The reporting of gains and losses on the stock of cooperatives has been a pressing issue in many farm communities as value-added cooperatives and other cooperatives have failed or merged with cancellation of patronage equities. In many instances, the question is the proper characterization of the equity interest relinquished by the patron and whether losses are ordinary losses or capital losses.

Rev. Rul. 70-64

A 1970 revenue ruling, Rev. Rul. 70-64, has provided helpful guidance for situations similar factually to the facts in the ruling. In that ruling, a taxpayer operating a chicken farm became a member of an agricultural cooperative for purposes of acquiring supplies and marketing eggs and chickens. The cooperative followed the practice of retaining patronage dividends to augment capital with qualified written notices of allocation. The cooperative normally redeemed the qualified notices of allocation, usually within one to two years. In the year in question, the cooperative redeemed the qualified written notices of allocation but at less than their stated amount on issuance. Thus, the taxpayer incurred a loss when the allocation was redeemed. The question was the nature of the loss—whether an ordinary loss or a capital loss.

The ruling states that—

“...the taxpayer joined the cooperative to facilitate his business and to make it more profitable. The transaction that gave rise to the issuance of the notice of allocation arose in the ordinary course of taxpayer’s trade or business. Accordingly, the loss incurred by the taxpayer upon redemption of the qualified written notice of allocation is an ordinary loss deductible...under the provisions of section 165 of the Code.”

The loss was measured by the difference between the stated amount included in income in the earlier year and the amount received upon redemption.

It is noted that the loss did not involve an equity investment by the patron in the cooperative; rather, the loss involved the failure to receive the benefit of amounts reported into income in the earlier year.

Investment in cooperatives

The more difficult question is the proper treatment of gains and losses for equity interests in a cooperative which were purchased or otherwise acquired in a

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
transaction that did not involve allocated patronage earnings.\textsuperscript{10}

It is important to note that all assets are considered to be capital assets other than for specified exceptions.\textsuperscript{11} The exceptions are for—(1) inventory property,\textsuperscript{12} (2) property held by the taxpayer primarily for sale to customers in the ordinary course of a trade or business,\textsuperscript{13} (3) depreciable property used in the trade or business,\textsuperscript{14} (4) real property used in the trade or business,\textsuperscript{15} (5) copyrights and compositions,\textsuperscript{16} and (7) U.S. Government publications.\textsuperscript{17}

Stock in a cooperative does not seem to fall within any of the exceptions.\textsuperscript{18} Therefore, it would appear that an investment in stock of a cooperative, including a value-added cooperative, would be a capital asset with a loss properly characterized as a capital loss.\textsuperscript{19}

**Cooperative part of “trade or business”?**

A further question is whether an equity interest in a cooperative could be classified as a “Section 1231 asset” which would permit net losses to be treated as ordinary losses.\textsuperscript{20} Some have argued that, since membership in some cooperatives requires members to be producing a particular product (e.g., corn or sugar beets), membership in the cooperative could be deemed a part of the trade or business.

The problem with that argument is that the definition of “property used in the trade or business” for purposes of Section 1231 capital gain (or ordinary loss) treatment is relatively narrow—

“The term ‘property used in the trade or business’ means property used in the trade or business, of a character which is subject to the allowance of depreciation provided in section 167, held for more than 1 year, and real property used in the trade or business, held for more than 1 year...”\textsuperscript{21}

Obviously, cooperative stock or other equity instruments in a cooperative are neither depreciable property nor real property used in the trade or business.\textsuperscript{22}

**In conclusion**

Losses attributable to allocated patronage which has been reported into income appear to be deductible as ordinary trade or business losses.\textsuperscript{23} However, losses from investments in cooperative equities would seem to be properly characterized as capital losses.\textsuperscript{24}

**FOOTNOTES**

2. See I.R.C. §§ 165, 1231, 1221.
4. Id.
5. I.R.C. § 1388(c).
7. Id.
8. Id.
9. Id.
10. See I.R.C. § 1388.
12. I.R.C. § 1221(1).
13. Id.
15. Id.
17. I.R.C. § 1221(5).
18. Cf. Peake v. Comm’r, 10 TCM 577 (1951) (taxpayer’s interest in cooperative apartment venture consisted of stock in cooperative apartment corporation rather than of proprietary lease and deduction for loss in year investment became worthless was long-term capital loss).
22. Id.

**CASES, REGULATIONS AND STATUTES**

by Robert P. Achenbach, Jr.

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**BANKRUPTCY**

**FEDERAL TAX-ALM § 13.03[7].**

**DISCHARGE.** The debtor failed to file tax returns for several years and the IRS created substitute returns based upon an interview of the debtor under oath. The debtor argued that the substitute returns were sufficient to make the taxes dischargeable under Section 523(a)(1)(B). The court held that the substitute returns were not sufficient because the debtor did not sign the returns or participate in the execution of the returns. The decision is designated as not for publication. *In re Wright*, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,127 (9th Cir. 2001).

**CONTRACTS**

**WARRANTY.** The plaintiffs were cotton farmers who purchased cotton seed from the defendants. The plaintiffs alleged that the seed was old, resulting in loss of yield. The seed was purchased by the defendant from the producer who placed the seed in labeled bags. The labels contained codes which indicated the seed’s age; however, the defendant’s employees did not know the codes or the age of the seed. The

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\*Agricultural Law Manual (ALM).
plaintiffs brought an action in breach of implied warranty of fitness for a particular purpose, fraud and breach of fiduciary duty. The court upheld the trial verdict for the defendant because the plaintiffs failed to demonstrate that (1) the defendant had a duty to determine and communicate the age of the seed; (2) the defendant’s employees knew or should have known the age of the seed; (3) the defendant had any fiduciary duty towards the plaintiffs; and (4) the defendant knew the plaintiffs were relying on the defendant’s skill and judgment to select the seed. The court also noted that the seed was purchased on credit and that the credit agreement carried a limitation of warranty denying any representation as to the fitness of the seed. Day v. Tri-State Delta Chemicals, Inc., 165 F. Supp. 2d 830 (E.D. Ark. 2001).

FEDERAL AGRICULTURAL PROGRAMS

CONSERVATION RESERVE PROGRAM. The CCC has issued proposed regulations which amend the amendments to the CRP regulations which would make certain orchard lands, vineyards, berry lands, and hay lands eligible for enrollment in the CRP and provide for acquisition of private sector technical assistance. 66 Fed. Reg. 63339 (Dec. 6, 2001).

KARNAL BUNT. The APHIS has adopted as final regulations which establish new areas to be regulated because of the existence of Karnal bunt disease. The regulations also remove other areas from regulation. 66 Fed. Reg. 63151 (Dec. 5, 2001).

SWINE. The APHIS has adopted as final regulations amending the current requirements for moving swine interstate to allow persons to move swine interstate without meeting individual swine identification and certain other requirements if they move the swine within a single swine production system, and if each swine production system signs an agreement with the APHIS and involved state governments to monitor the health of animals moving within the swine production system and to facilitate traceback of these animals if necessary. 66 Fed. Reg. 65598 (Dec. 10, 2001).

FEDERAL ESTATE AND GIFT TAX

ANNuity. The IRS has issued a mortality table, based upon a fixed blend of 50 percent of the unloaded male mortality rates and 50 percent of the unloaded female mortality rates underlying the mortality rates in the 94 GAR, projected to 2002, for purposes of adjusting benefits or limitations under I.R.C. § 415(b)(2) and for determining the present value of plan benefits under I.R.C. § 417(e)(3) and the corresponding provisions of ERISA. Rev. Rul. 2001-62, I.R.B. 2001-__.

DONEE LIABILITY. The decedent had made inter vivos gifts to the taxpayers who were appointed executors of the decedent’s estate. The gifts were made more than 10 years before the decedent’s death. The gifts resulted in a gift tax liability for the decedent’s estate which was unpaid. The IRS sought to impose personal liability on the taxpayers as donees of the gifts under I.R.C. § 6324(b). The taxpayers argued that the lapse of the 10-year limitation period on the lien in I.R.C. § 6324(b) extinguished their liability for the gift tax. The court held that the 10-year period applied only as to the lien which secured the government’s claim for taxes. The court held that the proper limitation period on personal liability was the three-year period of I.R.C. § 6502(a) which had not expired because the gift tax return was not filed until 11 years after the gifts were made and a deficiency notice was filed within three years after the return was filed. See also Estate of Davenport v. Comm’r, 184 F.3d 1176 (10th Cir. 1999), United States v. Estate of Davenport, 2001-2 U.S. Tax Cas. (CCH) ¶ 60,426 (N.D. Okla. 2001).

FAMILY-OWNED BUSINESS DEDUCTION. In a Chief Counsel Advice letter the IRS ruled:

1. How should personal property be described on the Form 668H?

“The section 2057(i)(3)(P) lien is filed on Form 668H, Notice of Federal Estate Tax Lien, as modified pursuant to guidance issued to all Compliance Area Directors on May 4, 2001. There are no specific requirements in section 2057 or section 6324B to govern how personal property should be described in the lien notice. We take the position that a description of personal property should be sufficient as long as it reasonably identifies what is described. For example, the description should not merely provide the name of the qualified family-owned business corporation but should sufficiently reference the property used to secure the section 2057(i)(3)(P) lien, i.e., the number of shares of stock held in XYZ corporation. We don’t believe that such exact and detailed information as serial or i.d. numbers is required, however.

2. Would a section 2057(i)(3)(P) lien on personal property be enforceable against a subsequent purchaser of, or creditor who executed against, such property?

“...as long as the section 2057(i)(3)(P) lien notice is filed in accordance with section 6323(f), the section 2057(i)(3)(P) lien will have priority over a subsequent purchaser, holder of security interest, mechanic’s lien or judgment lien creditor. The section 2057(i)(3)(P) lien is, therefore, enforceable against a purchaser of, or creditor who executes by levy against, the subject property.

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“There are practical problems associated with the enforcement of the section 2057(i)(3)(P) lien against personal property, however. The Internal Revenue Service (the “Service”) may have no way of knowing the section 2057(i)(3)(P) lien property has been transferred or executed upon. The Service may not, therefore, be able to locate the purchaser or creditor in possession of the property in order to enforce its lien interest.

“Accordingly, it is preferable, whenever possible, to obtain an agreement to use real property to secure the section
The "interest" in the qualified family-owned business may include the underlying real property itself and is not limited to the type of ownership interest in the property such as shares of stock.

We have been formally advised of certain offices entering into additional agreements which may be effective to secure the Service's interest and prevent transfer of the section 2057(i)(3)(P) lien property in some cases. For example, we have learned that one office has drafted an escrow agreement which may be executed by the Service, the estate representative, the qualified heirs, and an escrow agent. Pursuant to such agreement, shares of stock used as section 2057(i)(3)(P) property are deposited with and held by an escrow agent bank, to be held and distributed by such agent only in accordance with certain terms and conditions. The agreement provides that in the event of tax recapture under section 2057(f) (described in item 4 below), the Service may pursue enforcement including requiring the administrative sale or delivery to the Service of the escrow property. The agreement further provides for termination of the escrow agreement upon the lapse of the time period for recapture under section 2057(f) or upon full payment of all estate taxes owed. Upon termination and agreement by the Service, the shares may be released to the qualified heirs if all taxes have been satisfied. You may wish to consider the use of a similar agreement, contingent upon local law." The ruling also discussed the circumstances which require a Chief Counsel review of the lien and transactions involving FOBD property which cause recapture of FOBD benefits. These issues and others will be discussed in an article by Neil Harl in the next issue of the Digest. CCA Ltr. Rul. 200149033, Nov. 1, 2001.

GENERATION SKIPPING TRANSFER TAX. The decedent had a step-brother who was not adopted by the decedent’s natural parents. The step-brother had three children, two of whom were more than 37 1/2 years younger than the decedent. The decedent bequeathed $1 million in trust to each of the children of the step-brother. The IRS ruled that the children were assigned to generations based upon their age difference with the decedent because none of the children were lineal descendants of the decedent’s father or mother; therefore, the children who were more than 37 1/2 years younger than the decedent were assigned to two generations below the decedent for GSTT purposes. Ltr. Rul. 200150003, Aug. 22, 2001.

GIFT. The taxpayer created an irrevocable trust with family members as beneficiaries but retained a testamentary power to appoint trust property to the beneficiaries or other family members. Any property not appointed by the taxpayer’s will would be distributed equally among the beneficiaries. The IRS ruled that the transfer of property to the trust was not a completed gift because the taxpayer retained a power to change the beneficiaries. Ltr. Rul. 200148028, Aug. 27, 2001.

GROSS ESTATE. The decedent’s estate included several pieces of real estate which were encumbered by mortgages. The estate argued that only the decedent’s equity interest was included in the gross estate. The court ruled that the full market value of the properties was included in the decedent’s gross estate and that the amount of the mortgages was an allowed deduction for the estate. Estate of Fung v. Comm’r, 117 T.C. No. 21 (2001).

IRA. The decedent owned two IRAs. The decedent’s surviving spouse was the sole beneficiary of the decedent’s estate and also served as executrix of the estate. The IRA funds were distributed directly to the decedent’s estate and the surviving spouse contributed the funds to IRAs in the spouse’s name. The spouse did not make a specific election to treat the decedent’s IRAs as the spouse’s own; however, the IRS noted that the proposed regulations do not provide the exclusive means for making this election. The IRS ruled that the IRA funds would not be considered as inherited from the decedent and that the spouse would not be taxed on the distribution to the estate or to the spouse. Ltr. Rul. 200151054, Sept. 25, 2001.

VALUATION OF STOCK. The taxpayers transferred stock in a corporation to their children. The stock was valued using a discounted future cash flow approach which included a “tax effect” which would occur if the corporation was converted to a C corporation, subject to corporate income tax. The court held that the “tax effect” could not be considered in valuing the stock because there was no evidence that the corporation would lose its S corporation status. A 25 percent discount for lack of marketability applied by the IRS was approved because the taxpayer failed to show that the discount was inappropriate. Gross v. Comm’r, 2001-2 U.S. Tax Cas. (CCH) ¶ 60,425 (6th Cir. 2001), aff’g, T.C. Memo. 1999-254.

FEDERAL INCOME TAXATION

ACCOUNTING METHOD. The IRS has announced that it will issue procedures under I.R.C. §§ 446 and 471 that will allow qualifying small business taxpayers with annual gross receipts of less than $10 million for the last three years to use the cash receipts and disbursements method of accounting with respect to eligible trades or businesses. The procedures will not apply to farming businesses. Notice 2001-76, I.R.B. 2001-52.

BAD DEBTS. The taxpayer was employed full time as a chemistry professor and also operated a money lending business. The taxpayer either directly loaned people or businesses money or purchased loans made by the businesses. The court held that the taxpayer operated a money-lending business for income tax purposes. Several of the debtors defaulted on their loans and the taxpayer obtained judgments against the debtors. The taxpayer claimed bad debt deductions for these loans. The court denied the bad debt deductions because either (1) the taxpayer was still receiving payments on the loans or (2) the taxpayer failed to provide evidence of the worthlessness of the loan or the financial

The taxpayer’s brother owned and operated an incorporated environmental consulting business. The taxpayer was employed at a university in an unrelated occupation. The business experienced financial difficulties and the taxpayer was made the sole shareholder in order for the corporation to obtain loans which the taxpayer personally guaranteed. The taxpayer also provided funds borrowed by the taxpayer against the taxpayer’s residence and pension fund. The corporation executed a promissory note for the funds provided by the taxpayer but the note was not signed, had no repayment or interest terms, provided no collateral and had no enforcement provisions. The court denied the taxpayer any bad debt deduction because the court held that no bona fide debt existed and that the funds were capital contributions to the corporation. The court noted that the corporation had no ability to borrow money from unrelated sources and that the taxpayer never received or demanded any repayment. **Fuscaldo v. United States, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,780 (E.D. Penn. 2001).**

**BUSINESS EXPENSES.** The taxpayer owned an 18 unit apartment building and claimed income and expenses on Schedule E for the operation of the building. The taxpayer also claimed expense deductions on Schedule C for a business named as the address of the apartment building. The taxpayer presented stacks of receipts to support the claimed deductions but failed to provide any explanation of how the receipts related to the claimed deductions. The court held that the expense deductions were disallowed for lack of substantiation. **Triplett v. Comm’r, T.C. Memo. 2001-320.**

**CORPORATIONS**

**CONSTRUCTIVE DIVIDENDS.** The taxpayers owned and operated a car dealership. The taxpayers did not own any vehicles but used vehicles belonging to the corporation. The taxpayers did not provide any evidence of the business or personal use of the vehicles. The court held that the fair rental value of the vehicles was included in the taxpayers’ income as constructively received. **Whitehead v. Comm’r, T.C. Memo. 2001-317.**

**COURT AWARDS AND SETTLEMENTS.** The taxpayer had purchased an automobile dealership and had filed a law suit against an automobile distributor for breach of contract, violation of state law, RICO violations, and fraud. The petition made no mention of personal injuries or claims for damages for personal injuries. The parties reached a settlement and the taxpayer’s attorney’s included language in the settlement that the majority of the settlement proceeds were paid for personal injuries but without naming any of the injuries. The court held that the entire settlement proceeds were included in gross income because (1) the settlement did not allocate any part of the proceeds to personal injuries but claimed all as for personal injuries, (2) the petition did not allege any personal injuries or seek damages for personal injuries, (3) no discovery was conducted as to the nature and extent of personal injuries, (4) the negotiations did not discuss any personal injuries, and (5) the defendant’s attorney testified that the settlement was only for economic damages. **In re Florida, 268 B.R. 875 (Bankr. M.D. Fla. 2001).**

**DEPRECIATION.** The taxpayers were three sheep-breeding partnerships which sold partnership interests to investors. The partnerships were denied depreciation and other business deductions for the sheep because the partnerships failed to provide evidence of ownership or even that the sheep existed. The appellate court affirmed in a case designated as not for publication. **River City Ranches #4 v. Comm’r, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,105 (9th Cir. 2001), aff’g, T.C. Memo. 1999-209.**

**DISASTER PAYMENTS.** On December 7, 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 severe storms and tornadoes on November 24-25, 2001. **FEMA-1399-DR.** On December 5, 2001, the President determined that certain areas in the Territory of Guam were eligible for assistance under the Act as a result of an earthquake on October 13, 2001. **FEMA-1397-DR.** On December 7, 2001, the President determined that certain areas in Mississippi were eligible for assistance under the Act as a result of severe storms, tornadoes and flooding on November 24, 2001. **FEMA-1398-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.

**EMPLOYEE BENEFITS.** An employer provided health coverage for its employees through a group health insurance policy which constituted accident or health coverage for purposes of the exclusion for employer-provided accident or health coverage under I.R.C. §106(a). The employer deducted amounts from the employees’ wages to pay for the insurance and then reimbursed the employees for the wage reduction. The IRS ruled that the reimbursement amounts that the employer paid to the employees were included in the employees’ gross income under I.R.C. § 61 and are subject to employment taxes under I.R.C. §§ 3401, 3121(a), and 3306(b). **Rev. Rul. 2002-3, I.R.B. 2002—.**

**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, 267 F.3d 510 (6th Cir. 2001), aff’g, 107 F. Supp.2d 937 (S.D. Ohio 2000).**

**HOME OFFICE.** The taxpayer was an architect who was employed by a commuter railroad. The taxpayer used a spare room as a home office, although the home office was not required as a condition of employment. The taxpayer performed 60 percent of the taxpayer’s work at the employer’s office with the remainder spent at the home office.
or at work sites. The taxpayer did not provide any evidence of the type of work performed at the work areas; therefore, the court looked at only the amount of time spent at each location. The court held that no home office deductions were allowed because the taxpayer’s principal place of business was the company office and the home office was not used for the convenience of the employer. The case is designated as not for publication. Tokh v. Comm'r, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,128 (7th Cir. 2001).

INTEREST RATE. The IRS has announced that, for the period January 1, 2002 through March 31, 2002, the interest rate paid on tax overpayments is 6 percent (5 percent in the case of a corporation) and for underpayments at 6 percent. The interest rate for underpayments by large corporations is 8 percent. The overpayment rate for the portion of a corporate overpayment exceeding $10,000 is the federal 3.5 percent.


LEY. The IRS has released Publication 1494, which contains tables that are to be used in computing the amount of an individual’s income that will be exempt from a notice of levy to collect delinquent taxes in 2002. Notice 2001-83, I.R.B. 2001-__.

PASSIVE ACTIVITY LOSSES. The taxpayer owned several residential rental properties in which the taxpayer actively participated. The taxpayer claimed passive losses in excess of $25,000 from the rental activities. The court held that the taxpayer could not claim more than $25,000 of the passive losses as a deduction because the taxpayer did not provide evidence of the amount of personal services and time devoted to the rental activity in order to meet the requirements of I.R.C. § 469(c)(7). Hajiyani v. Comm’r, T.C. Summary Op. 2001-183.

PENSION PLANS. For plans beginning in December 2001, the weighted average is 5.72 percent with the permissible range of 5.15 to 6.01 percent (90 to 106 percent permissible range) and 5.15 to 6.29 percent (90 to 110 percent permissible range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). Notice 2001-80, I.R.B. 2001-__.

QUALIFIED DEBT INSTRUMENTS. The IRS has announced the 2002 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>1274A(b)</th>
<th>1274A(c)(2)(A)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$4,217,500</td>
<td>$3,012,500</td>
<td></td>
</tr>
</tbody>
</table>

The $4,217,500 figure is the dividing line for 2002 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 $4,217,500 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 $3,012,500 or less (for 2002), both parties may elect to account for the interest under the cash method of accounting.


RETURNS. The IRS has announced that IRS Notice 1036 (Rev. December 2001), which contains the early release copies of the 2001 income tax withholding and advance earned income credit payment tables for wages paid in 2002, are expected to be posted shortly to the IRS website at http://www.irs.gov, under the Forms and Publications Section.

The IRS has determined that a taxpayer that is a partner, shareholder, or beneficiary of a taxpayer affected by the September 11, 2001, terrorist attack, is also an affected taxpayer eligible for all the relief granted by Notice 2001-61 and Notice 2001-68. Thus, for example, a partner that is an individual income taxpayer with an extended due date of October 15, 2001, for the 2000 return will have until February 12, 2002, to file the return. Taxpayers that qualify for relief under this announcement should mark “September 11, 2001, Terrorist Attacks - Passthrough Entity” in red ink on the top of their returns or other documents filed with the IRS.

The IRS has adopted as final regulations that authorize the Secretary of the Treasury to accept payment of taxes by credit card or debit card. 66 Fed. Reg. 64740 (Dec. 14, 2001), adding Treas. Reg. § 301.6103(k)(9)-1, 2.

SAFE HARBOR INTEREST RATES

<table>
<thead>
<tr>
<th>January 2002</th>
<th>Annual</th>
<th>Semi-annual</th>
<th>Quarterly</th>
<th>Monthly</th>
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<tr>
<td><strong>Short-term</strong></td>
<td></td>
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<tr>
<td>AFR</td>
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<td>2.97</td>
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<td><strong>Mid-term</strong></td>
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</tr>
<tr>
<td>AFR</td>
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<td>4.44</td>
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<tr>
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<tr>
<td><strong>Long-term</strong></td>
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<tr>
<td>120 percent AFR</td>
<td>6.57</td>
<td>6.47</td>
<td>6.42</td>
<td>6.38</td>
</tr>
</tbody>
</table>


SALE OF RESIDENCE. The taxpayer owned a condominium unit which was used as a residence. The taxpayer sold the unit and moved into an apartment in an apartment building owned by the taxpayer. The sale of the condominium resulted in gain for the taxpayer but the taxpayer argued that the gain was not included in income. The taxpayer did not provide any evidence to support exclusion of the gain under I.R.C. §§ 121 or 1034; therefore, the court held that the taxpayer could not exclude the gain under I.R.C. § 120 percent AFR 6.57 6.47 6.42 6.38 110 percent AFR 6.02 5.93 5.89 5.86 AFR 5.46 5.39 5.35 5.33 120 percent AFR 5.40 5.33 5.29 5.27 110 percent AFR 5.46 5.39 5.35 5.33 AFR 2.73 2.71 2.70 2.69 110 percent AFR 3.00 2.98 2.97 2.96 AFR 3.28 3.25 3.24 3.23 110 percent AFR 4.94 4.88 4.85 4.83 AFR 5.40 5.33 5.29 5.27 120 percent AFR 6.02 5.93 5.89 5.86 AFR 6.57 6.47 6.42 6.38 120 percent AFR 6.57 6.47 6.42 6.38.
limit for the maximum earned income tax credit is $4,910 for taxpayers with no children, $7,370 for taxpayers with one child, and $10,350 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. 2001-59, I.R.B. 2001-52.

TAX RETURN PREPARERS. The IRS has announced that tax return preparers, as defined in Treas. Reg. § 301.7216-1(b)(2), are advised that, although tax return preparers may be subject to the privacy provisions of the Gramm-Leach-Bliley Act, those provisions do not supersede, alter, or affect the preexisting requirements of I.R.C. § 7216 restricting the disclosure or use of tax return information by a tax return preparer. Specifically, the Gramm-Leach-Bliley Act does not permit use or disclosure of tax return information prohibited by I.R.C. § 7216 and regulations promulgated thereunder. Notice 2002-6, I.R.B. 2002-__.

WITHHOLDING TAXES. The IRS has ruled that, if an entity classified as a partnership becomes a disregarded entity for federal tax purposes and if the disregarded entity chooses to calculate, report, and pay its employment tax obligations under its own name and EIN pursuant to Notice 99-6, 1999-1 C.B. 321, the disregarded entity must retain the same EIN for employment tax purposes it used as a partnership. For all federal tax purposes other than employment obligations or except as otherwise provided in regulations or other guidance, a disregarded entity must use the TIN of its owner. The IRS also ruled that, if an entity classified as a disregarded entity for federal tax purposes calculates, reports, and pays its employment tax obligations under its own name and EIN pursuant to Notice 99-6 and if the federal tax classification of that entity changes to a partnership, the partnership must retain the same EIN it used as a disregarded entity. Rev. Rul. 2001-61, I.R.B. 2001-50, 573.

NEGLIGENCE

AERIAL SPRAYING. The defendant had used a helicopter to spray herbicide on fields neighboring the plaintiff’s land. Although the wind was light when the spraying began, the wind speed increased during the spraying. The defendant testified that the defendant believed that the wind was not headed toward the plaintiff’s property. However, the wind did blow the herbicide spray onto the plaintiff’s property, destroying several trees. The trial court had granted summary judgment to the plaintiff for treble damages under S.D. Code § 21-3-10 for wrongful injury to trees caused by trespass. The appellate court reversed, holding that S.D. Code § 21-3-10 did not apply where the trespass was “casual and involuntary.” The appellate court held that the defendant’s testimony that the defendant misjudged the wind direction raised a material issue of fact as to whether the trespass of the spray was casual and involuntary so as to make summary judgment improper. Kurth v. Aerial Blades, Inc., 634 N.W.2d 307 (S.D. 2001).

SECURED TRANSACTIONS

PRIORITY. A grain farmer borrowed money from the plaintiff bank and granted the bank a security interest in the crop. The bank perfected the security interest by filing a financing statement. The farmer identified one potential buyer of the grain whom the plaintiff notified as to the security interest. However, the farmer sold the grain to a different buyer whom the farmer directed to send the proceeds to another creditor, the defendant. Both the buyer and the defendant were not aware of the plaintiff’s security interest in the crop or proceeds at the time. The plaintiff conceded that, under Iowa Code § 554.9307(4)(a), the security interest did not survive the sale of the crop to a buyer who was not notified about the security interest; however, the plaintiff argued that, under Iowa Code § 554.9306(2), the security interest continued as to the proceeds which were paid to the defendant. The court acknowledged that there is a split of authority among the states as to whether UCC § 9-306(2) applies where the proceeds are not paid directly to the debtor. The issue involved whether the language “also continues in any identifiable proceeds including collections received by the debtor” means that all proceeds must have been received by the debtor or just collections. The court held that the security interest continues as to the proceeds whether or not the proceeds are first paid to the debtor; therefore, the defendant was liable for the proceeds to the plaintiff. The court noted that Iowa had adopted Revised UCC § 9-306 which no longer makes any distinction as to payment of the proceeds, eliminating the issue in this case. First State Bank v. Clark, 635 N.W.2d 29 (Iowa 2001).

STATE REGULATION OF AGRICULTURE

MILK MARKETING ORDERS. The plaintiff was a Vermont organic milk handler which purchased solely organic milk from producers for resale as organic milk and organic milk products. Vermont milk handlers were subject to the Northeast Interstate Dairy Compact which established a minimum price for milk and assessed handlers/processors the difference between the minimum price and the price established by federal regulation. Because of the higher costs of producing organic milk, the price paid by the plaintiff to producers was significantly above the federal price. The plaintiff sought an exemption from the assessment based upon the higher costs of producing organic milk. The Northeast Dairy Compact Commission ruled that the plaintiff failed to demonstrate that the costs of producing organic milk were significantly higher than non-organic milk; therefore, no exemption was allowed. The court upheld the commission’s ruling as not arbitrary, capricious or an abuse of discretion. Organic Cow, LLC v. Northeast Dairy Compact Comm’n, 164 F. Supp.2d 412 (D. Vt. 2001).

ORGANIC MILK: AN ENTITLEMENT? The Producer...
CITATION UPDATES

Francisco v. United States, 267 F.3d 303 (3d Cir. 2001), aff’g, 54 F. Supp.2d 427 (E.D. Penn. 1999) (court awards and settlements) see 12 Agric. L. Dig. 165.

Estate of Jameson v. Comm’r, 267 F.3d 366 (5th Cir. 2001), rev’g and rem’g, T.C. Memo. 1999-43 (business expenses) see 12 Agric. L. Dig. 156 (2001).

Estate of Powell v. United States, 166 F.3d 468 (W.D. Va. 2001) (gift) see 12 Agric. L. Dig. 68 (2001).

IN THE NEWS

PATENTS. The U.S. Supreme Court has ruled 6-2 that seeds for new plants developed through genetic engineering or other breeding techniques could claim protection under a section of federal patent law. The court held that the Plant Patent Act of 1930 and the Plant Variety Protection Act of 1970 were not the exclusive means to protect intellectual property rights in seeds and that seeds could be patented under the general utility patent law which does not have a “saved seed” exemption and no research exemption. A future issue of the Digest will publish an article on this case by Roger McEowen. J.E.M. Supply, Inc. v. Pioneer HiBred Inter., Inc., 534 U.S. ___ (2001).

PORK CHECKOFF. The U.S. District Court for the Western District of Michigan has just ruled that Secretary of Agriculture Ann Veneman acted in accordance with the law when she committed the U.S. Department of Agriculture to an agreement with the Michigan Pork Producers Assn., the National Pork Producers Council (NPPC) and three Michigan pork producers to continue the national pork checkoff program. Responding to a complaint from the Campaign for Family Farms that the agreement was illegal and invalidated a continuation referendum last year in which a majority of pork producers voted to recall the checkoff, the court declared that the referendum was not binding as former Agriculture Secretary Dan Glickman had no legal standing on which to call for the referendum. The court said, in accordance with law, an insufficient number of producers had petitioned USDA to conduct the referendum and that the results were, therefore, non-binding. The agreement led to a transfer in the responsibility for checkoff-funded projects in advertising, promotion, research and education from NPPC, which had been the primary program contractor to the NPPR Board. News Flash from Feedstuffs - Dec. 7, 2001.

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KEY SUPREME COURT RULING ON PLANT PATENTS
— by Roger A. McEowen* and Neil E. Harl**

A late 2001 U.S. Supreme Court ruling1 that newly developed plant breeds are patentable under the general utility patent laws of the United States has important implications for farmers, plant breeders and consumers.

Facts of the Case

Pioneer held seventeen general utility patents2 covering the manufacture, use, sale, and offer for sale of its inbred and hybrid corn seed products, and sold the protected seeds under a limited label license that allowed only the production of grain and/or forage, and prohibited the use of the seed for propagation or seed multiplication or the development of a hybrid or different seed variety. J.E.M Ag Supply (J.E.M.) bought patented seeds in bags bearing the license agreement. When J.E.M resold the bags, Pioneer sued for patent infringement. J.E.M. moved for summary judgment on the basis that Pioneer’s patents were invalid because plants are not patentable subject matter within the scope of 35 U.S.C. § 101, and that the Plant Patent Act (PPA)3 and the Plant Variety Protection Act (PVPA)4 set forth the only statutory protection for intellectual property rights in plants. J.E.M.’s motion was denied and the trial court ruled for Pioneer,5 the Federal Circuit affirmed,6 and the Supreme Court granted certiorari.7

Scope of 35 U.S.C. §101 – the Patentability of Plants

35 U.S.C.§101 provides:

“Whoever invents or discovers any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof, may obtain a patent therefor, subject to the conditions and requirements of this title.”

In Diamond v. Chakrabarty,8 the Supreme Court concluded that the Congress drafted 35 U.S.C. §101 broadly with the intent that the patent laws be given wide scope,9 and held that a manmade micro-organism fell within the statute’s scope. The Court noted that the Congress made a statutory distinction between products of nature and manmade inventions, rather than between living and inanimate things.

The Court’s language in Diamond v. Chakrabarty10 was generally believed to be sufficiently broad to suggest that even plants that could be protected under the PPA or the PVPA could be the object of a general utility patent. Indeed, this position was confirmed in a 1985 case involving genetically engineered corn,11 and since that time the U.S. Patent and Trademark Office has issued nearly 2,000 utility patents

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for plants, plant parts, and seeds under 35 U.S.C. §101. Consequently, the Pioneer Court had no trouble holding that newly developed plant breeds fall within the scope of 35 U.S.C. §101.

Exclusivity of PPA and PVPA

The crux of J.E.M.’s position was that the Congress, in enacting the PPA and the PVPA, provided the exclusive statutory means for protecting plant life because both Acts are more specific than 35 U.S.C. §101 and thereby carve out plants from utility patent law for special treatment. However, the Court noted that the PPA did not contain any statutory language indicating that the Congress intended the PPA to serve as sole means of protection for asexually reproduced plants. J.E.M. also maintained that the Congress intended the PPA as the sole means of protection for intellectual property rights in plants because existing general utility patent laws (as of 1930) did not allow for patents on plants, and that there would have been no reason to enact the PPA had general utility patent law allowed plant patents. The Court disagreed, reasoning instead that J.E.M.’s argument failed to account for the state of patent law and plant breeding as of 1930, which involved a general presumption that plants were products of nature and were not amenable to the written description requirement of utility patent law. Thus, when the PPA was enacted, the Congress believed that plants were not patentable under utility patent law because they were viewed as living things not amenable to a written description, and not because they could not have been patentable subject matter under 35 U.S.C. §101.

The Court also rejected J.E.M.’s argument that the PVPA was the exclusive mechanism for protecting intellectual property rights in plants. The Court noted that the language of the PVPA did not restrict the scope of patentable subject matter under 35 U.S.C. §101, and did not contain any statement of exclusivity. The Court took particular note that, at the time of the PVPA’s enactment in 1970, the PTO had already issued numerous utility patents for hybrid plant processes, and had assigned utility patents for plants since 1985 with no indication from the Congress that such action was inconsistent with the PVPA or the PPA.

Implications of the Court’s Opinion

In recent years, seed companies have been taking legal action against farmers for saving seed protected by a utility patent. Much of that litigation was on hold pending the Supreme Court’s opinion. It is now expected that the litigation will resume and intensify. An important point is that conventional seed as well as genetically modified seed may be patented. Farmers using such seed do not have the right to save any of the seed for replanting.

The opinion is also anticipated to further accelerate the amount of germplasm that is held privately rather than in the public domain as seed companies devote additional resources to patent any seed that is economically worth planting, whether genetically modified or conventional. That could have serious ramifications for the breeding programs of public plant breeders. Relatedly, the opinion clears the way for inbred and hybrid seed products developed by public research institutions to be patented consistent with the Bayh-Dole Act of 1980. This could result in public research being directed to a greater extent towards satisfying the desires of the firms that purchase the rights to the patents or otherwise exert pressure on public research, and to a lesser extent towards the desires of farmers and consumers.

The opinion could also lead to increased concentration, now approaching monopoly in some areas, of germplasm in private hands, reduced competition and innovation in plant breeding (including that from public breeding), increased concentration due to small seed companies being unable to find new breeding material, and greater control by the firm holding the patent over the crops grown from patented seed. Consumers may ultimately be negatively impacted by such events.

