did not pay the fee charged to the buyers, the debtor agreed to the commission, and the broker provided adequate services to justify the commission. In re Borek, 260 B.R. 886 (Bankr. S.D. Fla. 2001).

FEDERAL ESTATE AND GIFT TAX

No items

FEDERAL INCOME TAXATION

LEGISLATION. Legislation has been introduced in the U.S. House of Representatives to (1) establish a deduction for contributions to a Farm, Fishing, and Ranch Risk Management Account (FFARRM account); (2) exempt income tax averaging for farmers from the alternative minimum tax; (3) provide that the payment of dividends on the stock of a cooperative would not reduce net earnings; (4) increase the small producer ethanol credit; (5) include in the definition of the term “marketing the products of members or other producers” the feeding the products of members or other producers to cattle, hogs, fish, chickens, or other animals and selling the resulting animals or animal products; and (6) provide for a charitable deduction for gifts of food inventory. H.R. 2347. Legislation has also been introduced which would exclude from the preproductive expenses rules the costs of replanting edible crops destroyed by casualty. H.R. 2354.

ACCOUNTING METHOD. In the early 1990s, the taxpayer built and placed into service several gas station convenience stores and initially claimed depreciation deductions under the MACRS for the properties as nonresidential 31.5 or 39 year recovery property. In 1996 the taxpayer filed amended returns which reclassified the property as 15-year property, consistent with an Industry Specialization Program Coordinated Paper issued by the IRS. In 1996 and 1997 the taxpayer’s tax returns continued to claim depreciation deductions using the 15-year classification. The IRS argued that the change of depreciation method was a change in accounting method which required IRS approval. There was no disagreement that the properties were not properly 15-year recovery property. The court held that the change in the depreciation calculation was not a change in accounting method which required IRS consent. Brookshire Brothers Holding, Inc. v. Comm’r, T.C. Memo. 2001-150.

BUSINESS EXPENSES. The taxpayers operated a wholesale/retail business about six miles from their rural residence. The taxpayers maintained an office for the business at their residence and maintained several cattle at their residence. The taxpayers claimed travel expenses for use of automobiles to travel from their residence to their business, arguing that the travel was between two businesses. The court...
held that the travel expenses were not eligible for a business deduction because the primary purpose of the travel from the business to the residence was personal. The court also disallowed the travel deduction because the taxpayers did not keep complete records of the travel. The taxpayer restored a pond on their residence which had become stagnated after a winter storm caused several trees to fall into the pond. The court held that no casualty deduction was allowed for the expense of repairing the pond because the pond became stagnated over several months from several causes. The appellate court affirmed in a decision designated as not for publication. Barmes v. Comm’r, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,487 (7th Cir. 2001), aff’g, T.C. Memo. 2000-254.

The taxpayers, husband and wife, jointly owned a Christmas tree farm. The taxpayers claimed deductions for health insurance for the wife paid for by the business. The taxpayers argued that the wife was an employee of the husband and presented an employment agreement as proof of the employment relationship. The court disregarded the employment contract because the wife was paid more than the contract allowed, the wife worked less hours than the contract required and the wife’s work was more consistent with a co-owner relationship than an employment relationship. Therefore, the court held that the health insurance costs were not allowed as a business deduction. Poyda v. Comm’r, T.C. Summary Op. 2001-91.

COURT AWARDS AND SETTLEMENTS-ALM § 4.02[14]. The taxpayer was an employee of a large corporation and was offered the opportunity for early retirement in exchange for cash benefits. The taxpayer agreed to the early retirement and made one of several elections for the timing and amount of the severance payments. The taxpayer signed a general release of liability of the employer for a large number of possible actions against the employer. The release was used for all early retirees who terminated employment under the same program. The taxpayer had not made any tort claims against the employer. The court held that the money received by the taxpayer was included in income because (1) the release was required for all early termination employees, (2) the amount of money paid was dependent upon the taxpayer’s salary and length of employment with the company and not any claim made by the taxpayer, and (3) the payment was in the nature of severance pay and not settlement of a claim. The appellate court affirmed in a decision designated as not for publication. Metelski v. Comm’r, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,482 (3d Cir. 2001), aff’g, T.C. Memo. 2000-95.

The taxpayer was terminated from employment with the Federal Aviation Administration (FAA) and sought compensation under the Federal Employees’ Compensation Act (FECA) for emotional injury resulting from harassment and racial discrimination during the employment. The taxpayer did receive disability payments under the Federal Employees’ Retirement System (FERS). The taxpayer excluded the payments from income, under I.R.C. § 104, arguing that the payments should have been made under FECA and not FERS; therefore, the payments were excludible from income. The court held that, although the taxpayer may have suffered a disability resulting from employment and covered by FECA, the payments were actually made under FERS and were included in gross income. Norris v. Comm’r, T.C. Memo. 2001-152.

DEPRECIATION. The taxpayer was a partner in a partnership which purchased a horse breeding farm from a corporation principally owned by the taxpayer. The partnership had claimed depreciation deductions based on a purchase price of the farm of $1.5 million, although the partnership paid the corporation only $350,000 in cash with no additional indebtedness for the purchase price. The taxpayer attempted to demonstrate that the buildings cost more than $1 million to construct but the court held that (1) the taxpayer failed to prove the cost of constructing the buildings and (2) the cost of constructing the buildings was irrelevant because the partnership’s basis was dependent solely upon the purchase price paid by the partnership. The taxpayer also argued that the corporation received an interest in the partnership as part of the sales price, but the court rejected this claim because the sales contract made no mention of such consideration for the farm. Thus, the partnership depreciation deductions were limited to the portion of the $350,000 purchase price allocable to the depreciable property. Vajda v. Comm’r, T.C. Memo. 2001-159.

The taxpayers were denied depreciation deductions for two automobiles which the taxpayers claimed were used in their businesses. The court denied the deductions because the taxpayers failed to provide any record of the business use of the automobiles. Barmes v. Comm’r, T.C. Memo. 2001-155.

DISASTER PAYMENTS. On June 17, 2001, the President determined that certain areas in Florida were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of tropical storm Allison from June 11-15, 2001. FEMA-1381-DR. On June 21, 2001, the President determined that certain areas in Mississippi were eligible for assistance under the Act as a result of tropical storm Allison from June 8-13, 2001. FEMA-1382-DR. Accordingly, a taxpayer who sustained a loss attributable to the disasters may deduct the loss on his or her 2000 federal income tax return.

HEALTH AND ACCIDENT PLAN PAYMENTS. The court held that payments received under the Minnesota State Retirement System for disabilities were included in income because the payments would continue only while the taxpayer was unemployed. Goodchild v. Comm’r, T.C. Summary Op. 2001-102.

HOBBY LOSSES. The taxpayer owned an ocean yacht which the taxpayer used for personal and charter fishing. There was some evidence that the boat was also used to entertain employees of corporations owned by the taxpayer but the taxpayer did not maintain accurate and complete records of the boat’s use. The court held that the losses from the boat could not be deducted as business expenses because the taxpayer had no realistic expectation of ever making a profit from the boat. The court cited a magazine article in which the taxpayer stated that no profit could be made from the boat could not be deducted as business expenses. O’Connell v. Comm’r, T.C. Memo. 2001-158.

INCOME. The taxpayer was an attorney and had revenues which represented fees paid for work already performed and retainer fees for work to be performed in the future. The taxpayer did not keep accurate records of these payments and failed to file returns for two tax years. The IRS reconstructed
the taxpayer’s income for these two years by including in income all deposits to the taxpayer’s personal and business accounts from the trust accounts. Because the taxpayer lacked records to controvert the IRS determinations, the court upheld the IRS calculation of the taxpayer’s income for the two tax years. Kaufman v. Comm’r, T.C. Memo. 2001-161.

LEY. The taxpayer was assessed for tax deficiencies and the IRS sought to levy against the proceeds of insurance on a farm destroyed by fire which was owned by the taxpayer’s former wife. The evidence demonstrated that the taxpayer had transferred the property to the former spouse and divorced the spouse in order to hide assets from the IRS. The evidence also demonstrated that the taxpayer continued to use the farm and other assets transferred as the taxpayer’s own. The court held that the insurance proceeds were subject to the levy. Scoville v. United States, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,442 (8th Cir. 2001), aff’g, 2000-1 U.S. Tax Cas. (CCH) ¶ 50,163 (D. Mo. 2000).

LOSSES. The taxpayer had owned two adjacent lots which were not used in the taxpayer’s trade or business. In 1993 the taxpayer sold the lots to a third party in exchange for indebtedness owed to the third party. The taxpayer retained an option to repurchase the lots and gave the buyer a promissory note for the option. No payments were made on the option promissory note and in 1996, the taxpayer executed a relinquishment of the option. The taxpayer claimed a loss in 1996 for the sale of the lots for less than the income tax basis. The court held that no sale or exchange occurred in 1996; therefore, no loss deduction could be claimed in 1996. Hale v. Comm’r, T.C. Summary Op. 2001-99.

MARKET SEGMENT SPECIALIZATION GUIDE. The IRS posted a revised version of the Shareholder Loans Market Segment Specialization Program Audit Technique Guide (6-01) on its web site, http://www.irs.gov. The document addresses issues regarding loans to shareholders. It examines bona fide debt v. non bona fide debt, the mechanics of bona fide debt, below-market loans, demand loans, the de minimis exception, computations and interest issues on market rate loans. IRPO ¶ 217,925.

PENSION PLANS. The taxpayer was a family farm corporation which adopted an ESOP defined contribution plan. The plan had the same person as the trustee and only participant, the president of the taxpayer. Instead of paying the president wages for managing the farm, the taxpayer paid the president as an independent contractor, with the president reporting the income on Schedule C as a sole proprietor. The taxpayer claimed no deduction for wages and deducted the payments to the president as management fees. The IRS disqualified the ESOP because the taxpayer paid no compensation to employees. The taxpayer argued that the management fees paid to the president were sufficient to qualify the plan. The court held that the president was not employed by the taxpayer but was a sole proprietor, essentially self-employed. The court held that the management fees did not qualify as compensation to the president; therefore, the taxpayer could not claim any deductions for contributions to the ESOP, which was limited to 25 percent of the participant’s compensation. There was no discussion of whether the president would be considered an employee under other aspects of income tax law. The appellate court affirmed in a decision designated as not for publication. Van Roekel Farms, Inc. v. Comm’r, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,490 (8th Cir. 2001), aff’g, T.C. Memo. 2000-171.


For plans beginning in June 2001, the weighted average is 5.82 percent with the permissible range of 5.24 to 6.11 percent (90 to 106 percent permissible range) and 5.24 to 6.40 percent (90 to 110 percent permissible range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). Notice 2001-39, I.R.B. 2001–9.

The IRS has released three Industry Specialization Program Settlement Guidelines addressing hybrid arrangements of cafeteria and qualified retirement plans, the deductibility of health insurance for self-employed individuals and the retroactive adoption of accident and health plans. IRPO ¶¶ 180,048, 180,068, 180,080.

PENALTIES. The taxpayers had invested in jojoba partnerships which had been held to be without economic substance. The taxpayer’s deductions involving the partnership interests were disallowed. The issue in this case was whether the taxpayers were subject to negligence and understatement of tax penalties. The taxpayer did not fully read the partnership agreements and consulted only with a friend who was a CPA. The court held that taxpayers were subject to the negligence and understatement of tax penalties because the amount of investigation by the taxpayer was unreasonable, give the substantial tax deductions taken. Kessel v. Comm’r, T.C. Summary Op. 2000-176; Nilsen v. Comm’r, T.C. Memo. 2001–163.

TRUSTS. The taxpayers transferred their two sole proprietorship businesses to a trust. The taxpayers had all income and expenses run through the trust and filed personal income tax returns without reporting that income. The court held that the trust was a sham and that all income and expenses were treated as personal to the taxpayers. Barmes v. Comm’r, T.C. Memo. 2001–155.

INSURANCE

COVERAGE. The plaintiff had purchased property insurance to cover soybeans stored in bins located on the plaintiff’s farm. The policy excluded losses from mold but covered losses from “ensuing fire” from mold. Some of the stored soybeans were charred and blackened. The storage workers found clumps of beans which were too hot to handle and which glowed. The heat was caused by mold growth which created sufficient heat to “burn” the beans. No flames were seen but the beans smoked around the hot spots. The court held that the heat damage from mold was covered under the insurance policy which covered damage from “ensuing fire” because the plaintiff proved the existence of smoke, heat and orange light in the beans. In addition, the court held that the damage was covered under the policy because the damage was caused primarily by the heat, a covered damage, and not the mold. Bruce Oakley, Inc. v. Farmland Mutual, 245 F.3d 1027 (8th Cir. 2001).
LANDLORD AND TENANT

TERMINATION. The defendants had entered into a 99-year lease of a farm. The lease was renewable forever by the defendant’s family. The lease provided, however, that it could be terminated “for need.” The plaintiff was the guardian of the lessor and served a notice of termination of the lease, stating that the lease was terminated because the lessor was in bad health and needed to sell the property in order to qualify for medical benefits. The defendants claimed that the lessor had conveyed the farm in fee to them in a letter which indicated that the lessor intended the defendants to have the farm “till the end of this Age.” The court held that the termination was valid in that it was based on the need of the lessor. In addition, the court held that the lessor’s letter was ineffective to pass title to the defendants because the letter contained no words of transfer and the defendants gave no consideration for the letter. Earl v. Beager, 20 P.3d 788 (Mont. 2001).

PROPERTY

FENCE. The respondent filed a petition for a fence viewing because the respondent wanted to raise cervidae (animals of the deer family) on the respondent’s property. The respondent planned to build a 96 inch barbed wire fence but agreed that the neighbors needed to pay an assessment based upon a shorter fence. The neighbors offered to build their own fences but only the shorter version. The state law required the taller fence for cervidae farms. The viewers ordered the neighbors to pay a portion of the fence costs based upon the cost of a shorter fence, even though the respondent planned to build a taller fence. The neighbors challenged the order as an unconstitutional taking. The court noted that the neighbors failed to provide any evidence of loss of property use or value from the fence and noted that the neighbors would receive the benefit of protection from trespassing cervidae. The neighbors also argued that they should have been allowed to construct their own fences but the court held that the fences were inadequate for a cervidae farm; therefore, the fence viewer’s order was upheld. In re Petition of Bailey, 626 N.W.2d 190 (Minn. Ct. App. 2001).

STATE TAXATION

AGRICULTURAL USE. The plaintiff owned 50 acres of pasture which was not used for agriculture but left vacant. The land was not fenced and cattle owned by a tenant of the neighboring land often trespassed on the pasture for grazing. The plaintiff did not know about the trespassing in 1996, the tax year in issue, but when the trespass was discovered in 1999, the plaintiff entered into a pasture lease with the neighboring tenant. The plaintiff sought agricultural use valuation for the property for 1996 based upon the trespass grazing of the neighbor tenant. The court held that the trespass grazing of the land was not sufficient to support an agricultural use of the land because the plaintiff did not gain any monetary profit from the activity. Besch v. Jefferson County Bd. Of Comm’rs, 20 P.3d 1195 (Colo. Ct. App. 2000).

VALUATION. The taxpayer appealed the 50 percent increase in assessed value of the taxpayer’s farm. The assessment was based primarily on the location of the entire farm within the county and the taxpayer argued that the valuation was too high because the farm had several areas of lower quality soil. The taxpayer based the value on comparable sales of property with similar soils but the defendant board of assessment rejected the taxpayer’s evidence. The court held that the taxpayer had presented sufficient evidence of valuation to rebut the presumption that the assessment was correct. The court also held that the assessment was in error because it was not based on sales of comparable properties with comparable soils. The court held that the valuation of property based solely on the location within the county was arbitrary because the assessment board provided no evidence to support that valuation method. The court also cited Bartlett v. Davis County Bd. Of Equal., 613 N.W.2d 810 (2000) as requiring that farm land valuation be based upon soil classification. Schmidt v. Thayer County Bd. Of Equal., 624 N.W.2d 63 (Neb. Ct. App. 2001).

WATER RIGHTS

ABANDONMENT. The previous owner of the plaintiff’s property had irrigated the property from a creek under a water right. The previous owner had defaulted on a federal loan and the farm was owned by the FmHA for several years. The FmHA leased the farm to several third parties before selling it to the plaintiff. The lessees did not irrigate the property during four years and one lessee attempted to irrigate the property but the water was diverted by the watermaster, the defendant, in order to irrigate the defendant’s property. The lessee was able to irrigate only 25 acres in that year. An adjudication of water rights was commenced and the special master ruled that the water rights were abandoned for nonuse over five years, except for the 25 acres. The plaintiff argued that the five year period should have been tolled during the period that the watermaster diverted the water, preventing irrigation. The court held that the diversion did not toll the five year period because the land was not ready to support irrigation during that year. McCray v. Rosenkranz, 20 P.3d 693 (Idaho 2001).

CITATION UPDATES


Grojean v. Comm’r, 248 F.3d 572 (7th Cir. 2001), aff’g, T.C. Memo. 1999-425 (basis in S corporation) see p. 79 supra.

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FUTURE OF COMMODITY CHECK-OFFS
— by Neil E. Harl*

The United States Supreme Court, in a six to three decision, on June 25 created a different playing field for commodity check-off programs. The decision promises to be the center of the debate over mandatory check-off programs for several years. In the case before the court, United States v. United Foods, Inc., the court said that the mandatory mushroom check-off violates the First Amendment free speech rights of mushroom producers.

The opinion

The court opinion was written by Justice Anthony Kennedy who was joined by Justices Rehnquist, Stevens, Scalia, Souter and Thomas, with Stevens and Thomas concurring in the majority opinion. Justice Stephen Breyer dissented along with Justices Ginsburg and O’Connor. The line up represented quite a departure from the usual liberal-conservative split.

The statute in question, enacted by Congress in 1990, is the Mushroom Promotion, Research and Consumer Information Act. The legislation authorized the Secretary of Agriculture to establish a Mushroom Council and allowed the council to impose mandatory assessments on handlers of fresh mushrooms in an amount not to exceed one cent per pound of mushrooms produced or imported. Most of the funds raised by the assessments were spent for generic advertising.

Justice Kennedy noted that First Amendment concerns arise because of the fact that “producers subsidize speech with which they disagree.” The court noted that commercial speech is protected by the First Amendment to the U.S. Constitution. Justice Kennedy analyzed how the mushroom check-off was regulated. He said that greater regulation of the mushroom market might have been implemented but it was not. Justice Kennedy stated that the compelled contributions (in the form of the check-off) only served the advertising scheme in question. The check-off was not part of a broader regulatory framework. The advertising itself was the principal object of the regulatory scheme.

The earlier case

The court in United Foods was trying to juggle the facts in that case in light of an

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See the back page for details about the 2001 Agricultural Tax and Law Seminars Featuring discussion of EGTRRA 2001 by Dr. Neil E. Harl and Prof. Roger A. McEowen
earlier Supreme Court decision, *Glickman v. Wileman Brothers & Elliott, Inc.* In that case, the court upheld a marketing order that was part of a larger regulatory scheme with respect to California tree fruits. The court noted that producers in that case were compelled to contribute funds for cooperative advertising and were required to market their products according to cooperative rules. Moreover, the court noted that the marketing orders had received an antitrust exemption.

None of that was present in the *United Foods* case. In *United Foods*, the funds were directed into generic advertising with nothing preventing producers from making their own marketing decisions, there was no antitrust exemption and there were no marketing orders regulating mushroom production. Also, nothing required the mushroom growers in *United Foods* to associate as a group making cooperative decisions.

**Meaning of United Foods**

The meaning of *United Foods* and the implications for other check-off programs will not be known until challenges to those other check-offs are litigated, probably all the way to the U.S. Supreme Court.

The most likely interpretation, at this point, is that the court will be inclined to evaluate each check-off on the basis of what is required and what is involved with the statute authorizing the check-off and related statutes and whether the statutory framework comprises a “marketing scheme,” as noted in *United Foods*. The fact that a particular commodity is subject to various types of federal regulation is not likely to be as important as whether the check-off law embraces a fairly comprehensive marketing program. If it does, there is less likelihood that the check-off interferes with free speech. As the court noted in *United Foods*, if there is a “marketing scheme” involved, “…mandated participation in an advertising program with a particular message [is] the logical concomitant of a valid scheme of economic regulation.”

However, if the authorizing statute and the associated statutory framework does little more than levy the check-off rate against the commodity, and provide for the disbursement of funds, a challenge is more likely to be successful, and indeed, may well be unconstitutional.

That analysis would suggest that the pork and beef check-offs could be in jeopardy and the grain check-offs might, as well.

The beef check-off was litigated to the Tenth Circuit Court of Appeals in 1998 in the case of *Gaetz v. Glickman* with the Tenth Circuit upholding the check-off. Certiorari was denied by the U.S. Supreme Court in 1999. It is understood that the U.S. Supreme Court will be asked on August 9, 2001, to grant review of the case in light of *United States v. United Foods, Inc.* If review is granted, a decision in the beef check-off could come relatively soon.

**Reposition the check-offs?**

An obvious question is how the various check-offs could be repositioned to better withstand a constitutional challenge.

One possibility would be for the check-off program to become part of a broader, comprehensive marketing program. A commodity marketing program would seem to be on firmer ground in resisting a challenge to the constitutionality of a check-off program which is ancillary to the marketing program.

Greater government involvement in marketing of the commodity in question otherwise could help withstand a legal challenge. Check-offs in conjunction with government farm programs could, conceivably, be fashioned in such a manner as to create some protection from a First Amendment challenge.

Another possible strategy would be to shift check-offs to a voluntary status. That would, of course, eliminate revenue from those who feel their free speech is being infringed plus revenue from those who would be content to let others pay for promotion even though they agree with the message.

**The near term**

For check-off programs that are not part of a comprehensive marketing program, legal challenges could drag on for several years. The key question: is there political support (and producer support) for taking steps to recast the check-off programs in a manner to withstand constitutional challenge? The answer, at this stage, is far from clear.

**FOOTNOTES**

2. Id.
5. 7 U.S.C. § 6104(g)(2).
6. See note 1 supra.
9. See Note 1 supra.
13. See note 1 supra.
CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-ALM § 13.03.*

ESTATE PROPERTY. The debtor filed for Chapter 7 in September 1999 and was enrolled in several seven year production contracts. In October 1999, Congress passed the Market Loss Assistance Program (MLAP) and the Disaster Assistance Program (DAP) for 1999. Because the debtor was enrolled in the production contracts the debtor was eligible for and received assistance under the MLAP. The debtor also applied for and received payments under the DAP. The applications and payments were all made post-petition. The trustee sought to include the payments in the bankruptcy estate, arguing that the payments were “sufficiently rooted in the prebankruptcy past and so little entangled in the debtor’s ability to make a fresh start.” The trustee’s argument was based on \textit{Segal v. Rochelle}, 382 U.S. 375 (1966) which included in the bankruptcy estate an income tax refund received post-petition for the tax year in which the petition was filed. The court noted that the legislative history of the Bankruptcy Act of 1978 included a statement that \textit{Segal} was followed as to tax refunds but was silent as to other post-petition payments. The court held that the post-petition assistance payments were not included in the bankruptcy estate because, on the date of the petition, the legislation authorizing the payments had not been enacted. \textit{In re Vote}, 261 B.R. 439 (Bankr. 8th Cir. 2001).

The debtor was a beneficiary of a testamentary trust at the time of filing the bankruptcy petition. Under the trust, the debtor was entitled to monthly payments from trust income but was not entitled to any payments from trust corpus except in specified emergencies. The trust also contained a spendthrift clause which provided that neither income from the corpus nor the corpus itself was liable for the debts of the debtor. The court held that the spendthrift clause was valid and enforceable and prevented the trust corpus from being part of the bankruptcy estate. The court also held that, under Section 541(a)(5)(A), the income received by the debtor within 180 days after the petition was filed was part of the bankruptcy estate. \textit{In re Hunter}, 261 B.R. 789 (Bankr. M.D. Fla. 2001).

CHAPTER 12-ALM § 13.03[8].*

PLAN. In March 1993, a creditor obtained a money judgment against the Chapter 12 debtor and recorded the judgment immediately. The debtor filed for Chapter 12 in April 1994 and the debtor’s property included a farm and personal property with sufficient equity to satisfy the creditor’s judgment lien. The creditor filed a claim in the bankruptcy case but the debtor’s plan treated the creditor’s judgment as an unsecured claim. The creditor did not object to the plan and the debtor received a discharge after paying unsecured creditors 1 percent of their claims. The creditor then sought to enforce the lien and the debtor argued that the lien was voided by the confirmation of the plan without objection from the creditor. Although the court acknowledged that there was judicial precedent for voiding the lien where the creditor fails to object to a plan which mischaracterizes the claim, the court held that a judgment lien is not voided by a Chapter 12 plan which does not specifically mention the lien. \textit{In re Holloway}, 261 B.R. 490 (M.D. Ala. 2001), \textit{aff’d}, 254 B.R. 289 (Bankr. M.D. Ala. 2000).

FEDERAL TAX-ALM § 13.03[7].*

DISCHARGE. The debtor did not initially file income tax returns for 1990, 1991 and 1992. In February 1995 the IRS created substitute for returns for those years and made assessments based on those returns. The debtor then filed returns for those years with tax amounts much less than the assessments. The debtor sought to discharge the taxes because the debtor’s returns were filed more than three years before the bankruptcy filing. The court held that the taxes were nondischargeable under Section 523(a)(1)(B)(i) because the debtor did not file a return. Although the court does not explicitly state it, the holding implies that the debtor’s returns filed after the construction of the substitute returns were not considered as returns for purposes of Section 523(a)(1). \textit{In re Olson}, 261 B.R. 752 (Bankr. M.D. Fla. 2001).

The debtor failed to file and pay income taxes for 10 years, during which the debtor suffered from alcoholism. The court found that the debtor did no affirmative acts to avoid payment of the taxes but that the debtor was merely indifferent to paying the taxes, a condition caused by the alcoholism. Once the debtor sought treatment for the alcoholism, the debtor fully cooperated with the IRS and filed all of the unfiled returns. The Bankruptcy Court held that the taxes were dischargeable because the debtor did not willfully attempt to evade payment of the taxes. The Bankruptcy Court reiterated the holding in \textit{In re Haas}, 48 F.3d 1153 (11th Cir. 1997), that the mere failure to pay taxes when able to do so was not sufficient to render the taxes nondischargeable. The appellate court reversed, holding that the failure to file and pay taxes while fully conscious of the duty to file and pay while fully able to pay the taxes constituted a willful attempt to evade payment of the taxes. The court noted that the debtor had sufficient control over the debtor’s work to perform surgery for 12 to 24 hour shifts, which demonstrated that the debtor had made a knowing choice to ignore the filing and paying of the income taxes. Thus, in the Eleventh Circuit, the mere failure to pay taxes will not make the taxes nondischargeable, as in \textit{In re Haas}, but the failure to file and pay taxes will make the taxes nondischargeable. \textit{In re Fretz}, 244 F.3d 1323 (11th Cir. 2001), \textit{rev’d}, 248 B.R.
The debtor’s taxes were declared nondischargeable because the debtor’s tax returns for those taxes were held to be fraudulent. The returns understated income and the debtor did not have adequate records to support the deductions claimed. There was also evidence that the debtor established fictitious companies and defrauded third parties in an insurance scheme. In a decision designated as not for publication, the appellate court affirmed the holding that the taxes were nondischargeable because of fraudulent returns. *In re Bonner,* 2001-2 U.S. Tax Cas. (CCH) ¶ 50,512 (9th Cir. 2001).

**PLAN.** The debtors and IRS had disagreed over the amount of taxes owed but reached an agreement which was incorporated into a stipulation as part of the debtors' Chapter 13 plan. Two years later, the debtors filed amended returns showing no taxable income, based on tax protestor claims. The court held that the stipulation in the plan as to the amount of the tax claims was an admission which could not be set aside unless the debtors showed substantial injustice was involved. *In re Buckner,* 261 B.R. 478 (Bankr. E.D. Okla. 2001).

**HEDGE-TO-ARRIVE CONTRACTS.** The plaintiffs were grain producers who had entered into hedge-to-arrive (HTA) contracts with the defendant grain elevator. In the earlier decision, summary judgment was granted to the defendant on the issue that the contracts were not illegal off-exchange futures contracts because delivery of grain was intended, even though the contracts allowed indefinite rollover of the delivery date. In the second case, the jury found that the defendant owed a fiduciary duty to the plaintiffs and breached that duty by (1) failing to warn about all the risks inherent in HTAs, (2) failing to warn that the defendant may not have sufficient capital or credit to roll over the delivery date enough times to weather adverse market conditions, (3) failing to monitor the contracts and market conditions, (4) making false or misleading comments against the plaintiffs, and (5) conspiring with other elevators to make unreasonable demands on the plaintiffs to conceal the defendant’s inability to fund the HTA program. Actual damages totaled more than $740,000. The jury also found that the plaintiffs were entitled to punitive damages of over $1,290,000 for the defendant’s willful and wanton disregard of the plaintiffs’ rights. The cases are available on the Northern District of Iowa web site: http://www.iand.uscourts.gov. *Asa-Brandt, Inc. v. Farmers Co-op. Society,* No. C01-3021-MWB, (N.D. Iowa April 18, 2001) (summary judgment); *Asa-Brandt, Inc. v. Farmers Co-op. Society,* No. C01-3021-MWB, (N.D. Iowa July 13, 2001) (jury verdict).

**FAMILY LAW**

**CHILD SUPPORT.** As part of a divorce decree, the defendant was ordered to pay child support. The defendant was a self-employed farmer. The court held that, under N.D. Admin Code § 75-02-04.1-05(2), the support payments were to be based on the defendant’s income calculated by starting with the defendant’s adjusted gross income and adding allowed depreciation and subtracting capital expenditures for business assets. *Christl v. Swanson,* 626 N.W.2d 690 (N.D. 2001).

**FEDERAL AGRICULTURAL PROGRAMS**

**BRUCELLOSIS.** The APHIS has issued interim regulations amending the brucellosis regulations by changing Florida from a Class A to Class Free state. 66 Fed. Reg. 32893 (June 19, 2001).

**KARNAL BUNT.** The APHIS has issued interim regulations amending the karnal bunt regulations by adding Archer and Baylor counties in Texas to the list of regulated areas. 66 Fed. Reg. 37575 (July 19, 2001).

**FEDERAL ESTATE AND GIFT TAX**

**RETURNS.** The IRS has announced that, beginning with returns filed on or after January 1, 2001, the filing locations for some states have changed for the following tax returns: Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return; Form 706-CE, Certificate of Payment of Foreign Death Tax; Form 706-GS(D), Generation-Skipping Transfer Tax Return for Distributions; Form 706-GS(D-1), Notification of Distribution From a Generation-Skipping Trust; Form 706-GS(T), Generation-Skipping Transfer Tax Return for Terminations; Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return; Form 709-A, United States Short Form Gift Tax Return. Ann. 2001-74, I.R.B. 2001-__

** VALUATION.** The decedent had won a state lottery with the decedent’s sister. The two winners formalized the sharing of the prize, paid in annual installments, in a limited partnership agreement. Thus, when the decedent died, the decedent owned an interest in the partnership which was entitled to 19 annual prize payments. The IRS valued the right to receive the lottery installments by the partnership

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*Agricultural Law Manual (ALM).*
using the annuity tables of Treas. Reg. § 20.2031-3. The decedent’s estate argued that the lottery installments were not an annuity and should be valued by the fair market value of the installment payments as received by the partnership. The court held that, under Estate of Gribauskas v. Comm’r, 116 T.C. 142 (2001), lottery prize installments were annuity payments and had to be valued using the annuity tables. The court noted that, while the lottery installments did not have all the same characteristics as annuities, the lottery payments were as secure as an annuity and were required to be paid annually. The case does not rule on the value of the decedent’s interest in the partnership, although the IRS had allowed discounts for lack of marketability, restrictions on transfer and admission of new partners, and for lack of a controlling interest. Estate of Cook v. Comm’r, T.C. Memo. 2001-170.

VALUATION OF STOCK. The decedent died owning two-thirds of the stock of a large corporation. The decedent had established trusts for the decedent’s heirs and provided for transfer of the stock to a charitable foundation. There was disagreement between the heirs and foundation whether the voting and nonvoting stock or just the voting stock was subject to redemption by the corporation after the decedent’s death. The estate argued that the stock should be discounted because of the ambiguity of the redemption agreement. The IRS argued that the redemption agreement was irrelevant as to the value of the stock to the decedent at the decedent’s death because the redemption agreement did not take effect until after the decedent’s death. The court agreed with the IRS and held that the value of the stock was not affected by the redemption agreement. Estate of Schwan v. Comm’r, T.C. Memo. 2001-174.

FEDERAL INCOME TAXATION

BUSINESS EXPENSES. The taxpayer was a corporation which owned a jet. The corporation allowed its corporate officers to use the jet for personal purposes. The officers included the value of the use of the jet in their gross income and the taxpayer claimed the expenses for maintaining and using the jet as business deductions. The IRS argued that, under I.R.C. § 274(a)(1), the business deductions were not allowed because the aircraft was a facility used for entertainment. Thus, the taxpayer would be allowed a deduction only for the amounts determined to be deductible as compensation to the officers. The taxpayer argued that I.R.C. § 274(e)(2) provided an exception to section 274(a)(1) because the officers included the value of the flights as compensation. The court agreed with the taxpayer and allowed the deductions for the maintenance and use of the jet. Sutherland Lumber-Southwest, Inc. v. Comm’r. 2001-2 U.S. Tax Cas. (CCH) ¶ 50,503 (8th Cir. 2001).

DISASTER PAYMENTS. On June 29, 2001, the President determined that certain areas in Oklahoma were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of severe storms, flooding and tornadoes that began on May 27, 2001. FEMA-1384-DR. On July 7, 2001, the President determined that certain areas in Montana were eligible for assistance under the Act as a result of severe storms on June 3-14, 2001. FEMA-1385-DR. Accordingly, a taxpayer who sustained a loss attributable to the disasters may deduct the loss on his or her 2000 federal income tax return.

EMPLOYMENT BENEFITS. The taxpayer was a corporation which operated an airline. The taxpayer provided per diem allowances to its flight attendants and pilots based on union employment contract provisions and the flight schedules of the employees. The payments were considered compensation to the employees and the employees were not required to individually account for their expenses. The court held that the per diem payments were deductible as employee compensation. UAL Corp. v. Comm’r, 117 T.C. No. 2 (2001).

HEDGING. The taxpayer was a farming corporation wholly-owned by a husband and wife. The taxpayer raised corn, soybeans and cattle. The corn and soybeans were sold to another corporation in the hog farrowing business. The husband also owned 50 percent of the hog farrowing corporation. The taxpayer also sold corn and soybeans to a third corporation in which the husband owned 20 percent of the stock. The third corporation operated a hog finishing business. The husband and wife originally had a commodities account but transferred the account to the taxpayer when the taxpayer was incorporated. The taxpayer claimed losses from trading in hog futures and claimed the losses as ordinary losses from hedging transactions. The IRS treated the losses as capital losses because the taxpayer was not in the hog production business. The taxpayer argued that the futures transactions were hedges because the taxpayer sold grain to a hog producer which could lose money if the market price declined. The court held that the taxpayer failed to provide any evidence that the taxpayer could not sell the grain otherwise if the other two corporations did not buy the grain; therefore, the taxpayer was not at risk as to the market price of hogs. The taxpayer also argued that the participation of its major shareholder in the other corporations could be attributed to the taxpayer so as to give the taxpayer some risk in the price of hogs produced by those corporations. The court held that the corporations were separate entities and were not liable for each other’s losses; therefore, the taxpayer’s transactions in hog futures were not hedges and the losses had to be considered as capital losses. The court refused to apply the accuracy-related penalty to the taxpayer because the tax law of hedging is complex and the taxpayer relied on the advice of an accountant. Pine Creek Farms, Ltd. v. Comm’r, T.C. Memo. 2001-176.

INCOME. The taxpayer was a corporation which provided warehousing and distribution services for several grocery corporations. The taxpayer entered into several contracts with suppliers under which the taxpayer agreed to make a certain amount of purchases and the suppliers provided an up-front payment. The taxpayer also agreed to provide a certain amount of shelf space in each store for the goods purchased and to provide substantial marketing and advertising promotions of the products. Under the agreement, the up-front payments were to be repaid on a
prorated basis if the taxpayer failed to purchase the agreed amount or the suppliers felt that the marketing was not sufficient. The court held that the advance payments had to be claimed as income in the tax year received and not in the year the payments became nonrefundable. The court noted that the taxpayer had complete use of the funds when received and provided immediate consideration for the payments in the form of guaranteed shelf space and marketing efforts. Westpac Pacific Foods v. Comm’r, T.C. Memo. 2001-175.

LEGAL FEES. The taxpayer was a retired engineer but continued to provide consulting services. The taxpayer’s daughter was involved in a divorce proceeding which included a contest for custody of the daughter’s child. At one point the taxpayer also sought custody of the grandchild. The taxpayer claimed the legal expenses for the divorce and custody proceedings as business legal expenses. The court held that the legal fees were not deductible because the legal proceedings were not part of the business but were a personal expense of the taxpayer. Rupert v. Comm’r, T.C. Memo. 2001-179.

LEVY. The IRS had assessed taxes against an individual who had participated in a religious corporation with the taxpayer. Real property had been transferred to the individual who then purported to transfer the property to the corporation for no consideration. The property was again transferred to a trust in which the taxpayer was a trustee. The individual made use of the property during the time the property was held by the corporation and trust. The IRS attempt to levy against the property for the taxes owed by the individual and the taxpayer argued that the property was no longer owned by the individual but was property of either the corporation or the trust. The court held that the corporation was void because one of the signatures on the incorporation instrument was forged. The court also held that the transfer to the trust was ineffective for income tax purposes because (1) no consideration was given for the property, (2) the transfer was made while the individual was under threat of levy for back taxes, (3) the individual and taxpayer were closely related as part of the same organization, (4) the transfer was not recorded, and (5) the individual retained possession and use of the property. Michaels v. United States, 2001-2 U.S. Tax Ca. (CCH) ¶ 50,504 (E.D. Wash. 2001).