Clearly, the Congress bears the burden to modify the existing statutory language of 35 U.S.C. §101, the PPA or the PVPA if it is desired that plants not be patentable, or the projected impacts of the Court’s opinion be avoided.

FOOTNOTES

2. The patents were issued under 35 U.S.C. § 101.
4. 7 U.S.C. § 2321 et seq.
6. 200 F.3d 1374 (Fed. Cir. 2000).
9. The trial court in Pioneer Hi-Bred International, Inc. v. J.E.M. Ag Supply, Inc., 49 U.S.P.Q. 2d (BNA) 1813 (N.D. Iowa 1998), noted that the text of 35 U.S.C. § 101 has generally been construed liberally to include the diverse range of imaginable and unforeseen technological developments. See also, In re Bergy, 596 F.2d 952 (C.C.P.A. 1979) (section 101 drafted broadly and in general terms). Also, the Committee reports accompanying the 1952 revisions to the PPA indicate that the Congress intended statutory subject matter to “include anything under the sun that is made by man.” S. Rep. No. 82-1979 at 5 (1952). Likewise, in State Street Bank & Trust Co. v. Signature Financial Group, Inc., 149 F.3d 1368 (Fed. Cir. 1998), cert. denied, 525 U.S. 1093 (1999), the court noted the Congressional intent that the patent laws be construed liberally when it upheld a patent for a business method that used a mathematical formula. 447 U.S. 303 (1980).
10. Ex parte Hibberd, 227 U.S.P.Q. (BNA) 443 (Bd. Pat. App. & Interferences 1985) (maize plants within the understood meaning of “manufacture” or “composition of matter” and therefore were within the subject matter of 35 U.S.C. §101; PPA and PVPA enacted out of concern that plants would not qualify for patent protection rather than because Congress thought plants were inherently unpatentable).
11. The point is a critical one. The PPA only protects asexually reproducible plants, and the PVPA, while protecting sexually reproducible plants, contains...
exemptions for research and for farmers to save seed from their crops for replanting. Utility patents issued for plants do not contain such exemptions.

The Court noted that denying patent protection under 35 U.S.C. § 101 simply because such coverage was thought technologically infeasible in 1930 would be inconsistent with the forward-looking perspective of the utility patent statute. See, e.g., In re Bergy, 596 F.2d 952 (C.C.P.A. 1979) (section 101 drafted broadly and in general terms). Also, the trial court in Pioneer noted that the intent of the Congress in adopting the PPA and the PVPA was to extend patent protection to an area not often able to meet the requirements of 35 U.S.C. §112 (written description requirement), given the limits of plant science at the time each act became law. 49 U.S.P.Q.2d (BNA) 1813 (N.D. Iowa 1998).

ANIMALS

ANIMAL ABUSE. The defendant was convicted of one misdemeanor count of animal abuse under Mo. Rev. Stat. § 578.012, arising out of the escape of 30 cattle after a tree blew down in a storm onto the defendant’s fence. The defendant challenged the conviction on the grounds that the state failed to show that the defendant knowingly failed to provide adequate control of the cattle. The court pointed to extensive testimony from area farmers that cattle fences had to be inspected almost daily and that the defendant’s cattle had escaped on several occasions. In addition, the court noted that the defendant’s own testimony demonstrated that the defendant’s fence was particularly susceptible to damage from erosion and falling trees. The defendant also testified that the defendant did not frequently check the fences. The court held that the evidence demonstrated that the defendant was so careless in maintaining the fences that the defendant knew the cattle were going to escape; therefore, the state had proven the defendant knowingly failed to provide adequate control of the cattle. The decision is a bit troubling because the conviction arose from only one incident, the escape of the cattle after a storm blew a tree down on the fence. There was no discussion of how much time elapsed after the storm and before the cattle escaped, which would have indicated that the defendant’s infrequent fence inspection led to the cattle escape. Without this information, it appears that the defendant was convicted for the previous escapes as a pattern of behavior, since the event which gave rise to the conviction was beyond the control of the defendant. Justice may have been done, but bad law may have resulted. State v. Blom, 45 S.W.3d 519 (Mo. Ct. App. 2001).

BANKRUPTCY

GENERAL-ALM § 13.03.*

DISCHARGE. The debtor borrowed money from a bank and told the bank that the money was to be used for purchasing horses. The debtor granted the bank a purchase money security interest in all horses located at the debtor’s farm. The money was deposited in the debtor’s checking account but was never used to purchase horses. Instead, the debtor testified that the money was used for unforeseen expenditures, including paying off a loan on the debtor’s truck so the vehicle could be traded-in for a new truck, paying off large telephone bills, the purchase of new furniture for the debtor’s home, the purchase of a new heating unit and roof for the house, and mental health care for the debtor’s son. The loan was in default when the debtor filed for bankruptcy and the bank sought to have the debt declared nondischargeable, under Section 523(a)(2)(A), for false representation in obtaining the loan. The court held that the debtor did not intend to use the loan proceeds to purchase horses with the loan proceeds. The court found that several of the expenditures were not unforeseen: (1) the telephone charges existed before the loan was made, (2) the payment of the truck loan was not necessary for the trade-in, and (3) the purchase of the new furniture was not necessary. The court held that the debtor did not intend to use the loan proceeds to purchase horses and used false representation to obtain the loan; therefore, the loan amount was not dischargeable. In re McCoy, 269 B.R. 193 (Bankr. W.D. Tenn. 2001).

PREFERENTIAL TRANSFERS. Two days before the debtor’s marriage, the debtor transferred 712 acres of farmland to the debtor’s son for $10, but did not record the deed. The deed was recorded during divorce proceedings in which the former spouse was awarded a lien on the debtor’s interest in the farmland. The former spouse sued to set aside the transfer to the son but the state court ruled that the...
transferred. The former spouse and two other creditors filed an involuntary bankruptcy petition and the trustee sought to avoid the recording of the deed as a preferential transfer. The court held that the state court suit precluded the former spouse from relitigating the fraudulent transfer issue in bankruptcy but did not affect the right of the trustee to seek avoidance as to the other creditors. The Bankruptcy Court held that, under Arkansas law, Ark. Code § 4-59-206(1)(i), the conveyance occurred when the deed was recorded, because a good faith purchaser could have obtained an interest in the land superior to the transferee until the deed was recorded. Because the conveyance occurred within 90 days of the bankruptcy petition without consideration, the conveyance was avoidable as a preferential transfer. Although the court allowed avoidance of the farmland conveyance, no proceeds from the avoidance could be used to satisfy any claim of the former spouse. In re Marlar, 267 F.3d 749 (8th Cir. 2001), aff’d, 252 B.R. 743 (Bankr. 8th Cir. 2000), aff’d, 246 B.R. 606 (Bankr. W.D. Ark. 2000).

CHAPTER 12-ALM § 13.03[8].

CONFIRMATION OF PLAN. The debtor had borrowed money from a bank and pledged the farm land as security in a deed of trust. The debtor also borrowed other funds from the bank but the other loans were secured by personal property on the farm. The bank foreclosed on the farmland loan but the debtor filed for Chapter 12 before the property was sold. The Chapter 12 plan was confirmed and provided that all of the loans were to be secured by the farmland. The Chapter 12 case was dismissed before any discharge. The deed trustee then proceeded with the foreclosure sale which produced proceeds in excess of the farmland loan and costs of sale. The trustee applied the excess proceeds to the other loans and the debtor filed for Chapter 7. The Chapter 7 trustee sought recovery of the excess proceeds as property of the gross estate under theories of fraudulent conveyance under Section 548, breach of contract and wrongful foreclosure. The bank argued that the confirmed Chapter 12 plan was binding on the debtor and allowed the farmland to secure all of the loans. The court held that, upon dismissal of the Chapter 12 case, the parties were placed back in the position as before the filing of the Chapter 12 case unless the Bankruptcy Court orders otherwise. The court next held that the application of the excess sale proceeds to the other loans was not a fraudulent conveyance because the debtor received value from the reduction of the loans. The court held that the use of the excess proceeds by the deed trustee to pay the other loans was outside the trustee’s authority under the deed of trust. Because the excess proceeds should have been paid to the debtor, the excess proceeds were bankruptcy estate property and had to be returned by the bank. In re Keener, 268 B.R. 912 (Bankr. N.D. Tex. 2001).

CONVERSION. The debtor filed for Chapter 12 on May 15, 2001 and had filed the 2000 income tax return on March 27, 2001. Although the income tax return showed that less than 50 percent of the debtor’s gross income was from farming, the debtor filed for Chapter 12 under the belief that the debtor’s income from two farm corporations would be included in farm income for Chapter 12 purposes. When it became apparent that the income from the corporations would not qualify for farm income, the debtor sought to convert the case to Chapter 11. The creditors argued that conversion was not permitted either under the statute or because the debtor did not file the Chapter 12 petition in good faith. The court acknowledged that the courts were divided as to whether Chapter 12 cases could be converted to Chapter 11, since the state was silent on the point. However, the court held that a Chapter 12 case could be converted to Chapter 11 if the original filing was made in good faith and conversion would not prejudice creditors. The court held that the debtor did not have good reason to file for Chapter 12 since the income tax return clearly showed that less than 50 percent of the debtor’s gross income was from farming; therefore, the court held that the debtor could not convert the case to Chapter 11. The court stated that the case would be converted to Chapter 7 or dismissed. In re Gregerson, 269 B.R. 36 (Bankr. N.D. Iowa 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), aff’d sub nom., Robiner v. Demczyk, 269 B.R. 167 (N.D. Ohio 2001).

FEDERAL TAX-ALM § 13.03[7].

DISCHARGE. The taxpayer operated a restaurant over the tax years involved and failed to record all sales as income or deposit all cash receipts in the restaurant’s bank accounts. The taxpayer filed income tax returns which did not include the income even though the taxpayer’s accountant warned that the returns and records were missing substantial amounts of income. The court held that the taxes for these unreported income amounts were dischargeable under section 523(a)(1)(C) for filing of fraudulent returns and for willfully attempt to evade taxes. Mastroniti v. United States, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,140 (Bankr. M.D. Fla. 2001).

FEDERAL AGRICULTURAL PROGRAMS

TOBACCO. The CCC has issued final regulations which amend the tobacco marketing quota regulations at 7 C.F.R. part 1464 to require burley tobacco producers to designate where they will sell their tobacco in order to qualify for price
support and marketing cards. Currently only flue-cured tobacco producers, as a condition of price-support, must designate where they will market their tobacco. 67 Fed. Reg. 481 (Jan. 4, 2002).

**FEDERAL ESTATE AND GIFT TAX**

No new items.

**FEDERAL INCOME TAXATION**


**BUSINESS EXPENSES.** The taxpayers, husband and wife, owned several C corporations, two of which owned partnership interests in partnerships which developed, owned and operated businesses. The partnerships were assessed local taxes and the taxpayers paid the taxes for the partnerships. The taxpayer argued that the taxes were deductible as business expenses. The court held that the taxes would be deductible only if they were an ordinary and necessary expense of the taxpayers’ business. The court held that the taxpayers failed to provide evidence of any business operated by the taxpayers other than through the S corporations; therefore, the court disallowed the deduction for the taxes by the taxpayers. Griffin v. Comm’r, T.C. Memo. 2002-6.

**COURT AWARDS AND SETTLEMENTS-ALM § 4.02[14].** The taxpayer had been employed as a loan officer in a bank but was forced to leave when the taxpayer refused to divulge confidential information about clients. The taxpayer sued the bank for intentional interference with contract and economic expectations for wrongful discharge from employment. The parties eventually reached a settlement which included punitive damages and payment directly to the taxpayer’s attorneys. The taxpayer argued that the compensatory damages, the portion of the settlement paid to the attorneys and the punitive damages were excludible from income. The court acknowledged that the taxpayer’s lawsuit was based on tort but held that the settlement proceeds and punitive damages were included in income because the tort was not based on personal injuries. Although acknowledging a split of authority on the issue, the court also held that the settlement proceeds paid directly to the taxpayer’s attorney were included in income. Banaitis v. Comm’r, T.C. Memo. 2002-5.

The taxpayer filed a suit against a former employer for failure to pay overtime compensation and earned wages. The parties reached a settlement and the taxpayer received $15,000, although $2,500 was retained improperly by the taxpayer’s attorney. The taxpayer argued that the proceeds were not included in taxable income because the proceeds were unpaid wages for which the former employer would have withheld and paid income taxes. The court rejected this argument and held that the proceeds were included in the taxpayer’s income, except for the $2,500 withheld by the attorney. The $2,500 was excluded because the attorney refused to pay that amount to the taxpayer and the taxpayer could not force the payment without further litigation. Lehmuth v. Comm’r, T.C. Summary Op. 2001-190.

**EMPLOYEE BENEFITS.** The IRS has announced that it has revoked Notice 2001-10, I.R.B. 2001-5, 459 which provided guidance on “split-dollar” life insurance arrangements between employers and employees. The IRS also announced that it will issue proposed regulations that will provide comprehensive guidance regarding the federal tax treatment of split-dollar life insurance arrangements. The proposed regulations are expected to provide that, in an employment-related split-dollar life insurance arrangement, if an employer is formally designated as the owner of the life insurance contract, then the benefits provided to the employee under the arrangement are subject to tax. Under this regime, the employer will be treated for tax purposes as the owner of the life insurance contract prior to termination of the arrangement and will be treated as providing current life insurance protection and other economic benefits to the employee, which are taxable under Code Sec. 61. A transfer of the life insurance contract to the employee is taxed under Code Sec. 83. An employer will not be treated as having made a transfer of a portion of the cash surrender value of a life insurance contract to an employee for purposes of Code Sec. 83 solely because the interest or other earnings credited to the cash surrender value of the contract cause the cash surrender value to exceed the portion thereof payable to the employer. The proposed regulations are also expected to provide that, if the employee is formally designated as the owner of the life insurance contract under a split-dollar arrangement, then the premiums paid by the employer will be treated as a series of loans by the employer to the employee, if the employee is obligated to repay the employer. Where applicable, the loans are subject to the principles of I.R.C. §§ 1271—1275, 7872. If the employee is not obligated to repay the premiums paid by the employer, those amounts will be treated as compensation to the employee at the time the premiums are paid by the employer. Notice 2002-8, I.R.B. 2002-__.

**HOBBY LOSSES.** The taxpayers, husband and wife were employed as a business owner and a schoolteacher. The taxpayers started a horse breeding operation which was intended to be a source of retirement income. The court held that the operation was operated with the intent to make a profit because (1) the taxpayers made use of expert trainers, advertised extensively, kept separate and accurate records and abandoned unprofitable business practices; (2) the taxpayers sought the advice of experts, had experience in
In addition, elected farm income from net capital gain may not exceed an individual's taxable income. The elected farm income is to be treated as elected farm income. The regulations provide that farm income attributable to a farming business may not exceed total net capital gain. One-third of each type of elected farm income is then allocated to each base year. The proposed regulations provide that a farm income averaging election is made by filing Schedule J, Farm Income Averaging, with an individual's timely filed federal income tax return (including extensions). Treas. Reg. § 1.1301-1(e). In general, the proposed regulations had provided that if an individual has an adjustment for an election year or base year, the individual may also make a late farm income averaging election or change or revoke a previous election. The final regulations make the availability of late elections, changed elections and revocation of an election subject only to the generally applicable rules on the period of limitations on filing a claim for credit or refund. The regulations provide that the allocation of elected farm income to the base years does not affect any determination (other than the calculation of the I.R.C. § 1 tax attributable to the elected farm income) with respect to the election year or the base years. Treas. Reg. § 1.1301-1(c).

The regulations provide that calculation of the I.R.C. § 1 tax on elected farm income allocated to a base year is to be made without any additional adjustments or determinations with respect to that year. A future issue of the Digest will publish an article by Neil Harl on these regulations. 67 Fed. Reg. 817 (Jan. 8, 2002), adding Treas. Reg. § 1.1301-1.

LETTER RULINGS. The IRS has issued its annual list of procedures for issuing letter rulings. Rev. Proc. 2002-1, I.R.B. 2002-__.

The IRS has issued its annual list of procedures for furnishing technical advice to District Directors and Chiefs, Appeals Offices. Rev. Proc. 2002-2, I.R.B. 2002-__.

The IRS has issued its annual list of tax issues for which the IRS will not give advance rulings or determination letters. Rev. Proc. 2002-3, I.R.B. 2002-__.

The IRS has issued its annual list of procedures for issuing letter rulings on employee plans. Rev. Proc. 2002-4, I.R.B. 2002-__.

LIKE-KIND EXCHANGES. The taxpayers co-owned a ranch which was used for cattle grazing. The taxpayer granted a perpetual conservation easement on the land to a tax-exempt cooperative in exchange for other ranch land which was subject to a PCE. The IRS ruled that, assuming that a PCE was an interest in real property under state law, the PCE and the acquired interest in the ranch were like-kind property which entitled the taxpayers to not recognize gain for loss from the transaction. The IRS noted that gain would be recognized to the extent of the share of the PCE which applied to the residential portion of the original ranch and to the extent any other non-like-kind property was received in the exchange. Ltr. Rul. 200201007, Oct. 2, 2001.

PENSION PLANS. The IRS has published the cost-of-living adjustments (COLAs), effective on Jan. 1, 2002, applicable to dollar limitations on benefits paid under qualified retirement plans and to other provisions affecting such plans. The maximum limitation for the I.R.C. § 415(b)(1)(A) annual benefit for defined benefit plans is...

The IRS has issued a revenue procedure which provides (1) guidance to drafters of individual retirement arrangements, simplified employee pensions and SIMPLE IRA plans; (2) guidance to users of IRA model IRAs and plans; and (3) transitional relief for users of IRAs and plans that have not received IRS approval. The guidelines, which take effect on January 28, 2002, modify section 4.01 of Rev. Proc. 87-50, 1987-2 CB 647. Rev. Proc. 2002-10, I.R.B. 2002-4.

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. 536. Rev. Proc. 2002-8, I.R.B. 2002-__.


NUISANCE

HOG OPERATION. The plaintiffs were neighbors of the defendant with residences which existed prior to the existence of defendant’s hog farm. The plaintiffs claimed that the hog operation violated a township ordinance which prohibited land use which resulted in obnoxious dangerous odors beyond the boundaries of the land. The defendant argued that the state right-to-farm statute, Mich. Cod. Laws § 286.471 et seq., barred any nuisance action, including an action for violation of an ordinance. The trial court returned a verdict for the plaintiffs and awarded monetary damages on the basis of an agreement between the parties. The court noted that the statute had been recently amended to remove a provision which exempted local ordinances from application of the statute. The court held, however, that the amendment was not to be applied retroactively; therefore, the township ordinance was not pre-empted by the right-to-farm statute in this case. Although the court held that a suit under the local ordinance was not barred by the right-to-farm statute, the case was remanded for a new trial because the trial judge, as trier of fact, had made five visits to the area without informing the parties. The court also remanded on the issue of damages, holding that the only remedy available in court was an abatement of the violating use of the land. The court noted that, under Mich. Cod. Laws § 125.294, a use violation of an ordinance was a nuisance per se and required an abatement. The court also noted that any fines imposed under that statute could be imposed only by a township board. Travis v. Preston, 635 N.W.2d 362 (Mich. Ct. App. 2001).

STATE REGULATION OF AGRICULTURE

WETLANDS. The plaintiff had purchased land which was regulated wetlands and was previously used as a peat farm. The plaintiff wanted to convert the land with some trenching and filling to make it suitable for cranberry farming but the state denied a permit under the Michigan Wetlands Protection Act (WPA), Mich. Cod. Laws §§ 324.30301 et seq. The plaintiff argued that, under an exemption provided by Mich. Cod. Laws §§ 324.30305(2)(e), because the plaintiff was going to farm the land, the plaintiff was exempted from the WPA provisions. The Court of Appeals looked to the federal Clean Water Act (CWA) which required a state to enact laws at least as restrictive as the federal act in order for the state to administer the CWA in the state. Because the CWA prohibited activities on wetlands that made farming possible or expanded farming operations, the state law had to be interpreted to require the same restrictions. Therefore, the Court of Appeals held that activities on wetlands which made a new type of farming possible were prohibited by the WPA and the state was correct to deny the plaintiff’s permit. The Michigan Supreme Court affirmed as to the result but based its decision directly on the exemption statute. The court noted that the exemption statute lists farming as exempt from the permit requirements but lists activities which allowed an exemption: “plowing, irrigation, irrigation ditching, seeding, cultivating, minor drainage, harvesting for the production of food, fiber, and forest products, or upland soil and water conservation practices.” The court held that the drainage and filling proposed by the plaintiff were not of the same nature or class as the listed exempt activities; therefore, the plaintiff was required to obtain a permit for those activities. The court also held that the plaintiff’s cranberry farm would not be exempt under the grandfather exemption for existing farms because the cranberry farm was a different farming method from the previous peat farm. Huggett v. DNR, 629 N.W.2d 915 (Mich. 2001), aff’d, 590 N.W.2d 747 (Mich. Ct. App. 1998).
CITATION UPDATES


IN THE NEWS

By Roger A. McEowen

An Alabama federal District Court has certified a nationwide class action against Iowa Beef Packers, Inc. involving, as members of the class, all cattle producers with an ownership interest in cattle that were sold to IBP, exclusively on a cash-market basis, from February 1994 through and including the end of the month 60 days before notice being provided to the class. The legal question at issue in the case is whether IBP’s use of captive supply violated Sections 192(a), (d) and (e) of the Packers and Stockyards Act (PSA). The claim is that IBP’s privately held store of livestock (via captive supply) allows IBP to need not rely on auction-price purchases in the open market for most of their supply. IBP is then able to use this leverage to depress the market prices for independent producers on the cash and forward markets, in violation of the PSA. The court specifically noted that the plaintiffs had demonstrated that they possessed a workable economic analysis to determine the effect of captive supply on cash market prices. The case is of particular importance in that without class certification the case would have likely been dismissed. Also, as of November 30, 2001, retail beef prices were up 9 percent from the previous time period one year earlier, but live cattle prices were down 18 percent (about $300 per head). Picket v. IBP, No. 96-A-1103-N (M.D. Ala. Dec. 26, 2001).

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IRS THINKING ON FOBD LIENS
— by Neil E. Harl*

The inadequacies of the lien provision in the family-owned business deduction statute\(^1\) are prompting a series of IRS pronouncements on how to perfect a lien under the statute.\(^2\) A major issue is how to perfect the IRS lien if real estate values are not sufficient to secure the government’s claim in the event of recapture of tax benefits.\(^3\)

**General guideline**

The Chief Counsel’s Office has indicated that, where possible, the lien\(^4\) should identify the real property involved in the election and not rely on identifying personal property such as corporate stock.\(^5\) That ruling, on October 16, 2001,\(^6\) refers approvingly to escrow arrangements for personalty such as corporate stock (involving the Internal Revenue Service, the estate representative, the qualified heirs and an escrow agent).\(^7\)

In a letter dated November 14, 2001, an advisor in the Milwaukee office of the Internal Revenue Service indicated that—

“The § 2057 election in the…estate involves stock of a closely held corporation. Because the rules on the effectiveness of such notice are not clearly established, the Service will either take possession of the stock certificate or have the estate date and mark the certificates subject to the estate tax lien. We will file a lien on the stock in the county of residence of the qualified heir(s) owning the stock. If you wish you may substitute other collateral in lieu of the lien on stock. The amount of the lien will be $____, the amount of the recapture tax computed by the Service.”

Although the letter recites that the lien would be filed in the county of residence of each qualified heir, it is not clear where the lien would be filed, particularly in states with central filing for UCC security interests.

**Form 668-H**

The Chief Counsel’s Office has also indicated that Form 668-H, Notice of Federal Estate Tax Lien, is being revised and modified to include the FOBD lien.\(^8\) The ruling advised that the following changes should be made on the Form 668-H pending issuance of the revised form—

- Add “and/or Section 2057” to the Notice paragraph of the form by pen and ink.
- The phrase “regarding the specially valued property”\(^9\) should be stricken from the sentence beginning with “Name and address of agent.”

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

The Chief Counsel’s office has advised that third parties with interests in FOBD property must consent to the FOBD recapture provisions. A similar reference in the regulations under special use valuation has been held invalid by the Tax Court insofar as it required tenants in common to sign the agreement of personal liability.

Chief Counsel Review

A November 1, 2001, CCA letter ruling addressed the question of when review by the Chief Counsel’s office is needed. The ruling states—

“If both real and personal property are available, and a lien on the real property can adequately secure the Government’s interest, there is no requirement to seek Counsel’s advice. However, if the real property involved is inadequate, or if only personal property is involved, you should contact Counsel for assistance in adequately protecting the Government’s interest.”

Events triggering recapture

The November 1, 2001, CCA letter ruling also addressed the question of what would cause recapture. The ruling states—

“…in general, the sale or transfer of the section 2057(i)(3)(P) lien property would trigger the recapture tax…unless the sale: (i) was to a member of the qualified heir’s family; (ii) was through a qualified conservation contribution; (iii) qualifies as a § 1031 transaction (like-kind exchange); (iv) qualifies as a § 1033 transaction (involuntary conversion); or (v) was in the ordinary course of business.”

The latter point is especially important in light of the failure of the statute to include a provision permitting the sale or exchange of grain, livestock or other property “in the ordinary course of business” and the last-minute inclusion of a statement allowing such sales and exchanges in the conference committee report.

Conclusion

Guidance to date indicates that where the value of real estate subject to a FOBD election is inadequate to secure the government’s claim, perfection of the lien is likely to be somewhat ad hoc. The Chief Counsel’s Office seems to have little appetite for pursuing perfection under Uniform Commercial Code rules.

FOOTNOTES


6. Id.

7. Id.


9. Id.


12. Id.

13. CCA Ltr. Rul. 200149033, Nov. 1, 2001. For additional issues covered by this ruling, see p. 3 supra.

14. Id.

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

BANKRUPTCY

GENERAL-ALM § 13.03.1
EXEMPTIONS

TRUST. The debtor had established an irrevocable trust with the debtor retaining an income interest and the remainder passing first to the debtor’s spouse and then to the debtor’s children. The debtor transferred two corporations to the trust, one which operated a liquor store and one which operated a farm. Although all of the business assets were transferred to the trust and the debtor owned only an income interest in the trust, the debtor and spouse continued to operate the businesses without following the formalities of the trust. The debtor removed funds from the businesses without reporting the amounts as income, claimed the business assets as personal assets on loan applications, and commingled business assets without keeping complete records. The court held that the trust was a sham and invalid; therefore, the debtor could not claim an exemption for the debtor’s interest in the trust and all trust property was included in the debtor’s estate. In re Gillespie, 269 B.R. 383 (Bankr. E.D. Ark. 2001).

CONTRACTS

REVOCATION OF ACCEPTANCE. The defendant had purchased a combine from a dealer and the combine was partly financed through a loan from the plaintiff manufacturer of the combine. The defendant had many problems in operating the combine and sought to return the combine to the dealer in exchange for a new one. The plaintiff refused to accept the return of the combine. The defendant continued to use the combine but refused to make any more payments on the loan. The plaintiff repossessed and sold the combine and filed suit for the balance of the loan. The defendant counterclaimed for breach of implied and express warranties, breach of the implied warranty of fitness for a particular purpose and intentional misrepresentation. The jury verdict found that the plaintiff had breached the warranty and awarded the defendant the return of the downpayment. However, the jury verdict also reduced the award to the defendant by the fair market rental value of the combine for the time the defendant used it, an amount in excess of the damages awarded to the defendant. The judge allowed the plaintiff to amend the pleadings to include a claim in quantum meruit and awarded the plaintiff the difference between the fair rental value and the defendant’s downpayment. On appeal the plaintiff argued that the defendant had failed to properly revoke acceptance because the defendant continued to use the combine. The court noted that continued use after notification of revocation of acceptance did not, in itself, negate the revocation. The court held that, where replacement of the good would carry a high cost to the buyer, continued use was allowed after revocation of acceptance. The court held that the defendant could not afford to replace an expensive combine after making a substantial investment in the defective combine. In addition, the court noted that the defendant could not be expected to carry the burden of replacement when the plaintiff refused to accept the return of the combine. The plaintiff argued that the depreciation of the combine from the continued use rendered the revocation ineffective. The court noted that the plaintiff did not allege that the defendant damaged the combine in any way and held that depreciation alone was not sufficient to render the revocation ineffective. The defendant argued that the trial court’s acceptance of the post-judgment amendment of the pleadings to allow a quantum meruit claim was improper because the defendant was denied a chance to defend on that claim. The appellate court agreed, holding that the post-judgment amendment violated the defendant’s due process rights. The court reinstated the jury verdict which the court interpreted as having the effect of giving no award to either party. Deere & Co. v. Johnson, 271 F.3d 613 (5th Cir. 2001).

FEDERAL AGRICULTURAL PROGRAMS

CONSERVATION RESERVE PROGRAM. The CCC has adopted as final 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. The regulations also provide that CRP contracts will not be terminated for failure to plant cover when that failure was due to excess rainfall or flooding. 67 Fed. Reg. 2131 (Jan. 16, 2002).

FEDERAL ESTATE AND GIFT TAX

ALTERNATE VALUATION DATE. The decedent’s estate filed a timely estate tax return which did not include an alternate valuation date election. The estate was advised that the election was available and should have been taken. The estate requested an extension of time to file an amended return which would make the alternate valuation date election, decreasing the value of the gross estate and decreasing the estate taxes. The IRS granted the extension. Ltr. Rul. 200203031, Oct. 17, 2001.

GIFT. The taxpayer and deceased spouse had established a living trust. The trust provided that at the death of the decedent,
FEDERAL INCOME TAXATION

2001 RATE REDUCTION CREDIT ADVANCE PAYMENT. The IRS has provided guidance for reporting the rate reduction credit advance payment received by many taxpayers in 2001. One new line has been added to the 2001 individual tax return forms for use by taxpayers who did not receive the maximum amount of the 2001 advance payment to reflect the rate reduction credit that they can now claim. The IRS has announced that many early filers have made errors relating to that new line, and taxpayers are cautioned to read the instructions carefully in order to avoid delays in the processing of their returns. According to the IRS, some taxpayers are putting their advance payment amount on the credit line, when they should be leaving the line blank. Individuals who have already received the maximum amount for their filing status—$300 for single persons or married persons filing separately, $500 for heads of households, and $600 for joint filers or qualifying widow(er)s—should be leaving the line blank. Other taxpayers who are entitled to the credit are mistakenly leaving the line blank. The credit and the advance payments are the means by which taxpayers can obtain the benefit of the new 10 percent tax rate. If the 2001 income and filing status would give individuals a larger benefit than the advance payment that they received during 2001, they should claim the difference as a rate reduction credit on their 2001 returns. Dependents who are ineligible for advance payments or the credit can get the benefit of the lower tax rate by completing the "Tax Computation Worksheet for Certain Dependents" in the tax instructions. Taxpayers who made errors on their returns relating to the credit should wait to see if the IRS catches those mistakes during processing. If the IRS fails to contact them by the time they receive their refunds, they may file amended returns to correct the errors. IR-2002-06.

TRANSFEREE LIABILITY FOR TAX. The taxpayer was a shareholder in a corporation in real estate development. The corporation had reached a settlement with another corporation as to a loan and the agreement provided for payment to the

**Agricultural Law Manual (ALM).**
taxpayer’s corporation. The taxpayer had advanced funds to the corporation from time to time and was owed money at the time of the settlement. The taxpayer then received the money owed at a time when the taxpayer’s corporation was insolvent. The corporation filed late income tax returns which, although the returns showed no taxable income, had alternative minimum tax owed. The corporation had no funds to pay the tax and the IRS sought payment from the taxpayer as a receiver of corporate property. The court held that the money received by the taxpayer was money paid in consideration for the loans to the corporation and the taxpayer had no liability for the corporate taxes. Johnson v. Comm'r, 118 T.C. No. 4 (2002).

COURT AWARDS AND SETTLEMENTS-ALM § 4.02[14]. The taxpayer operated a consulting business as a sole proprietorship. The business provided seminars for other businesses which involved adventure activities with some risk of injury to the participants. One participant was injured and sued the taxpayer. The taxpayer’s insurer refused to defend the taxpayer in the lawsuit and the taxpayer sued the insurer for breach of contract. The taxpayer settled with the participant in exchange for the participant receiving a portion of any proceeds from the lawsuit against the insurer. The taxpayer and insurer settled and the taxpayer paid a portion of that settlement to the participant and the taxpayer’s lawyers. The IRS ruled that (1) the entire insurance settlement was included in the taxpayer’s gross income; (2) the taxpayer could deduct, as a business expense, the amounts paid to the participant and for attorneys’ fees; (3) the deductions were not subject to alternative minimum tax because the deductions were business expense deductions. Ltr. Rul. 2000203010, Oct. 4, 2001.

DEPRECIATION. The taxpayer was in the heavy equipment sales and leasing business. When the taxpayer initially acquired a piece of equipment, the equipment was considered inventory but if the equipment was leased, the taxpayer began to claim depreciation deductions for the equipment. Much of the equipment was leased several times but was always eventually sold. Upon sale, any gain was reported as ordinary income. In a Technical Advice Memorandum letter, the IRS ruled that the taxpayer did not have to characterize the equipment as inventory while it was leased. The IRS also ruled that if a piece of equipment was removed from the leasing operation and was held only for sale, the equipment had to be returned to inventory and depreciation could no longer be claimed as a deduction. TAM Ltr. Rul. 2000203001, May 11, 2001.

DISASTER PAYMENTS. On December 31, 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 a snow storm on December 24, 2001. FEMA-3170-EM. Accordingly, a taxpayer who sustained a loss attributable to the disaster may deduct the loss on his or her 2000 federal income tax return.

DISCHARGE OF INDEBTEDNESS. The taxpayers moved several times and did not receive deficiency notices from the bank. The taxpayers moved several times and did not receive deficiency notices from the bank. The bank eventually declared the loan uncollectible and discharged the debt. Based on testimony of the taxpayers as to the fair market value of their assets and debts in the year of the discharge, the court held that the taxpayers were insolvent in the year the loan was discharged. Therefore, the taxpayers did not recognize discharge of indebtedness income from the discharge of the loan. Anuncius v. Comm’r, T.C. Memo. 2002-21.

EXPENSE METHOD DEPRECIATION. The taxpayer was a dentist who purchased an X-ray machine to allow the taxpayer to provide X-rays for disabled patients. The taxpayer claimed expense method depreciation for the X-ray machine and also claimed disability access credit for the X-ray machine under I.R.C. §§ 38, 44. That court held that under I.R.C. § 44(d)(7)(A), no other deduction was allowed if the credit was taken. The taxpayer argued that, because the credit was claimed, the expense method depreciation deduction should have been reduced. The court held that the expense method depreciation election was irrevocable; therefore, the credit could not be allowed. Wadnizak v. Comm’r, T.C. Summary Op. 2002-1.

IRA. The taxpayer was married during the tax years involved but filed separate tax returns because the taxpayer believed that the taxpayer’s spouse was not properly reporting income. The taxpayer lived in a community property state. The spouse had made withdrawals from an IRA in the spouse’s name and did not include the withdrawals in income or pay the I.R.C. § 72 addition to tax on the withdrawals. The IRS assessed one-half of the withdrawals and one-half of the addition to tax against the taxpayer. The court held that, under I.R.C. § 408(d), (g), only the spouse was subject to inclusion of the withdrawal amount in income and the additional tax. See also Bunney v. Comm’r, 114 T.C. 259 (2000). Morris v. Comm’r, T.C. Memo. 2002-17.

In the summer of 1997 Congress created the so-called Roth IRA and provided that ordinary IRAs could be “rolled over” into Roth IRAs. The form that the legislation took, however, meant that if funds from a regular IRA were rolled over into a Roth IRA and then immediately withdrawn, the I.R.C. § 72 10 percent addition to tax would not apply. After Congress discovered this situation, in July 1998, it subjected such withdrawals to the 10 percent tax, effective January 1, 1998. The taxpayer had made a rollover distribution from an IRA to a Roth IRA and distributed funds from the Roth IRA prior to passage of the corrective legislation. Because the legislation was made retroactive, the taxpayer was assessed the 10 percent addition to tax on the withdrawal from the Roth IRA. The taxpayer challenged the retroactive application of the 10 percent tax to the withdrawal as unconstitutional because it was (1) a retroactive imposition of a penalty that denies the taxpayer due process, in violation of the Fifth Amendment, (2) a taking of the taxpayer’s property, for which the taxpayer was entitled to just compensation under that amendment, and (3) the imposition of an excessive fine, in violation of the Eighth Amendment. The court held that the retroactive application of the amendment was constitutional. Kitt v. United States, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,167 (Fed. Cir. 2002).

LEVY. The IRS has adopted as final regulations relating to the provision of notice to taxpayers of a right to a hearing...

LIKE-KIND EXCHANGES. The taxpayers co-owned a ranch which was used for cattle grazing. The taxpayer granted a perpetual conservation easement on the land to a tax-exempt cooperative in exchange for other ranch land which was subject to a PCE. The IRS ruled that, assuming that a PCE was an interest in real property under state law, the PCE and the acquired interest in the ranch were like-kind property which entitled the taxpayers to not recognize gain or loss from the transaction. The IRS noted that gain would be recognized to the extent of the share of the PCE which applied to the residential portion of the original ranch and to the extent any other non-like-kind property was received in the exchange. Ltr. Rul. 200201033, Oct. 18, 2001.

PARTNERSHIPS-ALM § 7.03.*

CONSISTENCY. The taxpayers joined with two other persons to purchase a fruit and vegetable farm in another state. The owners then formed a partnership which treated the farm as partnership property, although title to the farm was not actually transferred to the partnership. The partnership claimed expenses and other deductions from the farm on the partnership tax return and the taxpayers claimed their one-third share of partnership losses on their individual returns. The farm did not do well financially and the farm was sold. Just prior to the sale, the taxpayers transferred the partnership interest to a professional corporation owned by the taxpayers. However, no transfer agreement or other written document was executed. The sale of the farm produced significant gain which was reported on the partnership final return but the taxpayers did not include their share of the gain on their return. The taxpayers argued they had no gain from the sale of the farm because (1) the farm was not partnership property, since title was never transferred to the partnership and (2) the partnership interest belonged to the corporation on the date of the sale. The court held that the duty of consistency, as established by Belzter v. United States, 495 F.2d 211 (8th Cir. 1974), prohibited the taxpayers from treating the farm as partnership property over several years of tax returns and changing their position in the final tax return, especially when the statute of limitations on assessments had expired for some or all of the earlier tax years. The court also rejected the taxpayers’ claim that the partnership interest was owned by the corporation, because the taxpayers failed to provide any documentary evidence of the transfer. The appellate court affirmed in a decision designated as not for publication. Holten v. Comm’r, 2002-2 U.S. Tax Cas. (CCH) ¶ 50,182 (8th Cir. 2002), aff’d, T.C. Memo. 2000-99.


PENSION PLANS. The IRS has published the cost-of-living adjustments (COLAs), effective on Jan. 1, 2002, applicable to dollar limitations on benefits paid under qualified retirement plans and to other provisions affecting such plans. The maximum limitation for the I.R.C. § 415(b)(1)(A) annual benefit for defined benefit plans is increased to $160,000 and the I.R.C. § 415(c)(1)(A) limitation for defined contribution plans is $40,000. Notice 2001-84, I.R.B. 2001-53, 642.

The IRS has provided relief with respect to employee benefit plans for affected taxpayers who are unable to meet their federal tax obligations due to the September 11, 2001, terrorist attacks. The new notice supplements and expands the tax relief that was granted under Code Sec. 7508A in Notice 2001-61, I.R.B. 2001-40, 305 and Notice 2001-68, I.R.B. 2001-47, 504, in light of the enactment of the Victims of Terrorism Tax Relief Act of 2001 on January 23, 2002. I.R.C. § 7508A has been amended to provide that the IRS may give up to a one year extension for tax-related deadlines for employee benefit plan sponsors, administrators, participants, beneficiaries or others affected by a Presidentially declared disaster or terroristic or military action. No plan shall be treated as failing to be operated in accordance with its terms solely because it discredits any period by reason of such relief. Pursuant to the new law, with respect to minimum funding requirements in the event of temporary substantial business hardship, if the dates described in I.R.C. §§ 412(c)(10), (m) and section 302(c)(10)(e) of ERISA for making contributions to a plan fell within the period beginning on September 11, 2001, and ending on September 23, 2001, then the date on which such contributions must be made is postponed to September 24, 2001. If the date described in I.R.C. § 412(d)(4) and section 303(d)(1) of ERISA for applying for a waiver of the minimum funding requirements fell within the period beginning on March 15, 2001, and ending on February 28, 2002, then the date on which such waiver must be applied for is postponed to March 1, 2002. With respect to plans that are directly affected by the terrorist attacks, if the date described in I.R.C. §§ 412(c)(10), (m) and section 302(c)(10) or (e) of ERISA for making contributions fell within the period beginning on September 11, 2001, and ending on February 11, 2002, then the date on which such contributions must be made is postponed to February 12, 2002. A plan is considered to be directly affected by the terrorist attacks if, at the time of the attacks, any of the following were located in the New York counties of Bronx, Kings, New York, Queens or Richmond: the principal place of business of any employer that maintains the plan, the office of the plan or the plan administrator, the office of the primary recordkeeper serving the plan or the office of an attorney, enrolled actuary, CPA or other advisor retained by the plan or the employer at the time of the attacks to determine the funding requirements for the period described in the notice. A plan will also be considered to be directly affected by the terrorist attacks if the enrolled actuary for the plan was killed or injured or is missing as a result of the attacks. Notice 2002-7, I.R.B. 2002-__.

RETURNS. The IRS has announced that, for the 2002 tax filing season, individuals can check a box on their Forms 1040 to select a third-party designee— a friend, family member or paid preparer—who will be authorized to talk directly with the IRS to correct such issues as computation and data omissions that may arise during the processing of the return. The new third-party designation box is located just above the signature line of Form 1040. The designation also enables the third party to discuss the status of a refund, payment or other notice with

*Agricultural Law Manual (ALM)*
IRS representatives. The third party designation does not eliminate the need for a power of attorney with respect to issues dealing with examinations, underreported income, appeals and collections notices. IR-2002-04

The IRS has posted the following forms and instructions to its web site at www.irs.gov, in the "Forms & Pubs" section: Form 2210-F (2001), Underpayment of Estimated Tax by Farmers and Fishermen. This document is available at no charge and can also be obtained either (1) by calling the IRS's toll-free telephone number, 1-800-TAX-FORM (1-800-829-3676); (2) through FedWorld on the Internet; or (3) by directly accessing the Internal Revenue Information Services bulletin board at (703) 321-8020.

SAFE HARBOR INTEREST RATES
February 2002

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S CORPORATIONS-ALM § 7.02[3][c].


TAX SHELTERS. The taxpayer had invested in a jojoba partnership which was audited and denied research and development expense deductions. The taxpayer was 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 taxpayer was not an inexperienced investor and should have seen the need to seek expert advice about the tax and profit risks from the investment. Kellen v. Comm’r, T.C. Memo. 2002-19.

ZONING

AGRICULTURAL USE. An owner of farmland zoned for exclusive farm use (EFU) petitioned the county to allow the construction of 33 seasonal worker residences on EFU land. The court also held that LUBA correctly assessed the need for the workers in the area and not as to the particular property involved. Durig v. Washington County, 34 P.3d 169 (Or. Ct. App. 2001).

An owner of farmland zoned for exclusive farm use (EFU) petitioned the county to allow the construction of a residence on the land. The farmland was otherwise leased to a third party for hay and pasture. The county allowed the construction but the Land Use Board of Appeals (LUBA) remanded the proceeding back to the county for failure to use the proper standard for evaluating the practicability of farming on the property. The landowners argued that EFU land was impracticable for farming if the land would not produce at least $10,000 annual gross income. LUBA had rejected the $10,000 figure as based upon only commercial farming. LUBA held that the proper income level was the one used for farm tax deferral, which was much lower than $10,000, and which included noncommercial farming in determining the practicability of farming the land. The court upheld the LUBA ruling as enforcing the proper standard. Friends of Linn County v. Linn County, 34 P.3d 1213 (Or. Ct. App. 2001).

CITATION UPDATES

Gross v. Comm’r, 272 F.3d 333 (6th Cir. 2001), aff’g, T.C. Memo. 1999-254 (valuation of stock) p. 4 supra


IN THE NEWS

CONSERVATION RESERVE PROGRAM. CRP contracts expiring this year may be extended for another year, officials of the Farm Service Administration announced Friday. Farmers with contracts expiring on Sept. 30, have until May 31 to apply for the one-year extension. About 4,000 Iowa contracts covering 191,000 rural acres expire this year, said Derryl McLaren, state executive director. "This action will help ensure the continued safeguarding of this sensitive land as a new farm bill is developed," McLaren said. Producers enrolled in CRP receive rental payments and other financial incentives to remove lands from production for up to 15 years. CRP participants plant native grasses, trees, and other vegetation to improve water quality, soil, and wildlife habitat. McLaren said the extension would not change participants’ rental rates. All or a portion of the acreage currently under contract may be included in an extension, but no new acreage may be added. The USDA is not planning to offer a general CRP signup in fiscal year 2002, McLaren said. Niel Ritchie, National Organizer, Institute for Agriculture and Trade Policy

President Bush on January 23 signed into law the Victims of Terrorism Tax Relief Act of 2001 (HR 2884), which provides tax relief to families of those killed in the September 11 terrorist attack, the post-September 11 anthrax mailings and the Oklahoma City bombing. Bush, in a White House signing ceremony, singled out provisions of the new law that exempt from federal taxes payments made by charitable organizations to victims' families and its waiving of income and payroll taxes on wages earned by terrorism victims in the year of their death and the preceding year. Lower estate taxes will apply to victims of terrorist attacks and to members of the armed forces who have been killed in combat zones, Bush noted. The victims' tax-relief package also provides families of terrorist victims exemption from estate taxes. The new law also exempts death and disability benefits, workers' compensation benefits and government retirement plan benefits for people injured in the attacks. Disaster payments and payments to victims of the airline disasters also will not be taxed. The new law allows the Treasury Department to extend tax-filing deadlines for up to one year for victims and their families. By Paula Cruickshank, CCH News Staff

WORLD TRADE. The United States is illegally subsidizing the foreign sales of domestic corporations, ruled an appellate body of the World Trade Organization (WTO). An arbitrator will determine by March what compensation the U.S. must give the European Union (EU), which litigated the case. The decision, released on January 14, is the latest in several years of litigation between the EU and the U.S. on the treatment of foreign income earned by domestic corporations. The decision upholds an earlier WTO ruling that the tax law in dispute, the Foreign Sales Corporation Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, was inconsistent with international trade agreements.

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The proposed regulations for the income averaging provisions for farmers were made final on January 7, 2002. The final regulations addressed several of the shortcomings in the proposed regulations issued in 1999.

Farm landlords

The proposed regulations did not address the question of whether farm landlords were eligible for income averaging. However, the final regulations provide that rental income that is based on a tenant’s production (a share rent lease) is treated as income from a farming business if, after December 31, 2002, the landlord’s share of a tenant’s production is set in a written rental agreement entered into before the tenant begins significant activities.

The final regulations make it clear that a landlord is not considered to be engaged in a farming business if the rental is either a fixed rent (cash rent) or, for amounts received on or after January 1, 2003, even share rents based on a share of a tenant’s production determined under an unwritten agreement or a written agreement entered into after the tenant has begun significant activities on the land.

Surprisingly, the final regulations specify that whether the landlord materially participates in the tenant’s farming business “is irrelevant for purposes of section 1301.” Therefore, non-materially participating filers under Form 4835 or even filers on Schedule E are eligible for income averaging if the landlord’s share of a tenant’s production is set in a written rental agreement before the tenant begins significant activities on the land.

This places a premium on assuring that leases be in writing.

Eligibility of wages

The proposed regulations stated that, in general, income items passed through to partners or other owners in a pass-through entity, were eligible for income averaging. For S corporations, the character of income from corporate distributions continues in the hands of the shareholders who are eligible to average their incomes. However, under the proposed regulations, farm income did not include “wages.”

The final regulations state specifically that “a shareholder of an S corporation engaged in a farming business” may treat compensation received from the corporation that is attributable to the farming business as farm income.

The summary to T.D. 8972 (but not the final regulations themselves) states that
the income attributable to a farming business carried on by a partnership can be averaged without regard to the partner’s level of participation in the partnership or the size of the ownership interest.

Negative taxable income

The final regulations embrace the change in position first announced in the 2000 Farmers Tax Guide and in the Schedule J instructions allowing a base year’s taxable income to be negative. However, amounts such as a net operating loss or capital loss that may be deducted in one or more other taxable years in the form of a carryback or carryforward must be added back in computing negative taxable income.

Change in filing status

As did the proposed regulations, the final regulations state that an individual is not prohibited from making an income averaging election solely because the individual’s filing status is not the same as in the base years. However, the final regulations do not provide guidance on how the remaining bracket amounts are to be divided between the spouses if both spouses have elected farm income in a year following marriage dissolution, which was a shortcoming of the proposed regulations.

Amending returns

Under the proposed regulations, an individual could not make a late election, change an election or revoke an election unless there had been an adjustment to taxable income or tax liability or the Commissioner of Internal Revenue had consented. That requirement has been eliminated in the final regulations with the provision now stating simply that an election can be made on a “late or amended return if the period of limitations on filing a claim for credit or refund has not expired . . . .” and that a previous election can be changed or revoked if the period of limitations has not expired.

Effective dates

In general, the final regulations are effective for taxable years beginning after December 31, 2001. However, the requirement for a written lease agreement does not apply until December 31, 2002.

FOOTNOTES

1 See 64 Fed. Reg. 54,836 (Oct. 8, 1999).
4 See note 1 supra.
5 See Harl, “New Income Averaging Regulations,” 10 Agric. L. Dig. 165 (1999). The explanation to T.D. 8972 states, erroneously, that this was “consistent with the general principle that lessors of farmland are not ordinarily treated as engaged in a farming business with respect to the leased land.” See, e.g., Webster Corp. v. Comm’r, 25 T.C. 55 (1955), acq., 1960-2 C.B. 7, aff’d, 240 F.2d 164 (2d Cir. 1957) (income from crop share lease was not “rent” for personal holding company purposes where land managed by professional farm management firm); Ltr. Rul. 8133015, April 25, 1981 (farms managed by spouse as agent of incapacitated landowner under crop share lease eligible for installment payment of federal estate tax as “interest in closely-held business”).
6 Treas. Reg. § 1.1301-1(b)(2).
7 Id.
8 Id.
10 Prop. Treas. Reg. § 1.1301-1(b).
11 Id. See I.R.C. § 1366(b); Prop. Treas. Reg. § 1.1301-1(b).
16 Id.
20 Treas. Reg. § 1.1301-1(c)(1).
21 Treas. Reg. § 1.1301-1(c)(2).
22 Treas. Reg. § 1.1301-1(g).
23 See note 7 supra.
24 Treas. Reg. §§ 1.1301-1(g); 1.1301-1(b)(2).

AGRICULTURAL LAW

By Neil E. Harl

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

BANKRUPTCY

CHAPTER 12-ALM § 13.03[8].

CONFIRMATION OF PLAN. The debtors had filed a previous Chapter 12 case which was dismissed because the debtors failed to make any payments to the major secured creditor, a bank. The debtors immediately refiled for the current Chapter 12 case and filed a proposed plan. The new plan changed several items which were included in the previous plan: (1) the bank’s secured claim was decreased because some collateral was transferred to the debtors’ corporation, (2) the projected income was reduced but remained more than the historical income for the farm, (3) the bank’s secured claim interest rate was reduced, and (4) the value of the bank’s collateral was reduced. The court found that the debtors had not provided any reasons for the changes to the bank’s secured claim from the previous Chapter 12 plan, including the removal of some farm property from the list of collateral securing the bank’s claim. The court characterized the new plan as an attempt to avoid portions of the secured claim without an adversary proceeding on the avoidance action. The court held that the reduction in interest rate on the secured claim was also improper without evidence that the reduced rate equaled the market rate for similar loans. In addition, the court held that the income projections were unreasonable given the recent history of the farm and the lack of any buffer between the income projections and the plan payments, even given the reduced collateral and interest rate. The court held that the plan violations and the circumstances of the immediate filing after a plan default in a previous Chapter 12 case demonstrated a bad faith filing and the court dismissed the case. In re Szudera, 269 B.R. 837 (Bankr. D. N.D. 2001).

FEDERAL TAX-ALM § 13.03[7].

INTEREST. The debtor owned a residence which had a fair market value in excess of the nonrecourse indebtedness against it. The mortgagor obtained relief from the automatic stay to foreclose the mortgage and the property was sold to the mortgagor for less than the amount of indebtedness, with the remaining indebtedness discharged. The debtor sought to deduct the interest owed on the residence but the IRS argued that, because the residence sold for less than the fair market value, no part of the proceeds could be allocated to interest. The IRS also argued that, because the residence was property of the estate at the time of sale, any deductions accrued to the bankruptcy estate and not to the debtor personally. The Tax Court held that (1) the release of the automatic stay effected an abandonment of the residence such that the residence was no longer bankruptcy estate property at the time of sale and (2) in a foreclosure sale of a property with discharge of nonrecourse indebtedness, the amount of discharged indebtedness was deemed the amount received for the property. Because the

indebtedness included interest owed, the debtor was entitled to deduct the interest portion of the indebtedness discharged. The appellate court reversed, holding that the order releasing the automatic stay did not cause an abandonment of the residence because the order made no mention of any abandonment; therefore, the residence was bankruptcy estate property and any interest deduction belonged to the estate. Catalano v. Comm’r, 2002-1 U.S. Tax Cas. ¶ 50,203 (9th Cir. 2002), rev’d, T.C. Memo. 2000-82.

NET OPERATING LOSSES. The taxpayer was married to the decedent and filed a joint return for the year of the decedent’s death. The decedent had been a debtor in bankruptcy when the decedent died; however, the decedent bankruptcy case continued after the decedent’s death. The decedent, as debtor-in-possession, had net operating losses for the bankruptcy years and the taxpayer sought to include those net operating losses on the final joint income tax return. The IRS argued that the bankruptcy net operating losses were not available because the decedent died before the termination of the case. The court held that, under I.R.C. § 1398(j)(2), bankruptcy period net operating losses pass back to the “decedent” and, because the decedent was still considered the debtor after death, the NOLs passed to the decedent and were available on the taxpayer’s last joint return. Lassiter v. Comm’r, T.C. Memo. 2002-25.

FEDERAL AGRICULTURAL PROGRAMS

CROP INSURANCE. The FCIC has issued proposed regulations which add a new section for the insurance of millet crops. The provisions will be used in conjunction with the Common Crop Insurance Policy Basic Provisions, which contain standard terms and conditions common to most crops. The intended effect of this action is to convert the millet pilot crop insurance program to a permanent insurance program administered by FCIC for the 2002 and succeeding crop years. 66 Fed. Reg. 3036 (Jan. 23, 2002).

KARNAL BUNT. The APHIS has adopted as final regulations amending the karnal bunt regulations by adding Archer and Baylor counties in Texas to the list of regulated areas. 67 Fed. Reg. 3427 (Jan. 24, 2002).

The APHIS has adopted as final regulations amending the karnal bunt regulations by adding Throckmorton and Young counties in Texas to the list of regulated areas. 67 Fed. Reg. 5041 (Feb. 4, 2002).
FEDERAL ESTATE AND GIFT TAX

POWER OF APPOINTMENT. The decedent was the income beneficiary of two trusts created by the decedent’s parent prior to 1942. The trust provided that, upon the decedent’s death, the trust principal was to be paid as the decedent directed by power of appointment either by will or separate instrument. The power had no restrictions as to its beneficiaries, including the decedent’s estate. If the power of appointment was not exercised, the trust principal was to be paid to the decedent’s heirs. The decedent did not exercise the power of appointment and the trusts’ principal passed to the decedent’s heirs. Under I.R.C. § 2041(a)(1) a decedent’s estate does not include property which was subject to a power of appointment created prior to October 21, 1942 if the power holder does not exercise the power. The IRS ruled that, under I.R.C. § 2041(a)(1), the trusts’ principal was not included in the decedent’s estate. Ltr. Rul. 200205033, Nov. 1, 2001.

VALUATION OF STOCK. The decedent owned 39 percent of the stock of a champagne making company. The issue was the value of the stock for estate tax purposes and the court approved the use of a discounted cashflow method for valuing the company. The court also approved a 25 percent discount in the value of the shares for lack of marketability and a 10 percent discount for the minority interest. Estate of Heck v. Comm’r, T.C. Memo. 2002-34.

FEDERAL INCOME TAXATION

ACCOUNTING METHOD. In Notice 2001-76, I.R.B. 2001-52, 613, announced a proposed revenue procedure that would permit certain small businesses with average annual gross receipts of $10 million or less to use the cash receipts and disbursements method of accounting (“cash method”) and to treat inventoryable items as non-incidental materials and supplies (“materials and supplies method”) with respect to eligible trades or businesses. The IRS has announced that any qualifying small business taxpayer within the scope of the proposed revenue procedure (“small business taxpayer”) may change to these methods of accounting with respect to its eligible trades or businesses for any taxable year ending on or after December 31, 2001. The notice also provides procedures for obtaining automatic consent to change to these accounting methods. Notice 2002-14, I.R.B. 2002—__

CAPITAL EXPENSES. The IRS has announced the intent to issue proposed regulation providing rules and standards that the IRS and Treasury Department expect to propose in 2002 that will clarify the application of I.R.C. § 263(a) to expenditures incurred in acquiring, creating, or enhancing certain intangible assets or benefits. The proposed regulations are expected to cover the following circumstances:

1. Amounts Paid To Acquire Financial Interests. Under the expected regulations, capitalization will be required for an amount paid to purchase, originate, or otherwise acquire a security, option, any other financial interest described in section 197(e)(1), or any evidence of indebtedness.

2. Amounts Paid To Acquire Intangible Property From Another Person. Under the expected regulations, capitalization will be required for an amount paid to another person to purchase or otherwise acquire intangible property from that person.

3. Amounts Paid To Create or Enhance Certain Intangible Rights or Benefits. The proposed regulations will include a 12-month rule applicable to expenditures paid to create or enhance certain intangible rights or benefits. Under the rule, capitalization under Section 263(a) would not be required for (1) prepaid items; (2) certain market entry payments; (3) amounts paid to obtain certain rights from a governmental agency; (4) amounts paid to obtain or modify contract rights; (5) amounts paid to terminate certain contracts; (6) amounts paid in connection with tangible property owned by another; and (7) defense or perfection of title to intangible property. Under the expected regulations, capitalization will be required for an amount paid to another person to purchase or otherwise acquire intangible property from that person.

4. Transaction Costs. The proposed rules will require a taxpayer to capitalize certain transaction costs that facilitate the taxpayer’s acquisition, creation, or enhancement of intangible assets. In addition, this rule would require a taxpayer to capitalize transaction costs that facilitate the taxpayer’s acquisition, creation, restructuring, or reorganization of a business entity, an applicable asset acquisition within the meaning of section 1060(c), or a transaction involving the acquisition of capital, including a stock issuance, borrowing, or recapitalization. However, this rule would not require capitalization of employee compensation (except for bonuses and commissions that are paid with respect to the transaction), fixed overhead (e.g., rent, utilities and depreciation), or costs that do not exceed a specified dollar amount, such as $5,000. 67 Fed. Reg. 3461 (Jan. 24, 2002).

CASUALTY LOSS. The taxpayers claimed a casualty loss for damage to a boat from a storm. The taxpayers presented photographs of the boat, allegedly before and after the storm. However, the post-storm pictures had dates on the back that indicated that the pictures were taken before the storm; therefore, the court held that the taxpayers could not claim the casualty loss deduction for the boat because the taxpayers failed to prove that the storm occurred or that the boat was damaged by a storm. Stoddard v. Comm’r, T.C. Memo. 2002-31.

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 2002, 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 2002, 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 2002 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 2002 the depreciation limitations are as follows (the amounts are identical to 2001):

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For electric automobiles placed in service in 2002 the depreciation limitations are as follows:

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<tbody>
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<td>1st tax year</td>
<td>$9,180</td>
</tr>
<tr>
<td>2d tax year</td>
<td>14,700</td>
</tr>
<tr>
<td>3d tax year</td>
<td>8,750</td>
</tr>
<tr>
<td>Each succeeding year</td>
<td>5,325</td>
</tr>
</tbody>
</table>


The taxpayer was self-employed as a consultant and claimed depreciation deductions for a vehicle used in the business. The taxpayer supported the deduction with two oil change receipts and a mileage log constructed during an IRS audit of the taxpayer’s return. The court held that the taxpayer was not allowed a depreciation deduction and could not claim any other deductions in excess of those allowed by the IRS based on the standard mileage rate, because the taxpayer failed to substantiate the business use of the vehicle. Clark v. Comm’r, T.C. Memo. 2002-32.

HOME OFFICE. The IRS has issued a consumer alert regarding home-based business schemes that purport to offer tax “relief.” The promoters of these schemes claim that individual taxpayers can deduct most, or all, of their personal expenses as business expenses by setting up a bogus home-based business. However, the tax code requires that there be a clear business purpose and profit motive in order to claim business expenses. IR-2002-13.

LABOR EXPENSES. The taxpayer was an airline pilot who was involved in airplane racing. The taxpayer claimed deductions for labor expenses during the period when the taxpayer was constructing a racing airplane. The court held that the labor expenses incurred to build the airplane had to be capitalized in the basis of the airplane and could not be deducted currently. Also, the airplane was not placed in service during the year so no depreciation was allowed. Rose v. Comm’r, T.C. Summary Op. 2002-8.

LIKE-KIND EXCHANGES. The IRS has adopted as final regulations amending the definition of “disqualified person” for purposes of the like-kind exchange rules. Treas. Reg. § 1.1031(k)-1(k) defines a disqualified person to include an agent of the taxpayer at the time of the transaction. An agent includes a person that has acted as the taxpayer’s employee, attorney, accountant, investment banker or broker, or real estate agent or broker. During the year so no depreciation was allowed. Krukowski v. Comm’r, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,219 (7th Cir. 2002), aff’d, 114 T.C. 366 (2000).
PENSION PLANS. For plans beginning in January 2002, the weighted average is 5.71 percent with the permissible range of 5.14 to 6.00 percent (90 to 106 percent permissible range) and 5.14 to 6.28 percent (90 to 110 percent permissible range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). Notice 2002-9, I.R.B. 2002-5, 450.

The IRS has issued a reminder to employers and retirement plan administrators that they must amend their calendar year employees’ retirement plans to comply with the changes made by the “GUST” laws by the February 28, 2002, deadline. The deadline for non-calendar year plans is the last day of the plan’s fiscal year that began in 2001. The deadline affects qualified retirement plans, including Section 401(k) plans, defined benefit pension plans, profit-sharing plans, ESOPs and Keogh plans. Plans directly affected by the September 11 terrorist attack have been given an automatic extension to June 30, 2002, with the possibility to extend that deadline to December 31, 2002, upon filing an application for extension. IR-2002-19.

The IRS has provided additional relief with respect to employee benefit plans for affected taxpayers who are unable to meet their federal tax obligations due to the September 11, 2001, terrorist attacks. Pursuant to the Victims of Terrorism Tax Relief Act of 2001 (P.L. 107-134) enacted on January 23, 2002, with respect to minimum funding requirements in the event of temporary substantial business hardship, if the dates described in I.R.C. § 412(c)(10), (m) and Section 302(c)(10)(e) of ERISA for making contributions to a plan fell within the period beginning on September 11, 2001, and ending on September 23, 2001, then the date on which such contributions must be made is postponed to September 24, 2001. If the date described in I.R.C. § 412(d)(4) and Section 303(d)(1) of ERISA for applying for a waiver of the minimum funding requirements fell within the period beginning on March 15, 2001, and ending on February 28, 2002, then the date on which such waiver must be applied for is postponed to March 1, 2002. With respect to plans that are directly affected by the terrorist attacks, if the date described in I.R.C. § 412(c)(10) or (m) and Section 302(c)(10) or (e) of ERISA for making contributions fell within the period beginning on September 11, 2001, and ending on February 11, 2002, then the date on which such contributions must be made is postponed to February 12, 2002. Notice 2002-7, I.R.B. 2002-6.

RETURNS. The IRS has announced that taxpayers in Maine, Massachusetts, Michigan, Rhode Island and upstate New York (north of Westchester and Rockland counties) will have an extra day to file income tax returns because this year’s filing deadline falls on a state holiday where the IRS filing office is located, Andover, Mass. April 15, 2002, is Patriots’ Day in Maine and Massachusetts. Taxpayers in Connecticut, New Hampshire and Vermont, who used to file at Andover, now send returns to Philadelphia, where April 15 is not a holiday and no extra day applies.

The IRS has announced that employers have until February 15, 2002, to furnish household employees with W-2 Forms showing wages paid and employment taxes withheld. The extension of time is a result of a delay in shipment of Package H, the forms and instruction booklets sent yearly to those who filed tax returns as household employers in the prior year, to the IRS by its printer. Employers must still file Forms W-2 and W-3 with the Social Security Administration by February 28, 2002. Ann. 2002-19, I.R.B. 2002-__.

The IRS has announced the redesign of Schedule D, used to calculate capital gains and losses on the sales, exchanges and other disposition of investment property. On the redesigned form, 14 lines were cut to eliminate difficulty to the taxpayer, while four lines were added to enable taxpayers to take advantage of the new 8 percent rate on qualified capital gains. The redesigned form also eliminated 18 other lines to ease the potential burden that comes from calculating unrecaptured Section 1250 gains (generally related to the sale of real property) and the class of capital gains subject to the 28 percent rate. IR-2002-15.

S CORPORATIOS-ALM § 7.02[3][e].

SHAREHOLDER BASIS. The taxpayer was the sole shareholder of a corporation which operated an insurance company. The taxpayer was also the majority shareholder in a corporation in the restaurant business. The insurance corporation made several payments to the restaurant corporation with the payments shown as loans on the restaurant corporation’s books and as shareholder loans on the insurance corporation’s books. The court held that the insurance corporation made the payments on behalf of the taxpayer and that the restaurant corporation was indebted to the taxpayer and not the insurance corporation for the payments. Therefore, the payments increased the taxpayer’s basis in the restaurant corporation stock and allowed the taxpayer to take the taxpayer’s share of the restaurant corporation’s losses. The trial court determined the amount of the restaurant corporation’s losses based upon a last minute raising of the issue by the IRS. The taxpayer argued on appeal that it was denied due process because the issue of the amount of loss was not raised in the petition or during the trial. In a case designated as not for publication, the appellate court affirmed the allowance of a deduction for the taxpayer’s share of loss but reversed on the issue of the amount of loss, holding that the IRS failure to properly raise the issue precluded the trial court from changing the amount of loss deduction once it had been held that the taxpayer was entitled to a loss deduction. Culnen v. Comm’r, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,200 (3d Cir. 2001), aff’d in part and rev’d in part, T.C. Memo. 2000-139.

TRAVEL EXPENSES. The taxpayer was an airline pilot who was involved in airplane racing. The taxpayer claimed travel expenses during the period when the taxpayer was constructing a racing airplane. Although the taxpayer was stationed as a pilot in several other cities, the taxpayer maintained a residence in the city where the plane was constructed. The taxpayer claimed travel expenses for trips to the city of residence to work on the plane. The taxpayer claimed the per diem rate for travel expenses listed in the city of residence to work on the plane. The taxpayer was an airline pilot who was involved in airplane racing. The taxpayer claimed travel expenses during the period when the taxpayer was constructing a racing airplane. Although the taxpayer was stationed as a pilot in several other cities, the taxpayer maintained a residence in the city where the plane was constructed. The taxpayer claimed travel expenses for trips to the city of residence to work on the plane. The taxpayer claimed the per diem rate for travel expenses listed in the city of residence to work on the plane.
that the travel expenses were not deductible because the travel was to the taxpayer’s city of residence. *Rose v. Comm’r*, T.C. Summary Op. 2002-8.

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**LANDLORD AND TENANT**

**OPTION TO PURCHASE.** The plaintiff’s decedent leased real property to the defendant and the lease agreement allowed the plaintiff’s decedent to continue to live on the property and granted the defendant an option to purchase the property at a certain price. When the decedent died, the decedent’s family continued to live on the property although the lease did not allow them to do so. The residence was destroyed by fire and the decedent’s family left the property. Nearly two years after the fire, the defendant served notice to exercise the option at the agreed upon price, without any reduction for the loss of the residence. The plaintiff sued for unpaid rent and damages and the defendant sought specific performance of the purchase option; however, the defendant sought a reduction in the option price to compensate for the loss of the residence. The court held that, once the option had been exercised without reservation, the defendant was not entitled to any abatement for the loss of the residence because the loss occurred before the option was exercised. *Riddle ex rel. Riddle v. Elk Creek Salers*, 52 S.W.3d 644 (Mo. Ct. App. 2001).

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**PROPERTY**

**EASEMENT.** The plaintiff owned and operated a grain elevator neighboring a foundry owned by the defendant. The plaintiff had filed suit against the defendant for recognition of an easement over a portion of the foundry property for use as switch track for railroad cars. The switch track allowed the plaintiff to load a sufficient number of railroad cars so as to qualify for a $100/car discount. Although the easement was declared by a court, the defendant continued to hamper the plaintiff’s use of the switch track by placing a gate on the easement area. The trial jury found that the defendant unreasonably prevented the plaintiff’s reasonable use of the easement and awarded actual damages and prejudgment interest. The defendant appealed the jury verdict, arguing that there was no evidence to support the jury finding and that the plaintiff did not suffer any damages because the plaintiff could otherwise qualify for the large car discount. The appellate court affirmed the jury verdict as based on sufficient evidence. *Taylor Foundry Co. v. Wichita Falls Grain*, 51 S.W.3d 766 (Tex. Ct. App. 2001).

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**SECURED TRANSACTIONS**

**INSURANCE PROCEEDS.** The defendants had borrowed money from the FSA for their ranch and had granted a mortgage to the FSA in the property, including a residence. Under the loan agreement, the defendants were required to carry insurance on the house and did so. The house was destroyed by a fire and the insurance company paid the defendants the value of the house. The defendants used the proceeds to purchase a mobile home which was placed on other property. The defendants defaulted on the FSA loan and the ranch was sold upon foreclosure for an amount less than the loan balance. The FSA sought an equitable lien against the new house, claiming that, without the lien, the defendants would be unjustly enriched. The court held that the FSA lien against the house continued as to the insurance proceeds since the loan agreement required the defendants to carry insurance. The court also held that the doctrine of unjust enrichment applied to support an equitable lien against the new house. The court found that all five factors supported unjust enrichment: (1) enrichment of the defendants through the acquisition of the mobile home without a lien, (2) impoverishment of the FSA through the loss of its lien, (3) a link between the enrichment of the defendants and the impoverishment of the FSA, (4) lack of any justification for the enrichment or impoverishment, and (5) lack of a other legal remedy for the FSA. The court held that the amount of the lien was the amount of insurance proceeds plus interest. *In re Wilson*, 269 B.R. 829 (Bankr. D. N.D. 2001).

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**STATE TAXATION**

**AGRICULTURAL USE.** The defendant bank acquired farm property through foreclosure and leased the property for several years to someone who was supposed to farm the land. The land was taxed as farmland and was subject to rollback taxes if the land was not used for farming. Apparently, the tenant did not actually farm the land in 1991 through 1993. The plaintiff had purchased the land from the defendant bank in December 1995 and the deed warranted that no existing encumbrance existed except as shown in public records. However, in 1996, the plaintiff was assessed rollback taxes for 1991 through 1993, based upon a determination made in June 1996 by the county tax appraiser. The plaintiff sued for breach of the deed warranty, claiming that the rollback taxes were an encumbrance when the deed was transferred. The plaintiff sought recovery of the rollback taxes paid. The court held that Tex. Tax Code § 23.55(a) requires a determination by the chief appraiser before a rollback tax and lien can attach to a property. Because the plaintiff failed to provide evidence of a chief appraiser’s determination prior to the transfer of the deed, no breach of the deed warranty occurred. There was no discussion of the defendant’s liability based upon its knowledge of the tenant’s failure to farm the property. *Compass Bank v. Bent Creek Investments*, 52 S.W.3d 419 (Tex. Ct. App. 2001).
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by Roger McEowen & Neil E. Harl

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CHANGING CCC LOAN REPORTING

— by Neil E. Harl*

The choices in reporting Commodity Credit Corporation (CCC) loans have been clear for many years. But in early 2002, the Internal Revenue Service ruled that a change in reporting methods from treating CCC loans as income to reporting CCC loans as loans has been modified and relaxed. That is a significant change for affected taxpayers.