PENALTIES. The taxpayer had invested in a Jojoba growing partnership which was determined by the IRS to be ineligible for research and development deductions and other tax deductions. The taxpayer was assessed a deficiency after the taxpayer’s share of the disallowed deductions was also disallowed. The issue in this case was whether the taxpayer was also liable for the negligence and substantial understatement of tax penalties. The court found that the taxpayer did not consult income tax experts or agricultural experts before investing in the partnership in order to determine whether the investments and tax benefits were reasonable. Therefore, the court held that the taxpayer was liable for the negligence penalty. The court also held that the taxpayer was liable for the substantial understatement of tax penalty because the taxpayer had no authority for the deductions taken and did not fully disclose the investments on the tax returns. Carmenta v. Comm’r, T.C. Memo. 2001-177.

PENSION PLANS. The IRS has issued an alternative model amendment to the model amendment contained in the preamble for proposed regulations under I.R.C. § 401(a)(9), relating to required minimum distributions from retirement plans. Ann. 2001-82, I.R.B. 2001—__.

RETURNS. The IRS has released revised Publication 2194 (Rev. Dec. 2000), Disaster Kit; Publication 2194B (Rev. Dec. 2000), Disaster Losses Kit for Businesses; Form 966 (Rev. June 2001), Corporate Dissolution or Liquidation; Form 5558 (Rev. June 2001), Application for Extension of Time To File Certain Employee Plan Returns; and Instructions for Form 8390 (2000), Information Return for Determination of Life Insurance Company Earnings Rate Under Section 809. These documents are available at no charge (1) by calling the IRS's toll-free telephone number, 1-800-829-3676; (2) through FedWorld; (3) via the internet at http://www.irs.gov/prod/cover.html; or (4) by directly accessing the Internal Revenue Information Services bulletin board at (703) 321-8020.

SAFE HARBOR INTEREST RATES

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SOCIAL SECURITY BENEFITS. The taxpayer was disabled by a workplace accident and received workers compensation insurance and social security benefits. Because the insurance proceeds exceeded $25,000, the workers’ compensation proceeds above that amount were reduced by any social security benefits, $5,540. However, the social security administration also reduced its benefits by $5,540 because the taxpayer received workers’ compensation benefits. The double reduction was evidently in error, but the taxpayer ended up not receiving the $5,540 from either source. Even though the taxpayer did not receive either payment, the IRS argued that the taxpayer still had to include the social security benefits in income because the benefits were received in the form of workers’ compensation proceeds. The court found that the taxpayer did not receive the funds from either source; therefore, the $5,540 was not included in the taxpayer’s income. The court noted that when the erroneous double offset was corrected and the taxpayer received the payment from the social security administration, the amount would be included in gross income. De Both v. Comm’r, T.C. Summary Op. 2001-103.
The defendant was the surviving spouse of a decedent who had inherited from a parent an option to lease farm land which had belonged to the parent and which had passed to the decedent’s siblings. The siblings decided to terminate the lease and sought to quiet title to the property and to eject the surviving spouse. The evidence demonstrated that the decedent had refused to sign a written seven-year lease because the decedent did not want to be tied to a lease in case the price of livestock declined. Thus, the decedent tendered the next year’s rent at the end of each lease year. After the decedent’s death, the other heirs, who managed the farm through a trust, decided not to continue the lease but the defendant refused to vacate the property, arguing that the decedent had an oral seven-year lease. The court held that the evidence that the decedent did not want a seven-year lease and the annual payment established an oral year-to-year lease which the trust could terminate at the end of each year. Moen v. Thomas, 627 N.W.2d 146 (N.D. 2001).

STATE REGULATION OF AGRICULTURE

WAREHOUSES. The plaintiff sold soybeans to the defendant over five years but was not paid because the defendant filed for bankruptcy. The defendant executed some “delayed payment agreements” in the last of the five years but made only interest payments on the agreements. The plaintiff sought recovery under the defendant’s grain dealer’s $50,000 bond based on allegations that the defendant violated the Michigan Grain Dealers Act. The plaintiff sought payment of $250,000, arguing that the bond provided $50,000 of coverage for each year. The trial court held that the bonding provisions of the Grain Dealers Act did not apply to these sales because the Act applied only to warehouse-receipted sales for bailed grain and these sales were credit sales to the defendant. The appellate court affirmed that the Act applied only to grain held by a warehouse as a bailment evidenced by a warehouse receipt. Dan De Farms v. Sterling Supply, 625 N.W.2d 393 (Mich. Ct. App. 2001).

IN THE NEWS

(Courtesy of items in newspapers and other secondary sources)

COWS. The plaintiff was kicked by a neighbor’s cow while the plaintiff was helping the neighbor herd the cows. The plaintiff obtained a jury verdict for $10,000 but the appellate court reversed, holding that the plaintiff failed to connect the neighbor to the actions of the cow. Walkup v. Maudlin, (Iowa Ct. App. 2001) reported in Lawyers Weekly.

FENCES. The parties were land owners whose property was divided by a fence. The previous owners of the defendant’s land had used the land for raising livestock and had entered into an agreement to help maintain the fence. The defendant, however, did not raise livestock on the property. The plaintiffs applied to the township to require the defendant to contribute to the maintenance of the fence but were turned down. The trial court also sided with the defendant. The Iowa Supreme Court reversed, holding that all adjoining land owners must contribute to the maintenance of the fence, because the defendant received a benefit from the fence as a boundary marker. Dunclaff v. Ritcher Farms, (Iowa 2001) reported in Lawyers Weekly.
The Agricultural Law Press presents

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FEATURING DISCUSSION OF EGTRRA 2001

by Neil E. Harl and Roger A. McEowen

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LIENS FOR THE FAMILY-OWNED BUSINESS DEDUCTION

— by Neil E. Harl*

As has been reported since the 1997 enactment of the family-owned business deduction¹ and the substantial revisions in 1998,² many of the provisions in the statute were drawn from special use valuation³ including the provision on liens to secure the payment of any recapture tax.⁴ Unfortunately, the problem with liens under the family-owned business deduction (FOBD) is substantially more involved than the lien on land for purposes of special use valuation.⁵

A 2001 private letter ruling in the form of a memorandum to area IRS counsel has provided some guidance, albeit limited, on the issue of liens in the setting of the family-owned business deduction.⁶

The FOBD reference

The family-owned business deduction statute specifies that the provisions relating to the special lien for additional estate tax⁷ are applicable to the family-owned business deduction.⁸ Under that provision, a special lien is imposed on all qualified farm or closely-held business real property for which an election has been made to utilize special use valuation.⁹ The lien arises at the time the election is filed and continues until the potential liability for recapture ceases, the qualified heir dies or the tax benefit is recaptured.¹⁰ The Treasury Department may authorize other security to be substituted for the real property in question to secure the payment of the tax that could become due if events occur triggering recapture.¹¹ Moreover, the Treasury Department may subordinate the special lien to other obligations if sufficient collateral exists to protect adequately the Treasury’s interests.¹²

The special lien is not valid against a purchaser, holder of a security interest, mechanic’s lien or judgment lien creditor unless properly filed.¹³ Even though properly filed, the lien does not take priority over—(1) real property taxes and special assessments for public improvements;¹⁴ (2) mechanic’s liens for repair or improvement of the property;¹⁵ (3) security interests for the construction or improvement of real property (to the extent of the real property involved in the improvement);¹⁶ (4) a contract to construct or improve real property (to the extent of the proceeds of the contract);¹⁷ or (5) the raising or the harvesting of a farm crop or the raising of livestock or other animals (to the extent of the crops or livestock involved and the property affected by the general lien for unpaid federal taxes).¹⁸

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See the back page for details about the
Agricultural Tax and Law Seminar in Nebraska, Oct. 2-5, 2001
Featuring discussion of EGTRRA 2001
by Dr. Neil E. Harl and Prof. Roger A. McEowen
The FOBD lien

The almost casual reference in the FOBD statute to the lien utilized for purposes of special use valuation raises a number of questions of a practical nature regarding the lien to secure the government’s interest in the assets involved in an electing qualified family-owned business. 19 A lien on land under a special use valuation election involves establishment of a lien on real property in a fairly straightforward manner. 20 With an election under the family-owned business deduction statute, the assets involved may include land but may involve personal property or “goods” and, in the case of a tenant, may involve only personal property. 21 Such movables can serve as collateral for an obligation but perfection would necessarily have to follow Uniform Commercial Code rules under local law. 22 Moreover, the movables typically involve inventory items which are frequently sold in the course of business, necessitating a release of any security interest on a frequent basis. 23

For that reason, it has been anticipated that the Internal Revenue Service would require a lien on any land involved and, if that is not sufficient collateral, a security interest would be required on non-inventory assets used in the business. 24 Only if those assets produce insufficient collateral has it been anticipated that a security interest would be required of inventory-type assets. 25

The IRS, in Ltr. Rul. 200116001, 26 was asked to address two issues—(1) whether the Service could establish an enforceable lien on personal property qualifying for the family-owned business deduction; and (2) whether an estate could designate as security for the lien only those interests in a qualified family-owned business necessary to equal the amount of additional estate tax payable in the event of recapture. 27

In the ruling, IRS stated that a lien should be filed for any real property (using a modified version of Form 668-H, used in connection with special use valuation elections). 28 If the real property is insufficient to satisfy the lien amount, IRS is to be consulted as to the procedures for establishing the lien. 29

With respect to the question of whether an estate can select only those assets needed to equal the amount of additional estate tax payable on recapture, the ruling states that “an estate may not designate as security for the lien only those QFOBIs necessary to equal the amount of recapture tax; rather, the lien should cover all assets subject to the election under section 2057.” 30 The ruling goes on to explain that the estate should designate as security for the lien those assets for which a deduction is claimed. 31 Further, the lien amount should equal the maximum potential estate tax payable, assuming that all property subject to the election is subject to recapture. 32

In conclusion

The ruling discussed provides a glimpse of what is needed as guidance but much remains to come. The ruling states that proposed regulations should provide the needed guidance. 33
BANKRUPTCY

DISCHARGE. The debtor had granted a security interest to one creditor in the debtor’s farm products, which included soybean and corn crops. The debtor had given the creditor a list, containing one name, of the possible buyers of the grain. However, the debtor encountered financial difficulties and sold the soybeans to a different buyer and used the proceeds to pay other creditors and for living expenses, without first obtaining the consent of the creditor. The debtor also had no money to purchase feed for the debtor’s feeder pigs and used the corn crop as feed for the pigs. The pigs could not be sold because the market price was too low. Again, the debtor did not obtain the creditor’s consent for use of the corn as feed. The creditor sought to have the loan declared nondischargeable under Section 523(a)(6) for willful and malicious injury. The court discussed 727(a)(6) for willful and malicious injury. The court stated that the issue was what was the injury when a debtor converts collateral without consent. The court held that the injury in such cases was the conversion itself, not the resulting loss of collateral; therefore, the court held that the debtor intentionally caused the injury because the evidence demonstrated that the debtor intentionally sold the soybeans and fed the corn to the pigs. As to the second element of Section 523(a)(6), the court defined malicious as a conscious disregard of the creditor’s rights. The court noted that the debtor was fully aware of the security interest and that the sale and use of the grain violated the security agreement; therefore, the court held that the debtor maliciously injured the creditor and the loan was nondischargeable. The court noted that the debtor had meaningful reasons and good intentions for using the collateral, in hopes that an improvement in the price of feeder pigs would provide sufficient money to pay all debts. However, the court stated that the debtor’s failure to even consult with the creditor before converting the grain demonstrated the debtor’s lack of good faith. In re Russell, 262 B.R. 449 (Bankr. N.D. Ind. 2001).

ESTATE PROPERTY. The debtor owned interests in several employee pension plans and was receiving monthly annuity distributions when the debtor filed for Chapter 13. The IRS filed a claim for taxes which exceeded the value of the debtor’s property, excluding the annuity payments. Tax liens had been filed pre-petition and the issue was whether the pension plan payments were included in bankruptcy estate property so as to be considered as part of the property securing the IRS claim. The pension plans had clauses restricting assignment or attachment of the plan distributions or principal. The Bankruptcy Court had held that the pension plan payments were not estate property under state law because of the spendthrift clauses; therefore, the annuity payments did not secure the tax claims. However, the Bankruptcy Court had held that the tax liens would survive the bankruptcy and remain attached to the annuity payments. The District Court reversed and held that because the pension plan payments were subject to the tax liens, the plan restrictions were not effective under nonbankruptcy law; therefore, the pension plan payments were included in estate property. The District Court held that the present value of the monthly payments was part of the security for the tax claim. On remand, the Bankruptcy Court noted the contrary authority for the District Court’s holding but, in adhering to the law of the case, held that the tax claims were fully secured. In re McIver, 262 B.R. 362 (Bankr. Md. 2001), on rem. from, 255 B.R. 281 (D. Md. 2000).

EXEMPTIONS

CHILD TAX CREDIT. The debtors’ Chapter 13 plan required the debtors to turn over to the trustee all income tax refunds. The debtors sought to exclude the turnover of a tax refund to the extent the refund was created by the federal child tax credit (FCTC). The debtors argued that the credit was exempt under Ky. Rev. Stat. § 205.220(3) as a public assistance payment. The court followed In re Dever, 250 B.R. 701 (Bankr. D. Idaho 2000) which held that the FCTC was not intended as public assistance for low-income families because the credit was available for middle and upper level income families; therefore, the FCTC did not qualify for the public assistance exemption and had to be turned over to the trustee. In re Beltz, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,543 (Bankr. W.D. Ky. 2001).

FEDERAL TAX-ALM § 13.03[7].

DISCHARGE. Several years before filing for bankruptcy, the debtor had transferred most of the debtor’s personal property and some real property to a trust for the benefit of the debtor’s children. The property consisted of some farm equipment and farmland, with the remainder mostly household furnishings. The debtor continued to use the property as the debtor’s own. A few more pieces of property were contributed to the trust over the years. After the debtor filed for bankruptcy, the debtor failed to include the property in the trust which was in the debtor’s possession. At the creditors’ meeting, the debtor again failed to reveal the trust and made several erroneous statements about the ownership of the property. The IRS filed a motion to deny the debtor a discharge under Section 727(a)(2)(A) for concealment of assets and under Section 727(a)(4)(A) for falsely filling out the bankruptcy schedules. The court noted that Section 727(a)(2)(A) requires that the concealment occur within one year before the petition but held that where the debtor has continued to treat the property as the debtor’s, the transfer to the trust was a continuing concealment which carried over to
the one year period before the petition. The court held that the debtor would be denied a discharge under Section 727(a)(2)(A). The court also noted that the debtor even attempted to conceal the concealment by not listing the property on the bankruptcy schedules as in the debtor’s possession. The court also held that discharge would be denied under Section 727(a)(4)(A) because of the many false statements made on the schedules and at the creditors’ meeting. In re Korte, 262 B.R. 464 (Bankr. 8th Cir. 2001).

The debtor had failed to file returns or pay taxes for several tax years. For the first five years, the IRS made assessments based solely on substitute returns created by the IRS. For the last two years, the debtor filed returns after the IRS had made assessments and the debtor had filed an appeal with the Tax Court. During the assessments, the debtor responded to the IRS by raising several tax protestor arguments and the debtor raised the same arguments against the IRS claims in the bankruptcy case. The court held that the debtor’s failure to file returns and pay the taxes was a willful attempt to evade the payment of taxes and made the tax claims nondischargeable. In re Wilbert, 262 B.R. 571 (Bankr. N.D. Ga. 2001).

The debtor had failed to file returns and pay taxes for several tax years. The debtor’s reason was that the debtor’s employment changed to that of an independent contractor and the debtor was confused by the need to file estimated taxes. The IRS created substitute returns and filed assessments against the debtor. The debtor then filed late returns which were almost identical to the returns created by the IRS. The IRS sought to have the taxes declared nondischargeable for failure to file a return. The court held that once a substitute return is created, a taxpayer’s return will not qualify as a return for Section 523 purposes unless the return provides complete and detailed information which gives a more accurate calculation of the taxes owed. Because the debtor’s returns were mere copies of the IRS substitute returns, the debtor’s returns were disregarded and the taxes were nondischargeable. In re Hetzler, 262 B.R. 47 (Bankr. D. N.J. 2001).

**CONTRACTS**

**FORMATION.** The defendant, a pig producer, and the plaintiff a pig seller negotiated for a contract to sell segregated early-weaned pigs to the defendant. The plaintiff sent a written contract to the defendant setting forth various terms of the sale, including a price, number of pigs to be purchased and the term of the contract. The defendant returned the contract unsigned and with several changes, most notably, the number of pigs to be purchased and a definition affecting termination of the contract. The defendant reviewed another version of the contract, reinstated the defendant’s original changes and signed the contract. The reviewed copy was not signed by the plaintiff. The defendant made a purchase of pigs from the plaintiff but the parties agreed that the purchase was not made under the contract. The defendant received another version of the contract which was signed by the plaintiff but which did not contain the changes made by the defendant. This version was not signed by the defendant. The plaintiff attempted to sell some pigs to the defendant under the contract terms but the defendant refused, stating that no contract existed. The defendant did make several pig purchases from the defendant but at other quantities and prices than provided in the contract. The plaintiff produced at trial a document which purported to have both parties’ signatures but actually contained only a copy of the defendant’s signature. The court held that no contract existed because the parties intended that a contract had to have both signatures and both parties never signed an unchanged contract version. The court noted that the parties’ actions during and after the contract negotiations were consistent with the lack of an agreement. Flanagan v. Consolidated Nutrition, L.C., 627 N.W.2d 573 (Iowa Ct. App. 2001).

**FEDERAL AGRICULTURAL PROGRAMS**

**CENSUS OF AGRICULTURE.** The IRS has adopted as final a regulation which allows the IRS to disclose return information to the Department of Agriculture for purposes of the Census of Agriculture. 66 Fed. Reg. 39437 (July 31, 2001).

**FEDERAL ESTATE AND GIFT TAX**

**GENERATION SKIPPING TRANSFERS.** The IRS has provided guidance regarding requests for an extension of time to make an allocation of generation-skipping transfer exemption under I.R.C. §§ 2642(b)(1), (2) in view of the enactment of I.R.C. § 2642(g) by EGTRRA 2001. The notice also provides guidance regarding requests for an extension of time to make elections under I.R.C. §§ 2632(b)(3), 2632(c)(5) as added by § 561(a) of the Act. Notice 2001-50, I.R.B. 2001-__.

**INSTALLMENT PAYMENT OF ESTATE TAX.** The decedent owned interests in two trusts received from a predeceased spouse, one of which was QTIP. The trusts owned and operated a closely-held business and the decedent’s estate elected to pay the estate tax in installments. Upon the decedent’s death the trusts passed to two heirs who were the co-trustees. The trusts transferred the corpus to a limited liability company in exchange for membership interests in the LLC. The trustees then distributed the LLC interests to themselves. The IRS ruled that the transfers did not cause acceleration of the installment payment of estate tax because the transfers were mere changes in the form of owning the business. Ltr. Rul. 200129018, April 18, 2001.

**RETURNS.** The IRS has adopted as final regulations on the procedure for filing for an automatic six month extension to file Form 706. The extension request is made on Form 706-EXT and must include an estimate of the taxes due. The extension does not operate as an extension to pay the taxes. 66 Fed. Reg. 38544 (July 25, 2001).
FEDERAL INCOME TAXATION

ACCOUNTING METHOD. The taxpayer owned and operated an insulation installation business and claimed a deduction for the entire cost of supplies received in 1994 even though some of the cost was paid in 1995. The taxpayer marked the box on Schedule C to indicate that the taxpayer used the cash method of accounting and reported income based on that method. The IRS disallowed the portion of the supply costs which were not paid in 1994. The taxpayer argued that the taxpayer actually used the accrual method of accounting but the court held that the information on Schedule C was more consistent with the cash method; therefore, the taxpayer was limited to deduct the expenses actually paid in 1994. Woodlee v. Comm’r, T.C. Summary Op. 2001-110.

BUSINESS EXPENSES. The taxpayer was a corporation which owned an aircraft. The corporation used the aircraft for business purposes and allowed its corporate officers to use the aircraft for personal purposes. The officers included the value of the use of the jet in their gross income and the taxpayer claimed the expenses for maintaining and using the jet as business deductions. The IRS argued that, under I.R.C. § 274(a)(1), the business deductions were not allowed because the aircraft was a facility used for entertainment. Thus, the taxpayer would be allowed a deduction only for the amounts determined to be deductible as compensation to the officers. The taxpayer argued that I.R.C. § 274(e)(2) provided an exception to section 274(a)(1) because the officers included the value of the flights as compensation. The court agreed with the taxpayer and allowed the deductions for the maintenance and use of the jet. National Bancorp of Alaska, Inc., T.C. Memo. 2001-203; Midland Financial Co. and Subsidiaries, T.C. Memo. 2001-202.

The taxpayer, a dentist, claimed net losses from a horse breeding and racing operation. The taxpayer claimed net operating losses in excess of basis for three tax years before selling the interest in the horse operation. The court held that the casualty loss deduction is limited to the tax year in which the casualty occurred; therefore, the taxpayers were not entitled to a casualty loss deduction in 1996 for earthquake damage that occurred in 1994. Without explanation, the court also stated that the casualty loss deduction could also have been taken in 1995 when the FEMA appeals were completed. Randle v. Comm’r, T.C. Summary Op. 2001-115.

CONSTRUCTIVE RECEIPT OF INCOME. Under the employees’ contract, employees could elect to receive money in exchange for excess vacation days accrued during a calendar year of employment. The IRS ruled that the right to make the election did not constitute constructive receipt of income and income would not be realized until the election was made and the money paid. Ltr. Rul. 200130015, April 26, 2001.

CORPORATIONS-ALM § 7.03.*

DISREGARD OF CORPORATE FORM. The taxpayer had formed a corporation for a child identification business. Although the business did not actually start operations, the corporation entered into several agreements which were signed by the taxpayer as an officer of the corporation. The taxpayer claimed several business expenses on the taxpayer’s personal Schedule C, resulting in net losses for the tax year involved. The taxpayer argued that the corporation did not ever begin business operations and was not treated as a separate entity by the taxpayer. The court held that the business deductions belonged to the corporation and could not be claimed on the taxpayer’s personal return because the corporation was a legitimate business entity, had begun the business operation and held out as a separate entity in its business dealings. Cashman v. Comm’r, T.C. Memo. 2001-199.

DISTRIBUTION OF STOCK. The IRS has adopted as final regulations which provide that the stock of a controlled corporation will not be qualified property under I.R.C. §§ 355(c)(2) or 361(c)(2) if the stock is distributed as “part of a plan (or series of related transactions) pursuant to which 1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation.” The regulations provide guidance concerning the interpretation of the phrase “plan (or series of related transactions).” The regulations generally provide that whether a distribution and an acquisition are part of a plan is determined based on all the facts and circumstances. The regulations also set forth six safe harbors. Cashman v. Comm’r, T.C. Memo. 2001-199.

COURT AWARDS AND SETTLEMENTS-ALM § 4.02[14]. The taxpayer was asked to resign employment because the taxpayer was disabled by a motorcycle accident

sought federal and state assistance for the costs of repairing the damage and received some money from FEMA but not enough to cover all the repairs. The final appeal for the disaster assistance was made in 1995, and in 1996 the taxpayers used money borrowed from relatives to make the repairs. The taxpayers claimed the cost of repairs above the FEMA grant as a casualty loss in 1996, arguing that the loss did not occur until the costs of repair were paid. The court held that the casualty loss deduction is limited to the tax year in which the casualty occurred; therefore, the taxpayers were not entitled to a casualty loss deduction in 1996 for earthquake damage that occurred in 1994. Without explanation, the court also stated that the casualty loss deduction could also have been taken in 1995 when the FEMA appeals were completed. Randle v. Comm’r, T.C. Summary Op. 2001-115.
unrelated to the employment. The taxpayer sought payment from the employer because the taxpayer alleged that the employment termination violated the Americans with Disabilities Act. The employer paid a settlement to the taxpayer who did not file an ADA suit. The taxpayer failed to provide any evidence to support an allocation of the settlement among the possible ADA personal and nonpersonal injury claims; therefore, the court held that the entire settlement was included in income. *Managan v. Comm’r*, T.C. Memo. 2001-192.

DISASTER PAYMENTS. On June 21, 2001, the President determined that certain areas in Pennsylvania were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of tropical storm Allison on June 15-17, 2001. *FEMA-1383-DR*. On July 12, 2001, the President determined that certain areas in Virginia were eligible for assistance under the Act as a result of severe storms and flooding on July 8-10, 2001. *FEMA-1386-DR*. Accordingly, a taxpayer who sustained a loss attributable to the disasters may deduct the loss on his or her 2000 federal income tax return.

HOBBY LOSSES. The taxpayer provided photographic services to a business operated by the taxpayer and the taxpayer’s father. Once it became clear that the father’s business would cease, the taxpayer made efforts to increase the income from the photography business. Although the photography business at first produced seven years of losses, the taxpayer had managed four straight years of net profits, although some of the profit came from a small amount of business with the father’s corporation. The court held that the photography business was entered into with an intent to make a profit because (1) the taxpayer maintained complete and accurate records of the photography business, (2) had a business plan which had eventually produced profits and would continue to produce more profits in the future, (3) the taxpayer spent a considerable amount of time in the business, and (4) the taxpayer’s personal pleasure from photography was a minor aspect of the business. The IRS raised an issue on appeal which the court refused to rule on because the issue was first raised in the brief: the IRS argued that the photography business involved with the father’s business should have been treated separately from the taxpayer’s personal photography business, resulting in more years of losses and greater losses. The court stated that, even if the issue was properly raised, the businesses would be considered as one because the nature of the businesses was very similar and one grew out of the other. *Tamms v. Comm’r*, T.C. Memo. 2001-201.

The taxpayers raised thoroughbred horses and claimed loss deductions from the activity. The Tax Court held that the dominant motive of the taxpayers in operating the activity was the tax savings generated by the activity. The Tax Court identified the taxpayers’ lack of experience and training in horse breeding and excessive rental payments, but otherwise failed to provide support for its holding. The appellate court reversed in a decision designated as not for publication. The appellate court acknowledged that a dominant tax savings motive could be inferred if the tax savings would exceed the actual losses expected from the activity but stated that the record was insufficient to demonstrate whether the tax savings in this case exceeded the expected out-of-pocket losses. The appellate court noted that a business had a legitimate ability to structure the business to produce the maximum amount of tax savings. The case did not discuss any of the other nine factors in Treas. Reg. 1.183-2(b). *Steinbrecher v. Comm’r*, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,533 (9th Cir. 1993).

LETTER RULINGS. The IRS has announced that technical advice will not be issued on frivolous issues. For purposes of this program, a “frivolous issue” is one without basis in fact or law, or that espouses a position which has been held by the courts to be frivolous or groundless. Examples of frivolous or groundless issues include, but are not limited to:

1. frivolous “constitutional” claims, such as claims that the requirement to file tax returns and pay taxes constitutes an unreasonable search barred by the Fourth Amendment; violates Fifth and Fourteenth Amendment protections of due process; violates Thirteenth Amendment protections against involuntary servitude; or is unenforceable because the Sixteenth Amendment does not authorize nonapportioned direct taxes or was never ratified;

2. claims that income taxes are voluntary, that the term “income” is not defined in the Internal Revenue Code, or that preparation and filing of income tax returns violates the Paperwork Reduction Act;

3. claims that tax may be imposed only on coins minted under a gold or silver standard or that receipt of Federal Reserve Notes does not cause an accretion to wealth;

4. claims that a person is not taxable on income because he or she falls within a class entitled to “reparation claims” or an extra-statutory class of individuals exempt from tax, e.g., “free-born” individuals;

5. claims that a taxpayer can refuse to pay taxes on the basis of opposition to certain governmental expenditures;

6. claims that taxes apply only to federal employees; only to residents of Puerto Rico, Guam, the U.S. Virgin Islands, the District of Columbia, or “federal enclaves”; or that the Internal Revenue Code imposes taxes on U.S. citizens and residents only on income derived from foreign based activities;

7. claims that wages or personal service income are not “income,” are “nontaxable receipts,” or “are a nontaxable exchange for labor;” or

8. other claims the courts have characterized as frivolous or groundless. Rev. Proc. 2001-41, I.R.B. 2001-__.

LEGAL FEES. The taxpayers owned a farm and had sued the United States Army for injury to farm animals and the taxpayer’s family from contamination of the water by nerve agents. The suit sought personal injury damages and damages for injury to real property. The taxpayer claimed deductions for the legal fees in one tax year on Schedule F as business expenses. The court acknowledged that the personal injury damages would not be taxable; therefore, only the legal fees attributable to the real property damage claim could be deducted, because the damages would be included in income. The taxpayer failed to provide evidence to support any allocation of the possible damage award in order to allocate the legal fees; however, the court held that it would allocate $2,000 of the legal fees to the real property damage claim. *Land v. Comm’r*, T.C. Summary Op. 2001-111.

*Agricultural Law Manual (ALM).*
LIKE-KIND EXCHANGES. The taxpayers entered into a sale of real property using an accommodator to effect an exchange of properties. The taxpayer used the accommodator as a qualified intermediary to make use of the safe harbor rules of Treas. Reg. § 1.1031(k)-1(g)(4). The IRS ruled that the accommodator was not a qualified intermediary because (1) there was no actual transfer of the relinquished property to the accommodator and (2) the taxpayers failed to give notice to all parties of the assignment of the property to the accommodator. The taxpayers argued that the purchasers had actual notice of the assignment from the settlement statements. The IRS ruled that the settlement statements were not unequivocal in identifying the true relationship of the taxpayer and the accommodator; therefore, the settlement statements could not be used to satisfy the notice requirements. Thus, the IRS ruled that the transactions were not eligible for like-kind exchange treatment. TAM Ltr. Rul. 200130001, March 1, 2001.

PENALTIES. The taxpayer had invested in a Jojoba growing partnership which was determined by the IRS to be ineligible for research and development deductions and other tax deductions. The taxpayer was assessed a deficiency after the taxpayer’s share of the disallowed deductions was also disallowed. The issue in this case was whether the taxpayer was also liable for the negligence and substantial understatement of tax penalties. The court found that the taxpayer did not consult knowledgeable income tax advisors or agricultural experts before investing in the partnership in order to determine whether the investments and tax benefits were reasonable. Therefore, the court held that the taxpayer was liable for the negligence penalty. The court also held that the taxpayer was liable for the substantial understatement of tax penalty because the taxpayer had no authority for the deductions taken and did not fully disclose the investments on the tax returns. Serfustini v. Comm’r, T.C. Memo. 2001-183.

S CORPORATIONS
SHAREHOLDER BASIS. The taxpayers were siblings and their spouses who owned all the stock of an S corporation which operated a produce handling business. Two shareholders purchased improved real estate and leased it to the corporation. These shareholders also borrowed money from a third party creditor, used a portion of the money to pay off the property loan, and contributed the remainder of the loan to the corporation. The corporation was a signatory on the loan. The court held that the shareholders could increase their basis in the corporation by the amount of the loan contributed to the corporation because the shareholders made payments on the loan. Cox v. Comm’r, T.C. Memo. 2001-196.

SALE OF RESIDENCE. In a case involving tax law prior to passage of the repeal of I.R.C. § 1034, the taxpayers sold their previous residence for a gain in December 1991 and purchased a new residence for an amount less than the gain in May 1992. The taxpayers immediately began to plan and begin construction of a detached addition to the new residence. However, two years after the sale of the first house, the new addition was not in livable condition. The taxpayers had still not moved into the new addition over 6 years after beginning construction. The court held that the construction costs of the addition could not be added to the purchase price of the second residence for purposes of I.R.C. § 1034; therefore, the taxpayers were not eligible for rollover of the gain from the sale of the first house. The appellate court affirmed in a decision designated as not for publication. Parker v. Comm’r, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,528 (9th Cir. 2001), aff’g, T.C. Memo. 1999-347.


PRODUCT LIABILITY
PESTICIDE. The plaintiff was injured by contact with a registered pesticide manufactured by the defendant. The pesticide label had several warnings against any skin, eye, or lung contact with the pesticide by humans or animals. The product was purchased by the plaintiff’s parent and placed in an unlabeled spray bottle. The plaintiff sprayed the pesticide onto horses before the plaintiff rode them. The plaintiff alleged that the plaintiff came in contact with the pesticide during the application of the pesticide and during the riding. The plaintiff provided expert evidence that the contact with the pesticide caused the plaintiff’s injury. The plaintiff filed suit under theories of failure to warn, negligence, breach of express warranty, and strict liability. All of the causes of action were based on the same allegation that the defendant failed to provide some warning that the pesticide was not suitable for use on horses. The court held that all of the causes of action were preempted by FIFRA because they were based on the failure of the label to warn against the use of the pesticide on horses. The court acknowledged that the strict liability action could conceivably be based on other factors which would not be preempted by FIFRA; however, the plaintiff’s own expert evidence demonstrated that the pesticide was not defective in design, manufactured or labeled use. Netland v. Hess & Clark, Inc., 140 F. Supp.2d 1011 (D. Minn. 2001).

CITATION UPDATES
Foster v. United States, 249 F.3d 1275 (11th Cir. 2001), aff’g on point, 106 F. Supp. 2d 1234 (N.D. Ala. 2000) (court awards and settlements) see p. 85 supra.

Estate of Mitchell v. Comm’r, 250 F.3d 696 (9th Cir. 2001), rev’g in part, T.C. Memo. 1997-461 (estate valuation of stock) see p. 84 supra.

Est. of Simplot v. Comm’r, 249 F.3d 1191 (9th Cir. 2001), rev’g in part, 112 T.C. 130 (1999) (estate valuation of stock) see p. 86 supra.

Hillman v. Comm’r, 250 F.3d 228 (4th Cir. 2001), rev’g, 114 T.C. 103 (2000) (passive losses) see p. 78 supra.
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REFUNDS AUTHORIZED FOR FAILURE TO MEET QUALIFIED USE TEST

— by Neil E. Harl*

One of the more contentious issues in tax law in recent years has been the qualified use test for purposes of special use valuation of land for federal estate tax purposes.\(^1\) The Economic Growth and Tax Relief Reconciliation Act of 2001, H.R. 1836, has added another chapter to the saga by allowing refunds for some failures to meet the test, retroactive to January 1, 1977.\(^2\) That is very good news for affected taxpayers.

History of the qualified use test

Although the special use valuation statute was initially interpreted as not including a qualified use or “trade or business” test, IRS in 1980 took the position that the decedent must have had an “equity interest” in the farm operation (for special use valuation to be available to the estate) - (1) at the time of death and (2) for five or more of the last eight years prior to death.\(^3\) In addition, except for the two-year grace period,\(^4\) each qualified heir must have met the same test during the recapture period after death.\(^5\) As a practical matter, the IRS position meant that cash rent leases were not permissible, either in the pre-death period or in the recapture period after death.

Under pressure from Congress, IRS in a Senate Finance Committee hearing on April 27, 1981, announced a change of interpretation in the pre-death period.\(^6\) IRS indicated that the test could be met, in the pre-death period, by the decedent or a member of the decedent’s family.\(^7\) That meant that the qualified use test could be met with a cash rent lease to a family member as tenant. Later, in 1981, Congress amended the statute to reflect the IRS position.\(^8\) However, neither the IRS announcement nor the Congressional action addressed the post-death requirement. Cash rent leases in the post-death period (other than during the two-year grace period immediately following death) violated the requirement that each qualified heir had to be “at risk” in the operation.

Under an amendment enacted in 1988, retroactive to 1977, a surviving spouse who inherits qualified real property under a special use valuation election is permitted to lease the land on a “net cash basis” to a member of the spouse’s family without causing recapture.\(^9\) The Technical and Miscellaneous Revenue Act of 1988\(^10\) waived the statute of limitations on refunds for one year to enable taxpayers to utilize this relief provision. However, the 1988 amendment did not permit an estate that had

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Featuring discussion of EGTRRA 2001 by Dr. Neil E. Harl and Prof. Roger A. McEowen
never filed a special use valuation election to make a retroactive election and claim a refund for overpayment of federal estate tax.\(^\text{11}\)

Legislation enacted in 1997, and retroactive for leases entered into after December 31, 1976, specified that rental of land on a "net cash basis" by a surviving spouse or a lineal descendant of the decedent to a member of the family of such spouse or descendant did not cause recapture of special use valuation benefits during the recapture period after death.\(^\text{12}\) However, the 1997 amendment did not authorize refunds for years closed by the statute of limitations.\(^\text{13}\) A refund claim could be filed for interest for the open years.\(^\text{14}\)

**The 2001 Amendment**

The 2001 amendment allows refunds, retroactive to 1976, for estates eligible under the 1997 amendment if a refund or credit is barred by the statute of limitations.\(^\text{15}\) Under the 2001 amendment, if a claim for refund or credit is filed within one year from the date of enactment (June 7, 2001), a refund or credit is to be allowed if based on the application of the net cash leasing provisions for spouses and lineal descendants\(^\text{16}\) even though barred by the statute of limitations.\(^\text{17}\)

**Conclusion**

Taxpayers eligible for a refund or credit under the 2001 amendment should act promptly. It is rare for Congress to allow refunds or credits for periods barred by the statute of limitations. Further relief in this area seems unlikely.

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**FOOTNOTES**


5. *Id.*


10. TAMRA, § 6151(b)(2).

11. Ltr. Rul. 9122004, Feb. 21, 1991 (surviving spouse's cash rent lease of property to cousins would have triggered recapture tax otherwise).


14. *Id.*


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**CASES, REGULATIONS AND STATUTES**

by Robert P. Achenbach, Jr.

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**ADVERSE POSSESSION**

**PAYING TAXES.** The properties owned by the plaintiff and the defendant, including the disputed unimproved land, were once owned by one person. The defendant had purchased the defendant’s portion first, with the plaintiff’s portion first belonging to a charitable organization which was not subject to property taxes on its land. The disputed land, about three-tenths of an acre, was not included in the legal description of the defendant’s or plaintiff’s land. However, the description of the plaintiff’s land for real property tax purposes included the disputed property. The plaintiff paid the taxes for 13 years before learning that the tax description of the land did not match the title description of the plaintiff’s land. The plaintiff sought a declaration that the plaintiff had acquired title to the disputed land by adverse possession through Ark. Code § 18-11-103 which provided that the payment of taxes for 15 years for wild and unimproved land established a presumption of law that the payor had color of title to the land. The plaintiff argued that the 15 year requirement was met by tacking on the time the land was owned by the charitable organization, even though the charitable organization did not pay any taxes on the property. The court held that the 15 year requirement could be met only by actual payment of taxes and did not include years when no tax was due. The plaintiff also argued that the description of the land in the tax records gave the plaintiff color of title to the disputed land. The court held that the error in the tax records could not be used to give the plaintiff title to the land. *Hunter v. Robinson, 40 S.W.2d 337 (Ark. Ct. App. 2001).*

**ANIMALS**

**SEARCH AND SEIZURE.** The plaintiff owned several horses which were kept either in a barn located 60 feet from the plaintiff’s residence or in a neighbor’s pasture. The defendant was a volunteer investigator for the Illinois Department of Agriculture and received a complaint that the plaintiff’s horses were mistreated. The defendant entered the pasture and inspected the barn without first obtaining a warrant. The defendant determined that the horses were not being properly cared for and left a notice of apparent violation on the plaintiff’s door. The plaintiff attempted to
contact the defendant but before contact could be made, the defendant had the horses seized. The court found that the horses were not mistreated and that the defendant had mischaracterized the horses’ condition in order to obtain the seizure action. The plaintiff brought a civil action for violation of the Fourth Amendment protections against unreasonable search and seizure. The court held that the plaintiff had an expectation of privacy in the barn; therefore, the warrantless search was a violation of the Fourth Amendment. The court also held that the seizure of the horses was unreasonable in that (1) the horses were not in any danger to justify seizure without first notifying the plaintiff, (2) the defendant did not first obtain the permission of the Department of Agriculture using accurate information about the condition of the horses, and (3) the defendant did not reasonably conclude that the horses were in danger. The court also noted that the costs to the government and horses of a pre-seizure hearing were low compared to the injury to the plaintiff from the seizure of the horses without a hearing. The major focus throughout the court’s opinion is the finding that the horses were not mistreated and were well fed and cared for by the plaintiff. The defendant’s motion for summary judgment was denied, leaving open the jury questions of whether a constitutional violation occurred and what damage was suffered. Siebert v. Severino, No. 00-2654 (7th Cir. July 6, 2001).

BANKRUPTCY

GENERAL-ALM § 13.03.7

CLAIMS. The debtor had acted as executor for a deceased spouse’s estate and, as executor, filed a fraudulent estate tax return. The limitation period for assessment of estate taxes had elapsed but the limitation period for assessment of the debtor’s personal liability had not elapsed as of the bankruptcy petition filing. The IRS filed a claim for the debtor’s personal liability for the estate taxes. The trustee sought to recover into the bankruptcy estate, property distributed from the decedent’s estate to the decedent’s children. The trustee argued that the children remained liable for the estate taxes under state law. The court held that the children’s liability for estate taxes was limited to taxes charged against the estate. Here the debtor’s estate tax liability was based upon the debtor’s personal acts as fiduciary and was the personal obligation of the debtor; therefore, the children were not liable for the debtor’s estate taxes and the distributed property was not required to be turned over to the bankruptcy estate. In re Ulrich, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,566 (Bankr. E.D. La. 2001).

EXEMPTIONS

HOMESTEAD. The debtors, husband and wife, lived on 70 acres of rural land, part of which was used as citrus orchards. The debtors purchased the 70 acres in five parcels over five different times from five different sellers. In March 2000 a creditor obtained a money judgment against the debtors. The parcels were initially placed in an oral trust, but in April 2000, the parcels were transferred back to the debtors. The debtors filed for Chapter 7 in August 2000 and claimed the entire 70 acres as exempt homestead under Fla. Const. Art.X, § 4. The creditor argued that the exemption should be (1) denied entirely because the debtors fraudulently converted non-exempt assets, the property held in trust, to exempt assets, or (2) denied to the extent the property was used for commercial purposes as an orchard. The court acknowledged that some Florida courts have recognized a fraudulent conversion exception to the Florida exemptions but held that because no such exception existed in the exemption provision, the court would not create a judicial exception. Similarly, the court held that the exemption provision had no requirement that a residence not be used in part for commercial purposes. Therefore, the court held that the debtors could claim a homestead exemption for the entire 70 acres. In re Lowery, 262 B.R. 875 (Bankr. M.D. Fla. 2001).

FEDERAL AGRICULTURAL PROGRAMS

CROP INSURANCE. The FCIC has adopted as final regulations amending the forage seeding crop insurance provisions by (1) adding a new contract change date for South Dakota counties where the special provisions designate both fall and spring final planting dates; (2) adding cancellation and termination dates for South Dakota counties that will be applicable when the special provisions designate both fall and spring final planting dates; and (3) adding end of insurance period dates for fall and spring planted acreage in California, Colorado, Idaho, Nebraska, Nevada, Oregon, Utah and Washington. 66 Fed. Reg. 42729 (Aug. 15, 2001).

KARNAK BUNT. The APHIS has adopted as final regulations which amend the Karnal bunt regulations to provide compensation for certain growers, handlers, seed companies, owners of grain storage facilities, flour millers, and participants in the National Karnal Bunt Survey who incurred losses and expenses because of Karnal bunt in the 1999-2000 crop season. 66 Fed. Reg. 40839 (Aug. 6, 2001).

LIVESTOCK REPORTING. The Livestock Mandatory Reporting Act of 1999 (7 U.S.C. 1635-1636(h)) required the AMS to collect and publish information on price trends, contracting arrangements and supply and demand conditions. As required by the Act, AMS publishes such information in a manner designed to protect the identity of reporting entities and preserve the confidentiality of transactions. The confidentiality guideline adopted for the program, the so-called “3/60” guideline, was based on similar guidelines used throughout the Federal government. To satisfy the “3/60” confidentiality guideline, the following two conditions were required: (1) at least three reporting entities must be reflected in each category of data being reported during an individual reporting period, and (2) no single reporting entity could account for 60 percent or more of the total volume reported in any single data category during an individual reporting period. Upon review of the current program and the data that have been collected continuously since April 2, 2001, AMS has determined that the level of market participation is sufficiently diverse to permit the release of much of the data currently withheld from the public without compromising the confidentiality of business transactions. AMS will continue the practice of withholding the number and identity of entities
providing data for an individual report. In addition, given the frequency of data collection, the following guideline elements will be adopted: (1) at least three entities must provide data at least 50 percent of the time over the most recent 60-day time period; (2) no one entity may provide more than 70 percent of the data for a report over the most recent 60-day time period; and (3) no one entity may provide data more than 20 percent of the time, as the only entity, over the most recent 60-day time period. 66 Fed. Reg. 41194 (Aug. 7, 2001).

"MAD COW" DISEASE. The APHIS has issued interim regulations to prohibit, with limited exceptions, the importation of certain animal materials and their derivatives, and any products they are used in, from regions considered to present an unacceptable risk of introducing bovine spongiform encephalopathy ("Mad Cow" disease) into the United States. The interim regulations also require that those materials, when imported from regions not considered at risk for bovine spongiform encephalopathy, be accompanied by government certification regarding the species, region of origin, processing, and handling of the materials and the animals from which they were derived. 66 Fed. Reg. 42595 (Aug. 14, 2001).

PERISHABLE AGRICULTURAL COMMODITIES ACT. The plaintiffs were fruit and vegetable growers who sold produce to a produce reseller. When the reseller sold the produce, the seller produced invoices which created account receivables. The reseller sold these account receivables under a factoring agreement to the defendant for a percentage of the stated receivable. The reseller, however, failed to use the proceeds from the sale of the receivables to pay the plaintiffs. The plaintiffs sought recovery from the defendant under the PACA trust, arguing that the receivables were PACA trust assets which the defendant should have preserved for payment for the produce. The plaintiffs argued that the purchase of the receivables violated the PACA trust because the defendant did not make full payment for the receivables. The court found that the amounts paid for the receivables were commercially reasonable in that the reseller received more than the receivables were worth. The court held that, because the sale of the receivables was made in a commercially reasonable manner, no breach of the PACA trust occurred. The court also noted that the plaintiffs had not made any allegations that the funds received for the receivables were misspelled by the reseller. Boulder Fruit Express v. Transportation Factoring, Inc., 251 F.3d 1268 (9th Cir. 2001).

FEDERAL ESTATE AND GIFT TAX

CLAMS. The decedent had made inter vivos gifts of stock to children. The decedent filed a gift tax return and based the gift tax on a shareholder buy-sell agreement. The gift transfer provided that, if the stock value was later increased, the decedent would reimburse the donees for any additional gift tax paid. The IRS audited the decedent’s estate tax return and determined that the stock value was greater than claimed on the gift tax return but the assessment against the estate was barred as untimely. The IRS then assessed the donees for the gift tax. The state probate court allowed the donees’ claims against the estate for the additional gift tax paid. The estate sought a deduction for the gift tax paid under the state ruling. The District Court held that the deduction would be allowed as a valid claim against the estate. The next issue was the value of the claim against the estate. The estate had claimed a deduction for the entire amount of additional gift tax resulting from the increased valuation of the stock by the IRS. Nine months after the decedent’s death, the IRS and estate agreed to a compromise value amount which was much less than the initial IRS value. The appellate court remanded the case back to the District Court for a determination of the value of the claim against the estate for the potential additional gift tax liability and instructed the court that no evidence was to be presented concerning post-death events. The court followed Ithaca Trust Co. v. United States, 279 U.S. 151 (1929), which held that the value of estate assets and liabilities was to be determined as of the date of death, without any consideration of post-death events. Estate of O’Neal v. United States, 2001-2 U.S. Tax Cas. (CCH) ¶ 60,412 (11th Cir. 2001), rem’g, 2000-1 U.S. Tax Cas. (CCH) ¶ 60,365 (N.D. Ala. 1999).

LIFE INSURANCE. The decedent purchased three single premium life insurance policies on the decedent’s life while married and in a community property state. The spouse was initially named as the primary beneficiary. When the spouse died, the couple’s three children were named as the primary beneficiaries. After the decedent died, the spouse’s estate included one half of the cash surrender value of the insurance policies in the spouse’s estate. The decedent’s estate included the total proceeds of the insurance policies in the decedent’s estate. The decedent estate argued that its return was erroneous in that only one half of the proceeds should have been included in the decedent’s estate. The estate argued that, because the taxpayer was subject to community property law, only one-half of the insurance policy was owned by the decedent. The IRS argued that the insurance policy itself gave only the decedent the incidents of ownership, indicating that the policy was considered by the couple as the decedent’s separate property. The court examined Louisiana law and determined that the ownership of the insurance policy was determined by community property law but that the ownership of the insurance proceeds is determined by the insurance policy. Therefore, the court held that the decedent owned only one-half of the insurance policy and only one-half of the proceeds would be included in the decedent’s gross estate under I.R.C. § 2042. Estate of Burris v. Comm’r, T.C. Memo. 2001-210.

MARITAL DEDUCTION. The decedent had created a trust for the decedent’s child which was funded with only one dollar. The decedent’s will provided that if, on the decedent’s death the trust was not funded with $1 million, the amount necessary to fund the trust with $1 million was to be distributed to the trust from the decedent’s estate. The surviving spouse contributed $375,000 to the trust after the decedent’s death and the remaining $625,000 was distributed from the decedent’s estate. The IRS ruled that the marital deduction was to be reduced by the $375,000 paid by the surviving spouse. TAM Ltr. Rul. 200131001, Feb. 26, 2001.

*Agricultural Law Manual (ALM).*
The decedent had cohabited for 33 years with another person under death but the couple had never been married. The IRS examined state law and determined that the couple would not be considered as married under state law; therefore, any amount of the decedent’s estate distributed to the other person would not be eligible for the marital deduction. TAM Ltr. Rul. 200131004, April 25, 2001.

RETURNS. The decedent died in 1986 and the estate included an interest in a trust which was subject to a challenge by other beneficiaries. The challenge eventually was formalized into a lawsuit in 1991 and was adjudicated in 1994 with distribution of trust property to the estate. The executrix filed an estate tax return in 1995 which included some property for which a value was unknown. The IRS assessed an addition to tax under I.R.C. § 6651 for failure to timely file the estate tax return. The executrix claimed that the estate tax return was not timely filed because of the advice of the estate lawyer and accountant and because the extent and value of the estate was not discernable until the lawsuit was completed. The professionals testified that no advice was given as to the effect of not timely filing the return. The court held that the failure of the estate to file a return for almost 10 years was unreasonable because (1) the estate did not seek professional advice about the effect of failing to file any return, (2) pending litigation was not a sufficient reason not to file a return, and (3) the inability to determine a value of some estate assets was not a sufficient reason not to file a return. The court noted that the estate’s interest in the trust was minor compared to the remainder of the known estate. Estate of Thomas v. Comm’r, T.C. Memo. 2001-225.

REVOCABLE TRANSFERS. Ten years before death, the decedent created a power of attorney appointing an attorney and the decedent’s son as attorneys-in-fact to act for the decedent. The power of attorney authorized decedent’s attorneys-in-fact to act in decedent’s stead with respect to decedent’s ownership interests in real estate, chattels and goods, stocks and bonds, banking, insurance, claims and litigation, personal relationships and affairs, military pensions, records, reports and statements, and “all other matters.” The power of attorney did not explicitly authorize the attorneys-in-fact to make gifts of the decedent’s property. The attorneys-in-fact made gifts of $144,400 within three years before the decedent died. The court first examined Connecticut law and found only three Superior Court decisions as to whether the standard power of attorney includes the power to make gifts. The Connecticut courts were divided on the issue but the court held that, under Connecticut law, the power of attorney did not include the power to make gifts. The estate also argued that, under Estate of Pruitt v. Comm’r, T.C. Memo. 2000-287, and Estate of Bronston v. Comm’r, T.C. Memo. 1988-510, the gifts were not revocable because they were made under the consent of the decedent. The court noted that, in those cases the decedent had established a history of making similar gifts which supported an inference that the decedent consented to the gifts made by the attorneys-in-fact. The court held that the gifts were included in the decedent’s estate as revocable transfers. Estate of Gaynor v. Comm’r, T.C. Memo. 2001-206.

FEDERAL INCOME TAXATION

BAD DEBTS. The taxpayer was a corporation owned by one shareholder who also owned another corporation. The taxpayer operated grocery stores and the other corporation was in the used equipment and salvage business. The taxpayer was successful and obtained loans from a supplier on a regular basis. The shareholder used the shareholder’s control over the taxpayer to have the taxpayer obtain loans from the supplier which were paid to the salvage corporation for operating expenses. The supplier issued promissory notes to the taxpayer and took security interests in the taxpayer’s assets for the loans. However, the taxpayer did not issue any notes or seek security interests from the salvage corporation. The salvage corporation did not make any payments to the taxpayer, even when the salvage corporation had sufficient assets to do so. The salvage corporation eventually terminated and the taxpayer sought to claim the unpaid advances as bad debts. The court held that the advances were capital contributions and not loans because (1) the salvage corporation made no payments on the advances, (2) no security was provided for the advances, (3) the salvage corporation could not have obtained loans independent of the taxpayer, (4) the salvage corporation was thinly capitalized, and (5) the advances exposed the taxpayer to the risks of the salvage corporation’s business. Brazoria County Stewart Food Markets, Inc. v. Comm’r, T.C. Memo. 2001-220.

CAPITAL GAINS. The taxpayer had invested in a mutual fund which invested primarily in bonds, although some of the money was invested in stocks. The taxpayer received distributions from the fund of dividends and short- and long-term capital gains. The taxpayer omitted the long-term capital gains from line 5 of Schedule B because the line asked only for “gross dividends and/or other distributions on stock.” The taxpayer argued that, because the capital gains came from bonds, there was no place to include the gain in reported income. The court held that the gains had to be included in income on line 5 of Schedule B because of the statutory and regulatory authority which carried more weight than the instructions on the forms. Torre v. Comm’r, T.C. Memo. 2001-218.

CASUALTY LOSSES. The taxpayer, a lawyer, claimed a casualty loss deduction for damage to personal property and professional papers which were stored in a rented garage. The personal property included a used washing machine, lawn mower and law school books. The professional papers were records and memoranda from the law practice. The taxpayer claimed that the damage occurred from water which leaked through the roof. The taxpayer provided no evidence of the fair market value of the property, no evidence of the damage and no evidence of the value or condition of the property after the damage. The court disallowed the loss deduction because (1) water damage from a leaky roof was not a casualty loss since the damage did not occur suddenly, (2) the taxpayer did not provide any evidence to support the amount of loss, and (3) the professional papers had no income tax

The taxpayer purchased a house. The taxpayer claimed that the taxpayer was harassed and vandalized by neighbors and that the local police refused to prevent the harassment and vandalism. The taxpayer claimed that the actions of the neighbors and police resulted from racism. The taxpayer alleged that the taxpayer sold the house for a loss in order to escape the racism. The taxpayer claimed the loss as a casualty loss. The court held that the alleged racism was not a sudden occurrence that would produce a casualty loss for income tax purposes. The court also noted that the taxpayer did not identify any physical damage or quantify the amount of damage to the property. Torre v. Comm’r, T.C. Memo. 2001-218.

COURT AWARDS AND SETTLEMENTS-ALM § 4.02[14]. The taxpayer had filed a suit against the taxpayer’s former employer under the federal Age Discrimination in Employment Act of 1967. The parties reached a settlement and the taxpayer received payment to a trust account held by the taxpayer’s attorney. The attorney retained the portion for the legal fees and paid the remainder to the taxpayer. The taxpayer included only the amount received from the attorney trust account in income. The court held that the entire settlement payment was included in the taxpayer’s income with the taxpayer entitled to an itemized deduction for the legal fee retained by the attorney. The appellate court noted the split on this issue among the circuit courts: Excludible from income: Foster v. United States, 249 F.3d 1275 (11th Cir. 2001); Srivastava v. Comm’r, 220 F.3d 353 (5th Cir. 2000); Estate of Clarks v. United States, 202 F.3d 854 (6th Cir. 2000); Cotnam v. Comm’r, 263 F.2d 119 (5th Cir. 1959), Deductible from income: Young v. Comm’r, 240 F.3d 369 (4th Cir. 2001); Benci-Woodward v. Comm’r, 219 F.3d 941 (9th Cir. 2000); Baylin v. United States, 43 F.3d 1451 (Fed. Cir. 1995). The appellate court affirmed, noting that in Wisconsin, attorneys are prohibited from taking an ownership interest in a case; therefore, the taxpayer could not have assigned the contingent fee to the attorneys. The court compared the contingent fee arrangement to a sales commission, where the employer receives income from the sales and pays the employee a commission which is a deduction from the employer’s income. Kenseth v. Comm’r, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,570 (7th Cir. 2001), aff’g, 114 T.C. 399 (2000).

DISCHARGE OF INDEBTEDNESS. The taxpayer was a bank which offered credit cards to the public. The bank offered cardholders a program under which, in exchange for a monthly fee, the credit card balance would be extinguished after certain events (the events are not identified in the ruling). The IRS ruled that the extinguishing of a credit card balance under this program would not be discharge of indebtedness income because the bank received full consideration, the monthly fee, for the cancellation and the cancellation of indebtedness did not occur under a defined policy of the bank. See Treas. Reg. §§ 1.6050P-1(b)(2)(F), (G). Ltr. Rul. 200131027, May 9, 2001.

HOME OFFICE. During the tax year, the taxpayer resigned from full-time employment and actively sought employment elsewhere. The taxpayer used a typewriter on the kitchen table to write letters to prospective employers and the taxpayer’s answering machine was used to record messages from these contacts. No other use of the taxpayer’s residence was exclusively used on a regular basis for employment or a business. The court held that the taxpayer was not eligible for home office-related deductions because no part of the residence was exclusively and regularly used for a trade or business. The appellate court affirmed in a decision designated as not for publication Dixon v. Comm’r, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,564 (9th Cir. 2001), aff’g, T.C. Memo. 1999-310.

INTEREST. The taxpayers failed to pay taxes for five tax years and were assessed interest on those taxes. The taxpayers paid $228,000 in interest on the taxes in 1995 and claimed $166,000 of the interest as a business expense deduction and $44,000 as an investment interest deduction. The taxpayers provided no evidence that allocated the interest to any business or investment income from the five tax years. The court held that the interest was a personal interest expense which was not deductible as a business or investment expense because the taxpayer failed to prove that the interest resulted from any business or investment. Weil v. Comm’r, T.C. Memo. 2001-212.

LIKE-KIND EXCHANGES. The taxpayer, an S corporation, sold some real property in a like-kind exchange using a qualified intermediary. The acquired property was transferred by the intermediary to an LLC wholly-owned by the taxpayer. The IRS ruled that the LLC would be disregarded for purposes of the like-kind exchange rules and the transaction would be eligible for like-kind exchange treatment. Ltr. Rul. 200131014, May 2, 2001.

PARTNERSHIPS-ALM § 7.02[3][c].¹*

DEFINITION. The decedent and two children and the members of another family created a limited partnership. Each member contributed an interest in a ranch and the decedent also contributed $1 million in securities. Each member received an interest in the partnership in accordance with the value of the property contributed. The general partner was not formed until after the decedent’s death. The court found that the purpose of the partnership formation was to centralize management and to preserve the ranch as a family business. The IRS argued that the partnership was formed solely for the purpose of reducing the value of the decedent’s estate. The decedent had been diagnosed with breast cancer but died from another illness. The decedent had contributed $1.5 million in property and securities but the limited partnership interest received had a fair market value of $617,591. The District Court held that the partnership was valid. The appellate court affirmed in a decision designated as not for publication. Church v. United States, 2001-2 U.S. Tax Cas. (CCH) ¶ 60,415 (5th Cir. 2001), aff’g, 2000-1 U.S. Tax Cas. (CCH) 60,369 (W.D. Tex. 2000).

PASSIVE ACTIVITY LOSSES. The taxpayers, husband and wife, owned several commercial and residential rental properties. The wife was fully employed as a physician and spent no time managing the rental properties. The husband was a real estate agent and spent over 700 hours managing the properties. The issue was whether the husband spent more...
than 750 hours annually managing the properties in order for the losses from the activities to be considered nonpassive losses under I.R.C. § 469(c)(7)(B). The taxpayers claimed that the husband spent over 800 hours annually managing the properties. The court disallowed over 100 hours for each year because the time was not spent in the trade or business of managing the properties. The time was spent providing voluntary cleaning and other services. Therefore, the court held that the losses from the rental properties were passive losses subject to the passive loss rules. DeGuzman v. United States, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,560 (D. N.J. 2001).

PENSION PLANS. For plans beginning in July 2001, the weighted average is 5.80 percent with the permissible range of 5.22 to 6.09 percent (90 to 106 percent permissible range) and 5.22 to 6.38 percent (90 to 110 percent permissible range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). Notice 2001-48, I.R.B. 2001-33, 130.

The taxpayer was the surviving spouse of a decedent who had owned an interest in a pension plan provided by the decedent’s former employer. After the death of the decedent the employer continued to send payments to the taxpayer but included the decedent’s social security number on the plan statements which were sent to the taxpayer twice a year. The taxpayer did not include the payments in gross income, arguing that the payments were not made to the taxpayer. The court held that the nature of the income could not be changed by the error of the employer in using the wrong social security number; therefore, the plan payments were included in the taxpayer’s income. Whittaker v. Comm’r, T.C. Memo. 2001-224.

REFUNDS. In November 1997, the taxpayers filed IRS Form 1045, “Application for Tentative Refund,” requesting a tentative carryback adjustment for the 1994 tax year due to net operating losses from previous years. The IRS denied the application because the application was filed outside the one-year period of limitations within which such refund applications must be filed under I.R.C. § 6411(a). The IRS notified the taxpayers that they still had time to file a claim for refund, which could be done by filing IRS Form 1040X, “Amended U.S. Individual Income Tax Return.” The taxpayers, however, did not file a Form 1040X until after the three-year period of limitations for claims for refund due to net operating loss carrybacks set forth at I.R.C. § 6511(d)(2) had expired and the IRS denied their claim for refund. The taxpayers claimed that, by filing the earlier Form 1045 application, they filed an informal claim for refund, thus tolling the period of limitations for claims for refund set forth at I.R.C. § 6511(d)(2). The court held that Form 1045 was not a “duly filed” claim for refund under I.R.C. § 7422, therefore, the limitation period for refund claims was not tolled. Kirsh v. United States, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,569 (2d Cir. 2001), aff’g, 131 F.Supp.2d 389 (S.D. N.Y. 2000).

RETURNS. The taxpayer filed personal income tax returns and claimed five persons as dependents. The taxpayer listed a social security number for each dependent which was not the actual social security number for the dependent, although the numbers where assigned to real persons. The persons claimed as dependents were all Mexican nationals and the taxpayer provided no evidence of any social security number or taxpayer identification number having been assigned to the dependents. The court held that no deduction for the dependents could be allowed without a valid social security or taxpayer identification number. Vega v. Comm’r, T.C. Memo. 2001-214.

TRUSTS. The taxpayers, husband and wife, were self-employed as distributors of health products for another company. In 1991, the taxpayers formed a trust for their benefit and had all income payments made from the health products company directly to the trust. The taxpayer did not file any personal income tax returns for 1994 and 1995. In a 1998 Tax Court case, affirmed by the Ninth Circuit in 2000, the trust was held to be without economic substance in 1992 and 1993 and the taxpayers were held to be liable for self-employment taxes on their income. The court held that the trust was still without economic substance in 1994 and 1995 since the taxpayers had not provided any evidence to change the earlier holding. The taxpayers were also assessed the 20 percent accuracy penalty, the penalty for failure to file, and the penalty for underpayment of estimated taxes. Fox v. Comm’r, T.C. Memo. 2001-208.

PROPERTY

FENCES. The plaintiffs were two livestock farmers with property adjoining the defendant’s property. The defendant did not have livestock on the defendant’s property. The person who owned the defendant’s property before the defendant had orally agreed to maintain the fences between the properties; however, the defendant refused to maintain the fences. The plaintiffs applied to the county fence viewers to make a determination regarding the fence maintenance under Iowa Code 359A.1. The fence viewers and the District Court ruled that the plaintiffs should bear the full responsibility for maintaining the fence because the plaintiff were liable, under Iowa Code § 169C.4(1)(a), for any damages caused by trespassing livestock. The fence viewers believed that the existence of Iowa Code § 169C indicated that livestock owners should bear more expense for fences than non-livestock owning neighbors. The appellate court reversed, holding that the livestock trespass law did not modify or otherwise affect the enforcement of the fence maintenance responsibility of neighbors. The appellate court stated that the fence maintenance statute applied equally to adjoining landowners without regard to the use of the land by the owners. Duncalf v. Ritscher Farms, Inc., 627 N.W.2d 906 (Iowa 2001).

CITATION UPDATES

Sather v. Comm’r, 251 F.3d 1168 (8th Cir. 2001), aff’g, T.C. Memo. 1999-309 (gifts), see p. 101 supra.
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CARE NEEDED TO ASSURE HEDGING RESULT
— by Neil E. Harl

The line between hedging and speculation is critical, especially if a loss occurs. Although gains from speculative transactions are capital gains, losses are capital losses. Gains or losses arising from speculative transactions are treated as if they were 60 percent long-term and 40 percent short-term without regard to the actual holding period. Long-term capital losses can be used to offset long-term capital gains and, for individuals, up to $3,000 of ordinary income each year.

On the other hand, gains and losses from hedges are exempt from the “market-to-market” rules for speculative transactions and are treated as gains and losses from the actual commodities. Thus, gains are reported as ordinary income and losses are ordinary losses.

A July, 2001, Tax Court case has dramatized the importance to taxpayers of watching closely the requirements for a hedge. In particular, it is important to be sure the hedging account is held by the entity producing the actual commodities involved.

Tests for “hedge” status

The regulations, which became final in 1994, relaxed some of the requirements for a hedge. A taxpayer may hedge any part or all of its risk for any part of the period during which it has risk. Moreover, the frequent entering into and termination of hedging positions are not relevant to whether transactions are hedges. For a hedging program undertaken to reduce the overall risk of the taxpayer’s operation, the taxpayer generally does not have to demonstrate that each hedge entered into under the program reduced overall risk.

Basically, however, the courts have emphasized two tests in evaluating commodity futures transactions as hedges or as speculative ventures. Insurance test. If the taxpayer uses futures trading to offset price changes in actual commodities, (the “actuals”), the futures transactions are ordinarily treated as hedges. Even if the taxpayer did not own the actuals, the U.S. Supreme Court has

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See the back page for details about the Agricultural Tax and Law Seminar in Nebraska, Oct. 2-5, 2001 Featuring discussion of EGTRRA 2001 by Dr. Neil E. Harl and Prof. Roger A. McEowen
held that futures trading was hedging and not speculation if the commodity transactions were an integral part of the taxpayer’s business and the taxpayer acquired the actuals in the course of business. 13 Thus, “pre-hedging” is permitted (before a crop is planted and before feeder animals are acquired) but “post-hedging”, which involves attempts to hedge after the commodity is sold is not a hedge but is speculation. 14

“Direct relation” test. Under the direct relation test, there must be a reasonable quantitative relationship between the taxpayer’s involvement with the actuals and the commodity market transaction if the transaction is considered to be a hedge. 15 For the direct relation test to be met, the amount of futures trading in the particular commodity involved and the timing of purchases and sales must be related to the position of the taxpayer in the actuals. 16

Wrong entity hedging

A problem that is becoming increasingly common with multiple-entity business plans, with the overall farming or ranching operation divided between or among entities, is having the hedging transactions carried on by the correct entity. In Pine Creek Farms, Ltd. v. Comm’r, 17 a corn, soybean, cattle and hog operation was divided among several entities. The taxpayer, a C corporation, was engaged in producing corn, soybeans and cattle; the hog operation was handled by two other corporations, one for farrowing and one for finishing. The taxpayer corporation in the tax year in question had $40,934 of hedging losses of which $6,305 was from hog hedges. 18 IRS determined the $6,305 was a capital loss for the taxpayer and the Tax Court agreed. 19 IRS argued that the taxpayer was not engaged in the hog business and could not have hedging transactions in hogs. It didn’t matter that a shareholder of the taxpayer C corporation was engaged in hog production through the other two corporations.

A 1997 private letter ruling addressed a similar question. 20 In that ruling, a dairy farm was carried on by an S corporation but a shareholder attempted to hedge feed supplies. The S corporation’s business was not attributed to the shareholder for hedging purposes.

In conclusion

Among other points to watch, it is vital for hedging status that the hedging transactions be carried on by the correct entity.

FOOTNOTES

2 See I.R.C. § 1256(a)(3).
3 I.R.C. § 1256(a)(3).
4 I.R.C. § 1211(b).
5 I.R.C. § 1256(e)(1).
6 Pine Creek Farms, Ltd. v. Comm’r, T.C. Memo. 2001-176.
7 Treas. Reg. § 1.1221-2.
8 Treas. Reg. § 1.1221-2(c)(1)(iv).
9 Treas. Reg. § 1.1221-2(c)(1)(vi).
10 Treas. Reg. § 1.1221-2(c)(1)(ii).
12 E.g., Stewart Silk Corp. v. Comm’r, 9 T.C. 174 (1947).
13 E.g., Corn Products Refining Co. v. United States, 350 U.S. 46 (1955). See also, Crisp v. Comm’r, T.C. Memo. 1989-668 (futures transactions required as part of loan agreement were integral part of cattle raising business; gains were ordinary income).
14 Patterson v. Comm’r, T.C. Memo. 1981-43, aff’d in unpub. Op., 676 F.2d 705 (8th Cir. 1982) (farmer sold soybeans at harvest because of inadequate storage and bought soybean futures; transactions were held to be speculative, not hedges, on grounds taxpayer was not protecting against risk of loss as to actual commodities).
15 See, e.g., Comm’r v. Banfield, 122 F.2d 1017 (9th Cir. 1941) (mere fact of purchase and sale of wheat futures by wheat farmer did not make commodity transactions hedges).
16 E.g., Lewis v. Comm’r, T.C. Memo. 1980-334 (volume of futures trading by cattle feeder was three to five times the cattle on hand).
17 T.C. Memo. 2001-176.
18 Id.
19 Id.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ANIMALS

CRIMINAL NEGLECT. The defendant operated for several years a boarding house for the defendant’s and other’s horses. The defendant was convicted of two counts of violating Iowa Code § 717.2(2) for failing to properly

feed two horses. The case does not disclose any reasons for the lack of care. The two dead horses were discovered by a sheriff’s deputy at the edge of a field, observable from a road. The deputy took several photographs from a neighboring property and obtained a search warrant to have a veterinarian examine the horses for cause of death. The defendant claimed that the horses died in a storm; however, the expert witnesses testified that the horses died from
starvation. The defendant challenged the jury verdict of guilty on both counts on two issues: (1) that the statute provided for only one violation involving one period of neglect and (2) there was no probable cause to support the search warrant. On the first issue the court agreed that the statute limited to one the number of offenses with which a defendant could be charge for any uninterrupted period of neglect. Since the two horses died together, the court held that the defendant could be charged with only one violation. On the second issue, the court held that sufficient probable cause for the warrant was provided by the deputy’s personal experience with observing animals which had died from starvation and were under the defendant’s care. State v. Wells, 629 N.W.2d 346 (Iowa 2001).

**BANKRUPTCY**

**GENERAL-ALM § 13.03.**

**EXEMPTIONS**

ADDITIONAL CHILD TAX CREDIT. The debtor claimed an exemption for an income tax refund. The exemption was claimed under Ky. Rev. Stat. § 205.220(3) for benefits received under federal, state or local public assistance legislation. The debtor claimed that the refund resulted from the additional child income tax credit allowed under I.R.C. § 24(d). The court applied a three part inquiry as to whether the tax credit was in the nature of public assistance: whether the credit had a public assistance purpose, whether the credit was refundable, and at what income level did the credit phase out. The court held that the additional child credit had the public assistance purpose to help families with three or more children and was refundable. However, the court held that the credit was not eligible for the exemption because the credit was available to higher income families, thus demonstrating that the credit was not intended to serve as public assistance legislation. In re Beltz, 263 B.R. 525 (Bankr. W.D. Ky. 2001).

PREFERENTIAL TRANSFERS. The debtor owned a dairy farm which was operated by the debtor’s son. The son often made personal payments for dairy expenses which were reimbursed by the debtor. The son made a $12,000 payment on an insurance premium for the debtor and, as usual, the debtor reimbursed the son for that expense. That reimbursement, however, was made within 90 days before the debtor filed for Chapter 11 bankruptcy. The case was converted to Chapter 7 and the trustee sought to recover the $12,000 reimbursement as a preferential transfer. The son argued that the son was not a creditor and the reimbursement was not for an antecedent debt. The court held that the son’s payment of the debtor’s insurance obligation created a debt prior to the reimbursement for that payment; therefore, the reimbursement was a preferential transfer and the son was required to return the reimbursement to the bankruptcy estate. The case gives no indication why the son did not raise the issue of the exception in Section 547(c) for payments made in the ordinary course of business for normal business expenses. In re Mowry, 263 B.R. 499 (Bankr. W.D. Pa. 2001).

**FEDERAL TAX-ALM § 13.03[7].**

DISCHARGE. The debtor filed for Chapter 7 and received a discharge. After the discharge, the IRS audited the 1987 tax return of a corporation owned by the debtor and terminated in 1988. The IRS determined that the corporation owed taxes for 1987 and that the debtor was personally responsible for those taxes because the corporation made distributions of property to the debtor in 1987. The debtor argued that the debtor’s transferee liability for the corporation’s taxes was not a tax; therefore, the liability was discharged in the Chapter 7 case. The court held that I.R.C. § 6901(a) provided for collection of transferee liability in the same manner as collection of a tax liability; therefore, the debtor’s transferee liability was in the nature of a tax and was not discharged in the Chapter 7 case. In re McKowen, 263 B.R. 618 (D. Colo. 2001).

PREFERENTIAL TRANSFERS. The debtor was a general partnership. The general partner had fraudulently claimed income for the partnership from fake sales transactions. The partnership paid the income tax liability of its partners at the direction of the general partner, based on the inflated partnership income. When the limited partner learned that the income was falsely inflated, the limited partner had the partnership file amended returns which resulted in refunds to the limited partner. The trustee sought to recover from the IRS the excess tax payments made by the partnership to the IRS. The IRS argued that it was not an “initial transferee” of the tax payment because it did not exercise dominion and control over the funds since it was required to refund the money to the limited partner. The court held that the IRS did exercise some control over the taxes because it did not refund the entire amount to the limited partner. The IRS also argued that the partners were the initial transferees because the tax payments were made on their behalf by the debtor. The court held that an issue of fact remained as to whether the limited partner participated in the initial payment of taxes by the partnership for the partners, in which case, (1) the IRS was not the initial transferee of the limited partner’s taxes and (2) the IRS was an immediate or mediate transferee. The court did not decide the remaining issue of whether the IRS, as an immediate or mediate transferee, received the transfer of funds for value, and in good faith, without knowledge of the voidability (if appropriate) of the transfer, in which case the taxes could not be recovered from the IRS. In re C.F. Foods, L.P., 2001-2 U.S. Tax Cas. (CCH) ¶ 50,599 (Bankr. E.D. Pa. 2001).