The basic CCC loan pattern

As is well known, an eligible taxpayer may use agricultural commodities as collateral for a loan from the Commodity Credit Corporation. The loans are, basically, non-recourse so that, at maturity, if the loan plus interest is not paid, the commodity may be forfeited to the CCC as full payment for the loan.

No election made. If the election has not been made to treat CCC loans as income when the loan proceeds are received, the taxpayer has no taxable income until the commodity serving as collateral for the loan is sold or forfeited to the CCC as payment on the loan. Thus, the mere taking out (and payment of) a CCC loan does not in itself have income tax consequences. Income tax is due on forfeiture of the commodity to CCC or sale of the commodity after discharge of the CCC loan.

Election made to treat CCC loan as income. A taxpayer may elect to report CCC loans as income in the taxable year in which the loan is received. The election, once made, applies to all subsequent taxable years unless permission is obtained from the Internal Revenue Service to change back to treating CCC loans as loans.

The election to treat CCC loans as income applies to all commodities for that taxpayer. Actually, the election involves reporting as income the value of the commodity held as collateral up to the amount of the loan rather than reporting the loan itself as income.

If a taxpayer elects or has elected…to include in his gross income the amount of a loan from the Commodity Credit Corporation…then—

“(1) No part of the amount realized by the Commodity Credit Corporation upon the sale or other disposition of the commodity pledged for such loan shall be recognized as income to the taxpayer, unless the taxpayer receives an amount in addition to that advanced…as the loan.”

IRS has ruled that a Section 77 election, once made, applies to all loans in that year. For loans redeemed the same year, the courts have been divided. The Fifth Circuit Court of Appeals in the 1963 case of Thompson v. Commissioner held that no

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
income was realized from the loan allocable to a commodity that was redeemed in the same taxable year that the CCC loan was taken out. As the court stated—

“§ 77 does not prescribe that the loan is income. It prescribes that it should be ‘considered as income’ and when so done, the method of computing income so adopted shall be adhered to...”\(^{14}\)

The Ninth Circuit Court of Appeals, on the other hand, held in 1968 in *United States v. Isaak*\(^ {15} \) that the loan amount was income, even though redeemed the same year. As the court noted, the loan is the taxable event.

**Changing methods of reporting**

A taxpayer who has been reporting CCC loans as loans may shift at any time to reporting CCC loans as income.\(^ {16} \) The question is the procedure for shifting from reporting CCC loans as income to reporting such loans as loans.

Before 2002, under the regulations, application for permission to change had to be filed within 90 days after the beginning of the taxable year to be covered by the return.\(^ {17} \) IRS has established procedures for taxpayers to receive a 90-day extension of time for applying for a change in method of accounting under the regulations.\(^ {18} \) Note that, in general, requests for a change in method of accounting for several years have been able to be filed until the due date of the return with extensions.\(^ {19} \)

Effective for taxable years ending on or after December 31, 2001, IRS has ruled that a taxpayer reporting CCC loans as income can switch automatically to treating CCC loans as loans.\(^ {20} \) For the year of change, all loans that year are reported as loans.\(^ {21} \) Loans taken out previously continue to be treated as if the election to report loans as income was still in effect. As the 2002 guidance states, the change is made on a “cut-off” basis.\(^ {22} \)

This change can be very helpful for those wishing to shift back to treating CCC loans as loans late in the taxable year.

**FOOTNOTES**

1. See I.R.C. § 77.
4. See generally 11 Harl, *Agricultural Law* Ch. 90 (2001) for a discussion of the structure and functions of the CCC.
5. *Id.*
8. I.R.C. § 77(b).
10. See Treas. Reg. § 1.77-2(a).
13. 322 F.2d 122 (5th Cir. 1963), aff'g and remanding, 38 T.C. 153 (1962).
14. 322 F.2d 122, 131 (5th Cir. 1963).
15. 400 F.2d 869 (9th Cir. 1968).
17. Treas. Reg. § 1.77-1.
21. *Id.*

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**AGRICULTURAL LAW**

*By Neil E. Harl*

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

BANKRUPTCY

GENERAL-ALM § 13.03.¹

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 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 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. In re Vote, No. 01-2203 (8th Cir. 2002), aff’g, 261 B.R. 439 (Bankr. 8th Cir. 2001).

CHAPTER 12-ALM § 13.03[8].²

ELIGIBILITY. The debtors had pre-bankruptcy income from farm operations, off-farm employment and the sale of farm land. The farm land was sold to an unrelated party to be developed into a golf course. The debtors continued to hold land which was used as pasture but was available for sale for non-farm development. The debtors argued that the proceeds from the sale of the farm land should be included in farm income for purposes of qualifying for Chapter 12 because the land sale was a good business decision. The debtors pointed to In re Armstrong, 812 F.2d 1024 (7th Cir. 1987), which allowed the proceeds from the sale of farm machinery to be included in farm income. The court distinguished this case from Armstrong in that the debtors here did not make the land sale as part of a plan to save the remaining farm as a business. Instead, the court noted that the debtors seemed to be holding the farm only until a neighboring developer would be willing to buy more land. The court held that the land sale proceeds were not farm income and the debtors were not qualified for Chapter 12. In re Ross, 270 B.R. 710 (Bankr. S.D. Ill. 2001).

CHAPTER 13-ALM § 13.03.³

CONFIRMATION OF PLAN. The debtor filed for Chapter 13 and submitted a plan which provided for payments from income and from the sale of a farm, farm machinery and a bar over the period of the plan. A bank had a first lien in the bar and farm equipment and a second lien on the farm property. The bank objected to the plan because the secured lien interest rate and terms were modified by the plan. However, the bank failed to timely file a claim in the case. The court held that the debtor’s plan was not feasible because there was insufficient income to fund the plan; however, the court held that, unless no one objected to the bank’s late filed claim, the bank’s claim would be disregarded and the amounts needed to pay the secured claim would be applied to general unsecured creditors and produce sufficient funds to make the plan payments. The court allowed the other creditors an opportunity to object to the untimely bank claim. In re Michels, 270 B.R. 737 (Bankr. N.D. Iowa 2001).

FEDERAL TAX-ALM § 13.03[7].⁴

POST-PETITION INTEREST. The Chapter 7 trustee did not file or pay the bankruptcy estate’s income taxes for the four years of the case until the last year. The IRS added penalties and interest to the estate’s tax liability. The estate’s taxes and penalties were accorded administrative claim priority but the debtor argued that the interest on the taxes was not entitled to administrative claim priority. The IRS argued that the bankruptcy statute was not clear and that Section 503(b)(1) should be interpreted to include the interest as part of the taxes owed. The court held that Section 503(b)(1) was clear and provided administrative claim priority only to taxes and penalties; therefore, the interest on the taxes was entitled only to a fifth priority as provided by Section 726(a)(5). In re Weinstein, 272 F.3d 39 (1st Cir. 2001), aff’g, 251 B.R. 174 (Bankr. 1st Cir. 2000), aff’g, 237 B.R. 4 (Bankr. D. Mass. 1999).

FEDERAL AGRICULTURAL PROGRAMS

CHRONIC WASTING DISEASE. The APHIS has issued interim regulations under the animal health regulations to provide for the payment of indemnity by the USDA for the voluntary depopulation of captive cervid herds known to be infected with chronic wasting disease. 67 Fed. Reg. 5925 (Feb. 8, 2002).

LIVESTOCK INDEMNITY PROGRAM. The CCC has adopted as final 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. 67 Fed. Reg. 7265 (Feb. 19, 2002).

MILK. The CCC has announced that the regulations governing the Dairy Recourse Loan Program have been

PERISHABLE AGRICULTURAL COMMODITIES ACT. The plaintiff had its PACA license suspended for failing to provide documents and the plaintiff sought a stay of the suspension pending judicial review. The USDA argued that the court did not have jurisdiction to hear the case because (1) the petition for appeal was faxed to the USDA by the court and not mailed, as required by 28 U.S.C. § 2344 and (2) no final administrative decision had been made. The court found that the petition was mailed and faxed by the clerk of the court because the anthrax incident had caused significant delays in mail sent to governmental agencies. The court noted that it was frivolous for the USDA to complain about the use of a faster, more secure method of sending the petition. The court also found that the USDA suspension order was a final decision because the order had a lasting and continuous effect with no other recourse to the plaintiff but a judicial review. The USDA also argued that a stay was not necessary because the plaintiff was no longer in business, based on the testimony of an USDA auditor who visited the business. The plaintiff charged the auditor with perjury because the plaintiff had moved its business premises and the auditor and other USDA agents had visited the plaintiff's new location several times before the auditor claimed to have visited the closed business. The court held that there was sufficient evidence to demonstrate that the plaintiff was still in business and would be harmed by the license suspension. The court granted the stay pending review of the suspension order because the plaintiff had a good chance of success in overturning the suspension order since (1) the USDA did not provide any notice or hearing by an uninvolved party, such as an administrative judge, on the matter before suspending the license, and (2) the suspension was perpetual instead of the for 90 days as required by statute. Fine Foods, Inc. v. U.S.D.A., 274 F.3d 1137 (7th Cir. 2001).

TUBERCULOSIS. The APHIS has issued interim regulations amending the regulations regarding the payment of indemnity for animals destroyed because of bovine tuberculosis to provide that the APHIS will pay owners of the animals an indemnity equal to the difference between the net salvage received and the appraised value of the animals destroyed, up to $3,000 per animal. 67 Fed. Reg. 7583 (Feb. 20, 2002).

FEDERAL ESTATE AND GIFT TAX

VALUATION OF STOCK. The decedent’s estate included stock in a closely-held corporation. The stock was preferred stock subject to a redemption agreement at over $1,000 per share plus interest if the redemption occurred after specified dates. The estate valued the stock at book value, $10 per share, but the stock was redeemed under the redemption agreement a year after the decedent’s death at $1,000 plus interest. The Tax Court held that the redemption was relevant to the value of the stock at the decedent’s date of death because the redemption was foreseeable and the corporation had sufficient funds to make the redemption on the date of the decedent’s death. The Tax Court, however, allowed a 4 percent discount to the value of the stock as a “reasonable discount” for a potential purchaser. The appellate court remanded the case on this issue for the Tax Court to provide an explanation for the choice of a 4 percent valuation discount. Estate of Trompeter v. Comm’r, 2002-1 U.S. Tax Cas. (CCH) ¶ 60,428 (9th Cir. 2002), rev’g and rem’g, T.C. Memo. 1998-35.

FEDERAL INCOME TAXATION

BUSINESS EXPENSES. The IRS has announced its acquiescence in the following case. 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), aeqq, AOD/CC-2002-02.

The taxpayer owned a multiple unit residential rental property and claimed deductions related to the operation of the property. The court allowed the deductions to the extent the taxpayer provided written and other evidence to substantiate the expenses and disallowed all deduction for unsubstantiated expenses. Shelton v. Comm’r, T.C. Summary Op. 2002-9.

CAPITAL EXPENSES. The IRS has issued guidance that impact fees incurred by real property developers in connection with the construction of a new residential rental building are indirect costs that, pursuant to I.R.C. §§ 263(a), 263A, should be capitalized and added to the basis of buildings constructed. Accordingly, developers and operators of low-income housing may include such fees in the computation of the low-income housing credit. Rev. Rul. 2002-9, I.R.B. 2002-10.

CORPORATIONS-ALM § 4.02(14).*

GOLDEN PARACHUTE PAYMENTS. The IRS has issued proposed regulations relating to golden parachute payments under I.R.C. § 280G, effective for payments that are contingent on a change in ownership or control occurring on or after January 1, 2004. Taxpayers may rely on regulations proposed

*Agricultural Law Manual (ALM).*
SHAM CORPORATIONS. The taxpayer was an accountant who had established 13 corporations through which the taxpayer funneled much of the taxpayer’s income which was not reported on the taxpayer’s income tax returns. The court held that the corporations were shams and would be disregarded for income tax purposes because (1) the taxpayer used false EINs when forming the corporations; (2) the 13 corporations did not follow any corporate formalities such as maintaining books and records, issuing stock, holding annual meetings, electing officers, or issuing financial statements; (3) the corporations did not have employees, paid no salaries or dividends, did not conduct any legitimate business, and did not file tax returns; (4) the taxpayer did not treat the 13 corporations as separate business entities; and (5) the taxpayer often lent money from one corporate account and deposited repayments for that loan in other corporate accounts. Wapnick v. Comm’r, T.C. Memo. 2002-45.

COURT AWARDS AND SETTLEMENTS-ALM § 4.02[14]. The taxpayer had filed a sexual harassment suit against an employer and received a judgment for back pay, front pay, pension benefits, attorneys’ fees and court costs. Under the taxpayer’s legal fee arrangement with the taxpayer’s lawyers, about one-half of the award was paid to the taxpayer’s attorneys. The court held that all of the judgment was included in the taxpayer’s income because none of the award was for personal injuries. The taxpayer could not exclude the attorneys’ fees from income, because the attorneys did not have a property interest in the fee portion of the award. The taxpayer, however, could claim the fees as a miscellaneous deduction. Hukkanen-Campbell v. Comm’r, 274 F.3d 1312 (10th Cir. 2001), aff’d, T.C. Memo. 2000-180.

DISASTER PAYMENTS. On February 6, 2002, the President determined that certain areas in Arkansas were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of a severe ice storm on January 29, 2002. FEMA-1402-DR. On February 6, 2002, the President determined that certain areas in Missouri were eligible for assistance under the Act as a result of severe ice storms on January 29, 2002. FEMA-1403-DR. On January 24, 2002, the President determined that certain areas in Arkansas were eligible for assistance under the Act as a result of severe storms and flooding on December 15, 2001. FEMA-1400-DR. On February 1, 2002, the President determined that certain areas in Oklahoma were eligible for assistance under the Act as a result of severe ice storms on January 30, 2002. FEMA-1401-DR. Accordingly, a taxpayer who sustained a loss attributable to the disasters may deduct the loss on his or her 2001 federal income tax return.

EMPLOYEE BENEFITS. The IRS has announced that, consistent with prior practice, the IRS will not assert that any taxpayer has understated a federal tax liability by reason of the receipt or personal use of frequent flyer miles or other in-kind promotional benefits attributable to the taxpayer’s business or official travel. However, the IRS also stated that any future guidance on the taxability of these benefits will be applied prospectively. The IRS also stated that this relief did not apply to travel or other promotional benefits that are converted to cash, to compensation that is paid in the form of travel or other promotional benefits, or in other circumstances where these benefits are used for tax avoidance purposes. Ann. 2002-18, I.R.B. 2002–__.

INvoluntary Conversion. The taxpayer was a wood products manufacturer which owned timber forests. Some of the timber was damaged by storms, fires and insects. The plaintiff chose to sell the damaged trees on the open market instead of further processing and/or milling the damaged trees into finished products. The IRS argued that no involuntary conversion occurred because the trees were processed the same as undamaged trees. The court held that the taxpayer was eligible for the Section 1033 deferral because the taxpayer was forced to harvest, salvage and process the trees before the normal time. The court stated that the taxpayer’s situation was indistinguishable from the circumstances set forth in Rev. Rul. 80-175, 1980-2 C.B. 230, where the taxpayer’s trees were felled by a hurricane. The court held that the fact that the damage was sufficiently partial so as to result in a substantial amount of deferral was not a reason, under the statute, to deny relief. Willamette Industries, Inc. v. Comm’r, 118 T.C. No. 7 (2002).

LEGAL FEES. The taxpayer corporation claimed a deduction for legal fees paid for the criminal defense of the corporation’s sole shareholder who was charged with conspiracy to evade the taxes owed by another taxpayer. The court held that the legal fees were not deductible because the legal fees were not paid for the protection of the corporation or paid for matters relating to the business of the corporation. Capital Video Corp. v. Comm’r, T.C. Memo. 2002-40.

RETURNS. The IRS has announced that errors related to a new line on the basic income tax forms may delay refunds by a week or more for taxpayers filing incorrect returns. A credit is claimed on line 47 of Form 1040, line 30 of Form 1040A and line 7 of Form 1040EZ. The credit is for taxpayers who did not get the maximum benefit from the 2001 advance payments, and whose 2001 income or tax amounts qualify them for an additional amount. Taxpayers who received the limit for their filing status should leave this credit line blank. The maximum amounts are: $300 for a single person or a married person filing separately; $500 for a head of household; and $600 for a married couple filing jointly or a qualifying widow or widower. The main errors taxpayers make on the rate reduction credit line are: entering the advance payment amount, when the line should be blank because the taxpayer has already received the maximum benefit; entering a credit amount, when the line should be blank because the taxpayer is a dependent; leaving the line blank, when the taxpayer actually qualifies for the credit; or figuring the credit amount incorrectly. The IRS is
advising taxpayers that, if an error related to this credit has been made, the taxpayer should not file an amended return until after the IRS processes the original return. The IRS is rejecting e-filed returns that show the advance payment amount on this line or that show a dependent claiming the credit, so that the taxpayer or return preparer may quickly fix the problem and transmit a corrected return. IR-2002-19.

**SAFE HARBOR INTEREST RATES**

*March 2002*

<table>
<thead>
<tr>
<th></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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**SELF-EMPLOYMENT INCOME.** The taxpayers, husband and wife, retired from farming in 1988 and entered into a rental agreement with their sons to farm the property with the taxpayers and sons sharing profits and expenses equally. The taxpayers became members of a local agricultural cooperative by purchasing common stock in the cooperative and entering into production and marketing agreements with the cooperative. The agreements required the taxpayers to either deliver a certain amount of corn each year or to purchase corn from the cooperative pool of excess corn as a substitute. In return for petitioners' meeting their production and delivery obligations, the cooperative was obligated under the agreement to pay the taxpayers: (1) at least 80 percent of the loan value per bushel of corn delivered by each petitioner; (2) a storage fee and interest in some cases; (3) an additional payment ("value-added payment") for value added to the corn as a result of its processing and as further compensation for corn delivered by the taxpayers, if the cooperative determined that such a payment was warranted after calculating the net proceeds from all of its operations for the processing year and if the cooperative's lenders approved; and (4) payments from the cooperative's earnings as patronage dividends in accordance with the cooperative's bylaws. The taxpayers reported the value-added payments as capital gain income, which was not included in self-employment income. The IRS argued that the value-added payments were income from a trade or business and were liable for self-employment taxes. The taxpayers argued that the value-added payments were either investment income attributed to their common stock ownership or dividends from the stock, neither of which were self-employment income. Initially, the parties agreed that the rental of the farm to the sons was not a trade or business and the income from the farm was not self-employment income. The IRS argued that the taxpayers' involvement with the cooperative was sufficient to qualify as a trade or business in that the cooperative's actions as agents for the taxpayers could be attributed to the taxpayers. The court held that the cooperative did not function as the taxpayers' agent and that the taxpayers, although retired from active farming, continued to be active in dealing in corn through the cooperative. The court also noted that the cooperative form of business did not create an agency relationship with the members. The court held that the value-added payments resulted from the business of the taxpayers of acquiring and selling corn. The court also held that the exclusions of I.R.C. § 1402(a)(2) (dividends) or 1402(a)(3) (capital assets) did not apply to exclude the income from self-employment tax. Bot v. Comm'r, 118 T.C. No. 8 (2002).

**TAX SHELTERS.** The taxpayer, an orthopedic surgeon, 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 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. Welch v. Comm'r, T.C. Memo. 2002-39.

**TRAVEL EXPENSES.** The taxpayer claimed travel expenses for travel between the taxpayer's parents' home in Wisconsin and Chicago where the taxpayer performed with a band or traveled to other cities to perform with that band. The court held that the taxpayer's city of residence was Chicago because the taxpayer spent more time there and lived in Wisconsin only part time to save money. The taxpayer was allowed travel expense deductions for costs incurred while traveling with the band outside of Chicago. Bjornstad v. Comm'r, T.C. Memo. 2002-47.

**PRODUCTS LIABILITY**

**DAIRY COW.** The plaintiff purchased 115 diary cows from the defendant. Under Wash. Stat. § 16-86-015, the cows were required to be tested for brucellosis within 30 days of transfer. The cows were tested before delivery and one cow tested "suspect" for brucellosis twice and was slaughtered. The carcass, however, was tested as free of infection. The remaining cows were delivered more than 30 days later and were re-tested as required by the statute. Again, one cow tested as a reactor and was slaughtered, with the carcass testing as free of infection. The herd was quarantined for four months until the carcass was tested as infection free. The plaintiff sued the defendant for negligence, breach of the implied warranty of fitness for a particular purpose, strict liability and violation of the Consumer Protection Act. The defendant sought to dismiss the claims in tort as barred by the economic loss rule which allows only contract actions involving losses resulting from
commercial agreements or contracts. The court held that claims in tort were prohibited if the losses arose out of transactions bargained for by commercial parties. The court held that the negligence and strict liability claims were properly dismissed by the trial court because the brucellosis testing was part of the commercial transaction and the damages, if any, were caused by the testing of the cows and not the cows themselves. Hofstee v. Dow, 36 P.3d 1073 (Wash. Ct. App. 2001).

SECURED TRANSACTIONS

PRIORITY. The debtor granted the plaintiff credit union a security interest in all cattle owned by the debtor, including after-acquired cattle. The cattle were pastured on land owned by one of the defendants. The debtor and the landowner agreed to allow the debtor to pasture the cattle free in exchange for the debtor’s caring for the landowner’s cattle on the same land. The debtor defaulted on the credit union loan and the cattle were sold, with the proceeds placed with the court until the priority of the interests of the various parties was determined. The landowner claimed an agister’s lien for the value of the use of the pasture land. The court found that the landowner lived 300 miles from the pasture and did not ever take possession or control of the cattle nor did the landowner enter into any contract with the debtor for the care of the debtor’s cattle. The court held that the landowner did not have an agister’s lien or any other interest in the cattle. Another defendant had entered into a sales contract with the debtor to sell cattle to the debtor. The contract provided for installment payments to be made from the sales of the cattle. The defendant claimed that the transaction was a lease because the defendant retained the brand on the cattle. The court found that the parties had characterized the transaction as a sale and that the cattle carried brands of third parties; therefore, the transaction was a sale and the defendant had only an unperfected security interest in the cattle sold to the debtor. The defendant also argued that the defendant should recover at least the unpaid portion of the contract under equitable principles because the credit union would unjustly benefit from its security interest in the after-acquired cattle. The court acknowledged that equitable doctrines have been used to overcome the priority of security interest in the UCC, but held that the defendant had not demonstrated any sufficient equitable doctrine to overcome the credit union’s perfect security interest in after-acquired property. Daniels-Sheridan v. Bellanger, 36 P.3d 397 (Mont. 2001).

TRESPASS

TIMBER. The defendant was hired to cut timber on land neighboring the plaintiff’s land. One of the defendant’s employees incorrectly determined the boundaries of the neighbor’s land and included all of the plaintiff’s timber in the timber to be cut. Although the defendant admitted cutting the wrong trees, the parties did not agree as to the value of the timber cut. After a jury trial, the jury determined that the defendant willfully and intentionally cut the trees with the intent to deprive the plaintiff of the plaintiff’s property and determined the value of the trees cut. Because of this finding by the jury, the court trebled the damages as provided by state law. The defendant argued that the opinion of an expert witness as to the intent of the boundary marker employee was improperly ruled inadmissible. The court held that the jury had sufficient evidence to make that determination without the expert’s testimony. The court noted that the employee testified that the boundary was marked without any use of a survey or measuring devices, either of which would have shown that the boundary was too large. The defendant also argued that the damage award was excessive because it exceeded the difference in the fair market value of the land before and after the cutting. The defendant noted that the damage award, before trebling, exceeded what the plaintiff paid for the land just two years before the cutting. The court upheld the damage award because the award was based on the appraisals provided by several experts and because the defendant failed to show how the fair market value of the land affected the value of the trees. Auger Timber Co. v. Jiles, 56 S.W.3d 386 (Ark. Ct. App. 2001).

IN THE NEWS

LIKE-KIND EXCHANGES. CCH reported on a seminar held February 20 in Washington, D.C. titled “Current Issues Under Section 1031: Tenants in Common and Undivided Fractional Interests.” At the seminar, Deborah Harrington, attorney-advisor in the Treasury Department’s Office of Tax Legislative Counsel said that the IRS will be providing guidance as to when a co-tenancy is not a partnership for purposes of the like-kind exchange rules. The IRS plans to allow taxpayers to request rulings as to whether a co-ownership interest is a partnership or not. CCH NEWS-FEDERAL, 2002TAXDAY, 02/22/2002, Item #I.3.

NUISANCE. Lawyers Weekly has reported that a judge in Sioux County, Iowa District Court has awarded $100,000 for loss of value in a homestead after a corporate hog farm was built nearby. The plaintiffs had alleged that the company’s 4,000-head hog farm near their home was a nuisance that attracted bugs and harmed their emotional and physical health. They had sought punitive and compensatory damages, as well as an injunction that could halt their farm’s operations. The judge denied the injunction “since the award here made will adequately compensate the plaintiffs.” The judge had previously ruled that the Iowa right-to-farm law was unconstitutional because large farms could interfere with the use of a neighboring property and right to seek compensation. 2002 LWUSA 150 (Feb. 18, 2002).
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INCOME TAX CONSEQUENCES
OF ABANDONMENT

— by Neil E. Harl

The income tax consequences of abandonment in bankruptcy\(^1\) have posed significant problems for farm and ranch taxpayers for well more than a decade. With two Circuit Courts of Appeal embracing the “deflection” theory, the Eighth\(^2\) and Ninth\(^3\) Circuit Courts of Appeal decisions assured that a taxpayer filing bankruptcy is highly vulnerable to income tax liability on the property abandoned by the bankruptcy estate.

A 2002 Ninth Circuit Court of Appeals decision\(^4\) has provided further insight into what constitutes abandonment.

*Catalano v. Commissioner*

In the Ninth Circuit case of *Catalano v. Commissioner*,\(^5\) the taxpayer had borrowed $1.4 million from a bank to purchase a residence which secured the loan. Six years later, the taxpayer ceased making principal and interest payments on the obligation when the taxpayer filed bankruptcy. A year later, the bankruptcy court lifted the automatic stay on the property which permitted the lender to foreclose on the residence. The taxpayer claimed an income tax deduction for the mortgage interest from the foreclosure which the Internal Revenue Service disallowed. The Tax Court held that the relief from the automatic stay removed the property from the bankruptcy estate which resulted, in effect, in abandonment of the property by the bankruptcy estate.\(^6\) The Tax Court concluded that the taxpayer was deemed to have paid the accrued mortgage interest in the foreclosure sale. Thus, the taxpayer could claim a deduction for accrued mortgage interest as of the foreclosure date.\(^7\)

The Ninth Circuit Court of Appeals reversed, stating that, under the Bankruptcy Code, abandonment requires a formal notice and hearing\(^8\) which had not occurred in this case. The court noted that property is not considered abandoned from the bankruptcy estate unless the abandonment procedures in the Bankruptcy Code are satisfied. The court rejected the taxpayer's argument that the order lifting the automatic stay accomplished a de facto abandonment of the property. Therefore, the property was not considered abandoned. The taxpayer could not deduct the claimed mortgage interest.

Consequences of abandonment

Had the taxpayer been successful, in arguing that the property had been abandoned back to the taxpayer, the consequences could possibly have been significant and might have been costly to the taxpayer.

\* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
The Ninth Circuit Court of Appeals, the same court that decided the appeal in Catalano v. Commissioner held in 1995 that, in the event of abandonment in bankruptcy, the “deflection” theory applies and the taxpayer is liable for any gain on the property when the creditor takes action to acquire the property subsequent to abandonment. The Eighth Circuit Court of Appeals agrees with that characterization although that treatment has been rejected by a U.S. Bankruptcy Court in Massachusetts and criticized by this author.

Even worse, the Internal Revenue Service, in 1989, ruled that abandonment in bankruptcy effectively converts a recourse obligation into a non-recourse obligation (which was already the case in Catalano v. Commissioner) with the result that the entire difference between the income tax basis of the property and the amount of the debt was gain to the taxpayer. The personal liability of the taxpayer was discharged in bankruptcy. There is no discharge of indebtedness income for non-recourse obligations by the IRS view of the taxation of abandoned property. Discharge of indebtedness for a taxpayer in bankruptcy is not subject to income tax (although the taxpayer’s tax attributes and basis of property must be reduced). Similarly, for insolvent taxpayers not in bankruptcy, there is no income tax liability for discharge of indebtedness income to the extent of the taxpayer’s insolvency. Even if a farm or ranch taxpayer is solvent, income tax liability may be avoided under the solvent farm debtor rule although tax attributes and the basis of property must be reduced.

None of the rules apply to non-recourse indebtedness inasmuch as the entire difference between basis of the property and debt is gain and there is no discharge of indebtedness income.

In conclusion
Abandonment of property in bankruptcy is a treacherous concept from an income tax perspective. The reversal of the Tax Court in Catalano v. Commissioner narrows slightly the scope of abandonment with the Ninth Circuit Court decision serving notice that abandonment of property requires a formal notice and hearing with an unenthusiastic response to arguments for broadening the concept of abandonment in other situations involving a type of constructive or implied abandonment.

FOOTNOTES
2 In re Olson, 930 F.2d 6 (8th Cir. 1991) (abandonment of land to debtor; court offered no theory for holding that deflection approach applied).
3 In re Johnston, 49 F.3d 538 (9th Cir. 1995) (court held requirements for abandonment did not include consideration of effect on debtor’s “fresh start”).

BANKRUPTCY

CHAPTER 13—ALM § 13.03.*

DISPOSABLE INCOME. The debtors’ Chapter 13 plan was confirmed and contained a provision that all income tax returns to which the taxpayers became entitled during the plan were to be included in disposable income. The plan ended on April 4, 2001 and the debtors received a discharge on April 24, 2001.

The trustee then learned that the debtors received an income tax refund for 2000 taxes and sought to include the refund in the disposable income. The court held that the debtors became entitled to the refund on December 31, 2000; therefore, the refund was included in disposable income under the plan. In re Midkiff, 271 B.R. 383 (Bankr. 10th Cir. 2002).

DISCHARGE. The U.S. Supreme Court has unanimously decided an issue that has spawned numerous reported decisions that have produced a varied response to the issue of whether a

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

* Agricultural Law Manual (ALM).
bankruptcy case tolls the three-year period under Section 523 (a)(1)(A) for taxes. 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 trial and appellate courts 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, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,257 (S. Ct. 2002), aff’d, 233 F.3d 56 (1st Cir. 2000).

CONTRACTS

MITIGATION. The defendant entered into a contract to deliver cotton produced by the defendant. The defendant failed to deliver the cotton as agreed and the plaintiff was forced to purchase replacement cotton. The plaintiff sued for the difference in price, arguing that the defendant had breached the contract. The defendant argued that the contract was not valid because it did not establish a clear price. The court acknowledged that both parties had differing interpretations of some terms in the contract but held that the contract was clear as to the price. The defendant also argued that the plaintiff failed to promptly attempt to mitigate the damages by buying replacement cotton immediately after the defendant notified the plaintiff that the defendant did not intend to deliver the contract cotton. The defendant claimed to have given oral notice of the breach two months before the replacement cotton was purchased. The court held that the issue of when the breach occurred was one of fact for the jury. The court upheld the jury verdict for damages as supported by sufficient evidence. Carolyn B. Beasley Cotton Co. v. Ralph, 59 S.W.3d 110 (Tenn. Ct. App. 2000).

FEDERAL AGRICULTURAL PROGRAMS

ASIAN LONGHORNED BEETLE. The APHIS has adopted as final regulations amending the Asian longhorned beetle regulations to include additional quarantined areas in Illinois and New York. 67 Fed. Reg. 9285 (Feb. 28, 2002).

BLACK STEM RUST. The APHIS has adopted as final regulations amending the black stem rust quarantine and regulations to require that persons who request the addition of Berberis, Mahoberberis, or Mahonia spp. plants to the list of rust-resistant varieties in the regulations must provide APHIS with a description of the variety that can be used by inspectors to clearly identify the variety and distinguish it from others.

The regulations also require that inspectors verify, prior to interstate movement, that varieties match their description. The regulations add 32 new varieties to the list of rust-resistant Berberis, Mahoberberis, and Mahonia species. 67 Fed. Reg. 8177 (Feb. 22, 2002).

CITRUS CANKER. The APHIS has adopted as final regulations amending the citrus canker regulations by removing a portion of the quarantined area in Manatee County, FL, from the list of quarantined areas. 67 Fed. Reg. 9389 (March 1, 2002).

SHARED APPRECIATION AGREEMENTS. The FSA has adopted as final regulations amending the Shared Appreciation Agreement (SAA) and the servicing regulations of SAAs. The SAA ensures that FSA shares in any appreciation of real estate security when a farm borrower has received a writedown of a portion of a FSA debt. The amount due can be paid in full or amortized when the SAA matures or is triggered during the term of the agreement. The final regulation reduces the amortization interest rate on all SAA loans to the Farm Program Homestead Protection rate less 1 percent as of October 28, 2000, the date of enactment of the Agriculture, Rural Development, Food and Drug Administration, and Related Agencies Appropriations Act of 2001. 67 Fed. Reg. 7942 (Feb. 21, 2002).

FEDERAL ESTATE AND GIFT TAX

GENERATION SKIPPING TRANSFERS. 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 trial 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 trial 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 trial 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 trial court held that its holding complied with the final regulations discussed at 12 Agric. L. Dig. 4 (2001). The appellate court reversed, holding that the exercise of the power of appointment did not violate the requirements of the grandfather provisions for pre-1986 trusts. The appellate court followed the reasoning of Simpson, supra. Note: The final regulations provide that the lapse or exercise of a power of appointment does not affect the eligibility of a pre-1986 trust for the grandfather provision. Bachler v. United
instructor at four junior colleges, all part time positions. The


Business expenses. The taxpayer was a geography instructor at four junior colleges, all part time positions. The taxpayer reported the income from these jobs on Schedule C as business income and claimed business expenses for 85 percent of the rent of the taxpayer’s residence and for two rented storage units. The taxpayer argued that the spaces were used to store a substantial library of geographical materials. The court held that the taxpayer was an employee of the junior colleges and not an independent contractor; therefore, the income was not business income. The court disallowed the rental expense for the home as not incurred for the convenience of the taxpayer’s employer and disallowed the storage rent expense as not ordinary and necessary for the taxpayer’s business.


The taxpayer purchased a commercial building with the intent to renovate the building and use it for a restaurant and nightclub. The taxpayer claimed deductions for the renovation costs, interest on the construction loan and depreciation. The court found that the building was not used for profit because the building was used only by nonprofit volunteer groups. The court held that the renovation costs and interest expenses had to be capitalized in the basis of the building. The depreciation deduction was disallowed except for the portion which represented the section of the building which was rented for storage.


The taxpayer worked as a forester for California. In 1994, the taxpayer purchased 39 acres of burned forest land after conducting studies as to whether the land would support a commercial tree farm operation. During 1995 and 1996, the taxpayer attempted to plant one species of tree on the property but determined that the land would not support the commercial production of these trees. Although the taxpayer continued to improve the property, by 2001 no trees had been planted and the taxpayer still had not decided what trees could be feasibly produced on the land. The taxpayer claimed deductions for the expenses incurred in clearing the land and making improvements, including a road. The court held that, during 1995 and 1996, the taxpayer was not conducting a trade or business and was not entitled to any business deductions for the expenses. In addition, the court held that the expenses were part of the start-up costs to any future business and could not be currently deducted.


#AGRICULTURAL LAW MANUAL

**BAD DEBTS.** The taxpayer was a corporation with two shareholders. One shareholder had the option to purchase all of the other shareholder’s stock at a discount. The shareholder had financial difficulties and the corporation decided to try to prevent the options from being held by the shareholder’s creditors. The corporation loaned money to the shareholder who agreed not to exercise the options. The loan was nonrecourse and the value of the stock and options was greater than the loan amount. However, the corporation obtained the right to revoke the options if the loan was foreclosed. The shareholder defaulted on the loan and the corporation claimed a bad debt deduction for the difference between the amount owed and the options and stock received in the foreclosure. The court held that a bad debt deduction was not allowed because the transaction was, in substance, a sale of the stock and options because the shareholder had no reason to attempt to repay the loan and the purpose of the transaction was to prevent the shareholder from assigning the options and stock to the shareholder’s creditors.