**ENVIRONMENTAL LAW**

CLEAN WATER ACT. The defendant operated a dairy farm. Animal waste from the farm was stored in holding ponds, sprayed onto fields and stored on the defendant’s land. The plaintiffs were owners of land which was downstream from the defendant’s dairy farm. The plaintiffs
alleged two types of pollution of a stream governed by the Clean Water Act (CWA). The first type of alleged pollution was surface runoff of animal wastes into surface streams and canals which fed into the CWA-governed stream. The second type alleged that animal wastes seeped through the soil into underground water which percolated into streams which fed the CWA-governed stream. The defendant initially challenged the standing of the plaintiffs. The plaintiffs alleged that the pollution runoff prevented them from using their ponds for canoeing, fishing and swimming. The court held that the plaintiffs alleged sufficient injury for standing to bring the CWA suit. The court also held that standing was supported by the allegations and supporting affidavits demonstrating the causal connection between the animal waste disposal activities of the defendant and the resulting injury to the streams and ponds near the plaintiffs’ land. The defendant had obtained an NPDES permit and argued that the permit negated any violation of the CWA and the CWA pollution issues were moot. The court held, however, that, because the plaintiffs filed affidavits that the permit limit was being violated, the plaintiffs had sufficiently alleged a continuing violation of the CWA. The defendant also argued that the waters alleged to be polluted by the animal waste runoff were not “waters of the United States” governed by the CWA. The court held that, because the plaintiffs alleged that the pollution reached a stream which qualified as a “water of the United States,” the pollution of tributaries and feeder streams was governed by the CWA, even though the tributaries and feeder streams were not “waters of the United States.” The more difficult question involved whether pollution that first entered the groundwater before reaching CWA-governed waters was also covered under the CWA. The court acknowledged the split of authority on this issue and held that the CWA governed pollution which first enters groundwater before affecting CWA-governed waters. The court noted that the plaintiff still had to prove that the defendant’s animal wastes which were absorbed into the soil did affect CWA-governed waters. Idaho Rural Council v. Bosma, 143 F. Supp.2d 1169 (D. Idaho 2001).

**FEDERAL AGRICULTURAL PROGRAMS**

**BRUCELLOSIS.** The APHIS has adopted as final regulations amending the brucellosis regulations to change the classification of Oklahoma from Class A to Class Free. 66 Fed. Reg. 45749 (Aug. 30, 2001).

**DISASTER ASSISTANCE.** The CCC has announced the revised eligibility requirements for benefits under the 1998 Crop Loss Disaster Assistance Program multi-year provision. All interested parties must file applications prior to close of business on September 14, 2001. 66 Fed. Reg. 45276 (Aug. 28, 2001).

**FARM LOANS.** The FSA has announced the end of a temporary suspension, effective August 23, 2001, of direct and guaranteed farm ownership and farm operating loan financing for the construction of specialized facilities used for the production of hogs. 66 Fed. Reg. 44330 (Aug. 23, 2001).

**POLITICAL QUESTION DOCTRINE.** The plaintiffs were farmers who sought declaratory and injunctive relief against the President, the Secretary of Agriculture and the Secretary of the Treasury. The plaintiffs sought, in essence, an order requiring the defendants and their agents to maintain market conditions favorable to small farmers. Although the court acknowledged that the small farmer of America continues to face tough economic conditions, the court held that the suit involved only nonjusticiable political questions and dismissed the suit. Schroeder v. Bush, No. 00-1357 (10th Cir. 2001). affg. sub nom, Schroeder v. Clinton, No. 00-CV-154-K (D. Colo. July 6, 2000).

**SCRAPIE.** The APHIS has adopted as final regulations which restrict the interstate movement of sheep and goats from states that do not follow effective flock management practices for scrapie. The regulation amendments also require animal identification for sheep and goats moving interstate and reinstate a scrapie indemnity program to compensate owners of certain animals destroyed due to scrapie. 66 Fed. Reg. 43963 (Aug. 21, 2001).

**WETLANDS.** The plaintiff had received permission to repair drainage tile on a tract of land. The drainage tile was part of a drainage tile system which extended onto a neighboring parcel also owned by the plaintiff. The USDA, however, charged the plaintiff with conversion of wetlands on the neighboring parcel. Apparently the plaintiff’s repair of the drainage tile either affected the neighboring parcel or the plaintiff repaired more tile than was allowed under the permit. The plaintiff received a final lower administrative ruling which ruled that the plaintiff had improperly converted the wetlands on the neighboring parcel and gave the plaintiff 30 days to appeal that decision. The plaintiff alleged that an appeal was timely mailed to the National Appeals Division (NAD). The NAD denied an appeal because it asserted that no appeal was received by the NAD. The plaintiff argued that the appeal papers must have been lost in the mail or by the NAD and provided evidence of the mailing. The NAD refused to consider the plaintiff’s evidence of a mailing as “extenuating circumstances” and held that the plaintiff had not demonstrated “good cause” for acceptance of a late filed appeal. The court first ruled that the denial of the appeal was reviewable by the court as a final administrative decision. Next, the court held that the NAD had used the incorrect standard in ruling that “good cause” for the late appeal was not shown. The proper standard was whether extenuating circumstances had been shown for the late appeal. The court held that the NAD denial of the appeal was improper in that the NAD failed to consider the plaintiff’s evidence of a mailing as extenuating circumstances. The court noted that the NAD had not presented any evidence that the NAD staff did not lose the
FEDERAL ESTATE AND GIFT TAX

VALUATION. The decedent owned two ranches, one of which was leased to one son and the other leased to another son. Both leases were written and contained specific options for renewal. Under the decedent’s will the two sons inherited the two ranches in equal shares. The sons were appointed executors of the estate and, as executors, executed five year leases with five year renewal options. The estate claimed that these leases were written versions of an oral extension granted by the decedent before death and that the leases decreased the value of the decedent’s interest in the ranches. The IRS argued that no oral lease modification existed and that any modification of the original leases had to be written in order to be valid under Texas law. The court held that no oral modification of the written lease existed and that the written five year leases were ineffective to decrease the value of the ranches in the estate. The court noted that the leases were unnecessary in that the sons received the ranches under the will. Estate of Edwards v. Comm’r, T.C. Memo. 2001-229.

FEDERAL INCOME TAXATION

APPEALS. The taxpayer had filed a gift tax return and paid tax. The taxpayer later filed an amended return which showed no tax due but the IRS denied the claim for refund of the gift tax paid. The taxpayer sought judicial review of the IRS denial but the IRS decided to concede the issue and moved to dismiss the case. The taxpayer sought attorney’s fees and court costs. The IRS argued that its concession of the tax issue was a substantially justified position and, under I.R.C. § 7430, no attorney fees could be awarded. The court held that the focus of the Section 7430 inquiry could be at the administrative appeal level, the judicial review level, or at the appeal. The court held that the attorneys’ fees at the judicial level were not substantially justified; therefore, the IRS was not entitled to any attorney fees. Regimbal v. United States, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,583 (E.D. Wash. 2001).

BUSINESS EXPENSES. The taxpayer was employed as a computer instructor/systems analyst for three employers. The taxpayer claimed income and deductions related to the employment on Schedule C. The taxpayer did not provide any evidence of a business except for the filing of Schedule C and had few records to support any of the expenses claimed. The court held that the taxpayer was an employee and did not operate a trade or business and that most of the deductions were disallowed for lack of substantiation. Hinkle v. Comm’r, T.C. Summary Op. 2001-129.

C CORPORATIONS-ALM § 7.02*

STOCK REDEMPTIONS. The taxpayer wholly-owned two corporations. The taxpayer became indebted to the first corporation through direct distributions, corporate payment of personal obligations and distributions which the taxpayer contributed to the second corporation. The taxpayer’s indebtedness to the first corporation was released in exchange for stock in the second corporation. The IRS characterized the stock exchange as a stock redemption subject to recognition of gain and loss under I.R.C. § 304. The taxpayer argued that (1) Section 304 was not intended to apply to this transaction and (2) an exception for stock acquisition indebtedness applied in this case. The court held that Section 304 did apply to the transaction because the taxpayer retained control over both corporations and the stock was exchanged for property, the release of indebtedness. The court also held that the exception applied only to the portion of the indebtedness to the first corporation which was used to acquire an additional capital interest in the second corporation. Because the remainder of the debt was used for the taxpayer’s personal purposes, that debt was subject to Section 304 and had to be treated as a stock redemption under I.R.C. §§ 301 or 302. The court held that Section 302 did not apply because (1) the transfer was essentially equivalent to a dividend, (2) the transfer did not change the taxpayer’s control of the corporations, (3) the transfer did not cause a termination of the corporations, and (4) the transfer did not cause a partial termination of the corporations. The court held that the transfer of stock in exchange for the release of indebtedness, except for the portion characterized as debt for acquisition of the second corporation’s stock, was taxed as a dividend to the taxpayer. Combrink v. Comm’r, 117 T.C. No. 8 (2001).

CAPITAL ASSETS. The taxpayer was a partnership which owned and operated a ranch. When the ranch was purchased in 1976, it did not have any irrigation water rights but the taxpayer expected that such rights could be acquired because the land qualified for irrigation water. In 1983, the taxpayer acquired irrigation water use rights under a state-federal water use program for water from the lower Colorado River. In 1993, the federal government purchased these water use rights from the taxpayer and the issue was whether the water use rights were capital assets or whether the proceeds from the relinquishment of the rights were ordinary income. The Tax Court held that the water use rights were capital assets because (1) the water use rights arose from the ownership of the land, (2) the water was used in the business of the partnership but was not resold as a commodity or otherwise used directly to produce ordinary income for the taxpayer, and (3) the taxpayer had to purchase water from another source. The IRS argued that no sale or exchange occurred because the taxpayer’s receipt of the funds was subject to reimbursement of the water irrigation district in case the sale was revoked. The court held that, although a reimbursement liability existed, the
funds were transferred primarily as compensation for relinquishment of the water use rights; therefore, a sale did occur. The taxpayer argued that a portion of its tax basis in the land could be allocated to the water use rights relinquished. The court found that the original purchase price of the ranch did not include any cost for water use rights because the water use rights did not exist when the ranch was purchased; therefore, the Tax Court held that no tax basis of the land could be allocated to the water use rights. On appeal, the appellate court reviewed only the third holding that the taxpayer had no income tax basis in the water rights from the purchase of the land. The appellate court focused on the assertion that the price paid for the ranch included a premium for the expected water rights; therefore, that portion of the purchase price could be allocated to the water rights when sold. The appellate court cited Rev. Rul. 86-24, 1986-1 C.B. 80, which held that a portion of the purchase price of impregnated cows could be allocated to the calves. The case was remanded to determine, if possible, the premium paid for the land which could be allocated to the water rights. The court noted that, under Inaja Land Co., Ltd. v. Comm'r, 9 T.C. 727 (1947), if the premium could not be determined, the taxpayer may be allowed to allocate all of the ranch cost/basis to the water rights. Gladden v. Comm'r, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,597 (9th Cir. 2001), rev'g and rem'g, 112 T.C. 209 (1999).

DEPRECIATION. The taxpayers purchased rental real estate and held the property for over 14 years. The taxpayers made capital improvements to the property. The taxpayers did not claim any depreciation deductions for the entire 14 years. The taxpayers sold the property and deducted from the sale proceeds the property and water taxes owning against the property. The taxpayers used their undepreciated basis to determine that the sale of the property produced a loss. The court held that the real estate taxes and water taxes were not chargeable against the sale proceeds. In addition, the court held that the taxpayers' basis in the property had to be decreased by the amount of depreciation deductions allowable over the 14 years. Thus, the sale of the property produced gain to the taxpayers. Jakubowski v. United States, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,594 (10th Cir. 2001), aff'g, 2000-2 U.S. Tax Cas. (CCH) ¶ 50,604 (D. Colo. 2000).

DISASTER PAYMENTS. On August 15, 2001, the President determined that certain areas in Tennessee were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of severe storms and flooding that began on July 27, 2001. FEMA-1387-DR. On August 15, 2001, the President determined that certain areas in Kentucky were eligible for assistance under the Act as a result of severe storms, flooding and mudslides beginning on July 27, 2001. FEMA-1388-DR. On August 16, 2001, the President determined that certain areas in the District of Columbia were eligible for assistance under the Act as a result of severe storms, flooding and mudslides beginning on August 10, 2001. FEMA-1389-DR. Accordingly, a taxpayer who sustained a loss attributable to the disasters may deduct the loss on his or her 2000 federal income tax return.

DISCHARGE OF INDEBTEDNESS. The taxpayer purchased unemployment insurance for the taxpayer's credit cards. The insurance company made payments on the cards during two year when the taxpayer was unemployed. The taxpayer continued to make purchases with the cards and the cards accrued interest during these two years. The court held that the insurance payments were income to the taxpayer. Huynh v. Comm'r, T.C. Summary Op. 2001-131.

INCOME. The IRS has announced that it will revise the 2001 instructions for Form 1040 and Publication 17, to inform Holocaust victims or their heirs about the income exclusion provided by EGTRRA 2001 for restitution payments currently being made by European governments and industries. Revisions also are planned for Publication 553, which will highlight tax law changes for 2001, and Publication 525, which will define taxable and nontaxable income. IR-2001-75.

INTEREST. The taxpayer, a corporation, timely filed returns for several years. The returns were audited and a tax deficiency plus interest was assessed. The taxpayer claimed a deduction for the interest paid as a specified liability loss under I.R.C. § 172(f). The court upheld this deduction. The IRS argued that interest accrued within three years before the tax year the interest deduction was claimed was disallowed under I.R.C. § 172(f)(1)(B)(i). The IRS argued that the event which controlled the three year limit was the accrual of the interest. The court disagreed, holding that the defining event was the filing of the erroneous return; therefore, because the returns were all filed more than three years before the deduction was claimed, all the interest was deductible. The appellate court affirmed in a decision designated as not for publication. Host Marriott Corp. v. United States, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,580 (4th Cir. 2001), aff'g, 113 F. Supp.2d 790 (D. Md. 2000).

PENSION PLANS. For plans beginning in August 2001, the weighted average is 5.79 percent with the permissible range of 5.21 to 6.08 percent (90 to 106 percent permissible range) and 5.21 to 6.37 percent (90 to 110 percent permissible range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). Notice 2001-52, I.R.B. 2001-35, 203.

S CORPORATIONS-ALM § 7.02[3][c].*

TRUSTS. The IRS has issued proposed regulations which incorporate changes made to Code Sec. 1361 by the Small Business Job Protection Act of 1996, Pub. L. No. 104-88, to provide that a testamentary trust could be a permitted shareholder of an S corporation for a two-year period. The 1996 amendments also provided that a former qualified subpart E trust would be a permitted shareholder for a two-year period whether or not the entire corpus was included in the deemed owner's gross estate. The proposed regulations eliminate the special rules for determining whether trusts consisting of community property qualify for the two-year period. The proposed regulations refer to electing small
SAFE HARBOR INTEREST RATES

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WITHHOLDING TAXES. The taxpayer was a professional baseball team which was required to pay back wages under an employment settlement. The employees who received the payments did not work for the team in the year the back wages were paid. The Sixth Circuit Court of Appeals held that, under Bowman v. United States, 824 F.2d 528 (6th Cir. 1987), the wages were taxable under the FICA and FUTA rules in effect in the years the wages were earned, not when they were paid. The Sixth Circuit case was designated as not for publication. The U.S. Supreme Court reversed, holding that the back wages were to be taxed under FICA and FUTA tax rules in effect in the year the back wages were paid and not when the wages were earned. The final judgment was entered by the District Court pursuant to the U.S. Supreme Court ruling. Cleveland Indians Baseball Co. v. United States, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,593 (D. Ohio 2001), on rem from, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,517 (6th Cir. 2001), on rem from, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,341 (S. Ct. 2001), rev’g, 215 F.3d 1325 (6th Cir. 2000).

STATE REGULATION OF AGRICULTURE

MILK. The plaintiffs were Nevada dairy producers who sold milk to California processors. The plaintiffs challenged the California milk price stabilization program as violating the Commerce Clause of the U.S. Constitution. The court held that the case was governed by the holding of Shamrock Farms Co. v. Veneman, 146 F.3d 1177 (9th Cir. 1998), which held that the California program was immunized from Commerce Clause challenges by Section 144 of the 1996 Farm Bill. The plaintiffs also alleged that the program violated the Equal Protection Clause but the court held that the issue was insufficiently pled because the petition failed to allege facts to demonstrate that the classifications of producers are arbitrary or that they are not rationally related to legitimate state interests. Ponderosa Dairy v. Lyons, No. 99-16981 (9th Cir. Aug. 9, 2001).

ZONING

EXCLUSIVE FARM USE ZONE. A city owned land in an exclusive farm use zone and sought permission to spread pretreated waste effluent onto land to irrigate and fertilize poplar trees which would eventually be sold. The plaintiff was a neighboring land owner who challenged the proposed use of the land as violating the use restrictions of the zoning ordinance for an exclusive farm use zone. The plaintiff argued, and the Land Use Board of Appeals agreed, that the proposed use was a utility facility and required a finding that the facility could not be operated on other land. The court reviewed the legislative history of Or. Rev. Stat. § 215.283(1)(d) which defined a “utility facility” to mean equipment or apparatus. The court held that, in this case, the only equipment was the spraying equipment used to apply the effluent to the ground. The actual treatment, if any, of the effluent occurred through the natural absorption of the effluent by the ground and the tree roots. Because the treatment was done by the ground and roots, there was no equipment used in the treatment of the effluent and no utility facility would exist on the land. The court held that the proposed use of the effluent was a farm use compatible with the exclusive farm use zoning. Cox v. Polk County, 25 P.3d 970 (Or. Ct. App. 2001).

CITATION UPDATES

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FEATURING DISCUSSION OF EGTRRA 2001

by Neil E. Harl and Roger A. McEowen

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DEPRECIATING MOBILE HOMES
— by Neil E. Harl

Along with the broader issue of the cost recovery period for farm and ranch houses, the question of how to depreciate mobile homes and other types of temporary housing under the Modified Accelerated Cost Recovery System (MACRS) has confronted taxpayers from time to time. A July, 2001, Tax Court case has provided some insight into how such structures are to be depreciated.

Residential rental property.

Under MACRS, assets used in a business or held for the production of income are depreciable over 27 1/2 years if the assets are “residential rental property.” The term “residential rental property” is defined as “any building or structure if 80 percent or more of the gross rental income from such building or structure for the taxable year is rental income from dwelling units.” A “dwelling unit” is, in turn, defined as “a house or apartment used to provide living accommodations in a building or structure, but does not include a unit in a hotel, motel, or other establishment more than one-half of the units in which are used on a transient basis.”

Moreover, if any part of the building or structure is occupied by the taxpayer, “the gross rental income from such building or structure shall include the rental value of the portion so occupied.”

For purposes of ACRS depreciation, which applied to property placed in service after 1980 and before 1986, manufactured homes were subject to cost recovery over 10-years.

Rupert v. Commissioner

In the July, 2001, case of Rupert v. Comm’r, the taxpayer had purchased a 28 foot mobile home in 1982 for $36,000 for use on a lake site. The taxpayer removed the wheels and axles, placed the mobile home on foundation blocks and secured the structure with steel straps attached to ground anchors. The taxpayers also added improvements to the structure including a 12 by 24 foot deck, a “concrete perimeter,” storage area, electrical wiring, a water system, a boathouse, a dock and an electric lift.

The structure was used by the taxpayers occasionally as a vacation home from 1982 to 1985. Beginning in 1991, the structure was reported for income tax purposes as rental property. The taxpayers claimed depreciation beginning in 1991 on the basis of a 10-year life (under the assumption that the property was placed in service in 1982 when it was purchased and installed as a vacation home and, therefore, could be depreciated over 10-years).

The Internal Revenue Service disagreed with the 10-year recovery period and insisted that the property had been placed in service in 1991 when rental commenced. The Tax Court agreed and held that the structure was depreciable over 27 1/2 years as residential rental property under MACRS inasmuch as the...
property was placed in service in the year it was first rented and that determined the classification for cost recovery purposes. The court noted that if the structure had been placed in service before 1987, the cost recovery period would have been 10-years. In a footnote, the court stated that had the structure been placed in service before 1987, the property would have been depreciated out by 1996, the tax year under review by the Tax Court.

What if not permanently installed?
The Tax Court, in Rupert v. Comm’r, understandably did not take up the question of whether the classification result under MACRS would have been the same had the mobile home not been installed permanently on the lake site. Had it not been so installed, the question is whether the mobile home would be deemed a “building or structure” which is required for the property to be classified as “residential rental property.” If it were not so classified, the property might well be deemed seven-year property on the basis that it “does not have a class life.”

FOOTNOTES
9 I.R.C. § 168(h)(3).
10 T.C. Memo. 2001-179.
11 Id.
12 Id.
17 Id.
18 Id., footnote 6.
19 T.C. Memo. 2001-179.

CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-ALM § 13.03.*

AVOIDABLE LIENS. The debtors were farmers and claimed two pickup trucks as exempt under the Oklahoma exemptions for implements of husbandry and tools of the trade, Okla. Stat. Tit. 31, §§ 1(A)(5), (6). The debtors sought to avoid secured liens on the pickups as impairing the exemptions. The secured creditor had not filed any objection to the exemptions for the pickups and the debtor argued that the failure to object prevented any objection to the lien avoidance request. The court held that, because secured creditors do no need to file claims and objections and secured liens pass through bankruptcy, unless avoided, the creditor could resist the avoidance action even though no exemption objection was made. The court held that the creditors failed to demonstrate that the pickups were not used as tools in the debtors’ farming business; therefore, the pickups were exempt tools of the trade and the liens against the trucks were avoidable. In re Thompson, 263 B.R. 134 (Bankr. W.D. Okla. 2001).

EXEMPTIONS

HOMESTEAD. The debtors owned a rural residence on one parcel of land and three rental houses on three separate rural parcels of land. The debtors claimed all four properties as exempt rural residences under Tex. Const. Art XVI, § 51. The trustee argued that the three rental properties were not eligible for the exemption because the properties were not used by the debtors as a rural home. The court noted that separate parcels of farm land have been held to be included in the rural homestead, based upon the close connection between the operation of the farm and the use of the residence. However, the court held that mere use of income from separate parcels as support for the residence was not sufficient connection to include residential rental properties within the exempt rural homestead; therefore, the three rental properties were not eligible for the exemption. In re Webb, 263 B.R. 788 (Bankr. W.D. Tex. 2001).

FEDERAL TAX-ALM § 13.03[7].*

ADMINISTRATIVE EXPENSES. Under I.R.C. § 67(e), deductions for costs paid or incurred in connection with the administration of an estate or trust that would not have been incurred if the property were not held in such trust or estate shall be treated as allowable in arriving at adjusted gross income. The IRS ruled that Section 67(e) applied to the deductible administrative expenses of bankruptcy estates. Ltr. Rul. 200136004, May 17, 2001.

DISMISSAL. The debtor filed for Chapter 13 and the plan provided for payment of all nondischargeable taxes. During the three year plan the debtor made all the payments but failed to file and pay taxes for the three years of the plan.
The plan had a provision prohibiting the debtor from acquiring new debt during the plan and the IRS argued that the debtor’s failure to pay the post-petition taxes violated that plan provision and required the dismissal of the case. The court held that, once all plan payments have been made, the court is required to grant a discharge. The court noted that there is now a standing order requiring all debtors to file and pay income taxes and that, if the IRS objection had been made before all plan payments were made, the dismissal would have been granted. In re Parffrey, 264 B.R. 409 (Bankr. S.D. Tex. 2001).

POST-PETITION INTEREST. The debtors had filed for Chapter 11 and their plan provided for payment of all secured and unsecured priority tax claims. During the plan, payments were made to the IRS in excess of the required payments and the debtors sought the return of the excess payments. The court initially held that the overpayments were a refund due to the debtors, see In re Matunas, 261 B.R. 129 (Bankr. D. N.J. 2001), but the IRS sought a designation of the excess as an overpayment in order to offset the excess against the post-petition interest owed by the debtors. The court held that the IRS was entitled to the post-petition, pre-confirmation interest as a personal liability of the debtors, as contrasted to a bankruptcy estate liability. The court held that the excess payments were best classified as overpayments and could be used by the IRS to offset the debtors’ post-petition interest liability. In re Matunas, 264 B.R. 365 (Bankr. D. N.J. 2001).

CONTRACTS

POULTRY PRODUCTION CONTRACTS. The plaintiffs were farmers who had entered into broiler chicken production contracts with the defendant. Under the contracts, the plaintiffs were to construct, equip and operate poultry barns in return for the defendant’s agreement to regularly place newborn chicks in the barns. The defendant terminated the contracts after closing the nearby processing plant. The plaintiffs claimed that the termination of the contracts was without cause and brought suit alleging breach of contract, fraudulent inducement and misrepresentation, breach of the covenant of good faith and fair dealing, violation of Minn. Stat. § 17.92, and various other claims. The plaintiffs alleged that the defendant made several oral promises that the contracts would be terminated only for cause. The court held that no evidence of the oral promises was admissible because the contracts were unambiguous as to termination; thus, the actions for fraudulent inducement and misrepresentation were dismissed. The contracts had provisions for early termination which provided for compensation for financing costs incurred in constructing the barns. The court also dismissed the claims for breach of implied covenant of good faith and fair dealing because the contracts had express clauses dealing with termination of the contracts. The court upheld the action under Minn. Stat. § 17.92 which prohibited the termination of agricultural commodity production contracts without 180 days prior notice in writing and reimbursement for damages incurred by the producer’s investment. The court allowed evidence for damages only as to the construction of the poultry barns and not for the costs of operating the barns or lost profits. Crowell v. Campbell Soup, Nos. 99-3404, 99-3520 (8th Cir. Sept. 6, 2001).

FEDERAL AGRICULTURAL PROGRAMS

BRUCELOSIS. The APHIS has issued proposed regulations amending the brucellosis indemnity regulations to allow indemnity payments for sheep, goats, and horses destroyed because of brucellosis. 61 Fed. Reg. 47593 (Sept. 13, 2001).

CROP INSURANCE. The FCIC has issued interim regulations amending the procedures for the submission of policies, plans of insurance, or other rates or premium by insurance companies, or other persons or entities, to the FCIC Board of Directors for approval for reinsurance and subsidy. 61 Fed. Reg. 47949 (Sept. 17, 2001).

SUGAR. The CCC has announced implementation of a sugar payment-in-kind diversion program to reduce the CCC’s sugar inventory. 61 Fed. Reg. 47447 (Sept. 12, 2001).

WAREHOUSES. The FSA has issued proposed regulations revising the regulations administering the United States Warehouse Act to implement the provisions of the Grain Standards and Warehouse Improvement Act of 2000. The 2000 Act updates federal warehouse licensing operations, authorizes electronic warehouse receipts for all commodities, and authorizes the Secretary of Agriculture to establish regulations for voluntary systems for other electronic documents related to sales and transfers of agricultural products. 61 Fed. Reg. 47447 (Sept. 12, 2001).

FEDERAL ESTATE AND GIFT TAX

DISCLAIMERS. The decedent and spouse had established a trust for themselves and contributed community and separate property. The income interests were split between the grantors, depending upon whether the income came from community property or separate property. At the death of the decedent, the decedent’s share of community property and separate property in the trust passed to the spouse in two trusts, a marital and residuary trust. The marital trust was based upon the amount necessary to reduce the decedent’s estate tax to zero, with the remainder passing to the residual trust. The spouse was the trustee of these trusts. The spouse petitioned the state court to divide the marital trust into an exempt trust, for which a reverse QTIP election was made for GSTT purposes, and two non-exempt trusts. The spouse disclaimed any interest in one of the non-exempt trusts and the property passed under the trust provisions to the residuary trust which had the decedent’s children as beneficiaries. The children agreed to reimburse the spouse for any gift tax resulting from the passing of
property by the disclaimer. The IRS ruled that the spouse would not be deemed to have made a gift from the disclaimer, the spouse’s interests in the trust would not be valued at zero under I.R.C. § 2702, and the payment of any gift taxes by the recipients of property from the disclaimer would reduce the value of the gift. Ltr. Rul. 200137022, June 13, 2001.

GIFTS. The decedent’s predeceased spouse had made over $800,000 in payments to the spouse’s personal secretary. The decedent’s estate sought a refund of gift taxes paid on the transfers, arguing that the transfers were compensation rather than gifts. The court held that the payments were gifts because the spouse maintained a close personal relationship with the secretary, had made numerous gifts over the years and filed gift tax returns for the transfers. Estate of Powell v. Comm’r, 2001-2 U.S. Tax Cas. (CCH) ¶ 60,416 (W.D. Va. 2001).

SETTLEMENTS. The taxpayer was the spouse of a person who orally contracted with two owners of a business to manage their business for life. The couple was alleged to have agreed to execute wills which would have the business property pass to the taxpayer after the death of both of the business owners. After the death of the first owner, the second owner fired the taxpayer’s spouse and sold the business. The taxpayer sued the second owner for breach of contract and during that litigation the second owner died. The action was continued against the estate of the second owner. The estate settled with the taxpayer who sought a ruling that the settlement proceeds would not be included in gross income. The IRS characterized the taxpayer’s action against the estate as a breach of contract action but ruled that the result favorable to the taxpayer would have caused property to pass by inheritance to the taxpayer; therefore, the settlement proceeds were considered as inherited property and excluded from income. The ruling contains little discussion of the central issue of whether the settlement proceeds represented property which would have passed under a will. The ruling statement of facts was unclear whether a will ever existed or whether the will contained a bequest of the property involved. It is also not clear whether the taxpayer’s breach of contract action sought enforcement of a will bequest or merely alleged that the decedent failed to execute the will. It is also possible that the taxpayer’s action alleged that the sale of the business property was the breach and this breach prevented the will bequest from occurring at the death of the owner. It would seem that the ruling would be incorrect if (1) no will existed, (2) no bequest was included in the will, or (3) if the breach was alleged to have been the sale of the property because the source of the settlement proceeds would be only from the breach of contract damages and not from any bequest, making the damages includible in gross income. The ruling appears to focus on what would determine the measure of damages, the amount of property which would have passed under the contract-for will, and not the source of the cause of action, the breach of the contract. Ltr. Rul. 200137031, June 15, 2001.

TAX RATE. Commerce Clearing House has estimate that the gift tax annual exclusion amount for 2002 will increase to $11,000 due to adjustment for inflation. News-Federal, 2001 Tax Day, 09/19/2001, Item #6.

TRUSTS. The taxpayer was a trustee which incurred fees for its trust for investment strategy advice provided by private investment advisors and accounting, tax preparation, and management services. The court held that the fees were not deductible under I.R.C. § 67(e)(1) (allowing deductions less than or equal to two percent of adjusted gross income) because the fees “would not have been incurred if the property were not held in . . . trust.” The appellate court affirmed. Mellon Bank, N.A. v. United States, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,621 (Fed. Cir. 2001), aff’g, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,153 (Fed. Cls. 2000).

VALUATION. The decedent had won a state lottery and, at the decedent’s death was eligible for 17 more annual installment payments of the prize. Although the estate acknowledged that the remaining prize payments were included in the decedent’s estate, the estate argued that the installments should be valued under a fair market test. The court held that, because the installments were subject to anti-assignment restrictions under state law, the installments were not to be valued using the actuarial tables of I.R.C. § 7520. Estate of Shackleford v. United States, 2001-2 U.S. Tax Cas. (CCH) ¶ 60,417 (9th Cir. 2001), aff’g, 99-2 U.S. Tax Cas. (CCH) ¶ 60,356 (E.D. Cal. 1999).

The decedent’s estate included a 25 percent interest in a partnership. The estate had valued the interest using discounts for lack of marketability, lack of control, uncertain rights, and ownership of an undesirable mix of assets. Under Texas law and the partnership agreement, the decedent’s death dissolved the partnership and the estate’s interest in the partnership became an assignee’s interest. The IRS argued that the discounts were not applicable because the estate had the right to a 25 percent interest in the liquidated partnership assets. The court held that, under Texas law, the other partners had the right to continue the partnership and pay the estate the value of the decedent’s interest. The court held that the value of the decedent’s interest under those circumstances would be the fair market value, determined using discounts for lack of marketability, lack of control, uncertain rights, and ownership of an undesirable mix of assets. On remand, the District Court held that the fair market value of the decedent’s interest was entitled to a 20 percent discount for a minority interest, a 10 percent portfolio discount and a 35 percent discount for lack of marketability. Adams v. United States, 2001-2 U.S. Tax Cas. (CCH) ¶ 60,418 (N.D. Tex. 2001), on rem. from, 218 F.3d 383 (5th Cir. 2000), rev’g, 99-1 U.S. Tax Cas. (CCH) ¶ 60,340 (N.D. Tex. 1999).

VALUATION OF STOCK. The decedent owned 12,000 shares of stock in a bank corporation which had issued 100,000 total shares. The stock was not sold publicly but 1,100 shares were sold one month before the decedent’s death. The court used that sale as evidence of the fair market value of the stock because the sale was arm’s length and had no special circumstances. The court discounted the decedent’s stock by 10 percent for the large block of shares, acknowledging that the shares could be sold in smaller blocks over time. The heir had sold the stock and, based
upon the estate\’ valuation, calculated the capital gains tax on
the sale. Because the Tax Court had valued the stock higher,
the heir sought a refund of the capital gains tax from the sale
of the stock; however, the limitation period on refunds had
expired. The Tax Court allowed the heir to offset the
additional estate tax against the income tax refund under the
dolence of equitable recoupment. The appellate court
affirmed. Estate of Branson v. Comm\'r, 2001-2 U.S. Tax
Cas. (CCH) ¶ 50,622, aff\'g, T.C. Memo. 1999-231.

**FEDERAL INCOME TAXATION**

**BUSINESS EXPENSES.** The taxpayer had three
businesses as an accountant, a wedding minister and a notary
public. The taxpayer did not keep separate business records
for any of the businesses except for cancelled checks. The
court upheld all business deductions disallowed by the IRS
for lack of substantiation. Morin v. Comm\’r, T.C.

**CASUALTY LOSS.** The taxpayers owned a warehouse
which was destroyed by a fire in 1993. The taxpayers filed
an insurance claim which remained in dispute until 1995.
The taxpayer rebuilt the warehouse in 1995 and sought to
include the construction costs in the adjusted basis of the
original warehouse for purposes of calculating the casualty
loss. The court held that the amount of loss was limited to the
adjusted basis of the original warehouse on the date of the
casualty less any insurance recovery because the
construction created a new property. Because the insurance
recovery exceeded the taxpayers\’ basis in the old warehouse,
no casualty loss was allowed. Estate of Boyle v. Comm\’r,
T.C. Memo. 2001-235.

**COURT AWARDS AND SETTLEMENTS-ALM §
4.02[14].** The taxpayer agreed to a merger of the taxpayer\’s
company with another company with an exchange of stock.
The relations between the two parties soured and the
taxpayer eventually sued the other company for fraudulent
inducement to enter into a contract and interference with a
business relationship. The taxpayer received jury awards for
both claims plus prejudgment interest. The Tax Court
initially held that the jury awards for the claims and the
prejudgment interest were included in the taxpayer\’s gross
income but that decision was reversed. On remand, the Tax
Court again held that the taxpayer presented no evidence of
personal injury and no evidence that the jury award was
intended as compensation for personal injuries. Gregg v.
Comm\’r, T.C. Memo. 2001-245, on rem. from unpub. op.
(11th Cir. 2000), rev\'g, T.C. Memo. 1999-10.

**DEPRECIATION.** The taxpayer operated a farm and
manufactured meat and food products. The taxpayer
provided a wellness center for employees, had kitchens used
to test food products and operated distribution centers. The
taxpayer treated all of the assets as five year property under
asset class 57.0, Distributive Trades and Services. In a Chief
Counsel Advice letter, the IRS ruled that this was not correct
because the taxpayer was not in the food testing or food
distribution business and was not in the business of
providing employee wellness centers. The IRS ruled that the
taxpayer was in the farming and manufacturing businesses
and had assets in either asset class 01.1 Agriculture with a
class life of 10 years or class 20.4 Manufacture of Other
Food and Kindred Products with a class life of seven years.
The IRS ruled assets in the kitchens and distribution centers
were part of the manufacturing business and had a class life
of seven years. The wellness centers were associated either
with the farming business or manufacturing business
depending upon the primary use. CCA Ltr. Rul.

**DISASTER PAYMENTS.** On September 11, 2001, the
President determined that certain areas in New York were
eligible for assistance under the Disaster Relief and
Emergency Assistance Act, 42 U.S.C. § 5121, as a result of
fires and explosions on September 11, 2001. FEMA-1391-
DR. On August 27, 2001, the President determined that
certain areas in Ohio were eligible for assistance under the
Act as a result of severe storms and flooding on July 17-18,
2001. FEMA-1390-DR. On September 12, 2001, the
President determined that certain areas in Virginia were
eligible for assistance under the Act as a result of fire and
explosions on September 11, 2001. FEMA-3168-EM.

Accordingly, a taxpayer who sustained a loss attributable to
the disasters may deduct the loss on his or her 2000 federal
income tax return.

**DISCHARGE OF INDEBTEDNESS.** The taxpayer, a
partnership, owned a commercial building subject to a
mortgage and loan from a creditor. In 1993, the taxpayer and
creditor executed a “covenant not to sue” in exchange for
transfer of the title to the property to the creditor. The title to
the property was not transferred until 1994. The court held
that the discharge of indebtedness from the transfer occurred
in 1994 when the title to the property was transferred.

Lowry v. Comm\’r, T.C. Memo. 2001-238.

The taxpayer was a shareholder in a bank corporation
which had loaned money to a corporation owned in part by
the taxpayer\’s son. The son was a guarantor on the
corporation\’s loan. When the corporation\’s loan became
undersecured, the bank negotiated with the corporation and
the taxpayer for reduction of the loan and release of the son
as guarantor in exchange for the debtor\’s stock in the bank.
The IRS argued that the taxpayer realized gain on the
transfer of the stock in exchange for the loan reduction. The
court held that the taxpayer did not realize gain from the
transfer because only the corporation received the benefit of
the loan reduction. Friedland v. Comm\’r, T.C. Memo.
2001-236.

**EARNED INCOME TAX CREDIT.** The taxpayer
owned a condominium and three commercial properties
which were rented to third parties. The taxpayer did not
include the rental income in self-employment income and
argued that the taxpayer was not in the real estate rental
business. The court held that the rental income was not
qualified income for earned income tax credit purposes
because the income was not included in self-employment
income. Holbrook v. Comm\’r, T.C. Summary Op. 2001-
135.
IRA. The taxpayer had rolled over funds from employment pension funds to a personal IRA in 1992. The funds represented before and after tax income. In 1995, the taxpayer received a distribution from the IRA which was used for education and personal expenses. The court held that the entire distribution was subject to the early withdrawal penalty. 


INSTALLMENT REORTING. The taxpayer purchased a residence in 1993 and in 1995, sold a joint tenancy interest to a third party in exchange for a note requiring monthly payments for ten years and a balloon payment at the end of ten years. The taxpayer realized $145,000 of gain on the sale. The taxpayer filed a tax return by mailing the return on the extension due date in an envelope stamped by a private postage meter showing that date. The return did not reach the IRS until six days later. According to the U.S. Postal Service’s publications, the normal delivery time was three days. The return claimed the exclusion for sale of a residence, even though the taxpayer did not qualify for the exclusion because the taxpayer did not live in the residence for three years before the sale. The return also reported all of the gain from the sale. The taxpayer argued that the return did not contain an election out of the installment method because the return was not received by the extension due date. The IRS argued that the return was timely filed because it was mailed on the extension due date. The court held that, under Treas. Reg. § 301.7502-1(c)(1)(iii)(B), because the return was not delivered within the normal delivery time, the return could not be considered as timely filed; therefore, no valid election out of the installment method was made. 


INTEREST RATE. The IRS has announced that, for the period October 1, 2001 through December 31, 2001, the interest rate paid on tax overpayments is 7 percent (6 percent in the case of a corporate) and for underpayments at 7 percent. The interest rate for underpayments by large corporations is 9 percent. The overpayment rate for the portion of a corporate overpayment exceeding $10,000 is the federal 4.5 percent. Rev. Rul. 2001-47, I.R.B. 2001-39.

LIKE-KIND EXCHANGES. The taxpayer owned 98 percent of a partnership and the taxpayer’s son owned 2 percent of the partnership. The partnership owned real property contributed by the taxpayer and used by the partnership for its business. The son owned an S corporation which owned other similar property. The corporation and partnership exchanged the business properties which the IRS ruled were like-kind properties. The partnership moved its business to the new property but all of the parties began to liquidate all the properties. The partnership’s original property was sold, optioned or donated to a charity a little more than two years after the exchange. In a Chief Counsel Advice letter, the IRS ruled that the exchange occurred between related parties but, because the exchanged property was disposed of more than two years after the exchange, the recognition rule of I.R.C. § 1031(f)(1) did not apply to require recognition of the gain from the original exchange of properties. 


PARTNERSHIPS-ALM § 7.03.*

FAILURE TO FILE PENALTY. In a Chief Counsel Advice letter, the IRS has ruled that the IRS could change its administrative procedures to give notice to small partnerships that they may be entitled to abatement of the I.R.C. § 6031 penalty for failure to file a return. The notice form would contain the following questions:

1. Is the partnership a domestic partnership?
2. Does the partnership have 10 or fewer partners?
3. Are all partners natural persons (other than a nonresident alien) or an estate of a deceased partner?
4. Is each partner’s share of each partnership item the same as his share of every other item?
5. Have all the partners timely filed their income tax returns?
6. Have all the partners fully reported their share of the income, deductions, and credits of the partnership of their timely filed income tax returns?

If the partnership answers yes to all the questions and all partners sign the form, the IRS would abate the penalty. 


PENSION PLANS. The IRS has issued guidance relating to the effective dates for §§ 611(c), 613, and 636(a) of the Economic Growth and Tax Relief Reconciliation Act of 2001. Section 611(c) of EGTRRA increases the compensation limit of I.R.C. § 401(a)(17) and related sections. Section 613 of EGTRRA modifies the rules in I.R.C. § 416 regarding determination of top-heavy status. Notice 2001-56, I.R.B. 2001-38.

The IRS has issued sample plan amendments for the changes to the plan qualification requirements under I.R.C. § 401(a) that were made by the Economic Growth and Tax Relief Reconciliation Act of 2001. These sample amendments are designed to help plan sponsors and adopters of pre-approved plans to comply with the requirement to adopt good faith EGTRRA plan amendments on a timely basis. Notice 2001-57, I.R.B. 2001-38.

The taxpayer was a corporation which provided an ESOP for its employees. The taxpayer purchased all of the stock of another corporation in 1987. The stock purchased resulted in the two corporations being defined as affiliated corporations under I.R.C. § 410 such that all of the second corporation’s employees were considered the employees of the taxpayer. The total number of employees of both corporations was seven with only four employees covered by the taxpayer’s ESOP. Because the percentage of covered employees was less than 70 percent of the total employees, the court held that the taxpayer’s ESOP was no longer qualified. Beal Bros. Management Corp. v. Comm’r, T.C. Memo. 2001-234.

The taxpayer had provided an ESOP to employees as part of a federal program to financially rescue the company. Several years later as part of a collectively bargained employment contract, the taxpayer agreed to terminate the ESOP and redeem shares in the program for those employees who elected to redeem their shares. The taxpayer claimed a business deduction for the costs of redeeming those shares. The court held that the redemption costs had to
be capitalized. **Chrysler Corp. v. Comm’r, T.C. Memo. 2001-244.**

**REFUNDS.** The IRS has issued a clarification regarding when a refund or credit of an overassessed tax is allowed. Pursuant to the clarification, references in Rev. Rul. 78-127, 1978-1 C.B. 436, to Form 1166, Voucher and Schedule of Payments, and other processing forms are removed. The ruling is further modified to state that Treas. Reg. § 301.6407-1 delegates scheduling authority of an overassessment to a certifying officer and that the date the summary record of assessment is signed and the date on which the schedule of overassessments is signed are the dates of authorization for a credit or refund. **Rev. Rul. 2001-40, I.R.B. 2001-38, 276.**

The taxpayer attempted to file a claim for refunds for three tax years as a result of carryback losses. The taxpayer presented evidence that the return was placed in an envelope stamped by a private postage meter. There was no evidence presented that the IRS ever received the refund claim. The taxpayer argued that the timely mailing of the return was sufficient to consider the refund claim as timely filed. The court held that the “mailbox rule” did not apply because there was no evidence that the return was received by the IRS. **Cardinal Textile Sales, Inc. v. United States, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,630 (N.D. Ga. 2001).**

The taxpayer filed a claim for refund in 1997 for 1990, 1991, and 1992 based upon carryback of net operating losses from 1993. The court held that it had no jurisdiction over the claim because the claim for refund was not filed within three years after the due date for the 1993 return. **G of L Corp. v. United States, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,625 (D. Nev. 2001).**

**RETURNS.** The IRS and Financial Management Service have announced that businesses and individuals can now pay their taxes on the internet using the Electronic Federal Tax Payment System Online (EFTPS). Businesses and individuals can enroll for EFTPS-OnLine via the Internet, using a user-friendly web interface: http://www.eftps.gov. After enrollment, taxpayers will receive a confirmation kit by mail with instructions for obtaining an internet password. A unique Personal Identification Number will be mailed separately, to new EFTPS users, for added security. Businesses with over $200,000 in annual tax payments are required to use EFTPS. **IR-2001-77.**

The IRS has announced that the due date for all federal tax obligations falling between September 10, 2001, and September 24, 2001, is postponed to September 24, 2001 for taxpayers who, regardless of their location, continue to experience difficulties in meeting their filing and tax payment requirements due to events related to the September 11, 2001, terrorist attack on the United States. **Notice 2001-63, I.R.B. 2001-40.**

The IRS has also announced that it will suspend for six months enforcement activities such as levies, seizures and summonses for affected taxpayers. Although the IRS is not extending the deadline for employment or excise tax deposits, it will provide relief for businesses unable to make deposits because of the terrorist attacks. In addition, the IRS will waive penalties on tax deposits required to be made by such businesses between September 11, 2001 and October 31, 2001 if the deposits are made by November 15, 2001. **Notice 2001-61, I.R.B. 2001-40.**

The IRS has announced the list of designated private delivery services, effective September 1, 2001. **Notice 2001-62, I.R.B. 2001-40.**

**SAFE HARBOR INTEREST RATES**

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**TRUSTS.** The taxpayers operated a computer consulting business and transferred their residence to a trust which was the beneficiary of another trust to which the taxpayers transferred their consulting business. The taxpayers continued to supply all the services which generated the income for the business and continued to treat the assets as their own. The court held that the trusts were shams and the consulting business income was considered self-employment income to the taxpayers. **Caralan Trust v. Comm’r, T.C. Memo. 2001-241.**

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**SECURED TRANSACTIONS**

**LABORER’S LIEN.** The debtor hired two people to provide and drive semi-trucks to transport potatoes to a transporter and on to a cellar. Another person provided a dump truck to haul dirt from the transporter back to the farm. The dump truck was driven by whomever was available, including the person who provided the truck. The semi drivers also helped with the working of the transporter while waiting for a load to drive to the cellar, but those activities were provided without compensation. The three people filed farm labor liens under Idaho Code § 45-303 when it became clear that they were not going to be paid by the debtor. The creditors with security interests in the potato crop objected to the liens, arguing that the three people were not farm laborers under the statute because they did not provide labor on the farm. The court held that the two semi-truck providers/drivers were farm laborers because their operation of the trucks provided personal services essential to the production, harvest and storage of the potato crop. The trucks were held to be similar to the use of horses on a farm to accomplish the harvest tasks; thus, the liens for the drivers’ compensation and the use of the trucks was entitled...
to priority under the statute. However, the court held that the lien securing the rental of the dump truck was not entitled to priority under the statute because the mere rental of equipment was not labor. The court found that the services provided by the truck owner were voluntary and only incidental to the truck rental; therefore, there were no personal services provided with the dump truck. *In re Residential Ag, Inc.*, 264 B.R. 674 (Bankr. D. Idaho 2001).

**STATE TAXATION**

**VALUATION.** The plaintiff owned a one acre homestead which was valued at $8,000 for real property tax purposes, the valuation was based on six comparable sales. The plaintiff argued that the land should have been valued separately from the house and that the septic system and well were part of the house. The court held that the property was valued correctly as agricultural homestead because that was the property’s highest and best use. The court also held that the well and septic system were part of the land and the land value was appropriately adjusted for the age and condition of the well and septic system. The plaintiff failed to provide any other evidence to support the plaintiff’s claim that the property was worth only $300. The plaintiff provided summaries of 84 other properties but failed to provide adjustments for differences among the properties. *Weed v. County of Fillmore*, 630 N.W.2d 419 (Minn. 2001).

**IN THE NEWS**

**HERBICIDES.** An Oklahoma jury has awarded nine Oklahoma farmers $1,487,835 in damages for loss of crops from mislabeled herbicide. The defendant was a supplier and distributor of farm chemicals.

**PRICE FIXING.** Twenty-two states, Puerto Rico and the District of Columbia have joined in a suit against three European and three Japanese companies for price fixing vitamins used in animal feed, cereals and bread. See [http://www.vitaminlitigation.com](http://www.vitaminlitigation.com) or call 1-800-424-6662 for more information.

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FAMILY LIMITED PARTNERSHIP UPHELD ON APPEAL
— by Neil E. Harl

A decision by the Fifth Circuit Court of Appeal,1 on July 18, 2001, affirmed a decision of the United States District Court for the Western District of Texas2 which had upheld a family limited partnership formed two days before death to consolidate interests in a 23,000 acre family ranch.3 In that case, the decedent suffered from cancer but died from another malady.4

Facts in Church v. United States

In the facts of Church v. United States,5 the decedent, Elsie Church, died unexpectedly on October 24, 1993.6 The death occurred two days after Mrs. Church and her children signed a limited partnership agreement consolidating their interests in a ranch.7 Each partner contributed their individual interests in the ranch; in addition, Mrs. Church contributed approximately $1 million in securities inherited from her mother and her husband.8 At that time, the limited partners owned 57 percent of the ranch with another family, including Mrs. Church’s nephew, owning the remaining 43 percent.9

Mrs. Church owned 62 percent of the partnership and was to receive 99 percent of the taxable income from the securities and 62 percent of the income from ranch operations.9

As of October 24, 1993, the date of death, the corporate general partner had not been formed and the Certificate of Limited Partnership had not been filed with the State of Texas. Indeed, the corporate general partner was not formed until March of 1994 and the brokerage account in the name of Elsie Church was not changed to a partnership account until the same month.10 Her physician, who was treating Mrs. Church for cancer, testified that her death was unexpected and was unrelated to her bout with cancer.

The fair market value of the assets contributed to the limited partnership by Mrs. Church totaled slightly less than $1.5 million at her death.11 Of this figure, the value of the ranch accounted for $380,038 and the value of cash and securities contributed by Mrs. Church was $1,087,710.12

Controversy over the partnership

The estate’s valuation expert valued Mrs. Church’s limited partnership interest at $617,591.13 That figure was not challenged nor was any explanation provided in either court opinion14 of the methodology used in establishing the discounts to reach that value.

The district court found that the partnership was a valid limited partnership under state law as of the date of her death.15 The court rejected the argument by the government that Mrs. Church had an equitable interest in the securities at

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
death. The court indicated that Mrs. Church clearly expressed her intent to relinquish her beneficial interest in the assets when she signed the partnership agreement.\textsuperscript{16}

The government also argued that Mrs. Church had made a taxable gift in forming the partnership, represented by the difference between the value of the assets she contributed and the value of the partnership interest she received.\textsuperscript{17} The court rejected that argument, noting that the assignee interest that passed at her death was not comparable to the limited partnership interest she received in return for her contribution of assets and that the limited partnership did not increase the wealth of any partner.\textsuperscript{18} As the court noted, there was no donee for the purported gift.\textsuperscript{19}

The court held, as a matter of fact, that the partnership was not a sham inasmuch as it had business purposes.\textsuperscript{20} The court also found that the limited partnership "was not formed solely to reduce estate taxes."\textsuperscript{21}

The court observed that Mrs. Church did not have the unilateral right to amend or revoke the limited partnership agreement and that the partners had no express or implied agreement that Mrs. Church could continue to use or possess partnership property.\textsuperscript{22} The presence of such rights could have provided an additional argument for includibility of the full asset value in her estate.

**In conclusion**

With the taxpayer success in three recent Tax Court cases in addition to Church v. United States,\textsuperscript{23} IRS faces an uphill battle in pursuing its litigating position on family limited partnerships. In Estate of Strangi v. Commissioner,\textsuperscript{24} a family limited partnership was recognized for transfer tax purposes, with the court noting that a partnership is recognized if properly formed under state law regardless of business purpose even though set up two months before death. A similar outcome occurred in Knight v. Commissioner\textsuperscript{25} where a family limited partnership was recognized for federal gift tax purposes where all requirements of state law were recognized. In Estate of Jones II v. Commissioner,\textsuperscript{26} the transfer of a limited partnership interest by the donor of ranch interests to children was eligible for discounts for lack of control and lack of marketability (40 percent). Finally, in Estate of Hoffman v. Commissioner,\textsuperscript{27} the decedent’s 27.5 percent interest in a partnership was valued using a net asset value approach by applying a 47 percent discount for non-marketability and minority interest. In light of Congressional action to repeal the federal estate tax at the end of 2009\textsuperscript{28} (even though the repeal “sunset” a year later)\textsuperscript{29} it seems unlikely that IRS will pursue the limited partnership issue aggressively.

**FOOTNOTES**

1 Church v. United States, 2001-2 U.S. Tax Cas. (CCH) ¶ 60,415 (5th Cir. 2001).
2 Church v. United States, 2000-1 U.S. Tax Cas. (CCH) ¶ 60,369 (W.D. Tex. 2000).
4 See notes 1 and 2, supra.
5 2001-2 U.S. Tax Cas. (CCH) ¶ 60,415 (5th Cir. 2001, aff’g, 2000-1 U.S. Tax Cas. (CCH) ¶ 60,369 (W.D. Tex. 2000).
6 Id.
7 Church v. United States, 2000-1 U.S. Tax Cas. (CCH) ¶ 60,369 (W.D. Tex. 2000).
8 Id.
9 Id.
10 Id.
11 Id.
12 Id.
13 Id.
14 See notes 1 and 2 supra.
15 Id.
16 Id.
17 Id.
18 Id.
19 Id.
20 Id.
21 Id.
22 Id.
23 See notes 1 and 2 supra.
29 Id., Sec. 901.


**CASES, REGULATIONS AND STATUTES**  
by Robert P. Achenbach, Jr.

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**BANKRUPTCY**

**FEDERAL TAX-ALM § 13.03[7].**  
**DISCHARGE.** The U.S. Supreme Court has granted certiorari in the following case. The debtors filed their 1992 tax return on October 15, 1993 without paying the taxes. The debtors made a few small payments on the taxes but then filed for Chapter 13 in May 1996. The 1992 taxes were included in the case and the case was voluntarily dismissed in March 1997 on the same day that the debtors filed for a new Chapter 7 case. The debtors argued that the 1992 taxes were dischargeable because they were filed more than three years before the Chapter 7 bankruptcy case. The court held that the three year period in Section 523(a)(1) was tolled during the Chapter 13 case; therefore, the taxes were nondischargeable.  
*In re Young*, 233 F.3d 56 (1st Cir. 2000).

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**FEDERAL ESTATE AND GIFT TAX**

**CHARITABLE DEDUCTION.** The taxpayer established a ten-year charitable lead annuity trust. The taxpayer served on the board of directors of the charitable beneficiary of the trust. The charitable organization bylaws placed the annuity income from the taxpayer’s trust in a separate account and prohibited the taxpayer from voting on any aspect of the use of those funds by the charity. The IRS ruled that the transfer of stock to the trust was a completed gift and that the taxpayer had not retained any power over the annuity income. The IRS also ruled that the trust corpus would not be included in the taxpayer’s estate.  

**TRANSFERS WITH RETAINED INTERESTS.** The decedent transferred a residence to a trust for the benefit of the decedent’s grandchildren. The taxpayer’s daughter was named as trustee and had the power to distribute income to the beneficiaries. The beneficiaries also had the power to withdraw a maximum of any amounts contributed to the trust in a year or $10,000. The trust also provided that, at the death of the decedent, the residence was to be provided rent free to the decedent’s spouse. The decedent continued to live in the residence without paying rent to the trust and paid all expenses associated with the residence. Three of the beneficiaries were minors. The court held that there was an implied agreement between the parties to the trust to allow the decedent to continue to use the residence until death; therefore, the decedent retained an interest in the residence and the fair market value of the residence was included in the decedent’s estate.  

**VALUATION.** The taxpayer contributed property to a family limited partnership in exchange for a 5 percent preferred general partnership interest and 93 percent limited partnership interest. The preferred general interest was entitled to a minimum guaranteed distribution plus 5 percent of partnership net income. The taxpayer also had the right to withdraw from the partnership with 90 days’ notice and the right to terminate the partnership. The taxpayer’s children owned the remaining 2 percent general partnership interests. The IRS ruled that the taxpayer’s preferred general interest was an applicable retained interest and the withdrawal and termination rights were extraordinary payment rights. The IRS also ruled that the value of the applicable retained interest, the preferred general interest, had to be determined under I.R.C. § 2701 and the value was the lowest value of the guaranteed payment right, the withdrawal right or the termination right. The value of the gift to the children was to be determined using the subtraction method, subtracting the...
value of the preferred general partnership interest from the value of the property contributed to the partnership. Ltr., Rul. 200138028, June 21, 2001.

The decedent’s estate include an interest in a family trust which owned timberland. The decedent’s predeceased spouse had also owned an interest in the trust. The predeceased spouse’s estate applied a 25 percent discount for a fractional interest and the decedent’s estate discounted the decedent’s interest by a 60 percent fractional interest. The estate and IRS agreed as to the fair market value of the timberland held by the trust but disagreed as to the amount of discount to be applied to the decedent’s interest in the trust. The court noted that the trust management was under the control of one family member who had not managed the investment well and that the trust was formed in order to keep the land in the family. The court also noted that the decedent’s and predeceased spouse’s estate increased their claimed discount to 90 percent at trial. The court held that a 60 percent discount would be applied for the fractional interest, based on the opinions of the estate’s experts and the history of discounts used in the area. Estate of Baird v. Comm’r, T.C. Memo. 2001-258.

The decedent formed a family limited partnership and contributed stock in exchange for a 98 percent limited partnership interest and a 1 percent general partnership interest. The other 1 percent was received by the decedent child. The decedent then transferred a 45 percent limited partnership interest to the child, a 15 percent interest to the child’s spouse and a 38 percent interest to a trust. The main issue was the discount which would be applied to the value of the interests transferred. The court held that an aggregate 40 percent discount for lack of marketability and minority interest would be applied to each of the transferred interests. Estate of Dailey v. Comm’r, T.C. Memo. 2001-263.

FEDERAL INCOME TAXATION

BUSINESS EXPENSES. The taxpayer was an attorney who claimed business deductions for travel, meals and entertainment, and interest. The deductions were substantiated by a business calendar which identified the names of the clients or employees, detailed memoranda about the purpose of the meeting, and receipts and credit card statements. The court held that the taxpayer had adequately substantiated the travel and meals and entertainment expenses. The taxpayer claimed the deduction in 1995 even though the expense was incurred and paid for with the credit card in 1994. The taxpayer argued that the expense could be claimed in the tax year in which the credit card bill was paid, 1995, instead of the year in which the credit card debt was incurred, 1994, for the expense. The court held that the expense was deductible in the tax year the credit card debt for the business expense was incurred. The interest expense was paid on the credit card accounts which the taxpayer used to pay business expenses. The taxpayer argued that the interest was incurred as part of the business operation. The court held that the interest expense was an allowable business deduction to the extent the taxpayer demonstrated that the interest was actually paid. Burton v. Comm’r, T.C. Summary Op. 2001-155.

The decedent’s estate included stock in a personal holding company. The court held that the value of the stock was to be determined based on the fair market value of its assets, which consisted mainly of timberland, after taking into account the present-value, corporate-level capital gains tax consequences, but without regard to other discounts or a beneficiary settlement agreement. A discount was allowed for potential, corporate-level capital gains because the company had a valid I.R.C. § 631 election that treated the cutting of timber each year as though it were a sale or exchange of the timber. Moreover, the court found that the most likely buyer of the stock would be a timber company or pension fund that would take into account the present-value tax consequences of built-in capital gains when arriving at the amount to pay for the company's stock. The court held that the estate was entitled to a 3 percent lack-of-marketability discount because 3 percent of the assets of the company lacked marketability. However, a nuisance discount due to the existence of a minority shareholder was not allowed in light of the desirable assets of the corporation. The appellate court reversed on the issue of the proper discount for the capital gains liability. The appellate court held that the Tax Court had followed inconsistent assumptions that, on the one hand, a buyer would continue the long-term logging of the land and that, on the other hand, the low rate of return from logging would be too low for most investors. Est. of Jameson v. Comm’r, 2001-2 U.S. Tax Cas. (CCH) ¶ 60,420 (5th Cir. 2001), rev’d and rem’d, T.C. Memo. 1999-43.

C CORPORATIONS-ALM § 7.02[3]."

COMPENSATION. The taxpayers, husband and wife, were the sole shareholders and officers of a corporation which operated a concrete foundation business. The court held that the compensation paid to the taxpayers was unreasonable based on (1) compensation paid by similar businesses in the area and (2) the amount an independent investor in the corporation would consider reasonable in comparison to the return on the investment. B & D Foundations, Inc. v. Comm’r, T.C. Memo. 2001-262.

DISTRIBUTIONS. The IRS has adopted as final regulations which apply the rules of I.R.C. § 357(d), involving the treatment of liabilities assumed by a shareholder, to distributions under I.R.C. § 301. The proposed regulations provide that the amount of a distribution under Section 301 will be reduced by the amount of any liability that is treated as assumed by the distributee within the meaning of Section 357(d)(1) and (2). 66 Fed. Reg. 49279 (Sept. 27, 2001).

MERGER. The IRS had assessed taxes against a corporation and the assessment was upheld upon appeal to the Tax Court. The taxpayer corporation merged with that
corporation and under the merger agreement, the taxpayer agreed to assume all liabilities of the corporation. The IRS then assessed the taxpayer for the taxes owed by the prior corporation. The taxpayer argued that its liability for the taxes was limited to the value of the assets acquired from the former corporation and that it was the responsibility of the IRS to prove the value of the assets. The court held that the taxpayer had agreed to assume all of the former corporation’s liabilities but did not rule on the issue of whether the liability was limited to the value of the former corporation’s assets because the taxpayer presented no evidence as to the value of the former corporation’s assets.

**Eddie Cordes, Inc. v. Comm’r, T.C. Memo. 2001-265.**

**SALE OF ASSETS.** The taxpayer was the sole owner of a corporation which operated a beer distributorship. The taxpayer sold the company to unrelated parties and the sale agreement contained a covenant not to compete and a consulting agreement under which the taxpayer was hired as a consultant for five years. No allocation of the sales proceeds was made for intangible assets such as good will and going concern value. The IRS argued that a portion of the amounts allocated to the covenant not to compete and the consulting agreement was actually properly allocated to the intangible assets. The court noted that much of the taxpayer’s business was dependent upon the taxpayer’s personal relationship with retailers and the taxpayer’s personal knowledge of the area. The court also noted that the company buyers were unfamiliar with the beer distribution business in general and in the specific region supplied by the company in particular. The court assigned a portion of the sales proceeds to the covenant not to compete and the consulting agreement based on the importance of the agreements to the success of the buyers’ continuation of the company’s business. The court held that the remainder of the amount allocated under the sale contract to the covenant not to compete and the consulting agreement had to be allocated to the intangible assets. **Bemidji Distributing Co., Inc. v. Comm’r, T.C. Memo. 2001-260.**

**COORDINATES.** The taxpayer was a cooperative formed under a state cooperative limited liability statute which did not classify cooperative LLCs as corporations. The IRS ruled that the taxpayer was an eligible entity under Treas. Reg. § 301.7701-3 and not a per se corporation under Treas. Reg. § 301.7701-2(b)(1). **Ltr. Rul. 200139020, June 29, 2001.**

**COURT AWARDS AND SETTLEMENTS-ALM § 4.02[14].** The taxpayer’s employment as a regional manager of retail stores was terminated and the taxpayer brought suit against the employer for breach of contract, breach of the covenant of good faith and fair dealing, age discrimination under state law, fraud and deceit, and specific performance. The trial jury awarded damages to the taxpayer under the claim for breach of the covenant of good faith and fair dealing. The taxpayer argued that the award was excluded from gross income because one of the claims involved a tort or tort-like issue. The court held that the judgment was included in the taxpayer’s gross income because the award was based entirely on the contract cause of action and was not based on any tort or tort-like claim involving personal injury. The taxpayer had hired attorneys for the lawsuit under a contingency fee arrangement and the judgment award check was made out jointly to the taxpayer and the attorneys. The court held that the attorney’s fees were not excluded from the taxpayer’s income but could only be claimed as a miscellaneous deduction. The court followed **Benci-Woodward v. Comm’r, 219 F.3d 941 (9th Cir. 2000), affg, T.C. Memo. 1998-395** decided in the circuit to which this case is appealable. **Freeman v. Comm’r, T.C. Memo. 2001-254.**

The taxpayer was forced to resign employment by the taxpayer’s employer. The taxpayer joined a class action suit against the employer which alleged age discrimination and other torts. The taxpayer signed an agreement to pay the class attorneys one-third of any recovery. A settlement was reached and the plaintiffs in the action allocated the proceeds first to litigation and administration costs. One-third of the remainder was allocated to the attorneys’ fees, one-third to compensation for lost wages, and one-third for the tort injuries. The employer paid one-third of the settlement directly to the attorneys and the remainder to the class and agreed to withhold income taxes from the amount allocated to compensation for lost wages. The court held that the amount paid as attorneys’ fees by the employer was included in the taxpayer’s income because the liability for the fees was the responsibility of the taxpayer and not the employer. **Sinyard v. Comm’r, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,645 (9th Cir. 2001), affg, T.C. Memo. 1998-364.**

The taxpayer joined a class action suit against the taxpayer’s former employer under the FSLA for unpaid overtime compensation. A settlement was reached and was based on the number of hours worked by each participant in the suit. The taxpayer excluded from income the taxpayer’s share of the settlement, arguing that the settlement was actually based upon a claim for infliction of emotional distress. The court noted that no claim was included in the lawsuit or the settlement allocation among the plaintiffs. The court held that the proceeds of a suit under the FSLA were included in income because the FSLA action was not a tort or tort-like action for personal injuries. In addition, the court held that no portion of the settlement could be allocated to a claim for infliction of emotional distress because that claim was not included in the lawsuit, the settlement or the calculation of the taxpayer’s share of the settlement. **Ramey v. Comm’r, T.C. Summary Op. 2001-156.**

The taxpayer purchased an automobile dealership and eventually filed suit against the manufacturer’s distributor for breach of contract, violation of state and federal antitrust and racketeering laws, fraud, and injunctive relief. The parties reached a settlement which did not allocate any of the proceeds to any personal injury claim. The court held that the settlement proceeds were included in the taxpayer’s income because the law suit did not allege any personal injuries and the settlement did not allocate any of the proceeds to compensation for personal injuries. **In re Jones,**
DEPRECIATION. The taxpayers were partnerships which claimed depreciation for natural gas pipelines owned and operated by the partnerships. The partnerships' operations did not involve any production of the natural gas. The court held that under Rev. Proc. 87-56, 1987-2 C.B. 674, pipeline transportation was a separate business and the assets were properly classified under Class 46.0 as 15-year property for depreciation purposes. Saginaw Bay Pipeline Co. v. United States, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,642 (E.D. Mich. 2001).

DISASTER LOSSES. The IRS is reminding taxpayers who have suffered property losses due to the September 11, 2001 terrorist attacks that they may get a quick tax refund by claiming such losses on amended returns for tax year 2000. Affected taxpayers include individuals and businesses in presidentially-declared disaster areas. By amending tax year 2000 returns, taxpayers may receive refunds in a few weeks rather than after the filing of a 2001 return. Taxpayers that were granted extensions to file tax year 2000 returns may include disaster losses on such returns. IR-2001-87. In addition, the IRS reminded corporate taxpayers that they may claim a quick refund of estimated tax overpayments before they even file their tax return. This could help fiscal year filers whose expected profits were reduced or eliminated by the September 11 terrorist attacks or by other conditions. The proper form is Form 4466, “Corporation Application for Quick Refund of Overpayment of Estimated Tax.” IR-2001-90.

DISCHARGE OF INDEBTEDNESS. The taxpayer was employed as a real estate agent in an agency company. The taxpayer had financial difficulties and the employer agreed to purchase the taxpayer’s house and rent it back to the taxpayer. The taxpayer failed to make all rent payments. The taxpayer made a sale of real estate and the employer withheld a portion of the commission due to the taxpayer because the taxpayer disputed the amount owed. The court found that the amount was not in dispute because the taxpayer disputed the amount owed for the rent. The taxpayer argued that the amount was not in dispute because the taxpayer did not pursue the matter. The court held that the entire commission was income to the taxpayer. Velasco v. Comm’r, T.C. Memo. 2001-252.

EMPLOYEE EXPENSES. The IRS has issued revenue procedures updating Rev. Proc. 2000-39, I.R.B. 2000-41, 340, which provide rules under which the amount of ordinary and necessary business expenses of an employee for lodging, meals, and incidental expenses or for meals and incidental expenses incurred while traveling away from home will be deemed substantiated under Temp. Treas. Reg. § 1.274-5T when a payor (the employer, its agent, or a third party) provides a per diem allowance under a reimbursement or other expense allowance arrangement to pay for such expenses. This revenue procedure also provides an optional method for employees and self-employed individuals to use in computing the deductible costs of business meal and incidental expenses paid or incurred while traveling away from home. Use of a method described in this revenue procedure is not mandatory and a taxpayer may use actual allowable expenses if the taxpayer maintains adequate records or other sufficient evidence for proper substantiation. This revenue procedure does not provide rules under which the amount of an employee’s lodging expenses will be deemed substantiated when a payor provides an allowance to pay for those expenses but not meals and incidental expenses. Rev. Proc. 2001-47, I.R.B. 2001-__.

HOBBY LOSSES. The taxpayer was an attorney who owned an apple and timber farm. The taxpayer planted oak and walnut trees on the timber land and expected the trees to be suitable for sale in 40 years. The court held that the farm was not operated with an intent to make a profit because (1) the taxpayer did not have a business plan for making a profit and did not keep complete records of the farm activities, (2) the taxpayer did not have any previous farming experience and did not consult experts on how to make the activity profitable, (3) the taxpayer spent a minimal amount of time on the activity, (4) the activity never produced a profit, (5) the taxpayer offset the losses against substantial income from other activities, and (6) the taxpayer used the activity primarily for recreational purposes. The court acknowledged that the oak and walnut trees would eventually have much value and potential for profit, but the court held that the more waiting for trees to grow was not enough to make the activity a business. Burton v. Comm’r, T.C. Summary Op. 2001-155.

The taxpayer was an attorney and accountant and owned a 100 acre farm which the taxpayer inherited from parents. The taxpayer allowed a brother-in-law to use a portion of the land for growing hay and pasture rent free but the brother-in-law provided some maintenance of the farm. The taxpayer used the farm timberland for growing oak and walnut trees which would produce marketable wood in 30-50 years and marketable nuts in five years. The court held that the farm was not operated with the intent to make a profit because (1) the taxpayer did not have a business plan to make the farm profitable and did not keep full and accurate records, (2) the taxpayer did not have the expertise to make the farm profitable and did not seek the advice of experts, (3) the taxpayer expended significant amounts of time on the farm but did not provide evidence that this time was spent making the farm profitable, (4) although the farm appreciated in value over the period it was held by the taxpayer, the average appreciation each year did not exceed the annual losses, (5) there was no evidence that the taxpayer had contributed to the success of the farm when it was held by the parents, and (6) the farm had only losses and no source of income for three years. The other factors of Treas. Reg. § 1.183-2(b) were found to be neutral on this issue. Mitchell v. Comm’r, T.C. Memo. 2001-269.

The taxpayer was a medical doctor and the taxpayer and spouse started an activity which purchased, trained, showed and sold jumper horses. The activity was started primarily because the taxpayer’s children were interested in riding
jumper horses. The horses were maintained at third party farms and operated by employees. The activity was terminated when the child no longer participated in riding the horses. The court held that the activity was not engaged in with the intent to make a profit because (1) the taxpayers did not have a business plan for making the activity profitable; (2) the taxpayers did not have any expertise in running a profitable horse business and did not obtain the advice of experts on making the activity profitable; (3) the taxpayer failed to provide evidence of a significant amount of time spent at the activity; (4) the activity only produced losses; (5) the taxpayers had significant income from their medical practice which was partially offset by the losses; (6) the taxpayers and their children received significant amounts of person pleasure from the activity; and (7) the taxpayers carried on the activity primarily to provide riding horses for their children. The taxpayers were not assessed an accuracy-related penalty because the taxpayers reasonably relied on the advice of professionals in filing their tax returns. Prieto v. Comm’r, T.C. Memo. 2001-266.

IRA. The taxpayer was employed during 1997 for a month and a half with an employer who provided an employee pension plan. The taxpayer contributed $131 to the pension plan before terminating employment and accepting employment at two other companies which did not offer pension plans. The taxpayer opened an IRA during 1997, contributed $2000 to the account and claimed a $2000 IRA deduction on the 1997 return. The taxpayer argued that the IRA deduction was allowed because the taxpayer’s interest in the pension plan never vested under the rules of the plan. The court held that, under Treas. Reg. §1.219-2(b), the taxpayer was an active participant in a defined benefit plan sometime in 1997; therefore, under I.R.C. § 219(g)(1), the taxpayer was not eligible for an IRA deduction in 1997. Held v. Comm’r, T.C. Summary Op. 2001-149.

The taxpayer was employed during 1997 for two weeks with an employer who provided an employee pension plan. The taxpayer contributed to the pension plan before terminating employment. The taxpayer opened an IRA during 1997, contributed $2000 to the account and claimed a $2000 IRA deduction on the 1997 return. The taxpayer argued that the IRA deduction was allowed because the taxpayer’s interest in the pension plan never vested under the rules of the plan. The court held that, under Treas. Reg. §1.219-2(b), the taxpayer was an active participant in a defined benefit plan sometime in 1997; therefore, under I.R.C. § 219(g)(1), the taxpayer was not eligible for an IRA deduction in 1997. Naemi v. Comm’r, T.C. Summary Op. 2001-158.

MEDICAL SAVINGS ACCOUNT. The IRS has announced that the Archer Medical Savings Account (MSA) pilot project will not be cut off in 2001 because the number of individuals who have established Archer MSAs on or before April 15, 2001, has not exceeded 750,000. The applicable number of MSA returns projected to be filed for 2001 is 76,035. Ann. 2001-99, I.R.B. 2001-42.

PARTNERSHIPS-ALM § 7.03.*

PARTNER’S DISTRIBUTIVE SHARE. In 1993, the taxpayer owned a 5 percent interest in a partnership. In 1993, the partnership exchanged some real estate for other real estate and recognized gain on the transaction. The partnership return for 1993 reported that the taxpayer’s share of the gain was $61,983. The taxpayer failed to report the share of partnership gain on the taxpayer’s income tax return because no actual distribution of the gain was made to the partners. The court held that the taxpayer had to report the taxpayer’s share of the gain as income, whether distributed or not. Chama v. Comm’r, T.C. Memo. 2001-253.

PENSION PLANS. For plans beginning in September 2001, the weighted average is 5.77 percent with the permissible range of 5.20 to 6.06 percent (90 to 106 percent permissible range) and 5.20 to 6.35 percent (90 to 110 percent permissible range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). Notice 2001-58, I.R.B. 2001-39, 299.

SOCIAL SECURITY BENEFITS. The taxpayer lived in Washington D.C. during 1997 while receiving medical treatment while the taxpayer’s spouse lived in California, the couples’ primary residence. The couple did not file a joint return for 1997. The court held that the taxpayer lived apart for the spouse for 1997 for purposes of I.R.C. § 86(c). The taxpayer incurred legal expenses in obtaining the social security medical benefits and some of the benefits were paid directly to the lawyers. The court held that the amounts paid to the lawyers was considered part of the benefits received by the taxpayer. Reese v. Comm’r, T.C. Summary Op. 2001-153.

The taxpayers, husband and wife, received social security benefits in a tax year in which they had adjusted gross income sufficiently high to include 85 percent of the social security benefits in gross income under I.R.C. § 86. The taxpayer had excluded the social security benefits from income on the basis of statements made to them by an IRS employee. The court held that the IRS was not bound by the statements of the employee as to interpretations of law; therefore, the social security benefits were included in gross income. Clayborn v. Comm’r, T.C. Summary Op. 2001-152.