**ACCOUNTING METHOD.** The taxpayers were two medical professional corporations which provided chemotherapy services. The staff physicians examined patients and prescribed the chemotherapy for the patients’ conditions. The taxpayers provided pharmacy services for drugs which were not administered at the clinics but were part of the chemotherapy regimen as well as the drugs which were used at the clinic. The IRS argued that the taxpayers were required to maintain inventories of the drugs as merchandise. The court held that the drugs were not merchandise but were part of the medical services offered by the taxpayers; therefore, the taxpayers were not required to use the accrual method of accounting. The appellate court affirmed in a decision designated as not for publication.

Mid-Del Therapeutic Center, Inc. v. Comm’r, T.C. Memo. 2002-63.
INTEREST RATE. The IRS has announced that, for the period April 1, 2002 through June 30, 2002, the interest rate paid on tax overpayments remains at 6 percent (5 percent in the case of a corporation) and for underpayments at 6 percent. The interest rate for underpayments by large corporations is 8 percent. The overpayment rate for the portion of a corporate overpayment exceeding $10,000 is the federal 3.5 percent. Rev. Rul. 2002-13, I.R.B. 2002-__.

NET OPERATING LOSSES. The taxpayer claimed net operating losses for three tax years and carried them forward to the fourth year to offset income in that year. The taxpayer provided no evidence to support the claims of net operating losses for the three years except the income tax returns filed for those years. The taxpayer did not make any election to carry the net operating losses forward. The court held that the deduction for the carried-forward losses was disallowed because (1) the tax returns were insufficient substantiation and (2) the losses should have been carried back to previous tax years first and the taxpayer provided no evidence to determine whether the losses were offset by income in those earlier tax years. Gale v. Comm'r, T.C. Memo. 2002-54.

PARTNERSHIPS-ALM § 7.03.*

CHARITABLE DEDUCTION. The taxpayer was a partnership, organized as an LLC, which acquired a farm from a family corporation which had used the farm for raising and training horses. The corporation had ceased business and neighbors decided to purchase the farm in order to preserve it. The neighbors formed the partnership solely for the purpose of acquiring the farm in order to preserve the rural nature of the land. The partnership transferred a conservation easement to a nonprofit corporation. The easement prevented development of the land. The partners each received a “distribution tract” which remained subject to the conservation easement. The IRS ruled that the conservation easement was a “qualified conservation contribution” under I.R.C. § 170(h) and that each partner was eligible for a charitable deduction for the partners’ distributive share of the value of the conservation easement. Ltr. Rul. 200208019, Nov. 26, 2001.

PENSION PLANS. For plans beginning in February 2002, the weighted average is 5.70 percent with the permissible range of 5.13 to 5.98 percent (90 to 106 percent permissible range) and 5.13 to 6.27 percent (90 to 110 percent permissible range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). Notice 2002-16, I.R.B. 2002-9, 562.

The IRS has released a list of entities that have been approved by the Commissioner to serve as a nonbank trustee or custodian for Archer medical savings accounts, custodial accounts of a pension plan qualified under I.R.C. § 401, custodial accounts described in I.R.C. § 403(b)(7), trust or custodial accounts of individual retirement accounts established under I.R.C. §§ 408(a), 408A or 530 and custodial accounts of eligible state deferred compensation plans described in I.R.C. § 457(b). These accounts are tax-exempt if the trustee or custodian is a bank (for Archer MSAs, a bank or insurance company) or an approved nonbank trustee or custodian. Ann. 2002-12, I.R.B. 2002-8, 533.

RETURNS. The IRS has announced the release of revised Pub. 969, Medical Savings Accounts; Pub. 3920, Tax Relief for Victims of Terrorist Attacks; and Pub. 1542 (Rev. February 2002), Per Diem Rates (For Travel Within the Continental United States) designed for employers who pay a per diem allowance to employees for business travel away from home on
or after October 1, 2001, within the continental United States. 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; (3) through FedWorld; or (4) by directly accessing the Internal Revenue Information Services bulletin board at (703) 321-8020.

TAX SHELTERS. The taxpayer was involved in several successful non-farm businesses and financial operations and 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 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 the claim of losses. Finazzo v. Comm’r, T.C. Memo. 2002-56.

NEGLIGENCE

RECREATIONAL IMMUNITY. The plaintiff was injured while hunting in a tree stand which collapsed. The tree stand was constructed by the nephew of the property owners. The nephew used the tree stand for hunting and allowed the plaintiff to use the tree stand for hunting. The plaintiff sued the nephew, who was represented by the nephew’s insurance company. The defendant claimed that the nephew was immune from liability under Wis. Stat. § 895.52 because the injury occurred on the defendant’s property while used for recreational purposes. The major issue was whether the statute could apply to a tree stand located on real property owned by third parties. The court held that “property” under the statute included structures, whether or not the owner of the structure also owned the underlying real property; therefore, the accident was covered by the recreational immunity statute and the defendant was not liable for the plaintiff’s injuries. The court noted that the holding was consistent with the purpose of the statute in promoting recreational use of rural property. Peterson v. Midwest Security Ins. Co., 636 N.W.2d 727 (Wis. 2001), aff’d, 617 N.W.2d 876 (Wis. Ct. App. 2000).

NUISANCE

HOG FARM. The plaintiffs were rural neighbors of a hog farm operated by the defendant. A jury awarded 52 of the 108 plaintiffs $100,000 each as compensation for the impairment of their use of their properties by the odors and water contamination by the defendant’s hog farm. The defendant argued that the award was improper because the plaintiffs failed to prove that the hog farm was a temporary nuisance. The plaintiff argued that the evidence failed to show that the nuisance was abatable. The court noted that the defendant had claimed in pre-construction announcements that the facility would have no odors or effect on the water because the facility would use the latest scientific methods to control odors and waste disposal. The court listed several fairly simple waste control methods which would have easily lessened the odors and discussed other evidence presented by the plaintiffs of waste management technologies available to abate the odors and reduce pollution from the hog facility. Thus, the court held that the plaintiffs had presented substantial evidence of the ability of the defendant to abate the nuisance and that the nuisance was temporary. The defendant also argued that one plaintiff did not own the property on which they lived and could not file a claim for nuisance. The court held that ownership of the property was not a prerequisite to bringing a nuisance claim where the plaintiffs were rightfully occupying the property during the nuisance. Hanes v. Continental Grain Co., 58 S.W.3d 1 (Mo. Ct. App. 2001).

PROPERTY

EASEMENT. The plaintiff and defendant owned neighboring rural properties which were previously part of one farm. Both properties were linked to a road by a gravel one-lane roadway which first passed over a third party’s land, then over the defendant’s land before splitting into two lanes, one of which led to the defendant’s residence and the other to the plaintiff’s property. The defendant closed the gravel portion with a gate as a security measure and the plaintiff sued to remove the gate, claiming a right of way over the roadway as (1) a public passway, (2) a prescriptive easement, or (3) quasi-easement by implication. The trial court ruled against the roadway being a public roadway because the roadway was not dedicated by the state or county and the evidence was insufficient as to the amount of public use. The trial court also ruled against a prescriptive easement because the first use of the road by an unrelated party was permissive and a prescriptive easement cannot arise without adverse use of the roadway for 15 years. The trial court also rejected the claim of quasi-easement because the evidence showed that the defendants did not purchase their land with the knowledge of any claim of an easement over their property. The appellate court affirmed. Cole v. Givin, 59 S.W.3d 468 (Ky. 2001).

The plaintiff owned 240 acres of farm land neighboring land owned by the defendant. The defendant’s land was formerly a farm but the defendant constructed a golf course and fishing club on the property. The defendant’s land had a ditch crossing it which flowed to the plaintiff’s property. The defendant negotiated with the plaintiff for use and alteration of the ditch but the parties failed to agree. The defendant then proceeded with alteration of the ditch and disposal of waste water into the ditch. The plaintiff sued for trespass on its easement and asked for restoration of the ditch to its original state. The trial court
ruled that the defendant had violated the plaintiff’s easement and allowed the defendant to either (1) restore the ditch to its original condition or (2) be responsible for all maintenance of the ditch such that the ditch would provide as much water as it did before the alterations. The defendant chose the second option. The appellate court affirmed the trial court’s ruling that the defendant had violated the easement and held that a land owner burdened by a water easement may not alter the waterway without either the downstream owner’s consent or a court decree allowing the alteration. The appellate court, however, held that if the plaintiff can prove damage to the plaintiff’s use of the easement, the defendant must restore the ditch to its original condition. The court used the Restatement (Third) of Property (Servitudes) test for damages as “(1) significantly lessen the utility of the easement; (2) increase the burdens on the owner of the easement in its use and enjoyment; or (3) frustrate the purpose for which the easement was created.” Roaring Fork Club, L.P. v. St. Jude’s Co., 36 P.3d 1229 (Colo. 2001), aff’g in part and rev’g in part, 15 P.3d 281 (Colo. Ct. App. 1999).

SECURED TRANSACTIONS

LANDLORD’S LIEN. The defendant cash leased farm land to a tenant. The lease claimed a lien for the defendant in the tenant’s crops and proceeds. However, the defendant did not record the lease or lien. The plaintiff bank had a perfected security interest in the tenant’s crops and proceeds and claimed a priority security interest in the tenant’s crop proceeds. The defendant argued that N.D.C.C. § 47-16-03 created a superpriority in favor of the landlord for unpaid rent in any crops grown on the rented land. The statute referred to a lien for the “rental share of the lessor” and the plaintiff argued that the statutory lien applied only to crop-share leases. The court agreed and held that the defendant did not have a statutory lien for unpaid cash rent. Security State Bank v. Orvik, 636 N.W.2d 664 (N.D. 2001).

STATE REGULATION OF AGRICULTURE

POULTRY. The plaintiff operated a poultry transportation business in several states. The state tested two shipments made by the plaintiff and tested two birds as positive for avian influenza virus. The state then tested the plaintiff’s facilities and also found positive samples of the virus. The state ordered the quarantine of all poultry on the plaintiff’s premises at the time and required the plaintiff to destroy all the birds and clean the facilities. The plaintiff claimed that the test results occurred because the plaintiff had just vaccinated the birds for the virus. The quarantine was eventually lifted and the plaintiff was reinstated as an approved poultry wholesaler. The plaintiff filed a claim for compensation with the state but the claim was returned for lack of substantiation as to the value of the destroyed birds. The plaintiff sued for compensation, arguing that the inspectors exceeded their discretionary authority by failing to account for the vaccination as a cause of the positive test results. The court held that the state inspectors had made every effort to determine the source of the test results and, in view of the lack of contrary evidence, were justified in ordering the destruction of the birds. The court noted that the only impediment to the plaintiff’s full compensation was the plaintiff’s own failure to substantiate the value of the birds lost. Webster v. Moquin, 175 F. Supp.2d 315 (D. Conn. 2001).

IN THE NEWS

ECONOMIC STIMULUS BILL. The Job Creation and Worker Assistance Act of 2002 also known as the Economic Stimulus bill was passed by the U.S. House of Representatives and the U.S. Senate and signed into law by the President on March 9.

A major provision is a 30 percent extra depreciation allowance for both regular tax and AMT purposes. The new 30 percent depreciation allowance is for eligible property for which there was no written contract in effect before September 11, 2001, to acquire the property. The original use of the property must begin with the taxpayer (be new property) and be “acquired” by the taxpayer on or after September 11, 2001 and before September 11, 2004 and placed in service before January 1, 2005. Thus, some property on the 2001 return may be eligible. The statute could be read as allowing the 30 percent allowance first, before expense method depreciation or regular depreciation. However, the Blue Book, which has already been published by the Joint Committee on Taxation in electronic form, takes the position in Section 1 that the 30 percent allowance is claimed after expense method depreciation. The basis remaining after expense method depreciation and the 30 percent allowance have been claimed is eligible for regular depreciation. The 30 percent depreciation allowance is available for depreciable property with a recovery period of 20 years or less, computer software, water utility property and qualified leasehold property. Passenger automobiles subject to the depreciation limits may be eligible for up to $4600 of this extra depreciation. The passenger automobile provision increases the limitation under I.R.C. § 280F(a)(1)(A)(i) by $4600 (which is for the first taxable year in the recovery period). Sec. 101.

The legislation also extends the two-year net operating loss carryback to five years for net operating losses occurring in any taxable year ending during 2001 or 2002. Remember, farming net operating losses are already eligible for a five year carryback. Sec. 102. H.R. 3090, Job Creation and Worker Assistance Act of 2002.

ESTATE TAX. The Congressional Research Service has issued a report on the distribution of assets in taxable estates that filed returns in 1999. The report found that farm assets represented 0.31 percent of the total value of taxable estates that filed tax returns in 1999. 2002 ARD 040-5 (CCH).
Mark your calendars now for the

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by Neil E. Harl and Roger A. McEowen

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ADDITIONAL DEPRECIATION ALLOWANCE
AND LOSS CARRYBACKS

— by Neil E. Harl*

On March 9, 2002, the President signed into law the Job Creation and Worker Assistance Act of 2002.1 The legislation contains one tax provision of particular significance for agriculture2 and another of significance to the tax treatment of non-farm businesses3 in addition to other sections extending unemployment benefits4 and extending expiring or expired provisions.5 The legislation is particularly notable because of the fact that the two major tax provisions are retroactive to 2001.6

Additional depreciation allowance

The legislation, which was enacted as the long-debated and delayed economic stimulus package, authorized additional depreciation for eligible property up to 30 percent of the adjusted income tax basis of qualifying property7 for both regular income tax and alternative minimum tax purposes.8

Eligible property. The legislation defines eligible to include several categories of assets—

- Property with a recovery period of 20 years or less.9 That definition necessarily includes all three-year property10 (which includes breeding hogs and some horses); five-year property11 (which includes business automobiles, light trucks and breeding and dairy animals); seven-year property12 (which includes farm machinery and equipment, grain bins, farm fences and other property not specifically classified in another depreciation group); ten-year property13 (which includes single purpose agricultural and horticultural structures and trees and vines producing fruits and nuts); 15-year property14 (which includes non-farm fences, tile lines and other land improvements); and 20-year property15 (which includes farm buildings). The 2002 law does not extend the additional depreciation allowance to residential rental property16 (which is depreciable over 27 1/2 years and could include tenant houses or houses occupied by employees)17 and nonresidential real property18 which is depreciable over 39-years.19

- Computer software.20

- Water utility property.21

- Qualified leasehold property.22 That category of property eligible for the additional depreciation allowance is defined in terms of investment to the interior of a building which is nonresidential real property23 (39-year property) if the investment is—(1) made pursuant to a lease or by the lessor; (2) the portion of the building involved is occupied exclusively by the lessee; (3) the improvement is placed in service more than three years after the building was placed in service;

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and (4) the investment does not include enlargement of the
building, elevators, escalators or any structural component benefiting a common area or the internal structure of the building.  

New property. The 2002 law specifies that the property must be new property (the original use must commence with the taxpayer after September 10, 2001). That means used machinery and equipment, "used" breeding or dairy animals and buildings, fences, tile lines and other improvements on the purchase of a farm are not eligible.

Passenger automobiles. The 2002 legislation states that passenger automobiles subject to the depreciation limitations per year are eligible for an increase of $4600 which is for the first taxable year in the recovery period.

Order of deduction. The statute states that the adjusted income tax basis for eligible property for which the additional depreciation is claimed is "reduced by the amount of such deduction before computing the amount otherwise allowable as a depreciation deduction under this chapter for such taxable year and any subsequent taxable year." That would suggest that the additional depreciation deduction is claimed first, then expense method depreciation is claimed next (for property eligible for that depreciation allowance—which is a narrower definition than that applicable to the new additional depreciation allowance) and then regular depreciation is claimed.

However, the Joint Committee on Taxation in its “Blue Book” states that the new 30 percent depreciation allowance is claimed after expense method depreciation is claimed (which is limited to $24,000 in 2001 and 2002 and $25,000 thereafter and was not increased in the latest legislation).

Effective date. The legislation states that the property must be acquired by the taxpayer after September 10, 2001, and before September 11, 2004 (but only if no written binding contract for the acquisition was in effect before September 11, 2001), or acquired by written contract after September 10, 2001 and before September 11, 2004 and placed in service before January 1, 2005 (except for certain property with longer production periods).

If a taxpayer makes an election with respect to any class of property, the new provision does not apply to all property in that class (which would otherwise be the case).

Reporting for 2001. The IRS has issued revised Form 4562, Depreciation and Amortization, and Form 2106, Employee Business Expenses, for reporting the additional first-year depreciation. The IRS has advised that taxpayers who have already filed their 2001 returns can file amended returns using Form 1040-X or 1120-X, together with the new revised forms, to obtain the tax benefits available under the Act.

Loss carryback

The 2002 legislation also extends the two-year net operating loss carryback to five years for net operating losses occurring in any taxable year during 2001 or 2002. Keep in mind that “farming losses,” beginning in 1998, have been eligible for a five-year carryback.

The 2002 legislation includes an election to disregard the five-year carryback just as the 1998 enactment allows taxpayers to elect not to have the five-year carryback provision apply to “farming losses.” The IRS is revising the instructions for various 2001 forms that relate to NOLs and will post the revisions to its website.

www.irs.gov. For information regarding the development of other materials relating to the Act, interested parties can access the home page link to “New Law May Cut Your 2001 Tax.”
CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr.

ADVERSE POSSESSION

RIGHT-OF-WAY. The plaintiff acquired a right-of-way along a river to build a levee and to maintain a "borrow pit" from which it extracted soil for use on the levee. The defendant and predecessors had acquired the land between the borrow pit and the river and farmed the land for over 30 years before the parties discovered that a portion of the farmed area was actually included in the right-of-way. The court held that the defendant had acquired title to the disputed strip by adverse possession. The plaintiff argued that the use was permissive because the plaintiff benefited from the defendant's use of the land. The court rejected this argument, holding that the permissive use exception to adverse possession required an affirmative act of permission from the plaintiff to the defendant or the defendant's predecessors. White River Levee Dist. v. Reidhar, 61 S.W.2d 235 (Ark. Ct. App. 2001).

BANKRUPTCY

FEDERAL TAX-ALM § 13.03[7].

DISCHARGE. The Chapter 7 debtor failed to file income tax returns for 1980 and 1986 and filed returns for 1987 through 1991 in 1995. The 1995 filing was made after the IRS had constructed substitute returns and made assessments based on those substitute returns. The court held that the debtor's returns filed in 1995 would be disregarded for purposes of Section 523 and the taxes for those years were nondischargeable. The court noted that the debtor had not filed any returns for almost 10 years and that all the returns filed were filed late. In re Sgarlat, 271 B.R. 688 (Bankr. M.D. Fla. 2001).

ESTATE PROPERTY. The debtors received a payment from the IRS as part of the EGTRRA 2001 advance refund checks mailed to taxpayers resulting from the retroactive reduction of the lowest tax bracket to 10 percent. The debtors filed their Chapter 7 petition in April 2001. The court ruled that the payment represented a refund of 2001 taxes and was post-petition property belonging to the debtors. In re Rivera, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,285 (Bankr. D. Colo. 2002).

FEDERAL AGRICULTURAL PROGRAMS

CROP INSURANCE. The CCC has issued interim regulations which amend the regulations under the Noninsured Crop Disaster Assistance Program to remove area requirements, announce new requirements regarding the filing of applications, payment of service fees, and reporting of crop acreage, yield, and production. 67 Fed. Reg. 12446 (March 19, 2002).

TOBACCO. The CCC has adopted as final regulations which implement requirements of the Agriculture, Rural Development, Food and Drug Administration, and Related Agencies Appropriations Act 2002 (Pub. L. 107-76), which relate to agricultural market assistance for agricultural producers. Section 774 of Pub. L. 107-76 authorizes the Secretary of Agriculture to use funds of the CCC to make payments to eligible persons who own, control or grow tobacco on a farm for which a basic quota or allotment for eligible tobacco was established for the 2001 crop year under part I of subtitle B of title III of the Agricultural Adjustment Act of 1938. This eligibility is not affected by temporary transfers of undermarketed tobacco. Outlays under the programs implemented by this rule will total approximately $5 million. 67 Fed. Reg. 12829 (March 20, 2002).

FEDERAL ESTATE AND GIFT TAX

DEDUCTIONS. The decedent had an usufruct (life estate) in real property which produced substantial revenues from oil and gas and other mineral leases. The decedent's estate claimed a deduction for the revenues, less taxes paid by the decedent, because the estate claimed that the decedent was required to account for these revenues to the remainder holders, the decedent's children. At the time of the creation of the usufruct by the decedent's parent, the law of Louisiana required the accounting, but the law was changed during the usufruct to no longer require the accounting. The IRS argued that the revenues received after the change in the law were not eligible for the deduction. The court adopted the magistrate's opinion that the amendment of the law removed the decedent's obligation to account for revenues received after the amendment; therefore, no deduction for those revenues would be allowed for the estate. Estate of Albritton v. United States, 2002-1 U.S. Tax Cas. (CCH) ¶ 60,434 (M.D. La. 2001).
GIFT. Several years before death, the decedent owned just over 50 percent of a corporation, with the decedent’s child owning the remaining shares. As part of an estate plan, the decedent transferred the shares to the child in exchange for a 10 year promissory note under which the child would pay interest only for 10 years with the balance due on maturity of the note. The note was for $3 million. No attempt was made to negotiate the price or to determine the actual fair market value of the shares. The IRS assessed gift tax on the transfer several years later after the decedent’s death. The IRS argued that the value of the stock was over $8 million at the time of the gift. The estate argued that the gift was not complete because the child committed fraud in failing to pay the fair market value of the shares. The court held that the estate could not argue that the decedent had not fully understood the purpose of the original transaction as an estate planning device which froze the value of the decedent’s estate and completed the intent of the decedent that the child should have the stock. The court also determined the value of the stock to have been $4.9 million because of a marketability discount and a control premium. The appellate court affirmed as to the incomplete gift argument but remanded the case because the Tax Court did not consider and rule on the issue of whether a post-gift settlement could be considered as part consideration for the transfer of stock and thus lessening the amount of the gift. The appellate decision is designated as not for publication. Estate of Maggos v. Comm’r, 2002-1 U.S. Tax Cas. (CCH) ¶ 60,433 (9th Cir. 2002), aff’d in part and rem’g in part, T.C. Memo. 2000-129.

POWER OF APPOINTMENT. The decedent had established a revocable trust which became irrevocable upon the decedent’s death. After the decedent’s death, the trust continued as a “family trust” for the benefit of the decedent’s child. The child had the testamentary power to appoint the trust corpus outright or in trust “for such one or more of settlor’s descendants with such powers and in such manner and proportions as [child] may appoint by [the child’s] will making specific reference to this power of appointment.” Any property not so appointed passed to the decedent’s living descendants. The child also died and exercised the power of appointment to distribute the trust corpus outright to the child’s adult children. The IRS ruled that the child did not have a general power of appointment over the family trust because (1) the power was testamentary only and (2) the power was restricted to the decedent’s descendants; therefore, the corpus could not be appointed to the child’s estate or creditors. Thus, the trust corpus was not included in the child’s estate. Ltr. Rul. 2002100038, Dec. 5, 2001.

RECIPROCAL 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. The appellate court affirmed, holding that the Tax Court had substantial evidence to support its ruling. Estate of Schuler v. Comm’r, 2002-1 U.S. Tax Cas. (CCH) ¶ 60,432 (8th Cir. 2002), aff’d, T.C. Memo. 2000-392.

TRUSTS. The decedent had established a 10-year grantor retained annuity trust which was intended to meet the requirements of I.R.C. § 2702. The trust provided that, commencing on decedent’s death, the assets of the GRAT would be distributed first to the decedent’s estate (and through the estate to the beneficiaries) for the remaining term of the trust, and then to the daughter if she is living, and if not then living, to designated contingent beneficiaries. The decedent was the income beneficiary of the trust and died during the sixth year of the trust. The IRS ruled that, because the decedent had the right to income payments at the time of death, a portion of the trust was included in the decedent’s estate, under I.R.C. § 2036, equal to the amount of corpus necessary to yield the amount of the decedent's retained annuity, based upon an assumed rate of return equal to the I.R.C. § 7520 rate on the date of decedent's death. The IRS also ruled that the entire trust was included in the decedent’s estate under I.R.C. § 2039, because (1) the annuity payable to the decedent, and the payments to be made after decedent's death, were payable under the terms of the trust instrument, which constituted a contract or agreement, as required under I.R.C. § 2039(a); (2) the annuity was paid to decedent for a period that did not in fact end before death; and (3) under the terms of the GRAT, the annuity and other payments receivable by the estate (and, thus, the estate beneficiaries) and the remainder beneficiaries of the GRAT, were receivable by reason of surviving the decedent. Ltr. Rul. 200210009, Nov. 19, 2001.

The taxpayers, husband and wife, established a trust for their benefit funded with separate and jointly owned property. The taxpayers served as trustees and each had the authority to revoke or amend the trust and to direct the trustees to distribute corpus. The IRS ruled that the trust corpus would be included in either taxpayer’s estate upon the death of the first taxpayer to die. The IRS ruled that all trust property passing to the surviving taxpayer would be eligible for an increase in basis under I.R.C. § 1014(e). The trust provided for a marital trust share to pass to the surviving spouse to the extent the trust property was not included in the decedent’s estate in order to use up the unified credit amount. The IRS ruled that, on the death of the first taxpayer to die, the surviving spouse will make a completed gift under I.R.C. § 2501 of the surviving spouse’s entire interest in trust. This gift will qualify for the marital deduction under I.R.C. § 2523. The property not in the marital trust share would be treated as passing from the first taxpayer to die and would not be included in the surviving spouse’s estate. Ltr. Rul. 200210051, Dec. 10, 2001.
FEDERAL INCOME TAXATION

Job Creation and Worker Assistance Act of 2002

In addition to the provisions discussed in the lead article above, the JCWAA of 2002 also amended the 1997 legislation with two technical corrections on "deemed sales" to take advantage of the 18 percent and eight percent capital gains rates. One requires that any gain be included in income regardless of any other I.R.C. provision. Act Sec. 414(a)(1), amending Section 311(e)(2)(A) of the Taxpayer Relief Act of 1997, Pub. L. 105-34, 111 Stat. 836 (1997). The other specifies that a deemed sale of an activity with passive activity losses does not result in a deduction of those losses. Act Sec. 414(a)(2), amending Sec. 311(e)(2)(A)(5) of the Taxpayer Relief Act of 1997, Pub. L. 105-34, 111 Stat. 836 (1997). Both provisions have effective dates as if originally included in the 1997 Act.


BUSINESS EXPENSES. The taxpayer was a corporation which pled guilty to one-count of violating Section 1 of the Sherman Antitrust Act. The federal government also sought civil damages against the taxpayer but the parties settled for an amount paid by the taxpayer as actual damages. The government also sought civil damages resulting from a Defense Department contract for night vision equipment parts. The parties also settled these claims by a payment by the taxpayer. The taxpayer claimed a deduction for the two settlement payments as ordinary and necessary business expenses. The IRS ruled that the first settlement payment was not deductible because the payment was intended as compensation to the government. The IRS ruled, however, that the deductibility of the second settlement payment could not be determined because additional facts were needed to show the intent of the payment as either compensation or penalty. A penalty payment would be deductible. Ltr. Rul. 200210011, Nov. 19, 2001.

DISASTER LOSSES. On March 1, 2002, 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 a severe winter storm on December 24, 2001. FEMA-1404-DR. On March 12, 2002, the President determined that certain areas in Oregon were eligible for assistance under the Act as a result of severe winter storm on February 7-8, 2002. FEMA-1405-DR. Accordingly, a taxpayer who sustained a loss attributable to the disasters may deduct the loss on his or her 2001 federal income tax return.

The IRS has published a list of areas declared to be disaster areas by the President in 2001. Rev. Rul. 2002-11, I.R.B. 2002-10, 608.

GROSS INCOME. The taxpayers sold a business property under a sales agreement which provided for escrow of initial payments and the title to the property until the closing of the sale. The amounts paid into the escrow by the buyer were immediately transferred to the taxpayers who made personal use of the funds. The sales agreement provided for the return of the deposit funds if the sale failed to close due to the taxpayers' fault. The escrow agreement was extended into the next tax year and eventually fell through when the taxpayers could not supply clear title to the property. The taxpayers had to repay almost all of the deposits. The IRS argued that the deposits were to be included in the taxpayers' gross income when distributed to them because the taxpayers had a claim of right to the funds. The court held that the distribution was made only under a contingent claim and that the taxpayers always were liable for repayment until the sale closed. Therefore, the court held that the deposits were not included in the taxpayers' income in the year received. The appellate court affirmed in a decision designated as not for publication. Ahadpour v. Comm'r, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,274 (9th Cir. 2002), aff'g, T.C. Memo. 1999-9, acq. AOD 2000 FED (CCH) ¶ 46,283.

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. The final regulations have been restructured to implement the risk management standard of I.R.C. § 1221(b)(2)(A). No definition of risk management is provided, but instead, the rules characterize a variety of classes of transactions as hedging transactions because they manage risk. Risk reducing transactions still qualify as one class of hedging transactions, but there are also others. In addition, specific provision is made for the recognition of additional types of qualifying risk management transactions through published guidance or private letter rulings. Under the final regulations, as under the proposed regulations, transactions entered into for speculative purposes will not qualify as hedging transactions. The final regulations permit the determination of whether a transaction manages risk to be made on a business unit basis provided that the business unit is within a single entity or consolidated return group that adopts the single-entity approach. 67 Fed. Reg. 12863 (March 20, 2002), amending Treas. Reg. § 1.1221-2.

INSTALLMENT REPORTING. 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 a 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. The appellate court affirmed in a decision designated as not for publication. Bernice Patton Testamentary Trust v. United States, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,277 (Fed. Cir. 2002), aff’g, 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, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,293 (8th Cir. 2002), aff’g, 134 F. Supp. 2d 1093 (D. Neb. 2001).

PAYMENTS-IN-KIND. The taxpayer family farm corporation made payments of hogs to two officers as bonus compensation for labor performed for the taxpayer. The officers were brothers and the hogs transferred to them were scheduled to be sold by the corporation shortly after the transfer to the brothers. The brothers did not market the hogs separately from the corporation but the hogs were transported to market and sold in the same batch as the corporation’s hogs and sold to the same buyer on the same terms. The court held that the transfer of the hogs to the brothers was a disguised cash transfer with the sole purpose of tax avoidance; therefore, the value of the hogs was wages to the brothers and subject to FICA tax and withholding. Highway Farms, Inc. v. United States, 2002-1 U.S. Tax Cas. (CCH) ¶ 50281 (S.D. Iowa 2002).

PARTNERSHIPS-ALM § 7.03.*

CO-OWNERSHIP OF PROPERTY. The IRS has issued a revenue procedure which specifies the conditions under which the IRS will consider a request for a ruling that an undivided fractional interest in rental real property (other than a mineral property as defined in I.R.C. § 614) is not an interest in a business entity, within the meaning of Treas. Reg. § 301.7701-2(a). Rev. Proc. 2002-22, I.R.B. 2002—.

TRANSACTIONS WITH PARTNERS. The taxpayer was a general partnership with another partnership as a partner. The partner was a management company and contracted with the taxpayer for management services. The partner failed to file and pay employment taxes for its employees and the IRS sought to recover the unpaid taxes from the taxpayer. The court held that the management contract was treated as a transaction with a nonpartner because the compensation for the services was not tied to the partnership income. In re Sewickley Hospitality, Ltd., 2002-1 U.S. Tax Cas. (CCH) ¶ 50,273 (Bankr. S.D. Tex. 2002).

RETURNS. The IRS has announced that automatic four-month income tax return extensions are available by phone and computer, as well as by filing Form 4868. The phone number is toll-free at 1-888-796-1074. IR-2002-34.

The IRS has announced that VISA cards have joined the credit card program, enabling taxpayers to charge their federal taxes on any of the following major credit cards—VISA, MasterCard, American Express or Discover Card. The IRS has also expanded its credit card program to include installment agreement payments for tax year 1998 or later, and extension-related payments for taxpayers who live outside the United States and Puerto Rico. Taxpayers may also make payments of 2001 taxes and 2002 estimated taxes by electronic funds withdrawals (EFW). Enrollment can be made at www.eftps.gov. IR-2002-36.

As part of its acquiescence in result of Pekar v. Comm’r, 113 T.C. 158 (1999), the IRS has announced that it will accept as timely returns filed in foreign countries if the envelope is officially postmarked by the due date of the return. The IRS stated that delays caused by legal holidays will be allowed only if the holiday is a legal holiday in the District of Columbia. See Rev. Rul. 80-218, 1980-2 C.B. 386. AOD (Mar. 13, 2002).

S CORPORATIONS-ALM § 7.02[3][c].*

DISCHARGE OF INDEBTEDNESS. Section 402 of Pub. L. 107-147, 107th Cong., 2d Sess. (2002) amends I.R.C. § 108(d)(7)(A), effective for cancellations of indebtedness after October 11, 2001. The amendment overrules the decision in the following case. 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
The plaintiff purchased a blended fungicide which contained two fungicides in specific portions. The fungicide was applied to the plaintiff’s peanut crop but the crop was still damaged by blight. The plaintiff alleged that the purchased product did not contain the proper portions of each fungicide, causing the lack of control of the blight. The plaintiff sued the manufacturer, retailer and packager for fraud, misrepresentation, negligence, breach of warranty and conspiracy. The defendants argued that the claims were all preempted by FIFRA in that the basic issue was whether the label was correct in identifying how much of each fungicide was contained in the blend. The court held that the claims were not preempted by FIFRA because the claim did not allege that the blend was mislabeled and because no environmental damage was claimed. Hughes v. Southern States Co-op, Inc., 180 F. Supp.2d 1295 (M.D. Ala. 2001).
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DISTRIBUTIONS FROM VALUE-ADDED COOPERATIVES
— by Neil E. Harl

The handling of distributions from cooperatives and corporations is relatively clear-cut and certain, although occasionally problems arise. But distributions from value-added cooperatives are a somewhat different matter where a farmer typically plays a dual role as investor and as a supplier of needed raw materials. A 2002 Tax Court case has cast additional light on one aspect of that area of increasing importance to farm taxpayers, liability for self-employment tax on distributions.

General Rule

The general rule on liability for self-employment tax is well-known. Self-employment tax is imposed on net earnings from self-employment, defined as net earnings from a trade or business carried on by the taxpayer. Rentals from real estate are excluded but rentals involving the production of agricultural or horticultural commodities are subject to SE tax if the taxpayer materially participates in the production or management of production under the lease. The imputation of activities of an agent to a property owner as principal is specifically barred by a 1974 amendment.

The 1998 Case

In a 1998 small claims Tax Court decision, a Minnesota farmer, while actively farming, had become a member of a value-added cooperative. Membership in the cooperative required delivery of corn by the taxpayer to the cooperative. During that period, distributions from the cooperative were apparently reported as net earnings from self-employment. After the taxpayer retired, the taxpayer no longer produced corn to meet the obligation. However, the governing documents of the cooperative allowed a member to fulfill the obligation to deliver corn by paying a small fee and drawing from a pool maintained for members of the cooperative whose production fell below their commitment to deliver. The taxpayer, in keeping with the reduced level of involvement in the farming operation in retirement, took the position that the distributions from the cooperative were investment income and not subject to the 15.3 percent self-employment tax. IRS disagreed, believing that the taxpayer was engaged in a trade or business of processing and concluding, therefore, that the distributions were self-employment income.

The Tax Court, in a small claims decision, agreed with the taxpayer and held that the distributions from the value-added cooperative were investment income and not subject to SE tax. About a year later, the Chief Counsel's Office conceded the issue. The notice of concession indicated, however, that if the Form 4835 (or, presumably, any other form

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The language in the Chief Counsel’s Notice was especially notable in light of the fact that crop share landlords often claim expense method depreciation in retirement which requires “meaningful participation” for eligibility. While it is not clear whether “meaningful participation” requires less involvement than “active participation,” the two concepts are uncomfortably close for a reliable decision-making line to be drawn between the two concepts.

The 2002 Case

In a 2002 decision by the Tax Court, a retired farmer and his wife (who were members of a value-added cooperative which also required the delivery of corn) were operating under a crop-share lease with the sons as tenants. The court held that the retired farm taxpayers had to report the value-added payments from the cooperative as self-employment income. The court, while acknowledging the taxpayers’ reliance on the earlier case of Hansen v. Commissioner, cautioned that the case cannot be cited as precedent and held that the taxpayers were engaged in the trade or business of producing, marketing and selling corn and corn products in its relationship with the cooperative and thus were liable for the 15.3 percent self-employment tax. The court determined that, inasmuch as the value-added payments were directly related to the volume of corn delivered to the cooperative, the value-added payments had a direct nexus to their trade or business and must be included in self-employment income.

Surprisingly, in Bot v. Commissioner, the Tax Court stated that the conclusion was reached in light of the involvement by the taxpayers in the operation (which apparently fell short of material participation) and the involvement of the taxpayers’ sons. As stated by the Tax Court—

“We are satisfied that the value-added payments were derived from petitioners’ trade or business. Petitioners, either directly or through the sons as their agents, regularly acquired and delivered option pool corn to MCP [the value-added cooperative] which MCP processed and then marketed and sold for petitioners.”

The surprising feature is that, since enactment of a 1974 amendment, imputation of activities by an agent to a principal as property owner under a lease (and involving the production of agricultural or horticultural commodities) has been barred for purposes of self-employment tax liability. In Bot v. Commissioner, the only apparent business relationship of the taxpayer and the taxpayer’s sons was through the crop-share lease. If the parties’ relationship is through the lease, the language of the Tax Court is inconsistent with the statute. The Tax Court does not make it clear whether the agency relationship of the sons with the parents was through the lease or was independent of the lease. That distinction is significant in light of the bar on imputation of activities of an agent to a principal under a lease.

Even without imputation of the sons’ activities, the taxpayer might have been subject to 15.3 percent self-employment tax. Involvement may have been sufficient for trade or business status (referred to as “active participation” in the Chief Counsel’s Notice) which entails less involvement in the operation than “material participation” which is the test for trade or business status for purposes of liability for self-employment tax under a lease.

Is an LLC the solution?

Some are considering conveying the interest in the value-added cooperative to an LLC to avoid the self-employment tax problem. The difficulty with that is that the regulations addressing the circumstances under which an LLC member (or limited partner in a limited partnership) have SE income are still in a state of limbo. Under regulations proposed in 1997, an individual is considered to be a limited partner for self-employment tax purposes unless the individual has personal liability for the debts or claims of the entity, has authority to contract for or on behalf of the entity, or participates in the entity’s trade or business for more than 500 hours during the entity’s taxable year. However, the Taxpayer Relief Act of 1997 prohibited the IRS from issuing temporary or final regulations defining a limited partner for self-employment tax purposes before July 1, 1998. Although July 1, 1998, has come and gone, IRS has been unwilling to finalize the regulations.

In conclusion

The case of Bot v. Commissioner is unlikely to be the last word on the subject but it is becoming clear that retired members of value-added cooperatives need to watch their involvement under the arrangement with the cooperative if SE tax is to be avoided.

Footnotes

6. I.R.C. Sec. 1402(a).
7. I.R.C. Sec. 1402(a)(1).
8. Id. See notes 25-26 infra.
10. Id.
11. Id.
12. Id.
13. Id.
15. Id.
17. I.R.C. § 179.
20. Id.
23. 118 T.C. No. 8 (2002).
27. 118 T.C. No. 8 (2002).
CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr.

BANKRUPTCY

FEDERAL TAX-ALM § 13.03[7].*

DISCHARGE. The debtor had served as executor to a decedent’s estate which had failed to fully pay federal estate taxes due to the acts and omissions of the debtor. The IRS sought to have the estate taxes declared nondischargeable under Section 523(a)(4) as resulting from defalcation by the debtor committed while serving as a fiduciary. The debtor argued that the Section 523(a)(4) exception to discharge did not apply because the debtor owed no fiduciary duty to the IRS. The court held that, under Tex. Probate Code § 37, an executor owes a fiduciary duty to an estate’s creditors, including the IRS; therefore, the estate taxes owed as a result of the debtor’s actions as executor were nondischargeable. In re Tomlin, 266 B.R. 350 (N.D. Tex. 2001).

The taxpayer plead guilty to conspiracy to evade taxes by transferring income to an overseas corporation. After the conviction and amendment of the tax returns, the debtor continued to attempt to evade payment of the taxes involved by transferring assets to family members and using the proceeds of asset sales to make speculative investments which failed. The court held that the plea of guilty to conspiracy to evade taxes and the failure to pay the taxes while having sufficient assets to pay the taxes was sufficient to make the taxes nondischargeable for willful attempt to evade taxes under Section 523(1)(1)(C). In re Summers, 266 B.R. 292 (Bankr. E.D. Pa. 2001).

ESTATE PROPERTY. The debtors received a payment from the IRS as part of the EGTRRA 2001 advance refund checks mailed to taxpayers resulting from the retroactive reduction of the lowest tax bracket to 10 percent. The debtors filed their Chapter 7 petition in February 2001. The court ruled that the payment represented a refund of 2001 taxes. If the funds are less than or equal to the tax liability, it would be characterized as a refund and a pro rata share would go to the bankruptcy estate. If the debtors’ 2001 tax is less than the post-payment refund amount, all of the refund check is to be returned to the debtors. In re Lambert, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,317 (Bankr. D. Or. 2002).

PREFERENTIAL TRANSFERS. The Chapter 7 debtor owed delinquent child support payments and had filed for a refund on the debtor’s income tax. The IRS withheld the refund and paid it to the county Child Support Enforcement Agency which paid the amount to the debtor’s former spouse. The Chapter 7 trustee sought recovery of the refund as a preferential transfer. The IRS argued that the refund was exempt from preferential transfer status under Section 547(c)(7) as a child support payment. The trustee argued that the exception in Section 547(c)(7)(A) applied because the child support payment was essentially assigned to the county agency. The court held that, under Ohio law, the child support agency functioned only as a trustee for the former spouse and children in collecting and distributing child support payments; therefore, no assignment occurred and the payment of refund to the agency was not a preferential transfer. In re Sanks, 265 B.R. 566 (Bankr. N.D. Ohio 2001).

CONTRACTS

BREACH. The defendants entered into a lease/purchase agreement to acquire a ranch owned by the plaintiffs. The contract included the leasing of cattle owned by the plaintiffs. A dispute arose from a claim by the defendants that there was insufficient hay on the property to feed the cattle through the winter. The plaintiff filed suit to recover unpaid rent and for specific performance of the purchase contract. The defendants counterclaimed for the cost of replacement feed and for damages caused by misrepresentations by the plaintiffs and their real estate agent as to the quantity and quality of the property. The court held that the claim for misrepresentation was properly dismissed by the trial court because the defendants had made an inspection of the property and failed to object to any of the inconsistencies between the plaintiffs’ description of the property and the actual condition of the property. The court held that the defendants did not reasonably rely on the representations of the plaintiffs and their agent. Other claims were held not to be false, either because of the evidence presented by the plaintiffs or the failure of the defendants to prove the claims false. The jury had found that the lease/purchase contract was only a lease; therefore, the plaintiffs suit for specific performance was denied. The court noted that the parties disagreed on several aspects of the purchase terms of the contract; therefore, specific performance was not appropriate since the court could not determine the extent of the performance required by the contract. Dewey v. Wentland, 38 P.3d 402 (Wyo. 2002).

FEDERAL AGRICULTURAL PROGRAMS

CROP INSURANCE. The FCIC and the FSA have adopted as final regulations providing procedures for federal crop insurance program participant appeals of adverse decisions

PERISHABLE AGRICULTURAL COMMODITIES ACT. The plaintiff sold agricultural commodities to a PACA licensed produce handler. The handler had experienced financial difficulties and negotiated with a lender to continue a line of credit by assigning all accounts receivable to the bank. The bank was aware of the handler’s financial difficulties because several checks were returned for insufficient funds. The plaintiff sought to enforce the PACA trust against the bank as holder of the trust assets in breach of the PACA trust. The bank argued that the bank was a bona fide purchaser of the accounts and not subject to the PACA trust. The court held that the bank was not a bona fide purchaser of the accounts receivable because the handler remained liable on the accounts if they were not paid and the bank did not give any additional consideration for the accounts but merely applied them to pre-existing debt. The court held that the bank had constructive, if not actual, notice of the PACA trust and that the bank breached the trust by retaining the proceeds of the accounts receivable while the plaintiff went unpaid. Overton Distributors, Inc. v. Heritage Bank, 179 F. Supp.2d 818 (M.D. Tenn. 2002).

TOBACCO. The CCC has adopted as final regulations which amend the tobacco marketing quota regulations at 7 C.F.R. part 1464 to require burley tobacco producers to designate where they will sell their tobacco in order to qualify for price support and marketing cards. Currently only flue-cured tobacco producers, as a condition of price-support, must designate marketing cards. The court held that the LLC agreement made distributions of any income discretionary with the taxpayer as manager, thus making any economic benefit to the gifted interests only a future interest with uncertain benefit. An article by Roger McEowen on this case will appear in a future issue of the Digest. Hackl v. Comm’r, 118 T.C. No. 14 (2002).

FEDERAL ESTATE AND GIFT TAX

ESTATE TAX. The decedent was predeceased by a spouse whose estate was less than $600,000, resulting in no federal estate tax. The decedent received all of the predeceased spouse’s estate and had an estate tax liability of just over $100,000. The decedent’s estate argued that the estate tax was a violation of the equal protection rights because the combined estates were less than $1,200,000 and the decedents’ estates were unable to completely use the unified credit to avoid estate tax. The estate claimed that the decedents did not have the education to be aware of the estate planning available which would have reduced their estate taxes. The court noted that the estate failed to prove that the decedents were unaware of the potential estate planning savings and held that the imposition of the estate tax was not a constitutional violation. Estate of Koester v. Comm’r, T.C. Memo. 2002-82.

GIFTS. The taxpayer invested in timberland and formed a limited liability company to own and manage the properties. The taxpayer contributed the timberland, cash and securities to the LLC in exchange for voting and nonvoting stock. The LLC agreement provided that LLC members could not transfer, assign, convey, sell or encumber their interests without prior consent of the LLC manager, the taxpayer. The taxpayer made a series of annual gifts of voting and nonvoting interests in the LLC to the taxpayer’s children and claimed the annual exclusion for each of the gifts. The court held that the gifts were not eligible for the annual exclusion because the gifts were not present interests in property since the donees could not transfer, assign, convey, sell or encumber their interests. The court also noted that the LLC was projected to receive only net losses for many years during the growth of new trees and that the LLC agreement made distributions of any income discretionary with the taxpayer as manager, thus making any economic benefit to the gifted interests only a future interest with uncertain benefit. An article by Roger McEowen on this case will appear in a future issue of the Digest. Hackl v. Comm’r, 118 T.C. No. 14 (2002).

GROSS ESTATE. The decedent’s predeceased spouse’s will passed property to a trust for the decedent with the decedent as trustee and a general power of appointment over the trust corpus. The trust was funded with 41 percent of the stock of a corporation owned by the predeceased spouse and the decedent owned 50 percent of the stock in the same corporation. The court held that the stock in the trust had to be aggregated with the decedent’s own stock for purposes of valuing the stock for estate tax purposes. The court said family attribution was not relevant and distinguished Mellinger v. Comm’r. Estate of Fontana v. Comm’r, 118 T.C. No. 16 (2002).

TRUSTS. The taxpayer was the current life income beneficiary of a trust established by the taxpayer’s deceased spouse. The remainder holders were the taxpayer’s two children and two grandchildren. The trust provided for distribution of trust corpus at the death of the taxpayer; however, the taxpayer wanted to disclaim any further interest in the trust but only if no gift or income tax liability was incurred by the taxpayer. The parties obtained a probate court order amending the trust to allow for the disclaimer and the payment to the taxpayer from the trust of an amount equal to the gift and income tax incurred as a result of the disclaimer. The IRS ruled the value of the gift resulting from the disclaimer was the fair market value of the taxpayer’s income interest, based on the taxpayer’s life expectancy under I.R.C. § 7520, less the amount of money received by the taxpayer for the gift and income taxes. Ltr. Ruls. 200210018, 200210018, Nov. 28, 2001.

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. United States v. Engels, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,306 (N.D. Iowa 2001), aff’d on rehearing, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,723 (N.D. Iowa 2001).

*Agricultural Law Manual (ALM).*
Federal Income Taxation

Charitable Deduction. The IRS has announced that, as a result of the September 11, 2001, terrorist attacks, it has relaxed the substantiation requirements for certain charitable contribution deductions. Taxpayers who made charitable contributions of $250 or more after September 10, 2001, and before January 1, 2002, have until October 15, 2002, to obtain the required written acknowledgement from charities or get evidence of a good-faith effort to obtain it. Notice 2002-25, I.R.B. 2002-15.

Casualty Loss. The taxpayer and spouse suffered damage to their residence condominium from an earthquake. The taxpayer claimed a casualty loss in 1994 for damage assessments made by the condominium association and also claimed a casualty loss in 1995 for the cost of repairs. However, the taxpayer provided evidence of only a repair cost estimate but no evidence of any actual repairs. The taxpayer also did not provide any evidence of the value of the condo before and after the earthquake. The court held that the 1995 casualty loss deduction was not allowed for lack of substantiation. Schmidt v. Comm’r, T.C. Summary Op. 2002-23.

Depreciation. I.R.C. § 263A(e)(2)(A) states that a taxpayer electing out of the preproductive period capitalization rules is subject to alternative depreciation. Section 168(k)(1)(C) of Pub. L. 107-147 makes property subject to alternative depreciation ineligible for the 30 percent allowance except for the reference to Section 168(g)(7) which is made inapplicable - that is what makes property subject to an election as to a class of property (subject to an election as to a class of property) subject to alternative depreciation. Therefore, where a taxpayer has made an election under Section 168(g)(7), the property should be eligible for the 30 percent allowance. Of course, those subject to alternative depreciation are ineligible for the 30 percent depreciation election. Neil Harl.

The IRS has issued a revenue procedure which provides a safe harbor method of accounting for the cost of original and replacement tires for certain vehicles (original tire capitalization method) used in various business activities. Under the original tire capitalization method, a qualifying vehicle's tires are treated as part of the vehicle and not as separate assets. In addition, under the original tire capitalization method, the rotation of a tire from one vehicle to another (for example, from a tractor to a trailer) is not treated as a change in use within the meaning of I.R.C. § 168(i)(5). A taxpayer that uses the original tire capitalization method described in this section must use this method for the original and replacement tires of all of its qualifying vehicles. To use the new safe harbor, the taxpayer must use the same depreciation method, recovery period and convention applicable to the vehicle on which first installed, treat the original tires as being disposed of when the vehicle is disposed of and deduct the replacement tires as an expense. The procedure also provides a method for obtaining automatic consent of the IRS for changing to the original tire capitalization method. Rev. Proc. 2002-27, I.R.B. 2002-___.

Disaster Payments. The taxpayers were farmers in the Klamath Basin in Oregon and California whose irrigation water was denied during 2001 by order of the Department of the Interior in order to protect wildlife during the 2001 drought. The U.S. Congress appropriated money to compensate the farmers for the loss of crops resulting from their inability to use the irrigation water. The IRS ruled that the taxpayers could include the payments on their 2002 income tax returns if they can establish that, under their practice, income from irrigated crops that would have been grown during 2001 would be reported in a following taxable year. The IRS also ruled that the taxpayers could treat the payments as farm income for purposes of the farm income averaging rules. CCA Ltr. Rul. 200213026, Feb. 22, 2002.

Discharge of Indebtedness. The taxpayer had borrowed money on the taxpayer’s residence in California. The taxpayer defaulted on the loan and the house was sold at foreclosure. The lender received the proceeds of the sale and discharged the remaining indebtedness. The lender filed out a Form 1099-C and sent it to the taxpayer at the former residence address. The taxpayer did not receive the Form 1099-C because the taxpayer had moved to Texas. The taxpayer argued that no discharge of indebtedness occurred because the taxpayer did not receive the Form 1099-C. The court rejected this argument because the discharge of indebtedness occurred upon the lender’s decision not to seek payment of the loan deficiency. The taxpayer also claimed that the taxpayer was insolvent at the time of the discharge; however, the taxpayer did not provide proof of the taxpayer’s assets and liabilities at the time of the discharge. The court held that the taxpayer was not entitled for the insolvency exception for lack of proof of insolvency. Rinehart v. Comm’r, T.C. Memo. 2002-71.

The taxpayer was a lender which had attempted to collect on debts owed to it; however, the taxpayer failed to fully comply with state law on providing notice to debtors. The debtors filed a lawsuit and the parties reached a settlement agreement which provided for repayment of the money collected under the improper notices and release of any deficiencies remaining on the debts. The IRS ruled that the taxpayer did not have to issue any Form 1099-C for reporting discharge of indebtedness income because no identifiable event occurred as defined by Treas. Reg. § 1.6050P-1(b)(2). The IRS ruled that the discharge occurred as a result of state law and not any agreement between the lender and debtors. Ltr. Rul. 200212004, Dec. 20, 2001.

Employee Benefits. The IRS has suspended the filing requirement imposed on specified fringe benefit plans by I.R.C. § 6039D. Employers maintaining specified fringe benefit plans under I.R.C. § 125, dealing with cafeteria plans, I.R.C. § 127, dealing with educational assistance plans, or I.R.C. § 137, dealing with adoption assistance plans, have been relieved of the requirement that they attach Schedule F, Fringe Benefit Plan Annual Information Return, to Form 5500, Annual Return/Report of Employee Benefit Plan. IR-2002-43.
HOBBY LOSSES. The taxpayers, husband and wife, operated a horse breeding activity which the court held was not operated with an intent to make a profit because (1) although the taxpayers kept separate records of the activity, the records were insufficient to form a business plan or to analyze the business; (2) although the taxpayers had some experience with horses and consulted some experts, the experts were not given adequate records with which to fully advise the taxpayers; (3) although the taxpayers spent considerable time on the activity, most of the time was recreational; (4) the taxpayers failed to provide evidence that the business or assets would appreciate in value enough to offset the losses; (5) the operation had only losses; and (6) the losses offset income from other employment. Reimer v. Comm’r, T.C. Summary Op. 2002-26.

The taxpayer was employed as an airline pilot and spent much of the taxpayer’s free time building and improving airplanes built from kits. The taxpayer claimed deductions for losses from the airplane building activity. The court held that the losses were not allowed because (1) the activity only had losses, (2) the taxpayer did not have a business plan to make the activity profitable, (3) the taxpayer did not keep records of the activity other than income tax returns and flight logs, and (4) the losses offset income from the taxpayer’s employment. Parker v. Comm’r, T.C. Memo. 2002-76.

INCOME. The taxpayer was a medical doctor who entered into an agreement with a hospital to establish a practice in the area in exchange for a guaranteed income. The hospital agreed to pay the taxpayer any amount needed to produce the guaranteed minimum income and the taxpayer agreed to repay these amounts if the taxpayer’s income exceeded the guaranteed amount or the agreement was terminated. After about a year, the parties executed a promissory note to cover the payments made by the hospital. The court held that the guarantee payments made by the hospital were loans and not gross income to the taxpayer because the amounts were always intended to be repaid. Rosario v. Comm’r, T.C. Memo. 2002-70.

MEDICAL DEDUCTION. The IRS has ruled that it will allow a personal medical deduction (subject to the 7.5 percent adjusted gross income limitation) for expenses, except for diet foods, relating to a weight loss program used to treat a diagnosed medical condition. The ruling applies for 2001 and tax years for which an amended return is still allowed. Rev. Rul. 2002-19, I.R.B. 2002-16.

NET OPERATING LOSSES. The taxpayers timely filed their 1992 income tax return and included the second page of Form 1045, Application for Tentative Refund, which showed the calculation of a net operating loss for 1992. The taxpayer’s accountant also spoke with an IRS agent about the net operating loss carryback. The taxpayers did not otherwise file for a refund based on the carryback of the net operating losses. The taxpayers argued that the page two of Form 1045, the accountant’s call, and the provisions providing for carryback of NOLs were sufficient to give the IRS informal notice of their intent to carry the NOLs back to previous tax years. The court held that these items were insufficient to give informal notice and the period for claiming the refund had lapsed. Sumrall v. Comm’r, T.C. Memo. 2002-78.

PARTNERSHIPS-ALM § 7.03.*

CONTRIBUTIONS OF STOCK OF A PARTNER. The IRS has adopted as final 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 the regulations cannot be avoided through the use of tiered partnerships or other arrangements. For example, the 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 are to be adjusted in a manner that is consistent with the purpose of the regulations. 67 Fed. Reg. 15112 (March 29, 2002), adding Treas. Reg. § 1.705-2.

PASSIVE ACTIVITY LOSSES. The IRS has explained the effect under I.R.C. § 469 of a deemed sale of property on January 1, 2001, pursuant to a mark-to-market election under Section 311(e) of the Taxpayer Relief Act of 1997. In a technical correction to Section 311(e), section 414(a)(2) of the Job Creation and Worker Assistance Act of 2002 clarifies that a mark-to-market election is not a disposition for purposes of I.R.C. § 469(g)(1)(A). Thus, gain included in gross income by reason of a mark-to-market election may be passive activity gross income that can be offset by passive activity deductions, but the election does not otherwise affect the determination of the passive activity loss that is disallowed under I.R.C. § 469. Notice 2002-29, I.R.B. 2002-__.

PENSION PLANS. Prior to March 2002, interest rates used by pension plans to calculate current liability for purposes of determining the full funding limitation of I.R.C. § 412(c)(7) and the required contribution under I.R.C. § 412(l) must be within a permissible range around the weighted average of the interest rates on 30-year Treasury securities during the four-year period ending on the last day before the beginning of the plan year. Effective for March 2002, the IRS will determine and publish the rate of interest on 30-year Treasury securities solely on the basis of the monthly average of the daily determination of yield on the 30-year Treasury bond maturing in February 2031, pending the enactment of law changes to I.R.C. §§ 412 and 417 that address the discontinuance of the 30-year Treasury bond. The IRS has determined that the rate of

*Agricultural Law Manual (ALM).
interest on 30-year Treasury securities for February 2002 is 5.40 percent; this rate is the average of the 30-year Treasury
Constant Maturity interest rate determined each day through
February 18, 2002, and the yield on the 30-year Treasury bond
maturing in February 2031, determined each day for the
balance of the month. For plan years beginning in 2002 and
2003, Section 405 of the Job Creation and Worker Assistance
to provide that the permissible range is extended to 120
percent. The IRS has announced the revised interest rates for
2002 based on these changes and the April 2002 rates (which
remain the same as March 2002 due to the changes noted
above):

<table>
<thead>
<tr>
<th>Month</th>
<th>Weighted average</th>
<th>90-120% range</th>
<th>90-110% range</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 2002</td>
<td>5.71</td>
<td>5.14-6.85%</td>
<td>5.14-6.28%</td>
</tr>
<tr>
<td>February 2002</td>
<td>5.70</td>
<td>5.13-6.84%</td>
<td>5.13-6.27%</td>
</tr>
<tr>
<td>March 2002</td>
<td>5.69</td>
<td>5.12-6.83%</td>
<td>5.12-6.26%</td>
</tr>
<tr>
<td>April 2002</td>
<td>5.69</td>
<td>5.12-6.83%</td>
<td>5.12-6.26%</td>
</tr>
</tbody>
</table>

15.

SELF-EMPLOYMENT TAX. The taxpayers operated a
retail business and failed to report or pay self-employment tax
on the business income. The taxpayer argued that the tax
infringed upon the taxpayer’s First Amendment right to the free
exercise of religion. The court held that the assessment of self-
employment tax did not infringe on the taxpayer’s free exercise

The taxpayer owned a business and provided space for video
games in exchange for a fee. The IRS ruled that the fee was

The taxpayers were partners in a partnership which leased
Keno lottery equipment to various organizations. The partnership
handled the leasing of the equipment and maintenance of the bank accounts used to pay the winnings and income to the leasing organizations. The court held that the partnership’s involvement with the keno leases was a trade of business and that the taxpayers’ share of the partnership income were subject to self-employment tax. Bennett v. Comm’r, T.C. Memo. 2002-83.

TAX SHELTERS. The taxpayer, an owner of an equipment rental company, 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 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. Wiest v. Comm’r, T.C. Summary Op. 2002-32.

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. The appellate court
affirmed in a decision designated as not for publication.

Barmes v. Comm’r, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,312
(7th Cir. 2002), aff’d, T.C. Memo. 2001-155.

SECURED TRANSACTIONS

PRODUCER’S LIEN. The debtor was a processor of rice
and had purchased a variety of rice grown by a producer in one
crop year. The debtor also purchased rice from other producers
but commingled rice only of the same variety and only if
produced in the same crop year. Thus, the producer’s rice was
commingled by the debtor with the same variety of rice
produced by other producers in that same year. The producer
claimed a producer’s lien in all of the rice held by the debtor to
secure the rice sold to the debtor but not paid for. The court
interpreted Calif. Food & Agric. Code §§ 55631, 55634 as
providing a producer’s lien to the extent (1) a producer’s crop
is held separately by the buyer or (2) of the same crop held by
the buyer if commingled with similar crops. Thus, the court
held that the producer’s lien extended to all the rice held by the
debtor which was of the same variety and grown in the same
crop year and commingled with the producer’s crop. Because
the other varieties of rice and rice from other crop years were
segregated by the debtor from the producer’s crop, the
producer’s lien did not extend to rice of other varieties or from
other crop years. In re California Pacific Rice Mill, Ltd., 265

IN THE NEWS

The Nebraska Supreme Court has ruled that agricultural land,
under state law, is to be valued for property tax purposes at fair
market value - and that FMV is to be determined by
comparable sales, irrespective of the fact that nearby land in the
instant case had been sold to Ted Turner for inflated values. A
pending bill in the Nebraska legislature, LB 600, would change
the basis of agricultural land valuation from the prevailing
market value to its income producing capability. ____ v. ___,
263 Neb. 499 (2002).
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PROPOSED PACKER BAN ON LIVESTOCK OWNERSHIP OR CONTROL
— by Roger A. McEowen* and Neil E. Harl**

The U.S. Senate, on December 13, 2001, approved an amendment to the Senate version of the farm bill (The Agricultural, Conservation and Rural Enhancement Act of 2001) making it unlawful, with several exceptions, for a meat packer to own, feed or control livestock intended for slaughter.

The final version of the amendment, which was approved by vote of the U.S. Senate on February 12, 2002, would amend the Packers and Stockyards Act of 1921 to read as follows—

It shall be unlawful for any packer with respect to livestock, meats, meat food products, or livestock products in unmanufactured form, or for any live poultry dealer with respect to live poultry, to:

“(f) Own, feed, or control livestock directly, through a subsidiary or through an arrangement that gives the packer operational, managerial, or supervisory control over the livestock, or over the farming operation that produces the livestock, to such an extent that the producer is no longer materially participating in the management of the operation with respect to the production of livestock, except that this subsection shall not apply to—

(1) an arrangement entered into within 14 days before slaughter of the livestock by a packer, or a person that directly or indirectly controls, or is controlled by or under common control with, the packer;

(2) a cooperative or entity owned by a cooperative, if a majority of the ownership interest in the cooperative is held by active cooperative members that—

(A) own, feed, or control livestock; and

(B) provide the livestock to the cooperative for slaughter; or

(3) a packer that is owned or controlled by producers of a type of livestock, if during a calendar year the packer slaughters less than 2 percent of the head of that type of livestock slaughtered in the United States....”

The proposed legislation excludes forward contracts, marketing agreements and other types of marketing arrangements so long as the producer maintains material participation over the management of the operation.

* Associate Professor of Agricultural Economics and Extension Specialist, Agricultural Law and Policy, Kansas State University, Manhattan, Kansas. Member of Kansas and Nebraska Bars.

** Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University, Ames, Iowa; member of the Iowa Bar.
Meaning of “Material Participation”

The term “material participation” has a long history in agriculture as well as in other sectors of the economy. Each time the Congress has visited or revisited this area, the legislation enacted has used language sparingly—

- In 1956, Congress enacted an amendment to Section 1402 of the Internal Revenue Code to enable farm landowners to participate in the social security program. The amendment simply referred to “material participation” by the landowner in the production of agricultural or horticultural commodities. Regulations subsequently adopted by the United States Treasury have provided detailed guidance for that particular application of the term.6

- In 1986, Congress, in enacting the passive loss rule, made it clear that the guideline should be more demanding than merely “material participation” and so defined “material participation” on a basis which is “(A) regular, (B) continuous, and (C) substantial.”7 Again, the Congress signaled that the test should be more demanding in the setting of passive losses and the regulations and cases have reflected that Congressional enactment.

For the proposed language, the passage communicates clearly that the administrative agency with the rule-making power is expected to develop implementing regulations but the message is that producers’ involvement in management must not be diminished below a “material” level.

State-level bans

It is noted that Iowa8 (as well as Minnesota,9 Nebraska10 and South Dakota11) have state-level bans on packer ownership of livestock. The Iowa provision, for example, imposed a ban several years ago making it unlawful for a processor of beef or pork “to own, control or operate a feedlot in Iowa which hogs or cattle are fed to slaughter.” That language, while providing even less of a “bright-line” test, has not caused problems in Iowa, a leading livestock feeding state, particularly in hogs. Minnesota takes the position that livestock feeding is engaging in farming and thus is covered by the corporate farming statute.12

Reasons for acting

The rising level of concentration in meat packing (see Table 1) coupled with vertical integration from the top down have provided the impetus for action to be taken at the federal level. While some past consolidations in meat packing have resulted in efficiency gains, which have largely been passed on to consumers, recent data indicate that the portion of the retail meat dollar attributable to packers (referred to as the farm-wholesale spread) has turned higher since the mid 1990s as shown in Figure 1. That indicates higher incomes for packers which has occurred in recent years.

<table>
<thead>
<tr>
<th>Year</th>
<th>Cattle</th>
<th>Steer &amp; Heifers</th>
<th>Cows/Bulls</th>
<th>Hogs</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>28</td>
<td>36</td>
<td>10</td>
<td>34</td>
</tr>
<tr>
<td>1985</td>
<td>39</td>
<td>50</td>
<td>17</td>
<td>32</td>
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<tr>
<td>1990</td>
<td>42</td>
<td>55</td>
<td>18</td>
<td>33</td>
</tr>
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<td>1995</td>
<td>69</td>
<td>81</td>
<td>28</td>
<td>46</td>
</tr>
<tr>
<td>1996</td>
<td>66</td>
<td>79</td>
<td>29</td>
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<tr>
<td>1998</td>
<td>70</td>
<td>81</td>
<td>33</td>
<td>56</td>
</tr>
<tr>
<td>1999</td>
<td>70</td>
<td>81</td>
<td>32</td>
<td>56</td>
</tr>
</tbody>
</table>

Source: International Agricultural Trade and Development Center, University of Florida.

Figure 1. The Farm to Wholesale Spread in Beef (U.S.D.A. Data Adjusted for Inflation)
For gains from increased efficiency in meat packing to be passed on to consumers, competition must be present. Without competition, any gains are likely to be passed on to shareholders or used to pad costs within the slaughter firm.\footnote{See Harl and McEowen, “The Material Participation Test,” posted at www.econ.iastate.edu/faculty/harl/papers of interest.}

**FOOTNOTES**
\footnote{S. 1371, 107th Cong., 2d Sess. (2002).}
\footnote{S. 1731, 107th Cong., 1st Sess. (2001).}
\footnote{Id.}
\footnote{S. 1371, 107th Cong., 2d Sess. (2002).}

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**ARBITRATION CLAUSE IN CROP INSURANCE CONTRACT UPHELD**

- by Roger A. McEowen*

In an April 3, 2002, decision, the Iowa Supreme Court upheld an arbitration clause in a crop insurance contract.\footnote{See Harl and McEowen, “The Material Participation Test,” posted at www.econ.iastate.edu/faculty/harl/papers of interest.} The plaintiff purchased a multi-peril crop insurance policy from the defendant for the 1999 crop year, covering 1000 acres of corn. In June of 1999, the plaintiff submitted a notice of claim for prevented planting, a covered event under the policy, on the basis that conditions were too wet for planting. The defendant refused the claim, determining that the cause of loss was flooding from a nearby reservoir – a condition excluded from coverage under the policy. The defendant then sued for breach of contract, and the defendant moved to compel arbitration pursuant to the Federal Arbitration Act (FAA)\footnote{Treas. Reg. § 1.1402.} and a motion to stay. The trial court denied the defendant’s motion to compel arbitration on the basis of an Iowa law denying arbitration of adhesion (one-sided) contracts,\footnote{I.R.C. § 469(h)(1).} and likewise denied the defendant’s motion to stay. The defendant appealed.

Three issues were before the Supreme Court: (1) whether the Iowa arbitration statute denying arbitration of adhesion (one-sided) contracts\footnote{Iowa Code § 9H.2 (2001).} was preempted by the Federal Crop Insurance Act (FCIA);\footnote{Treas. Reg. § 1.1402.} (2) whether the Iowa law was preempted by the FAA;\footnote{Neb. Rev. Stat. § 54-2602.} and (3) whether the insurance policy was not an adhesion contract so as to be excluded from mandatory arbitration under Iowa law.\footnote{S.D. Const. Art. XVII, §§ 21-24.}

The Supreme Court first rejected the defendant’s argument that the Iowa arbitration statute\footnote{S.D. Const. Art. XVII, §§ 21-24.} was preempted by the FCIA because the issue was not raised at trial. On the issue of whether the FAA preempted the Iowa arbitration statute, the court reasoned that if the policy is a contract having a sufficient connection with interstate commerce, it is subject to regulation by the federal government. On that point, the court concluded that the sale of federal crop insurance clearly had a sufficient economic connection with interstate commerce to trigger the provisions of the federal law\footnote{Iowa Code § 679A.1.} despite Commerce Clause limitations recently recognized by the United States Supreme Court.\footnote{Iowa Code § 679A.1.} The court noted that the purpose of the FCIA is to “promote national welfare by improving the economic stability of agriculture through a sound system of crop insurance,” and as such was distinguishable from the criminal statutes at issue in the cases where the court failed to find a sufficient connection with interstate commerce to pass constitutional muster.\footnote{See n. 9 supra.}

Thus, the Iowa Supreme Court held that the FAA applied and conflicted with the Iowa statute.\footnote{See n. 9 supra.} As a result, the Iowa Supreme Court held that the trial court erred in refusing to enforce the arbitration clause and did not need to address the issue of whether the policy constituted an adhesion contract.

**FOOTNOTES**
\footnote{Haeberlin Farms, Inc. v. IGF Insurance Co., No. 31/00-0754, 2002 Iowa Sup. LEXIS 56 (Iowa Sup. Ct. April 3, 2002).}
\footnote{S. 1731, 107th Cong., 1st Sess. (2001).}
\footnote{Id.}
\footnote{Id.}
\footnote{Id.}
\footnote{Id.}
\footnote{See Harl and McEowen, “The Ban on Packer Ownership and Feeding of Livestock: Legal and Economic Implications,” posted on the web at www.senate.gov/~grassley/releases/2002/031302. An edited version has been accepted for publication in the *Drake Journal of Agricultural Law*.}

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ADVERSE POSSESSION

FENCE. The plaintiff’s farm and defendant’s farm were separated by a railroad right of way which was abandoned by the railroad. The defendant’s title included the right of way within the defendant’s property. The plaintiff constructed a fence on the defendant’s side of the right of way and claimed that the fence created a boundary sufficient to pass title to the right of way to the plaintiff when the railroad abandoned the right of way. However, the plaintiff admitted that the land on the defendant’s side of the right of way was not used for pasturing cattle until the railroad stopped running trains on the right of way, an event which occurred only six years before the right of way was abandoned. The court also noted that there was no agreement between the parties that the fence would serve as a boundary line between the properties. The court held that the plaintiff did not acquire title to the right of way by means of adverse possession or by establishing a boundary fence. Francis v. Rogers, 40 P.3d 481 (Okla. 2001).

BANKRUPTCY

FEDERAL TAX-ALM § 13.03[7].

DISCHARGE. The debtor was an anesthesiologist who filed for Chapter 11. The debtor failed to file returns and pay taxes for almost 20 years although the debtor was aware of the need to file and pay taxes and had substantial income and assets available to pay the taxes. The debtor made a few tax payments in order to release tax liens on property. During this time the debtor made substantial gifts to family members and transferred assets to entities which made the assets unreachable by IRS liens. The debtor also maintained substantial personal expenditures for vacations. The debtor eventually filed the returns and made some payments under orders of courts. The court held that, under Section 523(a)(1)(C), the taxes were not dischargeable because the debtor willfully attempted to evade the payment of the taxes. In re Eleazar, 271 B.R. 766 (Bankr. D. N.J. 2001).