The taxpayer received a lump sum payment of social security disability payments in 1997 for benefits which accrued in 1995 and 1996. The taxpayer excluded the payment from income, arguing that the payment was a disability payment. The court held that social security disability payments are included in income under I.R.C. § 86(d)(1). A portion of the payment was paid directly to the taxpayer’s lawyer. The court held that the payment to the lawyer was included in the taxpayer’s income and was eligible for the miscellaneous deduction as an expense incurred for the production or collection of income. Dela Cruz v. Comm’r, T.C. Summary Op. 2001-154.

The taxpayers had invested in a jojoba partnership which was audited and denied research and development expense deductions. The taxpayers were then denied a passthrough deduction for their share of those expenses. This case involved assessment of the I.R.C. § 6653(a)(1) 5 percent addition to tax for underpayment of tax for negligence. The court held that the taxpayers had unreasonably relied on the partnership promoter for information about the tax benefits of the partnership. The court noted that the taxpayers were not inexperienced investors and should have seen the need to seek expert advice about the investment. Davis v. Comm’r, T.C. Summary Op. 2001-151.

TRUSTS. The taxpayers, husband and wife, transferred their business assets and residence to two trusts. The trusts were held to be shams because the taxpayers carried on the businesses and used the residence as before the trusts were formed and exercised control over the trusts. Snyder v. Comm’r, T.C. Memo. 2001-255.

The taxpayers, husband and wife, transferred their business assets to seven trusts. Payments for services rendered by the taxpayers in these businesses, rental income, and other funds were deposited in the trusts’ bank accounts which the taxpayers retained control over for personal use. The income was reported on the trusts’ tax returns but were not included in the taxpayers’ income tax returns. The court held that the trusts were shams and ineffective assignments of income earned personally by the taxpayers. The court also held that the case was brought by the taxpayers primarily for delay and was based on frivolous arguments; therefore, the taxpayers were assessed $25,000 in I.R.C. § 6673(a)(1) penalties. Combs v. Comm’r, T.C. Memo. 2001-264.

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RECAPTURE UNDER FOBD
— by Neil E. Harl*

The beleaguered family-owned business deduction,1 which is slated for repeal after 2003,2 continues to pose problems of a practical nature.

Calculating recapture tax

If a recapture event occurs, within 10 years after the decedent’s death and before the qualified heir’s death, recapture tax is levied.3 The amount of the recapture tax is based on the value of all qualified family-owned business interests, at least those listed for purposes of the 50 percent test, not the amount for which the election was filed.4 The “adjusted tax difference” attributable to a qualified family-owned business interest is the amount bearing the same ratio to the adjusted tax difference with respect to the estate as the value of the interest bears to the value of all qualified family-owned business interests.5 The term “qualified family-owned business interests” is defined as interests which are—(1) included in determining the value of the gross estate6 and are acquired by a qualified heir.7

Therefore, if some assets are included in the qualified family-owned business interest for purposes of meeting the 50 percent test,8 but are not specifically elected for the deduction, disposition of the non-elected assets would appear to trigger recapture consequences nonetheless.

While regulations have not yet been issued for the family-owned business deduction provision, no rulings have been issued and no cases have been litigated to courts of record, the recapture form, Form 706-D, is consistent with this conclusion. Line 2 of Form 706-D requires the “total reported value of qualified family-owned business interests (from line 6, Schedule T, of the decedent’s estate tax return)” to be compared with the “qualified heir’s share of the total qualified family-owned business interests” in line 1. Line 6 of Schedule T to Form 706 requires the total reported value of all qualified family-owned business interests “reported on this return.” The net value of qualified family-owned business interests elected for the deduction is listed in line 15 of Schedule T, after the 50 percent test has been met. The recapture calculations make no reference to the line 15 amount which represents the amount specifically subjected to the FOBD election.

Interest on recapture tax

The FOBD statute9 imposes interest in the event of recapture from the time the “estate tax liability was due under this chapter and ending on the date such additional estate tax is due.”10 That suggests that the time for calculating interest begins nine months after death (when the estate tax liability “was due”) and ends, presumably, six months after the recapture event.11 For a recapture event late in the recapture period, that could mean a substantial amount of interest. It is doubtful that Congress intended such a punitive result.

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For special use valuation, which was the pattern of much of the statutory content of the family-owned business deduction, the statute specifies that the "additional tax" imposed is due and payable six months after "the date of the disposition or cessation." A revenue ruling issued in 1981 specifies, in the case of special use valuation, that interest on the additional federal estate tax due commences six months after the disposition and ends on the date the additional estate tax is paid. Unfortunately, Congress in drafting the family-owned business deduction statute undertook to state the interest rules in a more definitive manner and, in the process, created a bizarre result. Amending legislation will be needed to rectify the apparent error. Unfortunately, with FOBD slated for repeal, the chances for an amendment appear to be slim.

**Disposal of property in recapture period**

Under the family-owned business deduction, if a qualified heir disposes of a portion of a qualified family-owned business interest other than to a member of the qualified heir’s family or through a qualified conservation contribution, recapture occurs. Obviously, that means that any disposition of farm-produced commodities or any sale of farm equipment or breeding stock, for example, would lead to recapture if the transfer was to persons other than members of the qualified heir’s family.

When that was called to the attention of the tax-writing committees, language was added to the conference committee report as follows—

“The conferees clarify that a sale or disposition, in the ordinary course of business, of assets such as inventory or a piece of equipment used in the business (e.g., the sale of crops or a tractor) would not result in recapture of the benefits of the qualified family-owned business exclusion.”

With no statutory provision, however, a question is raised whether language in the conference committee report alone is a sufficient basis to sell assets in the course of business without recapture.

Legislation has been introduced to specify that the sale or exchange of property produced through the qualified use of qualified real property "would not be subject to recapture."

**In conclusion**

For the family-owned business deduction to be minimally workable, amending legislation is needed. Unfortunately, the chances for such amending legislation are dim.

**FOOTNOTES**


14. See note 2 supra.

15. I.R.C. § 2057.


18. The Joint Committee on Taxation apparently believed the conference committee report language was sufficient. See Letter from Kenneth Kies, Chief of Staff, Joint Committee on Taxation, to Sen. Charles Grassley, dated November 3, 1997 (response to question 1).

CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-ALM § 13.03.*

EXEMPTIONS.

FEDERAL CHILD TAX CREDIT. The debtor claimed an exemption, as a public assistance benefit, for the portion of a federal income tax refund which resulted from the child tax credit. The court held that the federal child tax credit was not public assistance because the credit was not available only for low income taxpayers. In re Seward, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,668 (Bankr. E.D. Ky. 2001).

FEDERAL TAX-ALM § 13.03[7].*

PREFERENTIAL TRANSFERS. The debtor was delinquent in payment of child support and had requested a refund for 1999 taxes. The IRS approved the refund but sent the refund to the county child support enforcement agency in partial payment of the debtor’s delinquent obligation. The debtor filed for Chapter 7 within 90 days after the transfer and the trustee sought recovery of the transfer as a preferential transfer. The trustee argued that the transfer was avoidable under Section 547(c)(7)(A) because the child support debt was assigned to the county agency. The court held that the debt was not assigned to the agency in that the agency acted only as a trustee for the custodial parent. In re Sanks, 265 B.R. 566 (Bankr. N.D. Ohio 2001).

EMPLOYER LIABILITY

INDEPENDENT CONTRACTOR. The plaintiff was a hunter who was injured while hunting on land which had been used to dump diatomaceous earth and fruit pomace (fruit processing waste). The plaintiff fell through an earthen covering and was burned because the wastes had started burning from spontaneous combustion. The plaintiff sued the fruit processor who had hired an independent contractor, the owner of the farm, to dispose of the wastes. The evidence indicated that the defendant had been notified that the farmer had been improperly disposing of the wastes by dumping them together in a pit on the farm. The evidence also indicated that the pit had started burning and had produced smoke and odors which were the source of complaints by neighbors to the defendant. The dumping was also not licensed. The defendant sought dismissal of the case, arguing that it was not liable for the injury because the improper disposal was the act of an independent contractor. The court held that the plaintiff had pled and shown sufficient facts that, if proved at trial, would support enforcing liability against the defendant for the acts of the independent contractor. The court also held that the same facts, if proved at trial would support a violation of the Hazardous Waste Management Act, Wash. Code Ch. 70.1.05, which would extend liability to the defendant for the acts of the independent contractor. Hickle v. Whitney Farms, Inc., 29 P.3d 50 (Wash. Ct. App. 2001).

FEDERAL AGRICULTURAL PROGRAMS

CONSERVATION. The CCC has issued a notice of financial assistance to eligible producers to promote water conservation in the Klamath Basin as provided for by the Supplemental Appropriations Act, 2001, Pub. L. 107-20. The notice sets out the method by which the payment will be distributed on behalf of eligible producers to eligible owners and operators who did not receive certain expected deliveries of irrigation water within the Klamath Basin during the past crop year, and who agree to promote water conservation methods in future agricultural activities. 66 Fed. Reg. 51637 (Oct. 10, 2001).

MILK MARKETING ORDERS. The plaintiffs were dairy farmers who claimed that they were adversely affected by federal milk marketing orders in violation of the Wisconsin antitrust law because milk processors were able to pay less for milk by manipulating data used to establish minimum milk prices. The court dismissed the action, holding that the filed rate doctrine barred an action for damages based on the marketing orders. The filed rate doctrine was created by the U.S. Supreme Court in Keogh v. Chicago & N.W. Ry. Co., 260 U.S. 156 (1922), and provides that rates established by administrative commissions cannot be reviewed by courts except as to whether the adoption process was flawed. In this case, there was no allegation that the rate making process was flawed. Servais v. Kraft Foods, Inc., 631 N.W.2d 629 (Wis. Ct. App. 2001).

WEEDS. The APHIS has issued proposed regulations which revise the regulations regarding the movement of plant pests by adding risk-based criteria for determining the plant pest status of organisms, establishing a notification process that could be used as an alternative to the current permitting system, and providing for the environmental release of organisms for the biological control of weeds. The proposed changes clarify the factors that would be considered when assessing the plant pest risks associated with certain organisms and facilitate the importation and interstate movement of regulated organisms. 66 Fed. Reg. 51340 (Oct. 9, 2001).
FEDERAL ESTATE AND GIFT TAX

INSTALLMENT PAYMENT OF ESTATE TAX. The decedent had owned 470 shares of a closely-held corporation. Under a shareholder agreement, the corporation was required to repurchase the shares from the decedent’s estate using the proceeds of life insurance on the decedent’s life and other funds. The corporation repurchased 86 shares with the life insurance proceeds and agreed to repurchase the remaining shares by purchasing 38.4 shares annually. The estate elected to pay the estate tax in installments. The central issue was whether the provision in I.R.C. § 6166(g)(1)(A) prevented the installment election. I.R.C. § 6166(g)(1)(A) provides that installment payments will be accelerated and due upon the sale or exchange of 50 percent of more of the decedent’s interest in a closely-held business. Because the corporation would eventually repurchase 50 percent or more of the decedent’s stock, the installment payments would be accelerated. In a Chief Counsel Advice letter, the IRS ruled that the estate was eligible for the installment payment of tax because it met the requirements at the time of the election. The IRS also discussed the I.R.C. § 6166(g)(1)(B) exception to acceleration of the installments where the sale of the stock constituted a redemption under I.R.C. § 303. Section 303 requires that the amount of the distribution in redemption of stock cannot exceed the sum of the estate, inheritance, legacy, and succession taxes (plus interest) and the amount of funeral and administration expenses allowable as deductions for Federal estate tax purposes. The IRS stated that estate should first make the calculations under Rev. Rul. 86-54, 1986-1 C.B. 356, which provides two alternative approaches to the requirement of I.R.C. § 6166(g)(1)(B) that estate tax must be paid in an amount not less than the amount of money and other property distributed in the Section 303 redemption on or before the date prescribed for payment of the first installment due after the date of the distribution (or, if earlier, on or before the day that is one year after the date of the distribution). CCA Ltr. Rul. 200141015, July 2, 2001.

The decedent’s estate had filed for an extension of time to file the estate tax return and had included payment of estimated estate taxes with the extension application. The estate timely filed the estate tax return and elected to make the eligible tax payments in installments. The estate filed for a refund of the taxes paid with the extension application to the extent the taxes were eligible for the installment provision. The amount paid with the extension application did not exceed the total estate tax due. Essentially, the estate requested the return of the estate taxes paid which were eligible to be paid under the installment election. In a Chief Counsel Advice letter, the IRS ruled that no refund was allowed because the taxes paid did not exceed the total estate taxes due. CCA Ltr. Rul. 200141013, June 28, 2001.

JOINT TENANCY PROPERTY. The IRS has issued an acquiescence in the following decision. In 1972, the decedent and spouse had acquired stock in a tenants’ corporation for an apartment in New York City. The title to the stock was held as joint tenants with right of survivorship. The court had insufficient factual development to determine the amount of consideration furnished by each taxpayer for the stock. At the death of the decedent, the estate included all of the value of the stock in the decedent’s estate. The spouse then sold the stock, using the federal estate tax basis for determining the gain from the sale. The IRS recomputed the gain from the sale, using only 50 percent of the value of the stock as the basis for federal estate tax purposes. The IRS argued that the 1981 amendment of I.R.C. § 2040(b)(2) made I.R.C. § 2040(b)(1) effective for all estates of decedents dying after December 31, 1981, regardless of when the joint tenancy property was purchased. The court followed Gallenstein v. United States, 975 F.2d 286 (6th Cir. 1992), to hold that the amendment did not apply to joint tenancy interests created prior to 1977; therefore, the decedent was not restricted to including only 50 percent of the value of the stock in the decedent’s estate but the amount of stock included would be determined under the consideration furnished test. See also Harl, “Basis for Joint Tenancy Property,” 9 Agric. L. Dig. 49 (1998). Hahn v. Comm’r, 110 T.C. 140 (1998), acq., AOD CC-2001-06. I.R.B. 2001—.

FEDERAL INCOME TAXATION

BAD DEBT DEDUCTION. The taxpayer provided consulting services and formed three corporations to accommodate the business needs of the consulting firm. The taxpayer provided the operating funds to the corporations through personal advances of funds. When the consulting business failed, the corporations also failed and the taxpayer claimed a bad debt deduction for the amounts contributed to the corporations. The Tax Court originally held that the amounts contributed were not loans but were equity contributions because (1) no promissory notes were executed, (2) no interest rate was set, (3) no terms of repayment were established and repayment was inconsistent and corresponded to income of the corporations, (4) the corporations were thinly capitalized, and (5) the amounts contributed were at high risk of nonpayment because the business depended upon one main client but no compensation was involved for this risk factor. On appeal, the appellate court reversed, holding that the Tax Court had failed to consider interest payments made by the three corporations as evidence supporting the taxpayer’s argument that the contributed funds were loans. On remand, the Tax Court held that the interest payments did not support characterization of the contributions as debt because (1) the interest income and deductions were not consistently or completely reported by the taxpayer and the other corporations, (2) the interest payments were followed by additional contributions to the corporations, and (3) the amounts of the interest payments were dependent upon the
income of the other corporations. Cerand & Co. v. Comm’r, T.C. Memo. 2001-271, on rem. from, 254 F.3d 258 (D.C. Cir. 2001), rev’g and rem’g, T.C. Memo. 1998-423.

COURT AWARDS AND SETTLEMENTS-ALM § 4.02[14]. The taxpayers filed suit for personal injuries arising out of an automobile accident. The taxpayers received a jury award for the personal injuries and the state court added statutory delay damages determined by applying an interest rate to the jury award over the time between the filing of the suit and the jury award. During the appeal process, the parties reached a settlement which was not much less than the total state court award. The court found that the delay damages were very similar to pre-judgment interest. The court held that the delay damages were included in the taxpayers’ income because the purpose of the delay damages was to compensate the taxpayers for the loss of the use of the jury award during the lawsuit. The court delayed ruling on the proper allocation of the settlement between personal injury compensation and delay damages pending presentation of evidence and arguments on the allocation issue. The appellate court affirmed on the delay damages issue. Francisco v. United States, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,625 (3d Cir. 2001), aff’g, 99-2 U.S. Tax Cas. (CCH) ¶ 50,625 (E.D. Penn. 1999).

DEPENDANTS. The taxpayer was not married and lived with the taxpayer’s minor child in a home owned and occupied by the taxpayer’s parents. The court found that the taxpayer provided more than one-half of the support for the child and was, therefore, eligible to claim the child as a dependent and to file using the head of household status. However, because the parents’ modified adjusted gross income exceeded the taxpayer’s, the taxpayer could not claim the earned income tax credit as to the child. Obriot v. Comm’r, T.C. Summary Op. 2001-162.

DEPRECIATION. The taxpayer operated a business renting video games and originally filed returns claiming depreciation deductions based on straight line depreciation over two years. The taxpayer sought to amend its original returns to elect out of MACRS under I.R.C. § 168(f)(1). The court held that the taxpayer could not elect out of the MACRS depreciation method because the taxpayer had originally depreciated the property using a term of years. New Gaming Systems, Inc. v. Comm’r, T.C. Memo. 2001-277.

The IRS has issued guidance providing taxpayers relief from the application of the mid-quarter convention contained in the depreciation rules. The notice provides that taxpayers may elect not to apply the mid-quarter convention if their third quarter includes September 11, 2001. The notice does not limit this provision to taxpayers directly affected by the terrorist attacks of September 11, 2001. Notice 2001-70, I.R.B. 2001—.

The taxpayer was an electric utility company which incurred costs in digging trenches for installing underground electrical facilities. The court held that the trenching costs had to be capitalized because the facilities had a useful life in excess of one year and would produce income over the life of the facilities. Florida Progress Corp. v. United States, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,679 (11th Cir. 2001), aff’g, 98-2 U.S. Tax Cas. (CCH) ¶ 50,591 (M.D. Fla. 1998).

DISASTER PAYMENTS. On September 21, 2001, the President determined that certain areas in Virginia were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of fire and explosions at the Pentagon on September 11, 2001. FEMA-1392-DR. On September 28, 2001, the President determined that certain areas in Florida were eligible for assistance under the Act as a result of severe storms, tornadoes and flooding beginning on September 13, 2001. FEMA-1393-DR. Accordingly, a taxpayer who sustained a loss attributable to the disasters may deduct the loss on his or her 2000 federal income tax return.

ENVIRONMENTAL CLEANUP COSTS. The taxpayer had purchased two existing retail store properties. The stores were not selling gasoline at the time of purchase and the taxpayer did not know that gasoline stations had been operated at the properties. Underground storage tanks were still in place and had leaked gasoline into the soil. The taxpayer claimed the soil cleanup expenses as a current business deduction but the IRS argued that the cleanup costs had to be capitalized into the purchase price of the properties. The court held that the cleanup costs had to be capitalized because the taxpayer did not cause the contamination and the cleanup improved the condition of the property, even though the value of the property did not increase above what the taxpayer paid for them. United Dairy Farmers, Inc. v. United States, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,680 (6th Cir. 2001), aff’g, 107 F. Supp. 2d 937 (S.D. Ohio 2000).

HOBBY LOSSES. The taxpayers, husband and wife, operated a cattle and deer operation. The taxpayers were also the sole shareholders of a corporation which operated a manufacturing facility. The court held that the taxpayers did not operate the cattle and deer operation with the intent to make a profit because (1) the taxpayers did not keep complete and accurate books, and did not have any business plan to make the operation profitable; (2) although the taxpayers had substantial knowledge of raising cattle, they had little experience in making such an operation profitable; (3) although the taxpayers spent considerable time on the operation, much of that time was spent in recreational activities; (4) although the real property appreciated, the appreciation was substantially less than the losses incurred; (5) although the taxpayers were successful with their manufacturing business, the taxpayer made little effort to make the cattle and deer operation profitable; (6) the operation had losses in 19 of the 20 years of operation; (7) the taxpayers had substantial income from other sources which was offset by the farm losses; and (8) the taxpayers received much personal pleasure from the cattle and deer operation as well as other aspects of rural life. The appellate court affirmed in a decision designated as not for publication. Kahla v. Comm’r, 2001-2 U.S. Tax Cas.
PENSON PLANS. The IRS has issued, in question and answer form, guidance on the I.R.C. § 415 limitation increases enacted by EGTRRA 2001, including: (1) benefit increases that may be provided as a result of the increased I.R.C. § 415 limitations under EGTRRA; (2) plan amendments that may be adopted to take into account the increased Section 415 limitations; (3) the effect of the increased Section 415 limitations on other qualification requirements; and (4) how the “sunset” provision of EGTRRA is taken into account for purposes of Sections 412 and 404. Rev. Rul. 2001-51, I.R.B. 2001-_, modifying, Rev. Rul. 98-1, 1998-1 CB 249.

The IRS has announced relief to employers who, because of the September 11th terrorist attacks, were not able to make required contributions to their pension plans on or before September 15, 2001, to satisfy the minimum funding standards. The relief concerns certain penalties relating to Form 5500 for defined benefit and money purchase pension plans that are required to be filed on or before October 15, 2001. Ann. 2001-103, I.R.B. 2001-43.

The taxpayer received an early distribution from a qualified retirement plan which triggered the 10 percent addition to income tax imposed by I.R.C. § 72(t). The taxpayer claimed the 10 percent tax as a deduction under I.R.C. § 164(a). The court held that the Section 72(t) tax is an addition to the income tax and under I.R.C. § 275(a)(1) no deduction is allowed for federal income taxes. Trace v. Comm’r, T.C. Summary Op. 2001-165.

The IRS has announced that revised determination letter forms for pension, profit-sharing, stock bonus and annuity plans will be available in late November 2001. The revised forms are intended to simplify application procedures for determination letters. Revised forms include Form 5300, Application for Determination for Employee Benefit Plan; Schedule Q (Form 5300), Elective Determination Requests; Form 5307, Application for Determination for Adopters of Master or Prototype or Volume Submitter Plans; Form 5309, Application for Determination of Employee Stock Ownership Plan; and Form 6406, Short Form Application for Determination for Minor Amendment of Employee Benefit Plan. The revised forms will be available from IRS distribution centers (1-800-TAX-FORM) and on the IRS web site at www.irs.gov, under “Forms & Pubs.” Ann. 2001-109.

RETURNS. The taxpayer was living with a same sex partner and claimed the partner as a deduction on the taxpayer’s income tax return, although the taxpayer had crossed out all references to “spouse” on the return. The taxpayer used the “married filing joint return” tax schedule, although the taxpayer marked out the term “married” on the return. The court noted that no change in the taxpayer’s marital status under state or federal law had occurred since the same issue was litigated for previous tax returns in Mueller v. Comm’r, T.C. Memo. 2000-132, aff’d, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,391 (7th Cir. 2001); therefore, the court held that the taxpayer could not use the joint return tax schedule or claim the standard deduction for joint returns. Mueller v. Comm’r, T.C. Memo. 2001-274.

The IRS has posted the following forms and instructions to its web site at www.irs.gov, in the “Forms & Pubs” section: Form 943 (2001), Employer’s Annual Tax Return for Agricultural Employees, and instructions; and Instructions for Form 940-EZ (2001), Employer’s Annual Federal Unemployment (FUTA) Tax Return.

S CORPORATIONS-ALM § 7.02[3][c].”

EMPLOYEE. The taxpayer was an S corporation with one shareholder who was a veterinary doctor. The shareholder provided consulting and surgical services for other veterinary clinics. The clinics paid the fees for the services to the S corporation. The corporation did not pay wages to the shareholder but claimed all payments as distributions of corporate income. Neither the corporation nor the shareholder paid employment taxes on the distributions. The court held that the shareholder was an employee of the corporation and the amounts paid to the shareholder were subject to employment taxes. The court also held that the I.R.C. § 530(a)(1) exception did not apply because the corporation did not have a reasonable basis for not treating the shareholder as an employee. Veterinary Surgical Consultants, P.C. v. Comm’r, 117 T.C. No. 14 (2001).

The taxpayer was an S corporation wholly-owned by a husband and wife. The corporation operated a drywall construction business and was managed by the husband who was a 99 percent shareholder, with the wife owning the other 1 percent. The shareholders claimed all income from the corporation on Schedule E as nonpassive income and the corporation did not withhold or pay any federal employment taxes on the amounts paid to the shareholders. The court held that the shareholder was an employee of the corporation and the amounts paid to the shareholder were subject to employment taxes. The court also held that the I.R.C. § 530(a)(1) exception did not apply because the corporation did not have a reasonable basis for not treating the shareholder as an employee. Yeagle Drywall Co., Inc. v. Comm’r, T.C. Memo. 2001-284.

SHAREHOLDER BASIS. The taxpayers owned and operated a trucking business as a partnership. The taxpayers formed an S corporation to handle the truck maintenance for the partnership. The corporation obtained an operating loan and the bank required the shareholders to guarantee personally the loan, including use of a second home mortgage to secure a portion of the loan. The partnership then transferred all assets to the corporation in a transaction treated as a sale for income tax purposes because the liabilities assumed by the corporation equaled the tax basis in the assets transferred. The taxpayer argued that their guarantee of the corporation’s debt increased their basis in the corporation. The court held that the guarantees did not increase the shareholders’ basis in the corporation because the loan was made to the corporation, the corporation made all payments on the loan, and the loan was not in default. The taxpayers also argued that the shareholder basis was increased by the amount the fair market value of the
partnership’s assets exceeded the liabilities assumed by the corporation. The court held that, because the transfer was structured as a tax-free sale, the taxpayers were prohibited from changing the character of the transfer later. The appellate court affirmed in a decision designated as not for publication. **Estate of Bean v. Comm’r**, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,669 (8th Cir. 2001), aff’d, T.C. Memo. 2000-355.

The taxpayer owned two corporations, a mining corporation and a farm corporation. The farm corporation was transferred to the taxpayer’s spouse during the tax years involved in the case. The mining corporation made distributions of dividends owed to the taxpayer and the distributions were either made directly to the farm corporation or passed on by the taxpayer to the farm corporation. The farm corporation incurred several years of losses and the taxpayer and spouse claimed deductions for those losses. The IRS argued that the amounts transferred from the mining corporation to the farm corporation were intercorporate loans which did not increase the taxpayer’s and spouse’s basis in the farm corporation. The court held that the transfers from the mining corporation to the farm corporation were contributions or loans from the taxpayer to the farm corporation or gifts to the taxpayer’s spouse and then contributed or loaned to the farm corporation; therefore, the transfers increased the basis of the taxpayer and spouse in the farm corporation sufficient to allow deduction of the farm losses. **Yates v. Comm’r**, T.C. Memo. 2001-280.

**SAFE HARBOR INTEREST RATES**

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**SAVER’S CREDIT.** The IRS has issued, in question-and-answer format, a description of the new “saver’s credit,” an income tax credit that is available to eligible taxpayers who contribute to a retirement plan or IRA, enacted as part of EGTRRA 2001. The IRS has also provided a sample notice that employers can give to employees explaining the credit. **Ann. 2001-106, I.R.B. 2001-44.**

**SELF-EMPLOYMENT TAX.** The taxpayer had income from the taxpayer’s legal practice but did not pay any self-employment tax, arguing that the self-employment tax was voluntary. The taxpayer provided no further argument or authority on this issue. The court held that self-employment taxes were mandatory. **Baker v. Comm’r**, T.C. Memo. 2001-283.

**SOCIAL SECURITY TAX-ALM § 4.06.** The maximum amount of annual wages subject to Old Age Survivor and Disability Insurance for 2002 will be $84,900, with all wages and self-employment income subject to the medicare portion of the tax.

**TRUSTS.** The IRS mailed a notice of deficiency to the taxpayer trust and the trust filed a petition in the Tax Court under the name of the trust and signed by a named person. The IRS and court sent requests to the trust for information which would establish the identity of the trustee or other fiduciary with authority to bring the petition for the trust. The requests were sent to the trust’s address in the name of the person who signed the petition. The trust failed to respond to the requests and the court dismissed the action. **Northstate Tax Consultants v. Comm’r**, T.C. Memo. 2001-279.

**UNEMPLOYMENT COMPENSATION.** The taxpayer erroneously listed unemployment compensation benefits as social security benefits on the taxpayer’s income tax return. The taxpayer, however, included the unemployment compensation in the taxable income and paid tax on the compensation. The IRS changed the return by excluding the listed social security benefits from income and increased the taxpayer’s refund. The taxpayer made several contacts with the IRS to verify the increased refund and was told each time that the refund was correct. The taxpayer eventually spent the extra refund amount. Two years later the IRS issued a deficiency based on the erroneous refund. The taxpayer argued that the deficiency notice was invalid because the taxpayer reasonably and in good faith relied on the advice of several IRS employees. The court held that the advice of IRS employees does have the force of law and does not negate a correct deficiency notice. The court noted that the taxpayer’s frequent contact with the IRS was based on the taxpayer’s own awareness that a problem may have existed with the increased refund. **Ferreira v. Comm’r**, T.C. Summary Op. 2001-167

**TAX SHELTERS.** These cases involved taxpayers who invested in a partnership which developed and operated jojoba farms. The taxpayer claimed tax losses more than double the initial investment in the first tax year and additional losses in following years. The losses were disallowed because the partnership was held to be a sham tax shelter. The issues in this case were whether the taxpayer was liable for the negligence component of the accuracy-related penalty and whether the IRS should have waived the understatement of tax component of the accuracy-related penalty. The court ruled that the taxpayer had sufficient business acumen that it was unreasonable for the taxpayer to not have sought expert tax advice before claiming substantial and accelerated tax losses more than double the initial investment. The taxpayers also failed to provide any substantial authority for their claim of losses. **Lopez v. Comm’r**, T.C. Memo. 2001-278.
SECURED TRANSACTIONS

PRODUCER’S LIEN. The debtor was a rice processor who had purchased several varieties of rice from a grower. The debtor segregated purchased rice by variety and crop year but commingled rice of the same year and variety from different producers. The grower sought to enforce its producer’s lien, under Cal. Food & Agric. Code § 55631, in order to recover amounts owed by the debtor for rice purchased from the grower. The grower argued that Cal. Food & Agric. Code § 55634 extended the producer’s lien to cover all rice in the debtor’s possession. The court held that Section 55634 allowed a producer’s lien to extend to a crop which was commingled with crops from other producers. Thus, a producer’s lien would cover a crop held separately by a buyer and the same crop even if commingled with other similar crops of other producers. Thus, the grower’s producer’s lien did not extend to other types of rice or to rice which was segregated by the debtor. The decision does not discuss how to allocate the remaining rice inventory among the competing producers’ liens. In re California Pacific Rice Mill, Ltd., 265 B.R. 237 (Bankr. E.D. Cal. 2001).

IN THE NEWS

SHARED APPRECIATION AGREEMENTS. “Farmers suing the federal Agriculture Department over a 1980s farm bailout would get some help from a House measure that delays government foreclosures on the loans. The delay would be in effect through the end of 2002. It is included as an amendment to the $170 billion farm bill the House passed Oct. 5, said Rep. Earl Pomeroy, D-N.D. The Senate Agriculture Committee is expected to start work on its farm proposals later this month. ‘Lenders, farmers and the U.S. Department of Agriculture all require more time to fairly sort out the disputed bailout agreements,’ Pomeroy said. ‘More than 100 farmers or ranchers from 16 states, including North Dakota, are suing the USDA over bailout deals signed under the Agricultural Credit Act of 1987. The act allowed farmers struggling through a severe economic slump to write off or restructure federal loans, provided they signed new, 10-year deals called shared appreciation agreements. The terms of those agreements are in dispute. The USDA says the farmers need to repay the debt that was written off when the deals were signed, although the agency would cap those bills at one-half the amount by which the land used as collateral has increased in value. The farmers argue the government would be entitled to a share of the appreciation money only if they had sold their land or stopped farming within the 10 years. They say the USDA has notified them it will foreclose on their property if they don’t pay the debt. The farmers sued the government in U.S. District Court in Fargo in June. They have until Oct. 30 to respond to the USDA’s request for dismissal. ‘The farmers’ lawyer, Sarah Vogel, said the House measure was not a response to the lawsuit and ‘just bought time, that’s all.’ While the lawsuit was not the direct cause of the amendment, it does show ‘the merit for it,’ Pomeroy said. This summer, the farmers asked U.S. District Judge Rodney Webb to order the government to stop collecting on the loans until the lawsuit was resolved. Webb refused, saying the farmers hadn’t met the legal burden required for the injunction they sought.’ Jack Sullivan, Associated Press, October 12, 2001.

NUISANCE. “A PorkNet Summary/ -- Oklahoma pork producers are now subject to new, more stringent odor laws. Gov. Frank Keating signed the rules Oct. 8. The new regulations are designed to punish hog operations where neighbors have complained about odor to the state’s Agriculture Department. Letters were sent to 10 farms on Oct. 9 telling them they must abide by the new regulations. The 10 farms have each had three or more complaints filed about the odors from their operations. Kendra Farms East will get an additional letter because officials say the operation has had three or more “verified complaints” filed against it within the past six months. Kendra Farms East must work with state officials on a plan to control odors and install new technology. The remaining farms must each stop spreading manure onto land on weekends, holidays and when the wind is blowing more than 20 mph. Verified complaints are those filed by neighbors within two miles of an operation; neighbors living farther away can file general complaints. A state official said all hog operations with more than 2,500 head will receive copies of the new regulations.” Mick Hinton, The Oklahoman, Oct. 9, 2001.

CITATION UPDATES

Estate of O’Neal v. United States, 258 F.3d 1265 (11th Cir. 2001), rem’d, 81 F. Supp.2d 1205 (N.D. Ala. 1999) (claims) see p. 132 supra.
HANDLING JOINT TENANCIES AT DEATH
— by Neil E. Harl*

It took nearly a decade, but the Internal Revenue Service has finally acknowledged the line of cases headed by *Gallenstein v. United States*¹ and followed by five more cases² holding that the so-called “consideration-furnished” rule of federal estate taxation of jointly-owned property³ could be applied at the first death of a husband-wife joint tenancy to produce a higher income tax basis in the hands of the surviving joint tenant.⁴ IRS has now acquiesced in the Tax Court decision, *Hahn v. Commissioner*,⁵ which removes the remaining doubt as to whether application of the consideration-furnished rule was acceptable in the case of husband-wife joint tenancies.⁶ In *Hahn v. Commissioner*,⁷ The Tax Court agreed that a surviving spouse could be entitled to a new income tax basis on 100 percent of the date of death value for property held in joint tenancy with a predeceased spouse.⁸

**Facts in *Hahn v. Commissioner***

In *Hahn v. Commissioner*,⁹ the husband, who was the first of the joint tenants to die, in 1972 had signed an agreement to purchase shares in a corporation representing an apartment. The shares were issued later to the husband and wife in joint tenancy. At the husband’s death, in 1991, the wife became the sole owner of the shares. The federal estate tax return included 100 percent of the value of the shares in the husband’s estate. That amount was, of course, covered by the federal estate tax marital deduction.¹⁰ On later sale of the shares, the wife (as the surviving joint tenant) claimed an income tax basis of $758,412. On audit, the Internal Revenue Service took the position that only 50 percent of the date of death value should have been included in the husband’s estate and, therefore, only that amount should have received a new basis at the husband’s death. The Tax Court disagreed.

**History of the “consideration furnished” rule**

Before 1977, the value of joint tenancy property was subject to federal estate tax in the estate of the first to die except to the extent it could be proved that the survivor contributed to its acquisition.¹¹ This became known as the “consideration furnished” rule.¹² Before 1982, the creation of husband-wife joint interests in land was not subject to federal gift tax unless so reported on a gift tax return timely filed.¹³ An important point in *Hahn v. Commissioner*¹⁴ and the other cases is that whatever portion of asset value is included in the decedent’s gross estate also receives a new income tax basis at death.¹⁵ A surviving joint tenant is considered to have acquired property from the decedent only to the extent that the property

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was required to be included in the estate of the deceased joint tenant. Thus, the portion of the property not included in the decedent’s estate retains the survivor’s income tax basis.

**The “fractional share” rule**

In 1976, the joint tenancy rule was amended to create a special rule for joint tenants who were husbands and wives married to each other. Under that rule, one-half the value was included in the estate of the first to die without regard to which spouse furnished the consideration to acquire the jointly-held property. Moreover, one-half the value received a new income tax basis at death.

**Applicability of “consideration furnished” rule before 1982**

The key question has been whether the “consideration furnished” rule continued to apply in the case of deaths after 1981. That question was first answered by *Gallenstein v. United States* in 1992 and confirmed by the other cases decided since 1992 including *Hahn v. Commissioner*. The *Gallenstein* case concluded that Congress had not repealed the “consideration furnished” rule for husband-wife joint tenancies either expressly or by implication. Indeed, in *Hahn v. Commissioner*, the court concluded that the “fractional share” rule “does not apply to spousal joint interests created before January 1, 1977.”

**To what property does Hahn apply?**

For federal gift tax purposes, by the general rule a gratuitous transfer of property by one person to that person and another as joint tenants is considered a gift of a proportionate part of the value. Before January 1, 1977, only three classes of property did not involve a gift when acquired by a husband and wife in joint tenancy—(1) the purchase of United States savings bonds registered as payable to the one providing the consideration “or” another did not (and still does not) constitute a taxable gift until and unless the one not providing consideration redeems the bond during the lifetime of the other without any obligation to account for the proceeds to the other owner; (2) the transfer of funds into a joint bank account did not (and still does not) produce a taxable gift until and unless the one not providing funds withdraws amounts for his or her own benefit; and (3) through 1981, for a joint tenancy in real property created after December 31, 1954, in a husband and wife, by one of the spouses, a taxable gift did not result at the time of the transfer unless the donor elected to treat the transfer as a gift. Contribution was defined in terms of “money, other property or an interest in property.”

Thus, these three types of property appear eligible for application of the “consideration furnished” rule at the death of the first to die of a husband and wife joint tenancy, although only the land exception is of much interest. Of course, it is necessary for the spouse who provided the consideration to die first in order for the surviving spouse to benefit from a new basis for up to 100 percent of the value of the property. Note that if assets had declined in value, and death of the first to die would result in a step-down in basis, the fractional share rule would result in a more advantageous result for the survivor. However, *Hahn v. Commissioner* states that “…section 2040(b)(1) [the “fractional share” rule] does not apply to spousal joint interests created before January 1, 1977.”

**Who can use Hahn v. Commissioner?**

Obviously, in the estate of the first to die of a husband-wife joint tenancy, if the estate applied the “consideration furnished” rule (for acquisition of eligible property before 1977 when the first to die contributed the consideration), the rule of *Hahn v. Commissioner* can be applied. What if the estate of the first to die was not sufficiently large to file a federal estate tax return? In that case, it would appear that, so long as an inconsistent position was not taken after the first death (and the facts otherwise support application of the “consideration furnished” rule), the “consideration furnished” rule could be applied. An “inconsistent position” could possibly have been taken on a depreciation schedule as the schedule was adjusted after death of the first joint tenant to die or on a state inheritance tax return in a state with rules for joint tenancy taxation similar to the federal rules. These possibilities await further illumination in rulings or cases or both.

**FOOTNOTES**

1. 91-2 U.S. Tax Cas. (CCH) ¶ 60,088 (E.D. Ky. 1991), aff’d, 975 F.2d 286 (6th Cir. 1992).
2. Patten v. United States, 96-1 U.S. Tax Cas. (CCH) ¶ 60,231 (W.D. Va. 1996), aff’d, 116 F.3d 1029 (4th Cir. 1997);
3. Anderson v. United States, 96-2 U.S. Tax Cas. (CCH) ¶ 60, 235 (D. Md. 1996); Baszto v. United States, 98-1 U.S. Tax Cas. (CCH) ¶ 60,305 (M.D. Fla. 1997);
5. I.R.C. § 2040(a).
6. See generally 5 Harl, *Agricultural Law* § 43.02[2] (2001);
10. See note 5 supra.
11. Id.
12. Id.
17. See notes 1 and 2 supra.
subsequent years. The contracts also contained clauses which required all disputes involving the contracts to be arbitrated under the National Grain and Feed Association arbitration rules. After the debtor defaulted on the contracts, the buyer obtained a state court judgment to enforce the arbitration provisions and the parties submitted the dispute to arbitration. The arbitration panel ruled that the hedge-to-arrive contracts were enforceable and not illegal off-exchange futures contracts because actual delivery of the grain was intended. The buyer filed a claim in the bankruptcy case based on the arbitration award. The debtor sought to challenge the claim on the basis that the arbitration award was improper because of industry bias of the arbitration panel and because the hedge-to-arrive contracts were illegal off-exchange futures contracts. The court held that the debtor failed to prove that the arbitration panel was biased or exceeded its authority and also upheld the panel’s ruling that the contracts were enforceable. In re Robinson, 265 B.R. 722 (Bankr. 6th Cir. 2001).

WARRANTY. The plaintiff purchased a used tractor from the defendant. The tractor immediately had mechanical problems and after six months of attempting to fix these problems and 160 hours of use, the plaintiff sued for breach of express and implied warranties, fraud, misrepresentation and deceit. The trial court held that the tractor had defective o-rings and the implied warranties of merchantability and fitness for a particular purpose had been breached. The appellate court held that sufficient evidence was presented to support the trial court’s ruling that the tractor had defective o-rings which caused the mechanical problems. The defendant argued that the plaintiff waited too long to claim that the implied warranties of merchantability and fitness for a particular purpose had been breached. The court held that, considering the plaintiff’s difficulty in determining the actual problem, the amount of time between the purchase of the tractor and the suit to recover damages was reasonable. Eggl v. Letvin Equip. Co., 632 N.W.2d 435 (N.D. 2001).

CONTRACTS

HEDGE-TO-ARRIVE CONTRACTS. The Chapter 12 debtor was a farmer who had entered into several hedge-to-arrive contracts which provided for delivery of grain but allowed the debtor to rollover the delivery of the grain to
FEDERAL AGRICULTURAL PROGRAMS

TOBACCO. The FSA has issued final regulations which implement the provisions of the Agricultural Risk Protection Act of 2000 regarding transfers of tobacco allotments, the lease and transfer of burley tobacco quota and recordkeeping for burley tobacco quota and acreage. It also implements the provisions of the Agriculture, Rural Development, Food and Drug Administration, and Related Agencies Appropriations Act of 2001 regarding the Tobacco Loss Assistance Program 2000. 66 Fed. Reg. 53507 (Oct. 23, 2001).

The FSA has announced the intention of the Secretary of Agriculture to release the burley tobacco farm designation information, which includes, but is not limited to, the farm serial number, operator's name and address and pounds designated to a specific market location and provides notice of the method in which interested parties can opt out of that release. The release will be to the designated warehouse operator, receiving station buying company or dealer in order to facilitate an orderly marketing of the 2001 crop of burley tobacco. 66 Fed. Reg. 53945 (Oct. 25, 2001).

FEDERAL ESTATE AND GIFT TAX

CHARITABLE DEDUCTION. The decedent owned an interest in property in which a conservation easement was granted to a charitable organization. The conservation easement transfer was completed after the decedent’s death but before the timely filing of the estate tax return. The owners of the other interests in the property claimed charitable deductions for the transfer on their federal income tax returns. The estate sought to make an election under I.R.C. § 2031(c)(9) to claim a charitable deduction for the decedent’s share of the conservation easement transferred. The Section 2031(c)(9) election requires that no other charitable deduction can be claimed for the conservation easement. The IRS ruled that the limitation on the Section 2031(c)(9) applies only as to the decedent’s interest in the property. Because no other person claimed a charitable deduction for the decedent’s interest in the conservation easement, the decedent’s estate could claim a charitable deduction as to that interest. Ltr. Rul. 200143011, July 25, 2001.

GIFT. The taxpayer had originally sold real estate to the taxpayer’s children for a downpayment and a promissory note. However, the taxpayer returned the downpayment checks and never attempted to collect on the note. The children executed a mortgage for the taxpayer and the taxpayer released the mortgage when one child needed to secure a loan on the property. When the checks were returned, an accompanying letter referred to the purchase of the real estate by the children and a gift of only the downpayment. The IRS filed a tax lien against the taxpayer’s property and the issue was whether the taxpayer had any attachable interest in the property when the tax lien was filed. The court held that if the transaction was a purchase, the taxpayer still had a right of payment which was subject to the lien. However, if the taxpayer had forgiven the entire note, no interest remained to be attached. The court held that the transaction was a sale in which the taxpayer retained an interest in the property sufficient for the tax lien to attach. See also United States v. Jepsen, 2000-2 U.S. Tax Cas. (CCH) ¶ 50,608 (W.D. Ark. 2000) (ruling on summary judgment). United States v. Jepsen, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,698 (8th Cir. 2001).

The taxpayer, as part of estate tax planning, formed a corporation and transferred cash, Treasury notes and tax-free municipal bonds to the corporation in exchange for all of the stock. The taxpayer made gifts of the stock to various family members and the main issue was the value of the gifts for federal gift tax purposes. The issues included (1) whether the corporation should be disregarded as having no economic substance and the gifts be valued based on the value of the underlying assets; (2) whether restrictions on the sale and use of the corporate assets should be disregarded; (3) whether restrictions on the sale of the stock should be disregarded; and (4) whether discounts for gifts of minority interests and lack of marketability should be allowed. In a Chief Counsel advice letter, the IRS ruled that the corporation should be disregarded because the corporation operated no business, paid no officers, had no employees, functioned as a mere conduit for planned family gifting, and was formed for the sole purpose of reducing federal transfer taxes. The IRS also ruled that the gifts did not satisfy the I.R.C. § 2703(b) “safe harbor” requirements for exception to the statute’s application and that no discounts from the fair market value of each proportionate gift of the corporation’s underlying cash and securities should be allowed. CCA LTR. Rul. 200143004, July 5, 2001.

SPECIAL USE VALUATION. The decedent’s daughter, as executor, sought legal advice as to whether the daughter or the decedent owned a ranch. The attorney advised that the daughter owned the ranch and that the ranch was not included in the decedent’s estate. The daughter timely filed the estate tax return and did not include the ranch in the gross estate. The daughter then filed a quiet title action in state court which ruled that the daughter held the ranch in constructive trust for the estate. The daughter, again under advice of counsel, did not amend the estate tax return to include the ranch in the decedent’s estate. The IRS audited the return and determined that the ranch was owned by the decedent at death. The daughter filed an appeal with the Tax Court which ruled that the ranch was included in the estate. The daughter requested an extension of time to file a special use valuation election. The IRS granted the extension. Ltr. Rul. 200143014, July 26, 2001.

TRUSTS. The taxpayers, husband and wife, each established a grantor retained annuity trust (GRAT). Each
trust provided that if the annuitant died with a surviving spouse, the surviving spouse would continue as annuitant. Each trust also allowed the grantor the power to revoke the remainder annuity for the surviving spouse. The taxpayers valued the remainder interests of both trusts using both lives. The court held that a qualified annuity interest had to set a certain term in order to qualify the trust as a GRAT. Because the lifetime of the secondary annuitant was uncertain and could be revoked, the GRATs had to be valued using a single life. Cook v. Comm’r, 2001-2 U.S. Tax Cas. (CCH) ¶ 60,422 (7th Cir. 2001), aff’d, 115 T.C. No. 2 (2000).

The taxpayers, husband and wife established a charitable remainder unitrust with the taxpayers as lifetime beneficiaries and a charitable organization as remainder holder. Each taxpayer had the power to revoke by will the survivor’s right to the benefits of one-half of the trust in the case of the death of a taxpayer. The taxpayer decided to divorce and, as part of the property settlement, divide the trust into two separate trusts, each owning one-half of the original trust assets and each as the lifetime beneficiary of the separate trusts. The trusts were identical except that no survivor beneficiary was included. The IRS ruled that (1) the division of the trust would not cause any of the trusts to fail to qualify as charitable remainder trusts under I.R.C. § 664; (2) the division of the trust would not terminate the trust’s status as a trust described in, and subject to, the private foundation provisions imposed on split-interest trusts under I.R.C. § 4947(a)(2), and would not result in the imposition of an excise tax under I.R.C. § 507(c); (3) the resulting trusts would not be treated as newly created organizations and would succeed to the aggregate tax benefits defined by I.R.C. § 507(d) in proportion to the fair market value of the assets transferred to the resulting trusts; (4) the proposed division of the trust would not be an act of self-dealing under I.R.C. § 4941; (5) the division of the trust would not be a taxable expenditure under I.R.C. § 4945; and (6) if reasonable in amount, the legal and other expenditures incurred by the trust to effect the division of the trust would not be self-dealing under I.R.C. § 4941 nor a taxable expenditure under I.R.C. § 4945. Ltr. Rul. 200143028, July 31, 2001.

**FEDERAL INCOME TAXATION**

**ACCOUNTING METHOD.** The taxpayer was a C corporation which manufactured and sold computer software programs. The taxpayer had annual gross receipts of just under $5 million. The taxpayer used a hybrid method of accounting for book and tax purposes. The IRS determined that the taxpayer should have used the accrual method of accounting and assessed a deficiency. The taxpayer argued that the IRS determination was an abuse of discretion because (1) the taxpayer had less than $5 million in gross receipts and met the exception of I.R.C. § 448(b)(3) because it had consistently used a cash method of accounting; (2) the taxpayer did not receive substantial income from the sale of merchandise; and (3) the taxpayer had already changed to the accrual method two years after the tax year involved here. The court held that (1) the $5 million limit did not entitle the taxpayer to use the cash method but merely provided a point at which the accrual method was required; (2) the software was considered merchandise; and (3) the taxpayer's later accounting change did not affect the propriety of the IRS action for the tax year involved here. Nemetschek North America, Inc. v. Comm’r, T.C. Memo. 2001-288.

**BAD DEBTS.** The taxpayer loaned $20,000 to a co-employee in 1987 and received a promissory note to be repaid in 23 days. No payments were made for seven years when the co-employee died in 1994. The taxpayer made no attempt to collect the debt from the co-employee’s estate and claimed the debt as a nonbusiness bad debt deduction in 1996. The taxpayer provided no evidence that the debt was uncollectible. The court held that the debt was not deductible because the taxpayer failed to demonstrate that the transaction was a bona fide debt and that the debt became worthless in 1996. The court noted that the taxpayer made no attempt to collect the debt for nine years, even after the co-employee died. Webb v. Comm’r, T.C. Summary Op. 2001-172.

**BUSINESS EXPENSES.** The taxpayer operated a construction business and claimed various deductions for business expenses. The taxpayer’s records were kept at the office of the taxpayer’s accountant and those records were lost through circumstances beyond the taxpayer’s control. The court accepted the testimony of the taxpayer as substantiation of the expenses to the extent the testimony was not controverted by evidence presented by the IRS. The court allowed most of the expense deductions but did not allow a depreciation deduction because the taxpayer did not present evidence identifying the property deprecated. Furnish v. Comm’r, T.C. Memo. 2001-286.

**CAPITAL GAIN.** Under Section 311(e) of TRA 1997, noncorporate taxpayers could elect to treat capital assets as having been sold and repurchased at fair market value on January 1, 2001. The election requires that any gain be “recognized notwithstanding any provision of the . . . Code.” The taxpayer made the election in respect to the principal residence owned by the taxpayer with a basis more than $250,000 less than the fair market value. The IRS ruled that the exclusion of gain provided in I.R.C. § 121 did not apply to the recognition of gain resulting from a Section 311(e) election as to the residence. A future issue of the Digest will publish an article by Neil Harl on this ruling and other features of the 1997 statute Rev. Rul. 2001-57, I.R.B. 2001-—.

**COURT AWARDS AND SETTLEMENTS-ALM § 4.02[14].** The taxpayer was convicted for two violations of the antitrust provisions under the Sherman Act. The taxpayer was also the defendant under a civil action brought under Section 4 of the Clayton Act for the same violations. In addition, the taxpayer had entered into settlement negotiations with a third party for the same violations, but no
law suit had been filed. The taxpayer reached settlements with both parties and claimed the settlement amounts as business deductions. The IRS ruled that the two-thirds exclusion of I.R.C. § 162(g) for payments made for damages under an action brought under Section 4 of the Clayton Act applied only to the settlement reached with the party who had filed suit against the taxpayer. The IRS ruled that the exclusion did not apply to the other settlement payment because no law suit had been filed. Ltr. Rul. 200143006, July 10, 2001.

IRA. The employer was employed until January 16, 1996 with an employer which provided a qualified pension plan. The employer made contributions to the plan and the taxpayer’s interest in the plan was vested. The taxpayer found new employment for the remainder of 1996 but that employer did not provide a pension plan. The taxpayer made a contribution of $2,000 to an IRA in 1996 and deducted that amount from gross income. The court held that the 1996 IRA contribution was not deductible because the taxpayer was a participant in a qualified pension plan during some portion of 1996. Trull v. Comm’r, T.C. Summary Op. 2001-168.

PASSIVE ACTIVITY LOSSES. The taxpayer was a 35 percent shareholder in an S corporation which operated a restaurant. The taxpayer claimed the taxpayer’s share of corporate losses but the IRS disallowed the losses as resulting from a passive activity. The taxpayer presented a written description of the time spent on corporate affairs which was prepared as part of the IRS audit process and also presented oral testimony as to the amount of time spent on corporate business. The court held that this evidence was not reliable and could not be considered in determining whether the taxpayer actively participated in the corporation’s business. The court held that the losses were passive activity losses because the taxpayer failed to prove that the taxpayer actively participated in the business. Newhart v. Comm’r, T.C. Memo. 2001-289.

PENSION PLANS. For plans beginning in October 2001, the weighted average is 5.76 percent with the permissible range of 5.18 to 6.05 percent (90 to 106 percent permissible range) and 5.18 to 6.34 percent (90 to 110 percent permissible range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). Notice 2001-65, I.R.B. 2001-43, 369.

The IRS has issued proposed regulations that provide guidance concerning the requirements for retirement plans providing catch-up contributions to individuals age 50 or older pursuant to the provisions of I.R.C. § 414(v) added by EGRTA 2001. The proposed regulations would affect I.R.C. § 401(k) plans, I.R.C. § 408(p) SIMPLE IRA plans, I.R.C. § 408(k) simplified employee pensions, I.R.C. § 403(b) tax-sheltered annuity contracts, and I.R.C. § 457 eligible governmental plans, and would affect participants eligible to make elective deferrals under these plans or contracts. 66 Fed. Reg. 53555 (Oct. 23, 2001).

REFUNDS. The IRS has announced that almost 300,000 advance payment checks authorized under EGRRTA 2001 remain unclaimed because of incorrect taxpayer addresses. Taxpayers have until December 5, 2001 to notify the IRS of their correct address in order to receive a check; otherwise, the 2001 tax payment will need to be included in the 2001 tax return as a credit. Form 8822 should be used to notify the IRS of a change of address. IR-2001-103.

RETURNS. The IRS has announced that the IRS Martinsburg Computing Center (MCC) Information Reporting Program call site now has a toll-free telephone number, 866-455-7438. The call site provides service to the payer community (financial institutions, employers, and other transmitters of information returns). The call site answers both magnetic media and tax law questions relating to the filing of information returns (Forms 1096, 1098, 1099, 5498, 8027, W-2G, and W-4). The call site also answers magnetic media questions related to Forms 1042-S, and tax law and paper filing related questions about Forms W-2 and W-3, as well as handling inquiries dealing with backup withholding and reasonable cause requirements due to missing and incorrect taxpayer identification numbers. The call site accepts calls from all areas of the country. Payers and transmitters may still use the original telephone number, which is 304-263-8700 or Telecommunications Device for the Deaf, 304-267-3367. These are toll calls. The call site can also be reached via e-mail at mccirp@irs.gov. Hours of operation for the Call Site are Monday through Friday, 8:30 a.m. to 4:30 p.m. Eastern time. Ann. 2001-107, I.R.B. 2001-44, 419.

The IRS has announced the publication of revisions of the following forms: Form 1040 (2001), U.S. Individual Income Tax Return; Form 1040, Schedules A&B (2001), Itemized Deductions and Interest and Ordinary Dividends, and instructions; Form 1040, Schedule E (2001), Supplemental Income and Loss, and instructions; Form 1040 or 1040A, Schedule EIC (2001), Earned Income Credit; Form 1040, Schedule F (2001), Profit or Loss From Farming, and instructions; Form 1040, Schedule J (2001), Farm Income Averaging, and instructions; Form 1040A, Schedule 2 (2001), Child and Dependent Care Expenses for Form 1040A Filers, and instructions; Form 1040A, Schedule 3 (2001), Credit for the Elderly or the Disabled for Form 1040A Filers, and instructions; and Form1040-EZ (2001), Income Tax Return for Single and Joint Filers With No Dependents; Form 1040, Schedule R (2001), Credit for the Elderly or the Disabled, and instructions; Form 1040, Schedule SE (2001), Self-Employment Tax; Form 1040-V (2001), Payment Voucher; Form 1041T (2001), Allocation of Estimated Tax Payments to Beneficiaries; Form 2106-EZ (2001), Unreimbursed Employee Business Expenses; Form 2441 (2001), Child and Dependent Care Expenses, and instructions; Form 4952 (2001), Investment Interest Expense Deduction; Form 4970 (2001), Tax on Accumulation Distribution of Trusts; Form 8752 (2001), Required Payment or Refund Under Section 7519; Form 8812 (2001), Additional Child Tax Credit; Form 8825 (2001), Rental Real Estate Income and Expenses of a Partnership or an S
Corporation; Form 8843 (2001), Statement for Exempt Individuals and Individuals With a Medical Condition; and Instructions for Form 1040, Schedule C (2001), Profit or Loss from Business; and Instructions for Form 1040A (2001), U.S. Individual Income Tax Return; Form 8863 (2001), Education Credits (Hope and Lifetime Learning Credits). These documents are available at no charge (1) by calling the IRS's toll-free telephone number, 1-800-829-3676; (2) through FedWorld; (3) via the internet at http://www.irs.gov/prod/cover.html; or (4) by directly accessing the Internal Revenue Information Services bulletin board at (703) 321-8020.

S CORPORATIONS-ALM § 7.02[3][c].*

BUILT-IN GAINS. The taxpayer was an S corporation which had been assessed for built-in gains tax for two tax years. The taxpayer appealed to the Tax Court but the IRS moved to dismiss for lack of jurisdiction. The IRS argued that the built-in gains tax was a subchapter S item which required the issuance of a final S corporation administrative adjustment and had to be determined in a unified audit and litigation procedure for an S corporation. The taxpayer argued that the built-in gains tax was not a subchapter S item and that Treas. Reg. § 301.6245-1T was invalid. The court agreed with the IRS and dismissed the case. New York Football Giants, Inc. v. Comm'r, 117 T.C. No. 15 (2001).

SOCIAL SECURITY TAX-ALM § 4.06.* Beginning with the January 2, 2002 payment, the monthly social security benefit payment is a maximum of $545 for an individual and $817 for a couple. The maximum amount of annual wages subject to Old Age Survivors and Disability Insurance for 2002 is $84,900, with all wages and self-employment income subject to the medicare portion of the tax. The retirement earnings test exempt amount (the point at which retirees begin to lose benefits in conjunction with their receipt of additional earnings) was eliminated for individuals age 65 through 69 as of January 2000. However, it remains in effect for individuals age 62 through 64 and a modified test applies for the year in which an individual reaches age 65. The retirement earnings test exempt amount will rise from $25,000 a year to $30,000 a year for the year in which an individual attains age 65; the test applies only to earnings for months prior to reaching age 65. One dollar in benefits will be withheld for every $3 in earnings above the limit and no limit on earnings will be imposed beginning in the month of the individual's 65th birthday. For retirees under age 65, the retirement earnings test exempt amount is $11,280 a year, with $1 withheld for every $2 in earnings above the limit. The amount of wages necessary for one quarter of coverage is $870.

TRAVEL EXPENSES. The taxpayer operated a delivery business and paid its drivers 40 percent of the delivery charge. A portion of the payment was straight wages, with the remainder allocated to reimbursement for car and other expenses. The drivers provided monthly statements of actual miles and expenses but the reimbursement amount did not equal the mileage rate and expenses reported. The difference occurred because the drivers could include more than one delivery in a single trip. The court held that the entire payment was wages subject to withholding because the reimbursement was not based on actual mileage or expenses and the taxpayer did not require the employees to return any reimbursement above the actual mileage rate or expenses reported. Shotgun Delivery, Inc. v. United States, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,700 (9th Cir. 2001), aff'd on point, 2000-1 U.S. Tax Cas. (CCH) ¶ 50,210 (N.D. Calif. 2000).

WITHHOLDING TAXES. IRS has announced procedures that business taxpayers may use to redesignate their estimated income tax overpayments as employment tax deposits, so that their overpayments can be used to pay their current employment tax obligations. To make the redesignation, taxpayers should contact the IRS through its disaster relief toll-free telephone number, 1-866-562-5227. Ann. 2001-112, I.R.B. 2001-__

JUDGMENTS

STATUTE OF LIMITATIONS. The defendant had entered into a grain supply agreement with a cooperative which used the grain to produce ethanol. The cooperative borrowed money from a lender and assigned the supply contract as security for the loan. The cooperative defaulted on the loan and the lender sought to enforce the grain supply contract and receive the grain from the defendant who refused. The lender obtained a judgment against the defendant and assigned the judgment to the plaintiff who attempt to collect almost 10 years after the original judgment but within the 10 year statute of limitations of Minn. Stat. § 550.01 for judgments. The defendant argued that the three year statute of limitation of Minn. Stat. § 550.366 applied because no debt was involved as to the defendant. The court held that the defendant’s failure to perform the grain supply contract created a debt involving agricultural personal property; therefore, the three year statute of limitations applied to bar recovery on the judgment. Westchester Fire Ins. Co. v. Hasbargen, 632 N.W.2d 754 (Minn. Ct. App. 2001).

LANDLORD AND TENANT

TERMINATION. The plaintiff farmed 250 acres under an oral lease with the plaintiff’s parents. The parents transferred the property to a trust for their benefit. The trust provided that the parents would serve as co-trustees with the plaintiff’s brother as a successor co-trustee upon the death of either parent. The mother also executed a durable power of attorney which designated the brother as the mother’s attorney-in-fact. The father died and the brother assumed the role of attorney-in-fact for the mother. The brother mailed a notice of termination of lease to the plaintiff by certified
mail along with a proposed cash lease. The plaintiff refused delivery of the notice. The brother then posted the notice on the plaintiff’s trailer. The court held that the brother had sufficient authority as successor co-trustee to terminate the oral lease and that the service of the termination notice at the plaintiff’s residence was sufficient. *Green v. Green, 29 P.3d 448 (Kan. Ct. App. 2001).*

**STATE REGULATION OF AGRICULTURE**

**INSPECTION FEES.** The plaintiff Colorado corporation was a registered commercial fertilizer handler in Kansas. Under Kan. Stat. § 2-1205, the plaintiff was required to pay an inspection fee based on the amount of fertilizer sold each year. The plaintiff argued that the fee was unconstitutional because it generated far more revenue than the cost of the inspection program and was vague in that it fails to designate who must register fertilizer under the program. The court held that although the statute does not designate who must do the registration, the fee statute provided sufficient guidance that fertilizer handlers must register the fertilizer they sell. The court also held that the revenues generated by the fee were not excessive because the revenue was also used in the state water fund used to protect state waterways. *Busby, Inc. v. Kansas Dept. of Agric., 29 P.3d 441 (Kan. Ct. App. 2001).*

**CITATION UPDATES**

*Kenseth v. Comm’r, 259 F.3d 881 (7th Cir. 2001), aff’g, 114 T.C. 399 (2000) (court awards and settlements) p. 134 supra.*

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In 1997, when Congress revamped the capital gains rules for eligible property, the maximum rate on net long-term capital gains for an individual was reduced from 28 percent to 20 percent. In addition, the rate for any net long-term capital gain which would otherwise be taxed at 15 percent was reduced to a 10 percent rate.

The 1997 Act also provided, beginning in 2001, for an 18 percent rate for long-term capital gains on eligible assets held for more than five years, 8 percent for those in the 15 percent tax bracket. That provision was made effective for property for which the holding period begins after December 31, 2000, except for those in the 15 percent tax bracket.

The purpose of the election is to make future gain on an asset eligible for the 18 percent rate (rather than the 20 percent rate). If the irrevocable election is made, any gain on the deemed sale is recognized on the 2001 income tax return; a loss from a deemed sale is not allowed in any tax year.

To make the election, taxpayers are to report the deemed sale on a timely filed 2001 income tax return (with extensions). If the deemed sale results in a loss, the taxpayer is to enter zero instead of the amount of the loss. The taxpayer should attach a statement to the return stating that an election has been made under Section 311 of the Taxpayer Relief Act of 1997 and specify the assets for which the election is made.

If an individual elects under the Taxpayer Relief Act of 1997 to treat the individual’s principal residence as being both sold and reacquired on January 1, 2001, for an amount equal to its fair market value on that date, the individual

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cannot exclude from gross income under the $250,000 residence exclusion ($500,000 on a joint return)\(^6\) any of the gain resulting from the deemed sale.\(^7\) IRS has ruled to that effect on the grounds that the statute requires that gain be recognized “notwithstanding any other provision” of the Internal Revenue Code.\(^8\) Therefore, the gain on the deemed sale is not eligible for the exclusion on sale of the principal residence.\(^9\)

**Property sold within one year of deemed election**

In late 2000,\(^10\) Congress acted to assure that an election to make a “deemed sale” of assets and recognize gain does not apply to assets disposed of in a recognition transaction within one year of the date the election would otherwise have been effective.\(^11\) Therefore, if an asset is sold in 2001, no election may be made with respect to that asset.\(^12\) In addition, the deemed sale and repurchase by reason of the election is not to be taken into account in applying the “wash-sale” rules.\(^13\) The amendment is designed to prevent a taxpayer from generating a short-term capital loss which could offset a short-term capital gain from other assets (such as corporate stock).

**In conclusion**

The changes made in 1997 and 2000 could have important implications for returns filed for the 2001 tax year.

### FOOTNOTES

4. I.R.C. § 1(h)(2).
5. I.R.C. § 1(h)(2).
7. Id.
10. See note 8 supra.
11. Id.
13. Id.
14. See note 8 supra.
15. See notes 8-12 supra.
19. See note 16 supra.
21. See notes 8-13 supra.
22. See note 19 supra.
23. Id.

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**CASES, REGULATIONS AND STATUTES**

*by Robert P. Achenbach, Jr.*

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**BANKRUPTCY**

### GENERAL-ALM § 13.03.

**EXEMPTIONS**

**HOMESTEAD.** The debtor had initially owned a rural residence. The debtor purchased an adjacent parcel of land which had a palm tree nursery on it. The debtor sold palm trees from the land as a business. The debtor filed for Chapter 7 and claimed both parcels as exempt rural homestead property under Fla. Const. art. X, § 4. The creditors objected to the homestead exemption for the palm tree nursery land only, arguing that a homestead could not include commercial property. The court held that the use of a portion of a homestead for business purposes did not disqualify property for the homestead exemption where the commercial use of the property was consistent with the rural character of the property. The court noted that a contrary holding would exclude all farm land from the rural homestead exemption. *In re McLachlan*, 266 B.R. 220 (Bankr. M.D. Fla. 2001).

**FEDERAL TAX-ALM § 13.03[7].***

**DISCHARGE.** The debtor did not timely file returns for 1987, 1988 and 1989. The IRS prepared substitute returns for those years and made assessments based on the substitute returns. In 1995, as part of an IRS leniency program, the debtor filed returns for those years which were almost identical to the substitute returns used by the IRS. The debtor filed for Chapter 7 in 1999 and sought to discharge the taxes for the years involved. The court held that Section 727 applied to make the taxes nondischargeable because the debtor failed to file a return for the taxes. The court held that the late-filed returns did not constitute returns for purposes of Section 727 because the returns served no purpose. *United States v. Ralph*, 266 B.R. 217 (M.D. Fla. 2001).

**SETOFF.** The debtor filed for Chapter 7 on May 19, 1998 and the debtor owed taxes for 1993. The case was considered a no asset case so no tax claim was filed by the IRS. The debtor filed and paid 1997 taxes in August 1998, claiming a refund. The debtor was granted a discharge, including the 1993 taxes, in September 1998. The IRS accepted the 1997 tax return but applied the refund to the 1993 taxes. The debtor sought to reopen the Chapter 7 case.

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*Agricultural Law Manual (ALM).*
and listed the tax refund as exempt property. The debtor argued that the tax refund, as exempt property, was not subject to the IRS’s right of setoff. The issue was whether Section 522, excluding exempt property from liability for pre-petition debts, or Section 553, allowing setoff of pre-petition debts, controlled where a setoff involved exempt property. The court acknowledged a split of decisions on this issue and held that Section 553 had precedence over Section 522, although the court did not explain the reason for this decision. Therefore, the IRS setoff of the refund against the discharged pre-petition taxes was allowed. The basic reasoning is that, because Section 553 lists several exceptions to the setoff rule and does not include Section 522, the Congress did not intend Section 522 to be an exception to the right of setoff. United States v. Luongo, 259 F.3d 323 (5th Cir. 2001), aff’d, 255 B.R. 424 (N.D. Tex. 2000).

CONTRACTS

WARRANTY. The plaintiff corporation was owned by a farmer who used to farm with a parent until the parent’s corporation filed for bankruptcy. The farmer wanted to purchase a planter but could not make the purchase until the farmer’s corporation, the plaintiff, was formed. The farmer reached an agreement with a landlord to have the landlord purchase the planter and then sell the planter to the plaintiff when formed. The purchase was made and the planter was eventually sold to the plaintiff corporation. The plaintiff alleged that the planter was defective and sought damages for breach of express and implied warranties against the manufacturer under Kan. Stat. §§ 84-2-313(1)(a), 84-2-314, 84-2-315 and for violation of Kan. Stat. § 50-623 et seq. for alleged deceptive practices. The court held that Kan. Stat. §§ 84-2-313(1)(a) (express warranty) and 84-2-314, 84-2-315 (implied warranties) did not apply because the plaintiff was not the original purchaser of the planter because the landlord made the purchase. The plaintiff also argued that Kan. Stat. § 50-623 et seq. (deceptive practices) did not apply because the plaintiff was not the original purchaser of the planter and because neither the landlord nor the plaintiff was a “consumer” covered by the statute. Limestone Farms, Inc. v. Deere & Co., 29 P.3d 457 (Kan. Ct. App. 2001).

ENVIRONMENTAL LAW

CLEAN WATER ACT. An environmental organization had brought a citizens’ suit under the Clean Water Act. Jurisdiction was allowed by the District Court under the EPA “migratory bird rule” but a claim for civil penalties was dismissed. The appellate court reversed and remanded the case on these issues because Solid Waste Agency of Northern Cook County v. U.S. Army Corps of Engineers, 531 U.S. 159 (2001) invalidated the Corps’ “migratory bird rule” as a basis for jurisdiction under the Clean Water Act. In addition, the court noted that Friends of the Earth, Inc. v. Laidlaw Environmental Services, Inc., 528 U.S. 167 (2000) held that private citizens could seek civil penalties for violations of the Clean Water Act. San Francisco Baykeeper v. Cargill Salt Div., 263 F.3d 963 (9th Cir. 2001).

FEDERAL AGRICULTURAL PROGRAMS

FARM LOANS. The plaintiffs, husband and wife, had borrowed money from the FmHA (now FSA) to purchase farm land. The plaintiffs defaulted on that loan and were allowed to deed the farm to the FSA and lease the farm back from the FSA for five years. The leaseback agreement also allowed the plaintiffs the option to repurchase the farm at the fair market value of the farm on the date the option was exercised. In June 1997, the husband called the FSA loan manager and orally notified the FSA that the plaintiffs intended to repurchase the farm. The FSA ordered an appraisal in September 1997 which determined a value of the farm as of October 9, 1997. The FSA also notified the plaintiffs that they had to make a written exercise of the option to repurchase the farm. The written option was executed and delivered on May 14, 1998. The National Appeals Division (NAD) ruled that the appraisal date was incorrect and should have been the date the written exercise of the option was executed, May 14, 1998. A new appraisal was made for that date. The plaintiffs argued that the option was properly exercised by the husband in June 1997 and that the NAD had no authority to require a written exercise of the option. The court held that the NAD had the authority to interpret the lease to require a written exercise of the option and its decision was not arbitrary or capricious. Nichols v. Glickman, 156 F. Supp.2d 1173 (D. Or. 2001).

MILK. The plaintiff was a processor of chocolate milk products and was subject to a regulation which placed milk used to make chocolate milk in two classes and fixed a price for each class. The regulation was enacted into law by the Federal Agricultural Improvement and Reform Act of 1996, Pub. L. No. 104-127 by referencing the regulation. The plaintiff argued that the enactment of the regulation by referencing violated the Presentment Clause of the U.S. Constitution and that the regulation and law violated the due process clause of the U.S. Constitution. The plaintiff argued that the enactment of the regulation by referencing violated the Presentment Clause because the regulation was not physically incorporated into the bill enacted by Congress and signed by the President. The court upheld the constitutionality of enactment of regulations by reference. The court also held that the dual pricing system used for milk used to make chocolate milk had a rational basis and did not violate the Due Process clause. Hershey Foods v. U.S.D.A., 158 F. Supp.2d 37 (D. D.C. 2001).
FEDERAL ESTATE AND GIFT TAX

TAX RATE. The decedent died in March 1993 during a time when the federal estate tax maximum rate had decreased to 50 percent because of a presidential veto and the application of the Economic Recovery Tax Act of 1981. In August 1993, legislation was passed which retroactively increased the maximum rate back to 55 percent. The decedent’s estate argued that the retroactive increase was unconstitutional. The court upheld the constitutionality of the retroactive increase in the estate tax rate. NationsBank of Texas, N.A. v. United States, 2001-2 U.S. Tax Cas. (CCH) ¶ 60,423 (Fed. Cir. 2001), aff’g, 99-2 U.S. Tax Cas. (CCH) ¶ 60,345 (Fed. Cls. 1999).

TRUSTS. The taxpayers formed a trust and transferred the income from the taxpayer’s businesses to the trust. The court held that the trust was a sham and that the trust income was properly attributed to the taxpayers personally. Residential Management Services Trust v. Comm’r, T.C. Memo. 2001-297; United States v. Engels, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,723 (N.D. Iowa 2001).

FEDERAL INCOME TAXATION

ACCOUNTING METHOD. The taxpayer was a corporation which operated a trucking business. The taxpayer was required to pay for a large number of permits, licenses, fees and insurance premiums. The items were valid for up to 12 months, sometimes carrying over to the tax year after the expense was made. The IRS argued that the taxpayer had to capitalize the expenses for these items over two tax years. The IRS pointed to Treas. Reg. §§ 1.263(a)-2, 1.461-1(a)(2) which require an expense to be capitalized if the item has a benefit to the taxpayer extending substantially over one year. The court held that the licenses, fees, permits and insurance premiums were properly allowed as a current deduction because (1) they all had benefits which lasted only one year, (2) the expenses reoccurred each tax year, and (3) the timing of the expenses was determined by independent government agencies. U.S. Freightways Corp. v. Comm’r, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,731 (7th Cir. 2001).

APPEALS. The IRS has announced a pilot program aimed at cutting the time it takes to resolve disputes between the tax agency and corporate taxpayers. The Large and Mid-Size Business Division Fast Track Dispute Resolution Pilot Program creates a new opportunity for corporate taxpayers to resolve outstanding issues early in the course of disagreements during the examination process. Under fast track, the taxpayer and LMSB officials have the option to choose between two alternatives. The parties can decide that the particular dispute should be resolved through mediation, where an appeals official will seek to facilitate communication and resolve factual issues. Alternatively, the taxpayer and LMSB officials can opt for dispute resolution that involves the appeals official rendering a settlement recommendation. In the pilot phase, the program is available to large and mid-sized businesses that currently have at least one open year under examination and at least one disputed issue. Rev. Proc. 2001-55, I.R.B. 2001--.

BAD DEBTS. The taxpayer was an employee and shareholder of a corporation. When the corporation began to have financial difficulties, the taxpayer contributed money to the corporation 29 times. The taxpayer claimed the money as a business bad debt deduction when the corporation terminated. The court examined 16 factors involving the contribution of the money to determine that a bona fide debt did not exist; therefore, the taxpayer could not claim a bad debt deduction for the loss of the money. Of the 16 factors, the court held that the following factors supported the determination that no bona fide debt existed: (1) only 11 of the contributions were evidenced by promissory notes or corporate resolutions; (2) the notes did not have fixed maturity dates; (3) repayment of the contribution was expected from corporate profits; (4) only the promissory notes provided the taxpayer with enforcement authority; (5) the repayment of the contributions was subordinated to other corporate debt; (6) no security was required for the contributions; (7) the corporation was thinly capitalized; (8) the corporation could not obtain third party financing; (9) the contributions were not repaid; (10) there was a high risk that the contributions would not be repaid; (11) even though the notes provided for interest, no interest was paid; and (12) the corporation had no unattached funds to make the repayments. Warning v. United States, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,729 (N.D. Okla. 2001).