The debtor failed to file income tax returns or pay taxes for two years. The IRS assessed the taxes after constructing substitute returns. The court held that the substitute returns were not considered returns for purposes of Section 523(a)(1) and the taxes were nondischargeable. In re Thompson, 272 B.R. 612 (D. Md. 2002).

PREFERENTIAL TRANSFERS. Within the 90 days before the debtor filed a Chapter 7 petition, the debtor received an income tax refund loan in which the debtor received funds in exchange for assigning a tax refund to the lender. The agreement provided for the debtor to establish an account with the lender which was used for designating the receipt of the refund from the IRS. The lender retained control over the account and transferred the funds to its own accounts immediately after the refund was received. The Chapter 7 trustee sought to avoid the transfer of the funds in the account as a preferential transfer. The court held that the transfer was not a preferential transfer because (1) the transfer was made in the ordinary course of business and (2) the transfer was a recoupment. The court stated that, although the debtor only had one business transaction with the lender, the transfer of the funds from the account to the lender was made within the whole business transaction. Thus, the court expanded the ordinary course of business exception to include a single set of related transactions instead of a business relationship established over time and several transactions. The court noted a split among the courts which have decided this issue. Warsco v. Household Bank F.S.B., 272 B.R. 246 (Bankr. N.D. ind. 2002).

CONTRACTS

ARBITRATION 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, 265 B.R. 722 (Bankr. 6th Cir. 2001), aff’d, 256 B.R. 482 (Bankr. S.D. Ohio 2000).

SPECIFIC PERFORMANCE. The plaintiffs leased farm land from the defendant for one crop year. The lease provided for termination after harvest or by November 1 at the latest. The lease also gave the plaintiffs an option to purchase the property at its appraised value or an agreed upon price. The plaintiffs harvested the crop in October and gave the defendants a written exercise of the option on October 31. The plaintiffs also testified that they had given an oral notice of the exercise of the option during the summer. The defendants refused the offer as untimely because the lease

* Agricultural Law Manual (ALM).
FEDERAL AGRICULTURAL PROGRAMS

No new items.

FEDERAL ESTATE AND GIFT TAX

LIFE INSURANCE. The decedent was a partner in a partnership composed of the decedent, the decedent’s brother and an unrelated person. The partnership owned real property which was leased to a corporation also owned in part by the decedent and the decedent’s brother. The partnership owned a life insurance policy on the life of the decedent and the partnership agreement provided for payment of the life insurance proceeds to the partnership and the partnership purchase of the decedent’s partnership interest. The IRS ruled that the life insurance proceeds were paid for the benefit of the partnership and were not included in the decedent’s gross estate under I.R.C. § 2042. Ltr. Rul. 200214028, Jan. 7, 2002.

VALUATION OF STOCK. The decedent owned a 49 percent interest in a corporation which operated a hair salon products business under the decedent’s name. The Tax Court had valued the full company at fair market value with a discount for the loss of the decedent to the company. The Tax Court also discounted the value of the stock by 35 percent for a minority interest and lack of marketability. Finally, the Tax Court discounted the value of the stock by 15 percent because it was close to other farmland owned by the plaintiffs and had soil needed to grow the crops produced by the plaintiffs. Schreck v. T & C Sanderson Farms, Inc., 37 P.3d 510 (Colo. Ct. App. 2001).

FEDERAL INCOME TAXATION

ACCOUNTING METHOD. The IRS has issued procedures under I.R.C. §§ 446 and 471 that will allow qualifying small business taxpayers with average annual gross receipts of less than $10 million for the last three years to use the cash receipts and disbursements method of accounting with respect to eligible trades or businesses. The procedures will not apply to farming businesses. Rev. Proc. 2002-28, I.R.B. 2002-18.

CAPITAL EXPENSES. The IRS has modified TAM Ltr. Rul. 200043016, July 14, 2000 and TAM Ltr. Rul. 200020313, Oct. 9, 2001 to conform with Rev. Rul. 2002-9, I.R.B. 2002-10, 614. The revenue ruling provided that impact fees incurred by real property developers in connection with the construction of a new residential rental building are indirect costs that, pursuant to I.R.C. §§ 263(a), 263A, should be capitalized and added to the basis of buildings constructed. Accordingly, developers and operators of low-income housing may include such fees in the computation of the low-income housing credit. TAM Ltr. Rul. 200216027, March 11, 2002.

CORPORATIONS-ALM § 7.03.*

CONSTRUCTIVE DIVIDENDS. The taxpayer was a corporation which owned and operated a country club. The corporation charges fees for use of the facilities and equipment and for food and provides a percentage discount to shareholders, many of whom own housing nearby. The corporation did not declare or pay dividends to the shareholders. The IRS ruled that the discount amount was a constructive dividend to the shareholders. Ltr. Rul. 200215036, Jan. 11, 2002.

ENROLLED AGENTS. The IRS has announced that the expiration date for current enrolled agent cards, which was set for March 31, 2002, has been extended to April 30, 2002. ANN. 2002-41, I.R.B. 2002-14, 739.

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, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,331 (10th Cir. 2002), aff'g, T.C. Memo 2001-2.

PARSONAGE EXEMPTION. Legislation has been introduced and passed in the U.S. House of Representatives which clarifies the exemption for the fair rental value of housing provided to ministers to include furniture and the cost of utilities. The legislation was in response to Warren v. Comm'r, No. 00-71217, 2002 U.S. App. LEXIS 3420 (9th Cir. Mar. 5, 2002) which held that the parsonage exclusion for a minister was the actual amount used to provide a home, not the fair market rental value of the home. The next issue of the Digest will publish an article on this case and legislation by Roger McEowen and Neil Harl. H.R. 4156.

PARTNERSHIPS-ALM § 7.03.*

PARTNERS. The taxpayer held the position of Of Counsel for a partnership which provided legal services. The taxpayer was paid a fee which did not depend upon the profits of the partnership and the partnership treated the compensation as a guaranteed payment. The IRS ruled that the taxpayer was not a partner and the payments were incorrectly classified as guaranteed payments. CCA Ltr. Rul. 200215053, No date given.

PASSIVE ACTIVITY LOSSES. The taxpayers, husband and wife, were owners of an S corporation which provided management services for several pass-through entities owned in part by the taxpayers. The pass-through entities paid the corporation a management fee which was paid to the taxpayers for their services to the corporation. The taxpayers also reported their share of the management expense from the several pass-through entities. The taxpayers argued that their share of the management fees paid by each pass-through entity was a separate trade or business and were nonpassive losses. The court held that the management fees were part of the rental activities of the pass-through entities and had to be characterized as passive losses. Hillman v. Comm'r, 118 T.C. No. 17 (2002).


PENSION PLANS. The IRS has adopted as final regulations which provide a uniform (and, arguably simplified) procedure for minimum required distributions from employee pension plans. A table is to be used to determine the minimum distribution required during their lifetime. Treas. Reg. § 1.401(a)(9)-5, Q&A 4 (26.2 years for those age 70, up to 1.8 years for those 115 and older).

For distributions from an individual account, the required minimum distribution is determined by dividing the account balance by the distribution period. Treas. Reg. § 1.401(a)(9)-5, Q&A 1. An exception applies if the employee's sole beneficiary is the employee's spouse who is more than 10-years younger than the employee, in which case the employee is allowed to use the longer distribution period measured by the joint life and last survivor life expectancy of the employee and spouse. Treas. Reg. § 1.401(a)(9)-5, Q&A 5.

Generally, the designated beneficiary is determined as of September 30 of the year following the year of the employee's death rather than as of the employee's required beginning date or date of death. Treas. Reg. § 1.401(a)(9)-4, Q&A 4. Any beneficiary eliminated by the distribution of the benefit or through disclaimer during the period between the employee's death and the end of the year following the year of death is disregarded in determining the employee's designated beneficiary for purposes of calculating the required minimum distribution. Id.

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). 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. 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. 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.

The regulations are applicable for calendar years beginning on or after January 1, 2003. For 2001 and 2002, taxpayers may rely on the new or old regulations. 67 Fed. Reg. 18987 (April 17, 2002).

TAX LIEN. The taxpayers, husband and wife, owned real property as tenants by the entireties. The IRS filed a tax lien against the property owned by the husband for taxes owed solely by the husband. The taxpayers then transferred the property to the wife solely in her name. The IRS sought to enforce the lien against the proceeds of the sale of the property, arguing that the transfer was fraudulent and subject to the tax lien. The taxpayers argued that the husband had no...
sole property interest under state law in the property held as tenants by the entireties. The U.S. Supreme Court held that the husband had sufficient property interests in the property to which the lien attached. The court pointed out that the husband had several property rights: the right to use the entireties property; the right to exclude others from it, the right of survivorship; the right to become a tenant in common with equal shares upon divorce; the right to sell the property; and to receive half the proceeds from such a sale; the right to encumber the property with respondent's consent; the right to block respondent from selling or encumbering the property unilaterally; the right to use the entireties property; the right to exclude others from it; the right of survivorship; the right to become a tenant in common with equal shares upon divorce; the right to sell the property with respondent's consent and to receive half the proceeds from such a sale; the right to encumber the property with respondent's consent; and the right to block respondent from selling or encumbering the property unilaterally. The court stated that the husband's inability to unilaterally alienate the property was not sufficient to prevent attachment of the tax lien. United States v. Craft, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,361 (S. Ct. 2002), rev'g, 233 F. 3d 358 (6th Cir. 2000).

SAFE HARBOR INTEREST RATES

<table>
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<th>May 2002</th>
<th>Annual</th>
<th>Semi-annual</th>
<th>Quarterly</th>
<th>Monthly</th>
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<tr>
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<td>6.92</td>
<td>6.86</td>
<td>6.82</td>
</tr>
</tbody>
</table>

TRUSTS. The taxpayer trust was established in 1945 and had passed through several generations of income beneficiaries. The trustees did not have any financial investment experience and hired outside financial advisors. The trust deducted the cost of the advisors from trust income; however, the IRS disallowed the deduction to the extent it exceeded 2 percent of the trust income. The IRS argued that the expense was a miscellaneous itemized deduction because the expense was not unique to the administration of a trust but was customary for investment of substantial assets. The court noted that Virginia law provided a trustee with absolute immunity from liability for investments made in any of the three statutory assets. See Va. Code § 26-40.01. Therefore, the court held that investment costs were not a unique administrative cost for trusts in Virginia and the costs were subject to the 2 percent of gross income limitation. The case leaves intact the conflict between Mellon Bank, N.A. v. United States, 265 F.3d 1275 (Fed. Cir. 2001) (trust investment fees subject to 2 percent limitation) and O'Neill v. Comm'r, 994 F.2d 302 (6th Cir. 1993) (trust investment costs fully deductible from trust income). Scott v. United States, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,364 (E.D. Va. 2002).

WORK CREDIT. Employers or their authorized representatives must submit Form 8850, Pre-Screening Notice and Certification Request for the Work Opportunity and Welfare-to-Work Credits, to state employment security agencies (SESAs) as part of the process of obtaining the tax credits. The IRS has announced that it will allow for the electronic submission of Forms 8850 with SESAs that establish systems to electronically receive the form. Generally, the electronic system must meet the following requirements: (1) The electronic system must ensure that the information received is the information sent; all occasions of access that result in the submission of a Form 8850 must be documented. Also, the design and operation of the electronic system, including access procedures, must make it reasonably certain that the persons signing and submitting Form 8850 and accessing the system are the job applicant and employer identified in the form. (2) The electronic submission must provide the SESA with the same information as the paper Form 8850. Ann. 2002-44, I.R.B. 2002-17.

NEGLIGENCE

TRACTOR. The plaintiff was injured while driving a tractor between one defendant’s farm and the other defendant’s farm. The defendants owned the tractor and one defendant had started to follow the tractor but turned back because of other business. The tractor was struck from behind by a car, causing the plaintiff’s injuries. The plaintiff argued that the defendant had a duty to follow the tractor and to provide the tractor with a rollover protection systems (ROPS). The court held that the plaintiff failed to show that the defendant had assumed any duty to follow the plaintiff and the plaintiff had not relied on the defendant’s following the tractor for safety. The court also held that the lack of a ROPS was an open and obvious condition of the tractor and the plaintiff assumed the risk of driving the tractor without a ROPS. Winn v. Pollard, 62 S.W.3d 611 (Mo. Ct. App. W.D. 2001).

CITATION UPDATES

Catalano v. Comm’r, 279 F.3d 682 (9th Cir. 2002), rev’g, T.C. Memo. 2000-82 (abandonment) see p. 27 supra.
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ADDITIONAL GUIDANCE ON THE 30 PERCENT DEPRECIATION ALLOWANCE
— by Neil E. Harl*

The legislation signed into law on March 9, 2002, the Job Creation and Worker Assistance Act of 2002,1 contained a highly important provision for farm and ranch (and other) taxpayers—an additional depreciation allowance of 30 percent of the adjusted income tax basis of qualifying property.2 In late April, the Internal Revenue Service issued needed guidance on how the depreciation allowance can be claimed and what should be done if the taxpayer does not wish to claim the 30 percent allowance.3

General rules
Under Rev. Proc. 2002-33,4 the recently-issued guidance, a taxpayer may make an election to not deduct the 30 percent depreciation allowance.5 In the event that election is made (not to claim the 30 percent amount), the property is subject to AMT depreciation adjustments for its depreciation life.6 It is important to note that if an election is not made to not deduct the 30 percent depreciation allowance, it is assumed the 30 percent amount is claimed.7 Thus, the 30 percent amount is considered “allowed” or “allowable.”8

In general, an election not to deduct the 30 percent depreciation allowance must be made by the due date (including extensions) of the federal income tax return for the year property is placed in service.9 An automatic extension of six months from the due date of the return (excluding extensions) is allowed for the election not to deduct the 30 percent depreciation amount if the return was timely filed.10

Taxpayers who did not claim the allowance on the 2001 return—and want to claim the amount

Under the statute, for property to be eligible for the 30 percent allowance, the assets had to be acquired after September 10, 2001 (with no written contract to acquire the property before September 11, 2001) and before September 11, 2004, and placed in service before January 1, 2005 (except for certain property with longer production periods).11 That means many farm and ranch taxpayers had filed their 2001 returns before the statute was signed into law.12

So how can taxpayers make the election to claim the 30 percent allowance for 2001? The recent guidance states that if an income tax return was filed before June 1, 2002, and did not claim the additional 30 percent depreciation allowance, if the taxpayer wishes to claim the depreciation amount, the taxpayer can either—

- File an amended return on or before the due date (excluding extensions) of the return for the next succeeding taxable year (that would be the due date for the 2002 return in

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

1 The legislation signed into law on March 9, 2002.
2 The legislation signed into law on March 9, 2002.
3 The legislation signed into law on March 9, 2002.
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12 The legislation signed into law on March 9, 2002.
most instances), in which case the amended return is to include the statement, “Filed Pursuant to Rev. Proc. 2002-33” at the top of the amended return, or

- File a Form 3115, Application for Change in Accounting Method, with the taxpayer’s federal tax return for the next succeeding taxable year (again, that would be the 2002 return in most instances). In that case, the Form 3115 is to be filed in accordance with the automatic change in method of accounting. The Form 3115 should include the statement, “Automatic Change Filed under Rev. Proc. 2002-33.” The deduction is claimed entirely in the year of change.

**Taxpayers who did not claim the allowance on the 2001 return and do not want to claim the amount**

For returns filed before June 1, 2002, the guidance states that the election not to deduct the 30 percent depreciation amount is considered made if—

- the taxpayer made the election by the due date of the return or within the six-months extension as required by the Form 4562 instructions (the Form 4562 instructions require a statement indicating the class of property for which the taxpayer is electing not to deduct the 30 percent depreciation allowance), or
- made the election by the due date of the return or within the six-month extension and attached a statement to the effect that the taxpayer is not deducting the 30 percent depreciation. A “deemed election” applies if the taxpayer did not claim the 30 percent depreciation deduction on the return and does not file an amended return to claim the 30 percent depreciation allowance. Therefore, for returns filed before June 1, 2002, the taxpayer need do nothing if—(1) the 30 percent allowance was not claimed and (2) the taxpayer does not want to claim the amount.

**Returns filed on or after June 1, 2002**

For returns filed on or after June 1, 2002, taxpayers wanting to claim the 30 percent allowance do so on Form 4562. For taxpayers not wanting to claim the 30 percent depreciation deduction, an election must be made not to deduct the depreciation as required by the Form 4562 instructions (attach a statement to the return indicating the class of property for which the taxpayer is electing not to deduct the 30 percent depreciation amount). If the original return is timely filed, a taxpayer apparently is allowed an automatic extension of six months from the original due date to make the election (not to deduct the 30 percent depreciation allowance). Thus, for returns filed on or after June 1, 2002, the taxpayer must either—

- Claim the 30 percent depreciation allowance on Form 4562, or
- Attach a statement to the income tax return that the taxpayer is electing not to claim the 30 percent depreciation allowance.

**Revoking elections not to deduct**

An election not to deduct the 30 percent depreciation allowance for a class of property is revocable only with the consent of the Commissioner.

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**Final note**

Remember, the 30 percent depreciation allowance is claimed after expense method depreciation has been claimed.

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**FOOTNOTES**

4. I.R.B. 2002-__.
5. Id.
6. Id., Sec. 3.01.
7. Id., Sec. 3.05.
8. See, e.g., Jakobowski v. United States, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,594 (10th Cir. 2001) (unclaimed depreciation (over 14-years) had to reduce basis; sale produced additional gain).
10. Id., Sec. 3.03(2)(a).
12. See n. 1 supra and accompanying text.
13. Rev. Proc. 2002-33, Sec. 4.01(1), I.R.B. 2002-__.
14. Id.
15. Id., Sec. 4.01(2).
17. Id.
20. Id., Sec. 4.02(2).
21. Id., Sec. 3.03(3)(a).

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**FARM ESTATE & BUSINESS PLANNING**

15th EDITION

By Neil E. Harl

The 15th Edition of this popular softcover book provides lay level guidance on farm estate and business planning concepts and planning pointers for farmers and ranchers. The book is updated to 2001 and contains the latest on the effects of the Economic Growth and Tax Relief Reconciliation Act of 2001. The book may be ordered by contacting Doane Agricultural Services, 11701 Borman Dr., Suite 100, St. Louis, MO 63146, Ph. 1-800-535-2342.
THE PARSONAGE EXCLUSION - FIRST AMENDMENT CONCERNS?
— by Roger A. McEowen*

Overview

On May 16, 2000, the United States Tax Court, in Warren v. Comm’r, held that the parsonage exclusion for a minister is the actual amount used to provide a home, not the fair market rental value of the home. The petitioner, a “minister of the gospel” with significant outside income, and his wife purchased a home in 1992 for $360,000. The fair market rental value of the home was $58,061 in 1993, $58,004 in 1994, and $59,479 in 1995. As compensation, the petitioner’s church paid the petitioner $77,663, $86,175 and $99,653 for the years 1993, 1994 and 1995, respectively. For some of the years in question, the entire amount of compensation was designated as a housing allowance and entirely excluded from the petitioner’s gross income.

The petitioner spent a total of $77,663 in 1993, $76,309 in 1994 and $84,278 in 1995 for home expenditures including the mortgage, utilities, furnishings, repairs, maintenance, taxes and insurance. Based on these expenditures, the petitioner excluded all of the 1993 compensation and reported $9,866 in 1994 and $19,654 in 1995. The IRS, in accordance with Rev. Rul. 71-280, determined that the petitioner’s exclusion was limited to the fair market rental value of the home and increased the petitioner’s gross income by the difference between the compensation paid and the fair market rental value of the home for 1993, 1994 and 1995.

The I.R.C. § 107 Issue

The issue facing the Tax Court was whether the exclusion from gross income provided by I.R.C. § 107 was limited, as the IRS asserted, to the fair rental value of the “parsonage.”

I.R.C. § 107 provides:

“In the case of a minister of the gospel, gross income does not include-

1. the rental value of a home furnished to him as part of his compensation or

2. the rental allowance paid to him as part of his compensation, to the extent used by him to rent or provide a home.”

The Tax Court, disagreeing with the contention of the IRS that the Congress, in enacting I.R.C. § 107, intended to impose a rental value limit on the exclusion, ruled that the exclusion is the amount actually used to provide a home not limited by the fair market rental value of the home. The IRS interpreted the exclusion to be the lesser of the amount used to provide a home or the fair market rental value of the home, and argued that permitting a greater exclusion would be contrary to both the “rental” language in the Code and the legislative history of concern for equality among ministers. The Tax Court noted that although I.R.C. § 107(1) limits the exclusion to the rental value of a home furnished as part of a minister’s compensation, there is no mention of rental value in I.R.C. § 107(2) or the regulations. The dissent stressed that the majority opinion ignored the modifier “rental” in I.R.C. § 107(2). The dissent concluded that the Congress intended that the exclusion be correlated to rental value, and that the majority’s opinion placed ministers or churches utilizing I.R.C. § 107(2) rather than I.R.C. § 107(1) in a more favorable position.

The IRS appealed the Tax Court’s opinion to the U.S. Circuit Court of Appeals for the Ninth Circuit.

The Constitutional Issue

At the Tax Court level, neither the IRS nor the Tax Court raised a constitutional question. Indeed, at the Tax Court level, the issue was framed solely as a matter of statutory construction – whether a clergyman receiving a cash housing allowance from a religious employer can exclude from gross income the full amount of the allowance spent on housing or can only exclude up to the rental value of the home. On appeal, however, the Ninth Circuit asked the parties whether either wanted to frame the issue in constitutional terms. Both the IRS and the petitioner declined, but the three-judge panel hearing the case, over strong dissent, ordered the parties to brief both the constitutionality of I.R.C. § 107(2) and the propriety of the court reaching the issue on its own initiative. The panel, in ordering the briefing of the constitutional issue, specifically mentioned as relevant to the constitutional status of I.R.C. § 107(2) the opinion of the United States Supreme Court in Texas Monthly, Inc. v. Bullock, which struck on Establishment Clause grounds a Texas sales tax exemption limited to religious literature. However, the court failed to cite a 1970 Supreme Court opinion that focused more on Free Exercise concerns and suggested that tax provisions like I.R.C. § 107 properly accommodate the autonomy of sectarian entities and persons. Briefs on the matter were due on May 3, 2002.

The primary concern of the Ninth Circuit panel seems to be that I.R.C. § 107 provides a more generous rule for exclusion of employer-provided housing for “ministers of the gospel” than is provided under I.R.C. § 119 for those in secular employment. Section 119 excludes from an employee’s income employer-provided lodging, but only if the lodging is on the employer’s premises, is provided for the employer’s “convenience,” is required as a condition of employment, and is furnished in-kind rather than through a cash allowance. Section 119 applies irrespective of whether the employer is a secular organization or a sectarian entity. Section 107, on the other hand, is limited to “ministers of the gospel.” In addition, I.R.C. § 107 contains no convenience-of-the-employer test, does not require that the excluded housing be located on the employer’s premises or be a condition of employment, and extends tax-free treatment to cash allowances. Thus, from a constitutional standpoint, the potentially controversial situations are those arrangements by which religious employers provide housing assistance to clergy that fail the I.R.C. § 119 tests for excludability, but satisfy the more lenient standard of I.R.C. § 107. That is the precise situation presented in Warren.

In the event the constitutional issue is addressed by the court, one possible view is that I.R.C. § 107 actually helps disentangle the government from sectarian affairs by not requiring the IRS to undertake the detailed analysis that would be necessary if the minister’s lodging were provided pursuant to I.R.C. § 119. That approach is consistent with the rationale of Walz and the

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dissent in *Texas Monthly*, and suggests that I.R.C. § 107 is constitutional. Conversely, another view is that tax benefits extended to religious institutions are constitutional only if they are provided equally to nonreligious activities in accordance with a secular purpose. Under this view, I.R.C. § 107 is not constitutional, but I.R.C. § 119 is not at risk because it has broad application and is not designed to assist religion.

**Possible Outcomes**

In the event that the Ninth Circuit decides to rule on the constitutional matter and finds I.R.C. § 107 unconstitutional, the opinion would only be binding within the jurisdiction of the Ninth Circuit. The case would then proceed to the United States Supreme Court where, given the present make-up of the Court, it is unlikely that the Court (if it agrees to hear the case) would find the provision unconstitutional.

Even if I.R.C. § 107 were ultimately held unconstitutional, religious employers would still be able to provide tax-free lodging to ministers pursuant to the more restrictive rules of I.R.C. § 119 – the lodging would have to be on the employer’s premises, be provided for the employer’s “convenience,” be required as a condition of employment, and be furnished in-kind rather than through a cash allowance. In that setting, the Congress would likely act to preserve the tax preference for ministers.

Of course, the Ninth Circuit could refrain from ruling on the constitutional issue, but reverse the Tax Court's opinion with the exclusion being limited to the rental value of the “parsonage” - the historic IRS position.

**Congressional Reaction**

The *Warren* case and the possibility of a federal court holding I.R.C. section 107 unconstitutional have moved the Congress. On April 16, 2002, the House passed legislation that would amend I.R.C. section 107(2) to provide specifically that the parsonage allowance is limited to an amount that “does not exceed the fair rental value of the home, including furnishings and appurtenances such as a garage, plus the cost of utilities.” A similar bill was introduced in the Senate on April 18, 2002 and cleared the Senate on May 2, 2002. Interestingly, neither the House nor Senate bills, if enacted into law, will have any effect on the *Warren* litigation and, thus, neither bill will prevent the Ninth Circuit from potentially addressing the constitutional issue. Both bills apply prospectively to tax years after 2001, and do no apply to 1993-1995, the years at issue in *Warren*.

**Final Point**

The *Warren* case would never have arisen had the petitioner followed the long-standing IRS position and claimed as a housing exclusion only the amount representing the rental value of the “parsonage.” Obviously, the petitioner drew the attention of the IRS by claiming (in some years) his entire compensation as a non-taxable housing allowance. The case certainly illustrates the perils of taking an overly aggressive position on the tax return.

It is true in agriculture and often true in tax law – pigs get slaughtered. Unwittingly, Rev. Warren (whose gross income for the years in issue placed him in the top two percent of all individual taxpayers in the United States and who can certainly provide his own housing without the benefit of I.R.C. § 107) may have taken all “ministers of the gospel” (many of whom desperately depend on the I.R.C. § 107 exclusion) to the tax slaughterhouse with him.

**FOOTNOTES**

5. Id.
6. Id.
7. Id.
8. Id.
10. Id. The court also appointed Prof. Erwin Chemerinsky of the University of Southern California Law School to act as amicus curiae and brief both the constitutional issue and whether the court has the authority to raise the issue on its own.
11. It is not possible for the court to find I.R.C. § 107(2) unconstitutional, and uphold the balance of the provision. Either all of I.R.C. § 107 is unconstitutional or the entire provision is constitutional.
13. Id. There was no majority opinion in *Texas Monthly*. Rather, a plurality of three justices held that the state sales tax exemption at issue was a religious subsidy that entangled the state with religion in determining the bounds of the exemption. Three justices wrote a dissenting opinion (authored by Scalia), and the three swing justices who made up the plurality opinion issued two separate concurring opinions.
15. 114 T.C. 343 (2000). An important point that should not be overlooked is that the Ninth Circuit, even as it raised the issue of the constitutionality of I.R.C. § 107(2), also expressed reservations about the propriety of a court considering an issue advanced by neither litigant and indicated that it may, after all, decline to resolve the constitutional controversy. Thus, the matter may be purely an academic exercise.
19. Of the justices that authored the plurality opinion in *Texas Monthly*, only Justice Stevens presently remains on the court. Justice O’Connor also remains on the Court and concurred in the plurality opinion. All three of the dissenting justices – Scalia, Rehnquist and Kennedy, remain on the Court.
21. See n. 1 supra.
22. H.R. 4156, the Clergy Housing Allowance Clarification Act of 2002. The legislation passed 408-0, and would apply to
The bill is estimated to raise $33 million in revenue over the next decade.


25 Id. Both bills provide that “notwithstanding any prior regulation, revenue ruling, or other guidance issued by the Internal Revenue Service, no person shall be subject to the limitations added... before January 1, 2002.” The most likely interpretation of that language is that it does not render the Warren litigation moot. Instead, the Ninth Circuit would have to interpret I.R.C. § 107 without the benefit of Rev. Rul. 71-280, but would not be precluded from reaching the same result.

S. 2200, 107th Cong., 1st Sess.

The legislation would apply to tax years beginning after December 31, 2001.

26 114 T.C. 343 (2000).


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**CASES, REGULATIONS AND STATUTES**

by Robert P. Achenbach, Jr.

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**BANKRUPTCY**

**FEDERAL TAX-ALM § 13.03[7].**

**DISCHARGE.** The debtor had failed to file returns for 1983 through 1986. The IRS made assessments based on substitute returns it created. The debtor made two offers in compromise which were rejected because the debtor had not filed returns. The debtor eventually filed the returns, claiming less tax due than the amount assessed by the IRS. The debtor sought to discharge the taxes because the returns were filed more than three years before the bankruptcy petition was filed. The court held that the debtor’s returns did not qualify as tax returns under Section 523(a)(1)(B) because the IRS had already created substitute returns and made an assessment and the debtor’s returns were not an honest attempt by the debtor to comply with the filing requirements. *In re Rushing, 273 B.R. 223* (Bankr. D. Ariz. 2001).

**NET OPERATING LOSSES.** The debtor owned two S corporations and filed for Chapter 11, with the stock passing to the bankruptcy estate. The corporations had net operating losses for the period between the start of its tax year and the date of the debtor’s bankruptcy petition. The debtor claimed the losses as net operating losses and carried the losses forward to post-bankruptcy tax years. The debtor did not elect to bifurcate the debtor’s tax year in which the petition was filed. In a Chief Counsel Advice letter, the IRS ruled that the debtor could not claim the net operating losses because the losses passed to the bankruptcy estate with the stock. The net operating losses would then be used to decrease the basis of the stock to the extent of discharge of indebtedness which occurred as part of the bankruptcy case. If any net operating losses remained after the basis reduction, they passed to the debtor. After the bankruptcy case closed, the lowered basis of the stock also passed on to the debtor. *CCA Ltr. Rul. 200217003, Dec. 14, 2001.*

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**FEDERAL AGRICULTURAL PROGRAMS**

**FOOT AND MOUTH DISEASE.** The APHIS has issued proposed regulations amending the indemnity provisions pertaining to the control and eradication of foot-and-mouth disease and other serious diseases, including both cooperative programs and extraordinary emergencies. *67 Fed. Reg. 21933* (May 1, 2002).

**KARNAL BUNT.** The APHIS has issued interim regulations amending the Karnal bunt regulations to prohibit grain grown in a regulated area from being used as seed outside the regulated areas. The interim regulations also remove the requirement that wheat seed, durum wheat seed, and triticale seed that originates within a regulated area be treated with a fungicide before it may be planted within a regulated area. *67 Fed. Reg. 21159* (April 30, 2002).

The APHIS has issued interim regulations amending the Karnal bunt regulations to provide compensation for certain growers and handlers of grain and seed affected by Karnal bunt who are not currently eligible for compensation, and for certain wheat grown outside the regulated area that was commingled with wheat grown in regulated areas in Texas. *67 Fed. Reg. 21561* (May 1, 2002).

**MIGRANT WORKERS.** The plaintiffs were migrant and seasonal agricultural laborers who resided in Texas. The plaintiffs were recruited in Texas by a Texas farm-labor contractor hired by the defendant, a New York dairy, for work in New York. The employment contracts contained a provision that jurisdiction over the contracts was in New York. The defendant argued that the Texas District Court lacked personal jurisdiction over the defendant who had no contacts with the state. The court held that the forum selection clause was unenforceable as contrary to the provisions of MSAWPA which prohibited the waiver of rights granted by MSAWPA. The court also held that the court had personal jurisdiction over the defendant because the defendant had “purposefully directed” its activities at the residents of Texas by hiring the Texas farm-labor contractor to hire residents of Texas.

MILK. The plaintiffs were milk producers subject to a milk marketing order under the Agricultural Marketing Agreement Act. The producers challenged as unconstitutional the exemption from the milk pricing provisions of the marketing order because the provisions violated the equal protection guarantees of the Fifth Amendment. The court held that the plaintiffs lacked standing to challenge the pricing provisions without first seeking administrative review. United Dairymen of Arizona v. Veneman, 279 F.3d 1160 (9th Cir. 2002).

PESTICIDES. The Federal Insecticide, Fungicide and Rodenticide Act (FIFRA), 7 U.S.C. § 136d(a)(2), requires pesticide registrants to report “factual information regarding unreasonable adverse effects on the environment” of a registered pesticide. The EPA issued a regulation, 40 C.F.R. § 159.158(a), which requires that this reporting include opinions of a registrant’s employees and agents. The plaintiff challenged the regulation as beyond the authority provided by the statute. The court held that the regulation was valid and not unreasonable or contrary to law. American Crop Protection Ass’n v. EPA, 182 F. Supp. 2d 89 (D. D.C. 2002).

WETLANDS. The USDA has issued proposed regulations setting out certain categorical minimal effect exemptions under the wetland conservation provisions of the Food Security Act of 1985, as amended. This proposed rule identifies five wetland conversion activities, which do not come under the type of wetlands or other criteria, would cause unreasonable adverse effects to the environment functions and values, and thus would render a producer ineligible for certain USDA program benefits. The five conservation activities would be (1) removal of woody vegetation, including stumps, from natural herbaceous wetlands; (2) removal of scattered woody vegetation, including stumps; (3) installation of grassed waterways for control on non-highly erodible croplands; (4) terrace construction for erosion control on erodible cropland; and (5) control of exotic invasive woody species, including stumps. 67 Fed. Reg. 19699 (April 23, 2002).

FEDERAL ESTATE AND GIFT TAX

CLAIMS. The decedent was killed in an automobile accident in which the other driver was also killed and the other driver’s spouse and child were injured. The spouse and child filed a claim against the decedent’s estate for the damages and also filed a lawsuit for damages, claiming that the decedent was at least partially at fault for the accident. The estate eventually settled with the spouse and child but claimed a deduction in the amount of the payments because the claim was too contingent at the decedent’s death. Estate of Godley v. Comm’r, 2002-1 U.S. Tax Cas. (CCH) ¶ 60,437 (4th Cir. 2002), aff’g on point sub nom., Estate of Powell v. Comm’r, 2001-2 U.S. Tax Cas. (CCH) ¶ 60,416 (W.D. Va. 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. Lane v. Comm’r, 2002-1 U.S. Tax Cas. (CCH) ¶ 60,437 (4th Cir. 2002), aff’g on point sub nom., Estate of Powell v. Comm’r, 2001-2 U.S. Tax Cas. (CCH) ¶ 60,416 (W.D. Va. 2001).

VALUATION. The decedent owned a 50 percent interest in five partnerships which owned and operated public assistance housing. Under contracts with HUD, the partnerships received guaranteed rents and subsidies for renting to low income and elderly tenants. The other 50 percent interests were owned by the decedent’s son who participated in the management of the company. The partnership agreement provided for the sale of the decedent’s interests to the son for $10,000 each and the estate claimed that amount as the value of each of the decedent’s interests. The court disregarded the purchase agreement price as based on a testamentary purpose. The court valued the partnerships using the value of the partnership assets and expected income. The court allowed a discount for the decedent’s interests for a lack of marketability, but did not allow a discount for a minority interest because (1) the HUD contracts provided a guaranteed income to both partners, (2) the partnership agreement required an annual distribution of net income to the partners, and (3) the partnership agreement required a vote of at least 75 percent of the interests to make any changes to the partnership agreement or to liquidate the partnership. Estate of Godley v. Comm’r, 2002-1 U.S. Tax Cas. (CCH) ¶ 60,436 (4th Cir. 2002).