CONSTRUCTIVE RECEIPT. The taxpayer was a corporation wholly-owned by one shareholder. The shareholder and the shareholder’s children were employees of the corporation. The corporation was an accrual method taxpayer with a fiscal year ending on July 31 but the shareholder and children were all cash method taxpayers. No employment contract existed and the employees did not take any compensation in previous years. However, in 1994 the taxpayer contributed money to the corporation 29 times. The taxpayer claimed the money as a business bad debt deduction when the corporation began to have financial difficulties, the taxpayer contributed money to the corporation. The taxpayer failed to executed the proper corporate formalities which would have made the compensation award

**COURT AWARDS AND SETTLEMENTS-ALM § 4.02[14].** The taxpayer had filed suit for employment discrimination against a former employer. The parties reached a negotiated settlement. The taxpayer sought a refund of income taxes withheld by the employer from the settlement. The taxpayer argued that the provision which excludes from gross income amounts received for physical injuries but includes in income amounts received for nonphysical injuries was a violation of the equal protection clause of the Fifth Amendment. The court held that the provision was constitutional because it had a rational basis in attempting to establish a uniform policy for taxation of lawsuit damage awards and settlements. *Young v. United States, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,732 (W.D. Ky. 2001).*

**DEDUCTIONS.** The taxpayer had sufficiently high income that, under I.R.C. § 68, a portion of the taxpayer’s state and local income taxes was not deductible. The taxpayer was also self-employed and was allowed a deduction for only a portion of the taxpayer’s health insurance costs. The taxpayer purchased an apartment and paid cash for the entire cost, leaving no mortgage interest to deduct. The taxpayer argued that these limitations were unconstitutional but the court held that the limitations on deductions were reasonably related to the Congressional purposes involved. *Campbell v. United States, 2001-2 U.S. Tax Cas. (CCH) 50,716 (S.D. N.Y. 2001).*

**DEPRECIATION.** The IRS has issued guidance providing taxpayers further relief from the application of the mid-quarter convention contained in the depreciation rules. The notice provides that taxpayers may elect not to apply the mid-quarter convention if their third or fourth quarter includes September 11, 2001. A future issue of the Digest will publish an article by Neil Harl on Notice 2001-70 and Notice 2001-74. *Notice 2001-74, I.R.B. 2001-__.*

The taxpayer was in the food manufacturing and distribution business and used reusable containers for shipping its products. The ruling does not identify the product or the type of container. The taxpayer’s business activity matches Asset Class 20.5, Manufacture of Other Food and Kindred Products, from *Rev. Proc. 87-56, 1987-2 C.B. 674*. Assets in class 20.4 have a recovery period of seven years for purposes of I.R.C. § 168(a) and 12 years for purposes of I.R.C. § 168(g). The taxpayer argued that the reusable containers were in asset class 20.5, Manufacture of Food and Beverages—Special Handling Devices. The IRS ruled that the containers were Asset class 20.4 because the containers were usable for other products and the containers would not have to be modified because of a change in product. *Ltr. Rul. 200144031, July 17, 2001.*

**DISASTER PAYMENTS.** On October 25, 2001, the President determined that certain areas in Oklahoma were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of tornadoes, severe storms, and flooding on October 9-10, 2001. *FEMA-1395-DR.* Accordingly, a taxpayer who sustained a loss attributable to the disasters may deduct the loss on his or her 2000 federal income tax return.

**IRA.** The taxpayer was employed for several years with an employer which provided a 401(k) pension account for the taxpayer. The account contained both employer and employee contributions. When the taxpayer terminated employment the amount in the pension plan was rolled over to an IRA. The taxpayer made withdrawals from the IRS but did not include the withdrawals in income. The taxpayer argued that the money rolled over to the IRS was post-tax contributions such that withdrawal was not subject to tax. The court held that the evidence indicated that all the funds in the pension account were pre-tax contributions from the employer and taxpayer; therefore, the taxpayer had no income tax basis in the IRA funds and they were included in the gross income when withdrawn. *Hendricks v. Comm’r*, T.C. Memo. 2001-299.


**PASSIVE ACTIVITY LOSSES.** The taxpayers were two brothers who each owned 50 percent of a C corporation which operated a construction and real estate sales business. When the corporation had financial difficulties, the brothers individually purchased construction equipment and leased the equipment to the corporation. The brothers claimed losses from the rental activity as business deductions but the IRS disallowed the deductions as passive activity losses. The taxpayers argued that the rental activity was excepted from the passive activity loss limitations by Temp. Treas. Reg. § 1.469-1T(e)(3) because the rental activity was incidental to the taxpayers’ nonrental activities. The IRS argued that the regulation required the taxpayers to stop using the equipment in their nonrental activity before using the equipment in the rental activity. The court held that the regulation did not contain any such requirement. The court also held that the taxpayers met the material participation requirements for the rental activity because the taxpayers elected to treat the rental and corporate activity as one activity for purposes of the passive activity loss limitation rules. *Blewett v. Comm’r*, T.C. Summary Op. 2001-174.

The taxpayer was an attorney who owned several pieces of rental real estate. The taxpayer claimed business deductions for losses from the rental activity and the IRS disallowed the losses as passive activity losses. The taxpayer provided summaries of the number of hours spent on the rental activity but the court dismissed the evidence as unreliable because it was not supported by contemporaneous written records. The court held that the taxpayer did not materially participate in the activity because the taxpayer failed to demonstrate that the taxpayer spent more than 500 hours on the activity or that the taxpayer spent more time on the rental

The taxpayers were trusts established under a decedent’s will. The trusts held commercial property which produced passive rental activity income and loss. The trusts borrowed money to purchase other interests in the properties and sought a ruling as to whether the interest on the borrowed money would be considered passive activity expense subject to the passive activity loss limitation rules. The IRS ruled that the interest expense resulting from a loan used to purchase property used in a passive activity would be subject to the passive activity loss limitation. Ltr. Rul. 200144013, Aug. 1, 2001.

The taxpayers owned the majority of the stock of an S corporation which provided management services for several partnerships in which the taxpayers owned an interest. The taxpayers actively participated in the management activities of the corporation but received passive income and losses from the partnerships. The taxpayers offset the passive income and nonpassive losses, arguing that was allowed by the legislative history of I.R.C. § 409 because the S corporation and partnerships were related entities with income and deductions arising from the same activities. The IRS argued that the offset was not allowed because the statute and regulations under the statute allowed such offset only for interest items by lenders. The Tax Court held that the failure of the IRS to promulgate regulations in keeping with the legislative history did not prevent the offset which was otherwise allowable under the letter and intent of the statute. The appellate court reversed, holding that the statute was plain and unambiguous in prohibiting the offset of passive income against nonpassive losses. Hillman v. Comm'r, 263 F.3d 338 (4th Cir. 2001), aff'g on rehearing, 250 F.3d 228 (4th Cir. 2001), rev'g, 114 T.C. 103 (2000).

PENSION PLANS. The IRS has issued proposed regulations relating to incentive stock options (ISOs) described in I.R.C. § 422(b) and options granted under an employee stock purchase plan (ESPP options) described in I.R.C. § 423(b). The proposals, which would affect employers granting such options and employees exercising the options, provide guidance concerning the application of FICA, FUTA and Collection of Income Tax at Source to the options. The IRS also released two related notices that set forth proposed rules regarding (1) an employer’s income tax withholding and reporting obligations upon the sale or disposition of stock acquired pursuant to the exercise of a statutory stock option and (2) application of FICA and FUTA to statutory stock options. Notice 2001-72, Notice 2001-73, I.R.B. 2001-___; NPRM REG-142686-01.

The IRS has issued a revenue procedure which extends the GUST 1 remedial amendment period under I.R.C. § 401(b) for qualified retirement plans. First, the revenue procedure extends the GUST remedial amendment period for all plans to February 28, 2002, if the period would otherwise end before then. Second, the revenue procedure provides an additional extension to June 30, 2002, for plans that were directly affected by the September 11, 2001, terrorist attacks. Finally, the revenue procedure provides that in cases of substantial hardship resulting from the terrorist attacks the IRS may, in its discretion, grant additional extensions of the GUST remedial amendment period to particular plans up to December 31, 2002. Rev. Proc. 2001-55, I.R.B. 2001-___.

PENALTIES. The IRS has issued a revenue procedure which identifies circumstances under which the disclosure on a taxpayer’s return of a position with respect to an item is adequate for the purpose of reducing the understatement of income tax under I.R.C. § 6662(d) (relating to the substantial understatement aspect of the accuracy-related penalty), and for the purpose of avoiding the preparer penalty under I.R.C. § 6694(a) (relating to understatements due to unrealistic positions). Rev. Proc. 2001-52, I.R.B. 2001-___.

RETURNS. The IRS has issued guidance supplementing the tax relief that it granted earlier to taxpayers affected by the terrorist attacks of September 11, 2001. The new measures supplement those provided in Notice 2001-61, I.R.B. 2001-40, 305, to extend additional tax deadlines for certain affected taxpayers. Those who have an extended filing deadline falling between December 1, 2001, through January 31, 2002, will have until February 15, 2002, to file any tax returns due. The extension applies to “affected taxpayers” that have difficulty meeting their federal tax obligations because their records, computers, or other essential supporting services were lost or damaged, or essential personnel were injured or killed, in the attacks. The IRS has also released a list of time-sensitive acts that may be postponed in a disaster. If an affected taxpayer has a deadline for performing any of the listed acts, the deadline is postponed by 120 days if it would otherwise expire between September 11, 2001, and November 30, 2001. This guidance applies to individuals serving in the armed forces in a combat zone, or in support of such armed forces, and to affected taxpayers within the meaning of Treas. Reg. § 301.7508A-1(d)(1). IR-2001-105, Nov. 2, 2001.

In Notice 2000-61, I.R.B. 2001-40, the IRS provided extensions and postponements for taxpayers affected by the September 11, 2001 terrorist attacks. In Notice 2001-68, the IRS announced that the extensions and postponements of Notice 2001-61 did not apply to owners of passthrough entities where only the entity was affected. The IRS has now announced that it has expanded the relief to partners, shareholders, or beneficiaries of passthrough entities that had income tax returns due (either originally or on extension) on or after September 11, 2001, and on or before November 2, 2001 (the date the IRS released Notice 2001-68), but did not file the return because the taxpayer believed that the IRS had granted a 120 day postponement solely by virtue of the taxpayer’s interest in an affected entity. Ann. 2001-117, I.R.B. 2001-___.

SALE OR LEASE. The taxpayer was approached by another person for financing of a restaurant. The other person owned a liquor license. The taxpayer agreed to construct the restaurant and lease it to the person. The taxpayer formed a corporation to purchase the land and
construct the restaurant. The lessee transferred the liquor license to the corporation for minimal consideration. The lease terms included rent over 15 years which corresponded to amortization of the construction costs at a 15 percent interest rate. The lease provided the lessee with the option to purchase the property after 10 years at 125 percent of the remaining lease payments. The lessee was responsible for all expenses and taxes from the property. During construction of the restaurant, the lease payments were adjusted to reflect additional construction costs. The corporation treated the transaction as a lease on its income tax returns but the lessee treated the payments as loan payments. The court held that the transaction was a sale and financing arrangement requiring the taxpayer to recognize gain from the transaction because (1) the conveyance of the liquor license for minimal consideration indicated that the license was transferred as collateral for the transaction, (2) the lessee had all the risks and benefits of ownership of the property and the taxpayer had a fixed return; (3) the payments included an interest component and were dependent upon the total cost of the construction; (4) the option to purchase gave the lessee all the benefits of any appreciation of the property; and (5) the lessee had been seeking a financing source for the restaurant. The appellate court affirmed in a decision designated as not for publication. Guaderrama v. Comm'r, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,714 (10th Cir. 2001), aff'd, T.C. Memo. 2000-104.

PRODUCTS LIABILITY

PECAN HARVESTER. The plaintiff was injured while operating a pecan harvester manufactured by the defendant. The harvester had become clogged and the plaintiff inspected the harvester while it was running. During the inspection, the plaintiff’s jacket was caught by the drive shaft, resulting in injury to the plaintiff. The plaintiff brought suit under the Louisiana Products Liability Act, La. Rev. Stat. § 9:2800.51 et seq., alleging that the harvester was unreasonably dangerous. The evidence demonstrated that a bolt on the drive shaft had been broken and was replaced with a larger bolt. The defendant’s main argument was that the plaintiff’s actions with the harvester, including the clothing worn at the time, were not within the scope of reasonably anticipated uses of the harvester. The court held that there was sufficient evidence that the plaintiff’s method of inspection and clothing were well within the reasonably anticipated actions for users of pecan harvesters. Ellis v. Weasler Engineering, Inc., 258 F.3d 326 (5th Cir. 2001).

SECURED TRANSACTIONS

FIXTURES. The debtor had purchased 80 acres of farmland on which a center-pivot irrigation system was installed. The debtor granted a mortgage to the lender which covered the land and all fixtures. Several years later, the debtor granted a security interest to another creditor in all farm equipment. The debtor sought to sell the land as part of a Chapter 12 bankruptcy case and the two creditors each sought to include the irrigation system under their security interests. The Bankruptcy Court looked to Peoples State Bank v. Clayton, 580 P.2d 1375 (Kan. Ct. App. 1978), which established a three step judicial test for determining whether personal property was a fixture under Kansas law. The court held that the irrigation system was a fixture covered by the mortgage because (1) the system was firmly attached to the realty above and below ground; (2) the system was not easily removed because it would be time consuming and expensive to dismantle and remove all the equipment; and (3) the system was necessary for the full use of the land. The court also noted a fourth test provided by the UCC that the goods would reasonably be expected to be sold with the land. The court held that farmland in the area required irrigation for full usefulness; therefore, buyer would reasonably expect to have an existing irrigation system included in the sale of the land. The court noted two cases which also held center-pivot systems to be fixtures: Rayl v. Shull Enterprises, Inc., 700 P.2d 567 (1984) Idaho 1984); Western Ag. Land Partners v. Washington Dept. of Revenue, 716 P.2d 310 (Wash. Ct. App. 1986). In re Sand & Sage Farm and Ranch, Inc., 266 B.R. 507 (Bankr. D. Kan. 2001).

WILLS

TESTAMENTARY CAPACITY. In June 1995, the decedent transferred the decedent’s farm to a land preservation charity, reserving a life estate in the decedent. In July and August 1995, the decedent executed amendments to the will which provided for passage of the decedent’s residuary estate to the land preservation charity. In the fall of 1995, the decedent was diagnosed to have Alzheimer’s disease. After the death of the decedent, the decedent’s will was contested by the decedent’s sister and nephew on the basis of the decedent’s lack of testamentary capacity when the will was executed. Although the sister and nephew presented expert testimony about the decedent’s Alzheimer’s disease, the court held that testimony was unreliable because it was based primarily on observations of the decedent several months after the will execution. The court also held that the testimony of the decedent’s advisors about the decedent’s condition at the time of the will’s execution supported a ruling that the decedent was competent at that time. Landmark Trust, Inc. v. Goodhew, No. 1999-381 (Vt. 2001).
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ZONING

AGRICULTURAL USE. The defendant county decided to construct a fire station on land zoned for exclusive farm use (EFU). The fire station was intended to serve primarily rural residents and businesses but was available for some urban calls. Approximately 5 percent of the station’s service area was within urban boundaries. The Oregon Land Use Board of Appeals (LUBA) ruled that the construction and operation of the fire station did not violate the EFU zoning because the station was to be used primarily for rural residents. The plaintiff argued that Or. Rev. Stat. § 215.283 (“Fire service facilities providing rural fire protection.”) allowed fire stations on EFU land only if the station exclusively served rural residents. The court held that the statute did not expressly set any limitation on the area served by a fire station on EFU land but the court reasoned that the fire station must at least serve a predominately rural area; therefore, the LUBA decision was correct. Keicher v. Clackamas County, 29 P.3d 1155 (Or. Ct. App. 2001).

CITATION UPDATES


Estate of Shackleford v. United States, 262 F.3d 1028 (9th Cir. 2001), aff’g, 99-2 U.S. Tax Cas. (CCH) ¶ 60,356 (E.D. Cal. 1999) (estate property valuation) see p. 148 supra.

Gladden v. Comm’r, 262 F.3d 851 (9th Cir. 2001), rev’g and rem’g, 112 T.C. 209 (1999) (capital assets) see p. 141 supra.

IN THE NEWS

LABOR. A federal District Court judge has ordered Iowa Beef Packing, Inc. to pay $3 million to 815 current and former employees for uncompensated time spent to put on and remove work clothing.

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**APPLYING THE AVERAGING CONVENTIONS**

— by Neil E. Harl

Two recently published Notices have focused attention on the application of the mid-year and mid-month conventions to depreciable property. Notice 2001-70 and Notice 2001-74 have provided a one-time break for property placed in service during the fourth quarter of 2001.

**General rule**

The half-year convention (permitting a half-year of depreciation to be deducted in the year property is placed in service) applies to three, five, seven, 10, 15 and 20-year property. Thus, a half-year of depreciation is allowed for the year eligible property is placed in service and a half-year the year the property is disposed of or retired from service if not already depreciated out. Note that the half-year convention applies to 20-year property which includes farm buildings. Under ACRS depreciation placed in service before 1987, farm buildings were subject to a mid-month convention.

If more than 40 percent of the basis of property placed in service during a taxable year (other than depreciable rental property and nonresidential real property) is placed in service during the last three months of the taxable year, a mid-quarter convention applies to all property placed in service during the taxable year. That means property placed in service during the fourth quarter would normally receive one-eighth of a year’s depreciation. It also means that property placed in service during the first quarter of the year would receive seven-eighths of a year’s depreciation, that placed in service during the second quarter would receive five-eighths of a year’s depreciation and property placed in service during the third quarter would be in line for three-eighths of a year’s depreciation.

Two recently published Notices have focused attention on the application of the mid-year and mid-month conventions to depreciable property. Notice 2001-70 and Notice 2001-74 have provided a one-time break for property placed in service during the fourth quarter of 2001.

For residential rental property and nonresidential real property, a mid-month convention applies in the month the property is placed in service and in the month the property is disposed of or retired from service if not already depreciated out.

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.

The next issue of the Digest will be published on January 4, 2002. Happy Holidays to you and yours from the Agricultural Law Press.
Notice 2001-70, Notice 2001-74

In late October of 2001, the Internal Revenue Service announced a one-time relaxation of the mid-year or half-year convention for 2001 only. Under that notice, if the third quarter of a taxpayer’s 2001 year includes September 11, 2001, the notice recognizes that the terrorist attacks on September 11 have disrupted plans to place property in service before October 1 and thus be assured of a half-year of depreciation in 2001.

The notice specifies that, to invoke the relief provision, a taxpayer should print or type on Form 4562, “Election Pursuant to Notice 2001-70.”

A few days after publication of Notice 2001-70, IRS published Notice 2001-74 which specified that the mid-year or half-year convention would be available in 2001 for property placed in service during the year if September 11 falls within the fourth quarter of the taxable year and added that the election could be made on Form 2106, Employee Business Expenses, when appropriate rather than on Form 4562.

Other depreciation convention rules

For partnerships and S corporations, the 40 percent test is applied at the partnership or S corporation levels except for those formed or availed of to avoid the mid-quarter convention or having the mid-quarter convention apply where it otherwise would not. In applying the 40 percent test, nonresidential real property and residential property are disregarded.

Any property placed in service and disposed of in the same taxable year is disregarded for purposes of applying the 40 percent rule. No depreciation is allowed for property placed in service and disposed of the same year. However, if such property is subsequently reacquired and again placed in service during the same tax year, depreciable basis as of the later of the dates placed in service is included.

The mid-quarter convention rules apply to alternative depreciation as well as regular depreciation.

“Listed property” is included in applying the mid-quarter convention rules.

In determining the income tax basis of property for purposes of the 40 percent test, any expense method depreciation purchased during the last three months of the year that is properly expensed is excluded from the aggregate basis of property placed in service. Any personal use of property is reflected in the calculation, also.

If property is subject to the half-year or mid-quarter convention in the year placed in service, the property is also subject to the half-year or mid-quarter convention in the year disposed of.

Nonrecognition transactions

In the event depreciable property is transferred in a nonrecognition transaction in the same taxable year that the property is placed in service by the transferor, the 40 percent test is applied by treating the transferred property as placed in service by the transferee on the date of the transfer. Thus, if the aggregate basis of property (including the transferred property) placed in service by the transferee during the taxable year, the mid-quarter convention applies to the transferee’s depreciable property including the transferred property. The depreciable basis of the transferred property is not taken into account by the transferor in applying the 40 percent test for the taxable year in which the transferor placed the property in service.

FOOTNOTES

3 See note 1 supra.
4 I.R.C. § 168(d)(1).
6 See I.R.C. § 168(e)(1).
7 See 4 Harl, supra note 2, § 29.05[2][C][ii] (2001).
9 I.R.C. § 168(e)(2)(B).
10 I.R.C. § 168(d)(3).
14 Id.
17 I.R.B. 2001-49, ___.
22 See Treas. Reg. § 1.168(d)-1(b).
23 See I.R.C. § 168(d).
25 Treas. Reg. § 1.168(d)-1(b)(2).
27 Treas. Reg. § 1.168(d)-1(c)(1).
29 Treas. Reg. § 1.168(d)-1(b)(7).
30 Id.
31 Id.

* Agricultural Law Manual (ALM).
CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr.

ADVERSE POSSESSION

COUNTY ROAD. The defendant and plaintiff owned ranches which were separated by a strip of land. Each party had its own fence running along the disputed strip and the strip itself was used as a dirt road for access by other neighbors and hunters to land at the end of the strip. The defendant decided to develop a portion of the land as a residential subdivision and petitioned the county to place a paved road on the strip. The defendant discovered that a petition to designate the strip as a road had been granted in 1921; however, the petition was not properly recorded and no one else had any actual knowledge of the road designation, either among the previous owners, neighbors or the parties. The court held that the lack of notice prevented enforcing the road designation against the plaintiffs who held title to the strip. The defendants also argued that the use of the road by neighbors and hunters established the strip as a public road by adverse possession. The court found that most of the public use of the strip was by permission; therefore, no public road was established by such use. Littlefield v. Bamberger, 32 P.3d 615 (Colo. Ct. App. 2001).

BANKRUPTCY

GENERAL-ALM § 13.03.*

EXEMPTIONS

HOMESTEAD. The debtors, husband and wife, owned two neighboring parcels of rural real estate which were claimed as a rural homestead exemption under Tex. Prop. Code § 41.002. One parcel was 59 acres and contained the debtors’ residence and the other 26 acres were used as a mobile home park. The court adopted a blended test which first examined the property under the factors in the statute to determine whether the property was rural or urban. If the property met the statutory definition of rural, the property qualified for the rural homestead exemption. If the property was classified as urban under the statutory test, the nature of the property was examined under the traditional judicial factors. The court held that both parcels met the statutory rural test because the parcels were not within a municipal boundary and were not served by municipal utility services. However, the court held that the 26 acres did not qualify as residential because the property was used as a business. Therefore, the court allowed the exemption for the 59 acre parcel but not for the 26 acre parcel. In re Perry, 267 B.R. 759 (Bankr. W.D. Tex. 2001).

CHAPTER 12-ALM § 13.03[8].*

ELIGIBILITY. The debtor was a corporation wholly-owned by one person. The debtor’s business was the raising, boarding and training of horses on rural property zoned for farming use. The court noted that the horse operation was subject to the same risks inherent in any farm operation and held that the debtor qualified for Chapter 12. In re Showtime Farms, Inc., 267 B.R. 541 (Bankr. E.D. Tex. 2000).

PLAN. The debtor’s Chapter 12 plan modified a secured loan from a creditor by reducing the interest rate from 10 percent to 9.25 percent and changing the loan term from nine years to a 30-year amortization rate with a ten-year balloon payment. The creditor objected to the modification of the loan as not providing the creditor with the full value of the loan over the plan period. The court held that the modification of the loan term would not of itself prevent confirmation of the plan. However, the court held that the debtor failed to demonstrate that the 9.25 percent interest rate was the market rate of interest for this type of loan; therefore, the modification of the loan interest rate prevented confirmation of the plan. The court used a two-part test to determine the sufficiency of the interest rate: (1) there is a rebuttable presumption that the loan contract rate was appropriate and (2) the debtor had the burden to prove that the plan payment interest rate was the market rate for similar loans. In re Showtime Farms, Inc., 267 B.R. 541 (Bankr. E.D. Tex. 2000).

FEDERAL TAX-ALM § 13.03[7].*

DISCHARGE. The debtor had filed income tax returns for 1993 and 1994 but had altered lines 23 and 24 and replaced them with “Non-taxable Compensation” and had altered the jurat language at the end of the form. The debtor filed for Chapter 7 more than three years later and sought to have the taxes declared dischargeable under Section 523. The court held that the altered forms were insufficient to qualify as filed returns under Section 523 because the alterations did not represent an honest and reasonable attempt to satisfy the filing requirements. In re Brumbaugh, 267 B.R. 800 (Bankr. S.D. Ohio 2001).

SETOFF. The IRS had filed an unsecured priority claim and an unsecured non-priority claim for past taxes owed by the Chapter 13 debtor. The debtor filed a tax return for 1999 which claimed a refund. The IRS set off the refund against the non-priority tax claim and the debtor claimed that the refund should have been set off against the priority tax claim first. The debtor argued that allowing the IRS to choose which claim would be set off by the refund was unfair to other unsecured non-priority creditors. The court held that the setoff was proper and allowable under Section 553. In re Crawford, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,769 (Bankr. W.D. Wis. 2001).
FEDERAL AGRICULTURAL PROGRAMS

PACA. The Chapter 13 debtor and spouse owned a corporation which was a dealer under the Perishable Agricultural Commodities Act (PACA) which purchased produce from a producer but failed to make payment for the produce. The debtor had personally guaranteed the corporation’s payment for the produce. The producer filed a claim in the bankruptcy case and sought priority for the claim under the PACA trust provisions. The producer argued that the debtor should be held liable under the PACA trust provisions because the debtor controlled the corporation and personally guaranteed payment. The court noted that there was no claim made that the debtor had received any of the proceeds of the sale of the produce. The court held that the debtor could not be held liable under the PACA trust provisions because the debtor was only secondarily liable for payment for the produce and had not received any of the proceeds from the sale of the produce. In re Ozcelik, 267 B.R. 485 (Bankr. D. Mass. 2001).

FEDERAL ESTATE AND GIFT TAX

CLAIMS. On the date of the decedent’s death, the decedent was involved in a suit filed by the lessor of an oil lease for excess royalty payments made to the decedent. The lessor received some favorable rulings soon after the decedent’s death but settled for a smaller sum than was originally sought from the decedent 15 months after the decedent’s death. The decedent’s estate valued the law suit claim as of the decedent’s death, based on the money judgment sought by the lessor. The IRS argued that the claim was to be valued at the amount that the estate eventually paid or that the estate had discharge of indebtedness income when the settlement was reached to the extent the actual amount paid was less than the claim allowed for estate tax purposes. The court held that the value of the claim was to be determined as of the date of death, based on the information available at that time. The court also held that the estate did not recognize discharge of indebtedness income when it settled for an amount less than the claim’s value as of the date of death. On remand, the Tax Court noted that the appellate court had rejected valuing the law suit at the time of death at the full amount sought by the lessor. The Tax Court also noted that the estate failed to provide any evidence of the value of the lawsuit as of the date of death. The Tax Court held that the IRS valuation was correct, based on all the evidence presented. Estate of Smith v. Comm’r, T.C. Memo. 2001-303, on rem. from, 198 F.3d 515 (5th Cir. 1999) rev’g, 108 T.C. 412 (1997).

FAMILY-OWNED BUSINESS DEDUCTION. In a Chief Counsel Advice letter, the IRS discussed several issues involving the I.R.C. § 2057(i)(3)(P) lien created by the FOBD election. The IRS stated that the lien should identify the real property involved in the election and not rely on identifying personal property such as stock in corporation which owns the property. The IRS also stated that Form 668H, Notice of Federal Estate Tax Lien, should be altered to include notification of the I.R.C. § 2057(i)(3)(P) lien. The IRS suggested that escrow agreements could be used to include personal property, such as corporation stock in the lien. Finally, the IRS stated that third parties with interests in FOBD property must also consent to the FOBD recapture provisions. See also Harl, “Liens for the Family-Owned Business Deduction,” 12 Agric. L. Dig. 121 (2001). CCA Ltr. Rul. 200148052, Oct. 16, 2001.

MARITAL DEDUCTION. The decedent’s entire estate passed to a marital trust for the surviving spouse, resulting in no estate tax. After the estate tax return was filed, the IRS assessed additional taxes and interest for a pre-death gift made by the decedent to the surviving spouse. That assessment was affirmed by the courts, but the estate sought to offset the tax and interest by estate administrative expenses which were in excess of the expenses claimed on the estate tax return. Some of the administrative expenses were charged to estate income and some to estate principal. The IRS argued that the administrative expenses would have to decrease the marital deduction because the expenses decreased the income and principal received by the surviving spouse. The court held that the extra administrative expenses charged to estate income did not diminish the marital deduction because the expenses did not constitute a material limitation on the surviving spouse’s bequest. The court also held that the extra administrative expenses charged to estate principal reduced the marital deduction, although this did not affect the overall estate tax because the entire estate passed to the surviving spouse. The court held that the expense for the interest on the tax deficiency did not reduce the marital deduction. Brown v. United States, 2001-2 U.S. Tax Cas. (CCH) 60,424 (C.D. Calif. 2001).

TRUSTS. The decedents, husband and wife, had established an irrevocable trust funded with a life insurance policy on both decedents. The trust provided that the decedents’ child was to be trustee and that upon the death of the second to die, the proceeds of the policy were to be paid to the trust. The trustee had the discretion to pay any inheritance, estate or income tax resulting from the taxpayers’ deaths. The wife was the second to die and the insurance proceeds were not used by the trustee to pay any taxes resulting from the decedent’s death. The IRS ruled that the insurance proceeds were not included in the wife’s estate because the trustee was not obligated to pay the taxes. Ltr. Rul. 200147039, Aug. 21, 2001.
FEDERAL INCOME TAXATION

BAD DEBTS. The taxpayer owned an interest in several companies. One construction company loaned money to a real estate partnership. The promissory note stated an interest rate but no due date. The note was listed in several audits and reports to the FmHA (now FSA). The construction company terminated without paying the loan and the partnership claimed a bad debt deduction. The taxpayer argued that the promissory note, audits and FmHA reports proved the bona fide debt. The court held that the taxpayer failed to prove that the loan was a bona fide debt. The court discounted the value of the audits and reports because the information was supplied by the taxpayer. Fedewa v. Comm’r, T.C. Summary Op. 2001-176.

BUSINESS EXPENSES. The taxpayer was self-employed as a computer engineer and claimed three payments as business expenses. However, the taxpayer provided no corroborating evidence of the business purpose of the expenses and the court denied the deduction as business expenses. The appellate court affirmed in a decision designated as not for publication. Simpson v. Comm’r, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,750 (6th Cir. 2001), aff’g, T.C. Memo. 1999-274.

CHARITIES. Several charities have made payments to individuals by reason of the death, injury or wounding of an individual incurred as a result of the September 11, 2001 terrorist attacks. The IRS has announced that it will treat such payments made by a charity to individuals and their families as related to the charity’s exempt purpose provided that the payments are made in good faith using objective standards. The IRS noted that legislation in this area is pending in Congress. Notice 2001-78, I.R.B. 2001-50.

DEPRECIATION. The taxpayers owned an S corporation with a third party. The third party retired and sold the stock back to the corporation. The stock sales agreement did not allocate any portion of the sales price to a covenant not to compete by the third party and no covenant not to compete was included in the sales agreement. However, the taxpayers claimed amortization deductions for the alleged value of a covenant not to compete. The Tax Court held that no portion of the stock sales price could be allocated to a covenant not to compete because the parties to the sale did not allocate, or intend to allocate, any portion of the sales price to such a covenant. The appellate court affirmed in a decision designated as not for publication. Miner v. Comm’r, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,752 (9th Cir. 2001).

PENSION PLANS. For plans beginning in November 2001, the weighted average is 5.74 percent with the permissible range of 5.17 to 6.03 percent (90 to 106 percent permissible range) and 5.17 to 6.32 percent (90 to 110 percent permissible range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). Notice 2001-71, I.R.B. 2001-55.


The taxpayer was a retired teacher. During employment as a teacher, the taxpayer made after-tax contributions to a pension plan. These contributions formed a tax basis in the pension plan which was allocated ratable to each year distributions were made after the taxpayer’s retirement. The taxpayer argued that the basis from these contributions should be increased to reflect the amount of inflation which occurred after the contributions were made. The court held that the taxpayer’s basis in the pension plan could not be increased for inflation because there was no authority in the statute or regulations for increasing basis because of inflation. The appellate court affirmed in a decision designated as not for publication. Nordtvedt v. Comm’r, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,772 (9th Cir. 2001), aff’g, 116 T.C. 165 (2001).

PERSONAL HOLDING COMPANY. The taxpayer was a calendar year basis personal holding company. In September 1997, the taxpayer declared a consent dividend to its shareholders under I.R.C. § 565. All the shareholders signed the proper consent Form 972. The taxpayer filed these consents and Form 973 (Corporate Claim for Deduction for Consent Dividends) with its Form 1120 in September 1997, pursuant to an extension to file. Some of the taxpayer’s shareholders were foreign persons. The taxpayer included a payment of 30 percent of the amount of the consent dividends attributable to the foreign shareholders with its Form 1120. Because the taxpayer had already filed its 1996 Form 1042, it filed an amended return to report the consent dividends in September 1997. The IRS assessed the taxpayer interest on the tax attributable to the consent dividends from the due date of the Form 1120, March 15, 1997, to the date the tax was paid in September 1997. The IRS ruled that the interest was assessed properly because, although the taxpayer had until the extended filing date to file the consent forms, the tax had to be paid by the original due date for Form 1120. Ltr. Rul. 200147005, June 15, 2001.

SAFE HARBOR INTEREST RATES

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PRODUCTS LIABILITY

FRONT LOADER. The plaintiff had owned a tractor and front-end loader for over 19 years. The plaintiff had altered the front-end loader by soldering on two brackets to hold a bale fork. The plaintiff was injured while transporting a large round hay bale when the loader lifted too high and caused the hay bale to roll back onto the plaintiff in the tractor. The tractor did not have a roll over protection system. The accident was apparently caused by a defective valve on the front-end loader which allowed the loader to rise without control. The plaintiff filed suit against the tractor and front-end loader manufacturer under the Kansas Product Liability Act, Kan. Stat. §§ 60-3301 et seq., for negligence, strict liability, and breach of warranty and included a claim for failure to warn. The defendant argued that its liability was extinguished by Kan. Stat. § 60-3302(a) because the tractor and front-end loader were past their useful safe lives. The statute provided a presumption that equipment over 10-years old was past its useful safe life. The plaintiff presented evidence of the equipment’s condition and expert testimony that the tractor and front-end loader were not past their useful safe lives. The court held that the plaintiff had presented sufficient evidence of the tractor and front-end loader’s condition to make their useful safe life a jury question. On the failure to warn claim, the defendant argued that the plaintiff had sufficient personal knowledge of the dangers involved in carrying large round hay bales to relieve the defendant of any duty to warn. The defendant also argued that the modifications to the front-end loader were sufficient to relieve the defendant of any strict liability. The court noted that, without the modification by the plaintiff, the front-end loader would not have been able to transport large round hay bales and the accident would not have happened. Therefore, the court dismissed the plaintiff’s claim in strict liability because of substantial modification of the front-end loader. Hiner v. Deere & Co., 161 F. Supp.2d 1279 (D. Kan. 2001).

PROPERTY

CONVERSION. The plaintiffs were co-owners of timberland with the defendant. The defendant had purchased a two-thirds interest in the timber held by siblings of the plaintiffs and had cut the timber or contracted with others to cut the timber without first obtaining permission from the plaintiffs. The defendant paid the plaintiffs their share of the value of the timber; however, the plaintiffs sued for conversion. The jury agreed with the plaintiffs’ valuation of the timber and awarded the plaintiffs the difference between what the defendant paid them and one-third of the true value of the timber, plus the cost of restoration. The defendant argued that, as co-owner, the defendant had the right to harvest the timber. The court upheld the jury verdict. Dillard v. Wade, 45 S.W.3d 848 (Ark. Ct. App. 2001).

SECURED TRANSACTIONS

PRIORITY. The debtor had granted a security interest in farm equipment and after-acquired property to a bank in 1985. In 1998, the debtor borrowed money from a creditor to purchase more farm equipment and granted a purchase-money security interest (PMSI) in that equipment to the creditor. The PMSI also contained a future advances clause to cover any additional loans. In 1999, the debtor borrowed additional funds from the creditor and a new promissory note was executed which referred back to the original loan and security interest. The additional funds were used to purchase more farm equipment. The loan amount was increased again in 2000 under the same terms. The PMSI creditor argued that its security interest had priority over the bank’s security interest because of operation of Iowa Code 554.9107(b) which provided superpriority to PMSIs. The court held that the “dual status” doctrine applied to the PMSI to allow superpriority status to the security interest to the extent the loan proceeds were attributable to the purchased equipment. To the extent the loan proceeds were used for other purposes, no superpriority was allowed. The court also held that the payments made by the debtor on the loan would be applied first to the first equipment purchases and then to the non-equipment purchase use of the loan proceeds, essentially a first-in first-out method. The court declined to make a final determination because the debtor and creditor had not provided sufficient evidence of the loan’s history to determine the extent of funds attributable to the purchase of the farm equipment. In re McAllister, 267 B.R. 614 (Bankr. N.D. Iowa 2001).

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