FEDERAL INCOME TAXATION

CHARITABLE DEDUCTION. The taxpayer owned shares of stock which were not publicly traded on a stock exchange market. The stock was issued by a bank holding company and was bought and sold through privately arranged sales. The taxpayer transferred the stock to a nonprofit foundation and claimed a charitable deduction based on the fair-market value of the stock as determined by a subsequent sale of the stock to another bank corporation. The court held that the taxpayer could claim a deduction only for the taxpayer’s basis in the stock because the stock was not qualified appreciated stock, under Treas. Reg. § 1.170A-13(c)(7)(xi)(A), since it was not readily available on an established securities market. The court also noted that the taxpayer failed to meet the substantiation requirements to demonstrate the appreciated value of the stock when transferred. Todd v. Comm’r, 118 T.C. No. 19 (2002).
COURT AWARDS AND SETTLEMENTS. The taxpayer was a plaintiff in a personal injury lawsuit and received a jury verdict for compensatory and punitive damages. The parties then entered a settlement agreement which did not allocate the funds received for the various types of awards. The court held that the settlement proceeds had to be allocated in the same ratio as the damages were allocated by the jury. In re Valencia, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,388 (Bankr. D. N.M. 2002).

DISASTER PAYMENTS. On April 4, 2002, the president determined that certain areas in Kentucky 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 17-24, 2002. FEMA-1407-DR. On April 5, 2002, the president determined that certain areas in Tennessee were eligible for assistance under the Act as a result of severe storms and flooding on March 15-20, 2002. FEMA-1408-DR. On April 2, 2002, the president determined that certain areas in Virginia were eligible for assistance under the Act as a result of severe storms and flooding on March 17-20, 2002. FEMA-1406-DR. Accordingly, a taxpayer who sustained a loss attributable to these disasters may deduct the loss on his or her 2001 federal income tax return.

HOME OFFICE. The IRS has published a new brochure, “Home-Based Business Tax Avoidance Schemes . . . At A Glance.” The schemes described in the document claim that by setting up a bogus home-based business, individual taxpayers can deduct most, or all, of their personal expenses as business expenses. The brochure includes some examples of personal expenses that are not deductible but are commonly claimed as business expenses in home-based business tax avoidance schemes. The brochure explains that no matter how convincing the claims that are found in marketing materials for these schemes may appear, nondeductible personal living expenses cannot be transformed into deductible business expenses. The tax code firmly establishes that a clear business purpose and profit motive must exist in order to generate and claim allowable business expenses. Taxpayers who claimed such deductions on a past tax return should file an amended return as soon as possible to limit possible interest and penalties on top of any taxes they might owe. Ann. 2002-48, I.R.B. 2002—.

IRA. In Rev. Proc. 2002-10, I.R.B. 2002-4, 401, the IRS provided guidance to users of its model individual retirement arrangements (IRAs), simplified employee pensions (SEPs) and SIMPLE IRA plans regarding the adoption of revised plans. According to those guidelines, existing model IRAs, SEPs and SIMPLE IRA plans, which do not reflect law changes made by the Economic Growth and Tax Relief Reconciliation Act of 2001 and required minimum distribution regulations, cannot be used to establish new IRAs, SEPs and SIMPLE IRAs after June 1, 2002. The IRS has extended the June 1 deadline to October 1, 2002. Accordingly, financial institutions can use existing model IRAs to establish new IRAs for customers through October 1. Similarly, employers can use existing model SEPs or SIMPLE IRA plans to establish such plans through that date. The deadlines by which revised model forms must be adopted under Rev. Proc. 2002-10 remain unchanged. Ann. 2002-49, I.R.B. 2002—.

PENSION PLANS. For plans beginning in May 2002, the weighted average is 5.69 percent with the permissible range of 5.12 to 5.82 percent (90 to 106 percent permissible range) and 5.12 to 6.25 percent (90 to 110 percent permissible range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). Notice 2002-32, I.R.B. 2002—.

RETURNS. The IRS has issued proposed regulations which eliminate regulatory impediments to the electronic filing of Form 1040, “U.S. Individual Income Tax Return.” These regulations generally affect taxpayers who file Form 1040 electronically and who are required to file any of the following forms: Form 56, “Notice Concerning Fiduciary Relationship;” Form 2120, “Multiple Support Declaration;” Form 2439, “Notice to Shareholder of Undistributed Long-Term Capital Gains;” Form 3468, “Investment Credit;” and Form T (Timber)” Forest Activities Schedules.” 67 Fed. Reg. 20028 (April 24, 2002).

SELF-EMPLOYMENT TAX. The taxpayer was a commodities futures trader who had originally made the trades on the taxpayer’s own account on the Chicago Board of Trade. However, for the tax year involved, the taxpayer conducted all trades through another broker because the taxpayer was being investigated by the CFTC. The taxpayer claimed all gains made in that year as capital gains and reported them on Schedule D. The expenses for the trades were deducted on Schedule C under the business of commodities trader. The court held that the gains made were self-employment income because the trades were made within the normal scope of the taxpayer’s business as a commodities trader, even though made through a broker. Rudman v. Comm’r, 118 T.C. No. 21 (2002).

STATE TAXATION

VALUATION. The plaintiff owned a farm on which the plaintiff had operated a hog farrowing facility since 1990. In 1999 the plaintiff built a house on the property a short distance from the farrowing facility. The plaintiff spent $328,000 in constructing the house but the county assessor valued the house at $540,000 for property tax purposes. The plaintiff challenged the valuation because it did not consider the negative effect of the proximity to the farrowing facility and the remoteness of the house from any road. The court held that the “external depreciation” caused by the proximity of the house to the farrowing facility was a valid factor in determining the value of the house and that this factor could not be ignored simply because the plaintiff chose the location of the house. Livingston v. Board of Equalization, 640 N.W.2d 426 (Neb. Ct. App. 2002).
ZONING

By Roger A. McEowen

MORATORIUM. This case arose as part of Lake Tahoe preservation efforts brought by the Tahoe Regional Planning Agency, a land use and planning organization. The Agency imposed a moratorium on development in Lake Tahoe from 1981 to 1984 to give the Agency adequate time to revise its land use plan for the lake and basin, areas that were threatened by rapid growth and the associated impact from a growing population. Authorities were concerned about the buildup of algae in the lake, which obscured the clarity of the water. An association of property owners who wanted to build single-family homes near Lake Tahoe brought a takings claim. The U.S. District Court found that a taking had occurred, but the Ninth Circuit reversed. The U.S. Supreme Court agreed to hear the case, and rejected the plaintiff’s argument that Lucas v. South Carolina Coastal Council, 505 U.S. 1003 (1992) required a finding that the moratorium was a categorical taking. The court said that Lucas only required analysis of regulatory taking claims as a categorical taking in the unusual case where there is a total prohibition on the beneficial economical use of property. The court reasoned that moratoria are essential land-use development tools and that the time it takes for a decision to be made should be protected. In addition, the court stated that fairness and justice could not be served if categorical rules are applied to numerous normal delays. The Chief Justice dissented, joined by justices Thomas and Scalia, and pointed out that the distinction between temporary and permanent prohibitions is tenuous and that the takings in the case lasted almost six years. A separate dissent, authored by justice Thomas and joined by Scalia, argued that regulations prohibiting all productive uses of property are subject to Lucas’ per se rule, regardless of whether the property involved retains theoretical useful life and value if, and when, the “temporary” moratorium is lifted. Tahoe-Sierra Preservation Council, Inc. v. Tahoe Regional Planning Agency, No. 00-1167, 2002 U. S. LEXIS 3028 (U.S. Sup. Ct. Apr. 23, 2002), aff’g, 216, F.3d 764 (9th Cir. 2000).

IN THE NEWS

2002 FARM BILL. The US House of Representatives by a vote of 280 to 141 approved the 2002 farm bill on May 2, 2002, despite a late bid to kill the plan by lawmakers who said the plan would encourage overproduction, fail to close loopholes for big farms and violate world trade rules. “First and foremost, this farm bill provides for a strong safety net for our agricultural producers,” said Charlie Stenholm, the Agriculture Committee’s Ranking Member. The bill, which would boost spending on crop and dairy subsidies by $31.2 billion through 2007, now goes to the Senate for a vote and the President has indicated that he will sign the legislation. @griculture Online (www.agriculture.com).

CITATION UPDATES

Bachler v. United States, 281 F.3d 1078 (9th Cir. 2002), rev’g, 2000-2 U.S. Tax Cas. (CCH) ¶ 60,390 (N.D. Calif. 2000) (generation skipping transfers) see p. 43 supra.

In re Young, 122 S. Ct. 1036 (2002), aff’g, 233 F.3d 56 (1st Cir. 2000) (discharge) see p. 43 supra.
Article: FARM SECURITY AND RURAL INVESTMENT ACT OF 2002

**Effective date.** The commodity provisions in the 2002 Act are effective with the 2002 crop year of each covered commodity through the 2007 crop year. [Act Sec. 1108.](#)

**Conditions for receiving direct and counter-cyclical payments.** The conference agreement rejected both the House and Senate provisions on sharing of payments between landlord and tenant and stipulated that “The Secretary shall provide adequate safeguards to protect the interests of tenants and sharecroppers” with the Secretary directed to provide “for the sharing of direct payments and counter-cyclical payments among the producers on a farm on a fair and equitable basis.” [Act Sec. 1105(d), (e).](#)

The 2002 Act also requires, as conditions for receipt of direct and counter-cyclic payments, that producers (1) comply with applicable conservation requirements; (2) comply with applicable wetland requirements; (3) comply with the planting flexibility requirements of Section 1106 of the Act (as to permitted crops on base acres on a farm); (4) use base acres and peanut acreage for agricultural and conserving uses, not for non-agricultural commercial or industrial use; and (5) effectively control various weeds and maintain the land in accordance with “sound agricultural practices.” [Act Sec. 1105(a)(1).](#)

The Act provides that a transfer or change in the interest of producers on a farm in base acres for which direct or counter-cyclical payments are made results in termination of the payments unless the transferee or owner agrees to assume the obligations of participation in the program. If a producer dies or becomes incompetent, the Secretary is to prescribe in regulations how the payments are to be made. [Act Sec. 1105(b).](#)

**Establishing payment yield.** The Secretary is required to establish payment yields for each farm for each covered commodity for the purpose of making direct payments and counter-cyclical payments. [Act Sec. 1102(a).](#)

The yield for a farm, in general, is the payment yield established for the 1995 crop of the covered commodity as adjusted by the Secretary to account for any additional yield payments made with respect to the crop. [Act Sec. 1102(b).](#)

If no yield is available, the Secretary is to establish an appropriate payment yield taking into account the payment yields applicable to the commodity for similar farms in the area but before the yields are updated to reflect the actual yield per planted acre for 1998 through 2001. [Act Sec. 1102(c).](#)

The payment yield for a farm for an oilseed is to equal the product of the following:

- the average yield for the oilseed for the 1998 through 2001 crops and
- the ratio resulting from dividing the national average yield for the oilseed for the 1981 through 1985 crops by the national average yield for the oilseed for the 1998 through 2001 crops. [Act Sec. 1102(d)(2).](#)

In the event the yield per planted acre for a crop of an oilseed for a farm for any of the 1998 through 2001 crop years was less than 75 percent of the county yield for that oilseed, the Secretary is to assign a yield for that crop year equal to 75 percent of the county yield for purposes of determining the average yield for the 1998 through 2001 crop years. [Act Sec. 1102(d)(3).](#)

If the owner of a farm elects to update the crop acreage base for all covered commodities using the average of the planted and prevented from planting acreage for 1998 through 2001, the owner has a one-time opportunity to elect to partially update the payment yields that would be used in calculating any counter-cyclical payments for covered commodities on the farm. If yields are updated for counter-cyclical payments for one

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covered commodity, yields must be updated for all covered commodities on the farm. *Act Sec. 1102(e)(1).*

In the event the owner of a farm elects to update yields for payments, the counter-cyclical payment yield for a covered commodity is to equal the yield determined under either of the following—

- The sum of the payment yield applicable for direct payments for the covered commodity on the farm and 70 percent of the difference between the average yield per planted acre for the crop of the covered commodity on the farm for 1998 through 2001 crop years and the payment yield applicable for direct payments for the covered commodity on the farm, or
- 93.5 percent of the average yield per planted acre for the crop of the covered commodity for the farm for the 1998 through 2001 crop years, excluding any crop year in which the acreage planted to the crop of the covered commodity was zero. *Act Sec. 1102(e)(3).*

The owner of a farm may not elect one method for one covered commodity and the other method for other covered commodities on the farm. *Act Sec. 1102(e)(5).*

If the yield per planted acre for a crop of the covered commodity for a farm for any of the 1998 through 2001 crop years was less than 75 percent of the county yield for that commodity, the Secretary is to assign a yield for that crop year equal to 75 percent of the county for the purpose of determining the average yield. *Act Sec. 1102(e)(4).*

The Conference Report (but not the statute) states that the Secretary is to recognize that producers planting crops for grazing that will be included as base acreage may be unable to furnish production evidence similar to that furnished by producers who harvest crops for grain. For those owners intending to partially update a crop’s counter-cyclical yield in that situation, the Secretary is to equitably determine the yield on the grazed acreage to be used for purposes of proven yields by either assigning a yield based on the actual production for that year on similar farms that harvested grain or other method determined appropriately by the Secretary. *Conf. Report on Act Sec. 1102.*

**Establishment of base acres and payment acres for a farm.**

For the purpose of making direct and counter-cyclical payments to a farm, the Secretary is to give an owner of the farm an opportunity to elect the method by which the base acres of all covered commodities on the farm are to be determined. *Act Sec. 1101(a)(1).*

Subject to the provision requiring the base acreage to be determined based on a four-year average, including the years in which the crop was not planted, and the treatment of multiple plantings or prevented planting on the same acreage, owners may choose the farm’s acreage base by either: (1) using the acreage planted on the farm to covered commodities for harvest, grazing, haying, silage, or other similar purposes for the 1998 through 2001 crop years including any acreage on the farm that the producers were prevented from planting to covered commodities because of drought, flood, or other natural disaster, or other condition beyond the control of the producers, as determined by the Secretary or (2) contract acreage that would be used to calculate the fiscal year 2002 production flexibility contract payments and the four-year average for each oilseed produced on the farm in the 1998 through 2001 crop years.” *Conf. Report under Act Sec. 1101(a).*

The Secretary is not to exclude any crop year in which a covered commodity was not planted for purposes of determining a four-year average. *Act Sec. 1101(a)(2)(B).*

The owner of a farm may increase the eligible acreage for an oilseed on the farm by reducing the production flexibility contract acreage for one or more covered commodities on an acre-for-acre basis, except that the total base acreage for each oilseed on the farm may not exceed the four-year average of each oilseed. *Act Sec. 1101(a)(2)(C).*

For purposes of determining the four-year average of acreage planted or prevented from being planted during the 1998 through 2001 crop years to covered commodities, acreage that was planted or prevented from being planted that was devoted to another covered commodity in the same crop year may only be used in the base calculation after the owner determines whether the initial commodity or the subsequent commodity, but not both, will be used. *Act Sec. 1101(a)(4).*

As soon as practicable after enactment, the Secretary is to provide notice to owners of farms regarding their opportunity to make the applicable base election. The notice is to include—

- Notice that the opportunity of an owner to make the election is being provided only once and
- Information regarding the manner in which the election must be made and the time periods and manner in which notice of the election must be submitted to the Secretary. *Act Sec. 1101(b)(1).*

The owner may make an election of base acres only once and must provide notice of the election to the Secretary within the time period and in the manner prescribed by the Secretary. *Act Sec. 1101(b)(2).* If an owner fails to make an election of base acreage, or fails to notify the Secretary, the owner is deemed to have chosen base acres reflecting the production flexibility contract acreage, plus oilseeds if applicable. *Act Sec. 1101(c).*

The election made by the producer applies to all covered commodities on the farm. *Act Sec. 1101(d).* The Secretary is to provide for an appropriate adjustment in the base acres for covered commodities for a farm whenever land under a conservation reserve contract expires, is voluntarily terminated or is released by USDA. *Act Sec. 1101(e)(1).*

For the crop year in which a base acre adjustment is first made, the farm owner is to elect to receive either direct payments and counter-cyclical payments with respect to the acreage added to the farm or a prorated payment under the conservation reserve contract, but not both. *Act Sec. 1101(e)(2).* Payment acres for both the direct and counter-cyclical payments are to equal 85 percent of the base acres. *Act Sec. 1101(f).*

The sum of base acres, base acres for peanuts, and acreage enrolled in CRP, WRP and other conservation programs which restrict or prohibit the production of an agricultural commodity...
cannot exceed the actual cropland acreage on the farm. If it does, the Secretary is to reduce the base acres so that the total does not exceed the actual cropland acreage. Act Sec. 1101(g)(1).

The owner of the farm is to be given the opportunity to select the base acres against which the reduction is to be made. Act Sec. 1101(g)(3). The owner of a farm may reduce, at any time, base acreage for any covered commodity for the farm provided the reduction of base acreage is permanent. Act Sec. 1101(h).

The Conference Report states that the Secretary is to allow owners of a farm who did not hold a production flexibility contract under the FAIR Act of 1996 to elect to calculate base acreage for planting history on the farm for crop years 1998-2001. The intent is to provide the opportunity to update base acreage to reflect a more recent planting history, to allow owners not holding production flexibility contracts to receive farm program benefits under the 2002 Act and to allow owners holding production flexibility contracts the opportunity to retain their base acreage and add oilseeds in a “limited manner.”

The Conference Managers expect the Secretary to recognize that, although the owner of the farm will be allowed the opportunity to make the applicable base election under Section 1101, it is important that other producers on the farm be notified of the acreage options available to the owner. Therefore, in addition to providing notice to the owner of the farm, notice is to also be provided to operators or producers on the farm of the owner’s opportunity to elect the method in which to calculate base acres.

The Conference Managers are aware that production flexibility contract acreage was not protected on acreage enrolled in the CRP during CRP signup 15 or later. The Conference Managers intend that the Secretary develop a method that provides for the restoration of base acreage on farms that permanently reduced contract acreage because of CRP enrollment. Since soybeans and other oilseeds did not have contract acreage prior to the 2002 Act, the Secretary is expected to treat soybeans and other oilseeds in a manner similar to and consistent with other covered commodities.

Conf. Report under Act Sec. 1101.

Payments available under the Act. For easy reference, the commodity loan rates, direct payments and target price levels for selected crops are shown in Table 1.

### Table 1. Commodity Loan Rates, Direct Payments and Target Prices for Covered Commodities

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>Corn (bu)</td>
<td>$1.98</td>
<td>$1.95</td>
<td></td>
<td>$0.28</td>
<td>$0.28</td>
<td>$0.28</td>
<td>$2.60</td>
<td>$2.60</td>
<td>$2.63</td>
</tr>
<tr>
<td>Sorghum (bu)</td>
<td>$1.98</td>
<td>$1.95</td>
<td></td>
<td>$0.35</td>
<td>$0.35</td>
<td>$0.35</td>
<td>$2.54</td>
<td>$2.54</td>
<td>$2.57</td>
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<tr>
<td>Barley (bu)</td>
<td>$1.88</td>
<td>$1.85</td>
<td></td>
<td>$0.24</td>
<td>$0.24</td>
<td>$0.24</td>
<td>$2.21</td>
<td>$2.21</td>
<td>$2.24</td>
</tr>
<tr>
<td>Oats (bu)</td>
<td>$1.35</td>
<td>$1.35</td>
<td>$0.024</td>
<td></td>
<td></td>
<td></td>
<td>$1.40</td>
<td>$1.40</td>
<td>$1.44</td>
</tr>
<tr>
<td>Wheat (bu)</td>
<td>$2.80</td>
<td>$2.95</td>
<td>$0.52</td>
<td>$3.86</td>
<td>$3.92</td>
<td></td>
<td>$5.80</td>
<td>$5.80</td>
<td>$5.80</td>
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<tr>
<td>Soybeans (bu)</td>
<td>$5.00</td>
<td>$5.00</td>
<td>$0.44</td>
<td></td>
<td></td>
<td></td>
<td>$5.80</td>
<td>$5.80</td>
<td>$5.80</td>
</tr>
</tbody>
</table>

Direct payments. Direct payments are to be made to eligible producers on farms for which payment yields and base acres are established for each of the 2002 through 2007 crop years at the payment rates shown in Table 1. Act Sec. 1103(a), (b). The amount of the direct payment is to equal the product of the payment rate of the applicable base crop, the payment acres and the payment yield. Act Sec. 1103(c).

For 2002, the Secretary is directed to make payments as soon as practicable after the date of enactment of the Act; for 2003 through 2007 the direct payments are not to be paid before October 1 of the calendar year in which the crop of the covered commodity is harvested. Act Sec. 1103(d)(1).

A producer may elect to receive up to 50 percent of the direct payment in advance for any of the 2003 through 2007 crop years. The payments may be made in any month during the period beginning on December 1 of the calendar year before the calendar year in which the crop of the covered commodity is harvested through the month the payment would otherwise be made. The producer may change the selected month for a subsequent crop year by providing advance notice to the Secretary. Act Sec. 1103(c)(2).

If a producer who receives an advance direct payment ceases to be a producer or changes shares before the date the remainder of the direct payments are to be made, the producer must repay the applicable amount of the advance payment. Act Sec. 1103(c)(3).

The Conference Managers state in the Conference Report that the Managers are aware that producers that elect to receive up to 50 percent of an advance direct payment might cease to be a producer on the farm before the date the remainder of the direct payment is made. The Managers assume the Secretary recognizes that different reasons exist for a producer ceasing to be a producer on a farm. Those reasons would include bankruptcy, foreclosure and similar situations that would preclude the producer from repaying the advance direct payment. Specifically, the Managers would not intend for this provision to apply in situations where a producer with winter wheat harvested a crop or failed to harvest the crop for weather-related reasons beyond their control and the acreage was subsequently under the control of another producer that intended to plant a subsequent crop, or other similar situations. Conversely, the Managers expect that there are a number of situations where the producer receiving the advance direct payment ceases to be a producer on the farm and should refund the advance direct payment. Conf. Report under Act Sec. 1103.

Note on constructive receipt. Whenever federal farm program payments are payable at the election of the owner or producer in an earlier taxable year, as is the case in the 2002 Act, the Internal Revenue Service has asserted the doctrine of constructive receipt to make the payments taxable in the earliest year the payments could have been received even though the election to receive the funds earlier was not made. E.g., Rev. Rul. 68-44, 1968-1 C.B. 191. A similar situation existed under the FAIR Act of 1996 and Congress enacted legislation in 1998 making payments under that legislation not subject to constructive receipt. Pub. L. No. 105-277, Sec. 2012, 105th Cong., 2d Sess. (1998). Similar legislation to Pub. L. No. 105-277 is recommended to the Congress.

Counter-cyclical payments. Counter-cyclical payments are to be made to producers on farms for which payment yields and base acres are established with respect to a covered commodity whenever the “effective” price is less than the “target” price. Act Sec. 1104(a).

The “effective” price for a covered commodity is equal to the sum of (1) the higher of the national average market price during the 12-month marketing year for the commodity or the national average loan rate for a marketing assistance loan for the commodity and (2) the payment rate for direct payments for the commodity. Act Sec. 1104(b). The loan rate and target price appear in Table 1 supra. Act Sec. 1104(c).

The payment rate for counter-cyclical payments is equal to the difference between the target price and the effective price for the commodity. Act Sec. 1104(d). The payment amount for counter-cyclical payments is the product of the payment rate, the payment
acres and the payment yield or updated payment yield, depending upon the election of the owner of the farm. *Act Sec. 1104(e).* The counter-cyclical payments are to be made “as soon as practicable” after the end of the 12-month marketing year for the covered commodity. *Act Sec. 1104(f)(1).*

If the Secretary estimates that counter-cyclical payments will be required, the Secretary is to give producers the option to receive partial payments. For partial payments for any of the 2002 through 2006 crop years, the first partial payment for the crop is to be made not earlier than October 1, and, to the maximum extent practicable, not later than October 31 of the calendar year in which the crop is harvested. The second partial payment is to be made not earlier than February 1 of the next calendar year. The third and final partial payment is to be made as soon as practicable after the end of the 12-month marketing year for the covered commodity. *Act Sec. 1104(f)(3)(A).*

For the 2002 through 2006 crop years, the first partial payment may not exceed 35 percent of the projected counter-cyclical payment for the covered commodity for the crop year. The second partial payment may not exceed the difference between 70 percent of the revised projection of the counter-cyclical payment for the crop of the covered commodity and the amount of the first partial payment. The final payment is to equal the difference between the actual counter-cyclical payment to be made to the producer and the amount of the first and second partial payments. *Act Sec. 1104(f)(4)(A).*

For the 2007 crop year, the first partial payment is to be made after completion of the first six months of the marketing year and the second and final partial payments are to be made as soon as practicable after the end of the 12-month marketing year for the covered commodity. *Act Sec. 1104(f)(3)(B).*

The first partial payment, for the 2007 crop year, may not exceed 40 percent of the projected counter-cyclical payment. The final payment is to equal the difference between the actual counter-cyclical payment to be made to the producer and the amount of the partial payment. *Act Sec. 1104(f)(4)(B).* The producer must repay the amount, if any, by which the partial payments exceed the counter-cyclical payment to be made in that crop year. *Act Sec. 1104(f)(5).*

**Required producer agreement.** Before producers may receive direct payments or counter-cyclical payments, the producers must agree, in exchange for the payments, to comply with applicable conservation requirements, applicable wetland protection requirements, planting flexibility requirements, use the base acres for an agricultural or conserving use and not for a non-agricultural commercial or industrial use and, on non-cultivated land attributable to the base acres, control noxious weeds and otherwise maintain the land in accordance with sound agricultural practices. *Act Sec. 1105(a)(1).*

The Secretary, at the request of the transferee or owners, may modify these requirements if the modifications are consistent with the objectives of this provision. *Act Sec. 1105(a)(3).*

A transfer of or change in the interest of a producer in base acres for which direct or counter-cyclical payments are made is to result in the termination of the payments with respect to base acres unless the transferee or owner agrees to assume all obligations under conservation, wetlands, planting flexibility, agriculture land use provisions and noxious weed control provisions. The termination date is determined by the Secretary. *Act Sec. 1105(b)(1).*

The Conference Report states that when there is a transfer (or change in) the interest of a producer in base acres for which direct or counter-cyclical payments are made, the intent is that the time frame for the succession to occur is to be “farmer-friendly.” *Conf. Report Under Act Sec. 1105(a).* If a producer entitled to a direct or counter-cyclical payment dies, becomes incompetent or is otherwise unable to receive payment, the payments are to be made as provided in regulations. *Act Sec. 1105(b)(2).*

A producer who receives direct payments, counter-cyclical payments or marketing loan benefits is required to submit annual acreage reports with respect to all land on the farm. *Act Sec. 1105(c).*

The Conference Report states that acreage reports provide important information for assisting in determining the eligibility of land to be accepted into the CRP. The Managers are aware that, in prior years, penalties have been imposed on producers submitting acreage reports found later to be inaccurate. The Managers understand that, under prior acreage limiting and acreage reduction programs, there was a need for very accurate reporting. However, under the 2002 Act, with the exception of determining the amount of fruits, vegetables and wild rice planted on base acreage, there is no need or requirement for that level of accuracy. Therefore, the Managers do not intend for any penalty to be applicable to inaccurate acreage reports on covered commodities or peanuts provided the producer has made a good faith effort accurately to report acreage. *Conf. Report Under Act Sec. 1105(c).*

The Secretary is to provide “adequate safeguards” to protect the interests of tenants and sharecroppers. *Act Sec. 1105(d).* Direct and counter-cyclical payments are to be shared among producers on a farm on a fair and equitable basis.” *Act Sec. 1105(e).*

**Planting flexibility.** In general, any commodity or crop may be planted on base acres on a farm. *Act Sec. 1106(a).*

However, the planting of fruits and vegetables produced on trees or other perennials is prohibited on base acres and the planting of fruits, vegetables (other than lentils, mung beans and dry peas) and wild rice is prohibited on base acres unless the commodity, if planted, is destroyed before harvest. *Act Sec. 1106(b).*

Those restrictions do not apply—

- In any region where there is a history of double-cropping of covered commodities with the commodities specified in the Act Sec. 1106(b);
- On a farm with a history of planting the commodities specified in the Act Sec. 1106(b) except that direct payments and counter-cyclical payments are to be reduced by an acre for acre planted to such an agricultural commodity; or
- On a farm with a planting history of a commodity specified in the Act Sec. 1106(b) except that the quantity planted may not exceed the average annual planting history of the commodity on the farm in the 1991-1995 period or 1998-2001 crop years (excluding crop years in which no plantings were made) and direct payments and counter-cyclical payments are reduced by an acre for each acre planted to such agricultural commodity. *Act Sec. 1106(c).*

For the 2002 crop year, if the calculation of base acres results in total base acres for a farm in excess of the contract acreage for the farm that was used to calculate the fiscal year 2002 payment, the planting of fruits, vegetables and wild rice on new base acres is allowed, provided the direct and counter-cyclical payments for the 2002 crop year are reduced on an acre-for-acre basis. *Act Sec. 1106(d).*

**Payment authority under the FAIR Act of 1996.** The authority to make production flexibility contract payments under the FAIR Act of 1996 is terminated as of the date of enactment of
the 2002 Act unless requested by a producer who is a party to the contract. **Act Sec. 1107(a).** In that event, the amount of the producer’s direct payment for fiscal year 2002 is reduced by the amount of the production flexibility contract payment. **Act Sec. 1107(b).**

**Marketing Assistance Loans.**

**Eligibility.** Non recourse marketing assistance loans are to be made available for producers for commodities produced on the farm including extra long staple cotton, wool, mohair, honey, dry peas, lentils and small chick peas for each of the 2002 through 2007 crop years. **Act Sec. 1201(a).** Producers on a farm are eligible for a marketing assistance loan for any quantity of a loan commodity produced on the farm. **Act Sec. 1201(b).**

The Conference Report states that loan commodities harvested for hay and silage and unshorn pelts are eligible only for a loan deficiency payment. **Conf. Report Under Act Sec. 1201.**

Producers that would otherwise be eligible but for the fact that the covered commodity is commingled with covered commodities of other producers in facilities unlicensed for the storage of commodities are eligible if the producer obtaining the loan agrees to redeem the loan collateral immediately. **Act Sec. 1201(c).** Producers are required to comply with applicable conservation requirements and applicable wetland protection requirements as a condition to receiving marketing loan assistance. **Act Sec. 1201(d).**

Authority for marketing assistance loans under the FAIR Act of 1996 cannot be used for the 2002 crop of loan commodities. **Act Sec. 1201(e).**

The Conference Report states that, beginning with the 2002 crop, the Managers intend for marketing loan and loan deficiency program benefits to be made available for all farms producing loan commodities regardless of whether the farm does or does not have base acreage. **Conf. Report Under Act Sec. 1201.**

**Loan rates.** The loan rates are as shown in Table 1 supra. **Act Sec. 1202.**

The Conference Report states that the Managers anticipate that the Secretary will take advantage of the change in national average loan rates to review and adjust, as appropriate, the county loan rates. To the extent practicable, for purposes of making loans and loan deficiency payments, the Secretary should designate loan rates “in those units that are consistent with the units in common usage in the industry.” The Conference Report also states that the provision for non-graded wool be made available for wool that has not been objectively measured for fiber diameter (micron) and yield. Documentation of objective measurement is commonly known as a core test, which is available through laboratory analysis. It is the intent of the Managers that the Secretary provide the graded wool rate to wool that meets the terminology used by the wool industry to define graded wool, such as core tested. **Conf. Report Under Act Sec. 1202.**

**Term of loans.** The term for marketing assistance loans is nine months beginning on the first day of the first month after the month in which the loan is made. **Act Sec. 1203(a).** The Secretary may not extend the term of a marketing assistance loan. **Act Sec. 1203(b).**

**Repayment of loans.** Producers of loan rate commodities (other than upland cotton, rice and extra long staple cotton), including wheat, corn, grain sorghum, barley, oats, soybeans, other oilseeds, dry peas, lentils, small chickpeas, wool, mohair and honey, are to repay a marketing assistance loan at a rate that is the lesser of the loan rate for the commodity plus interest or a rate that the Secretary determines will minimize forfeitures, accumulations of stocks, and storage costs; will allow the commodity to be marketed freely and competitively; and will minimize discrepancies in marketing loan benefits across state boundaries and county boundaries. **Act Sec. 1204(a).**

Producers of upland cotton and rice are to repay a marketing assistance loan at a rate that is the lesser of the loan rate for the commodity plus interest or the prevailing “world market price” (adjusted to U.S. quality and location), as determined in accordance with Section 163 of the FAIR Act of 1996. **Act Sec. 1204(b).**

Producers of extra long staple cotton can repay a marketing assistance loan at the loan rate plus interest as determined in accordance with Section 163 of the FAIR Act of 1996. **Act Sec. 1204(c).**

The Secretary is to prescribe by regulation the formula to determine the prevailing world market price for upland cotton and rice and a mechanism to announce the price periodically. **Act Sec. 1204(d).**

**Beneficial interest.** For the 2001 crop only, in the case of a producer who marketed or lost beneficial interest before repaying the loan, the Secretary is to permit the producer to repay the loan at the appropriate repayment rate that was in effect for the loan commodity as of the date the producer lost beneficial interest if the Secretary determines the producer acted in good faith. **Act Sec. 1204(f).**

**Conference Report on minor crop loan and repayment rates.**

The Conference Report states that, in determining loan repayment rates for loan commodities other than upland cotton and rice, the Secretary is to consider alternative methodologies, including establishing the Posted County Prices for grains and oilseeds at levels that reflect market prices at both terminal markets for counties with two terminal markets. The Secretary is expected to determine whether assigning equal weight to two terminal markets will better reflect local market prices than the current system of using the higher of the two terminal markets to establish the Posted County Price.

In implementing the marketing assistance loan for minor oilseeds, the Secretary is expected to establish a single sunflower loan rate in each county for oil-type, confection and other-type sunflowers combined. The Secretary is also expected to continue to announce weekly loan repayment rates for sunflowers reflecting local market prices that minimize potential loan forfeitures. Accordingly, sunflower seed loan repayment rates should reflect oil-type sunflower seed local market prices.

The Conference Report notes that a marketing assistance loan program has been established for pulse crops—dry peas, lentils and small chickpeas. The loan rate for dry peas is based on U.S. feed pea prices; the loan rate for lentils is based on the price of U.S. No. 3 lentils; and the loan rate for small chickpeas is based on the prices of chickpeas that drop below a 20/64 screen. Accordingly, the Secretary is expected to calculate regional pulse loan rates and repayment rates based on the prices of feed peas, No. 3 lentils and chickpeas that drop below a 20/64 screen. **Conf. Report Under Act Sec. 1204.**

**Loan deficiency payments.** The 2002 Act provides for the continuation of loan deficiency payments to producers who, although eligible for a marketing assistance loan, agree to forego a loan in favor of receiving an LDP. **Act Sec. 1205(a)(1).**

Non-graded wool in the form of unshorn pelts, hay and silage derived from a loan commodity are not eligible for a marketing assistance loan. However, the commodities are eligible for loan...
deficiency payments when unshorn pelts, hay or silage are derived from a loan commodity. *Act Sec. 1205(a)(2).*

The loan deficiency payment is determined by multiplying the payment rate by the quantity of the loan commodity produced, excluding any commodity for which the producer obtained a loan. *Act Sec. 1205(b).* The payment rate is the amount by which the loan rate exceeds the rate at which the loan may be repaid. *Act Sec. 1205(c)(1).*

The loan deficiency payment for unshorn pelts is based on the rate in effect for ungraded wool and the LDP for hay and silage is based on the loan commodity from which the hay and are derived. *Act Sec. 1205(c)(2), (3).* Loan deficiency payments do not apply to long staple cotton. *Act Sec. 1205(d).* A loan deficiency payment rate is to be based on the date the producer requests the payment. *Act Sec. 1205(e).*

For the 2002 crop of wool, mohair, honey, dry peas, lentils and small chickpeas (the “first-time” loan commodities) that would be eligible for a LDP except for the fact that the producer lost beneficial interest in the crop prior to the date of publication of the regulations implementing this provision, the producers are eligible for a LDP payment as of the date the producer marketed or otherwise lost beneficial interest in the crop. *Act Sec. 1205(f)(1).*

The legislation provides for loan deficiency payments on crop year 2001 commodities on farms that do not have an AMTA contract. The Secretary is to make payment on the date the producer marketed or lost beneficial interest in the loan commodity or the date the producer requested payment. *Act Sec. 1205(f)(2).*

**Payments in lieu of LDPs for grazed acreage.** For the 2002 through 2007 crop years, for a producer who would be eligible for a LDP for wheat, barley or oats, but who elects to use acreage planted to wheat, barley or oats for the grazing of livestock, a LDP payment may be made if the producer enters into an agreement to forego any other harvesting of the wheat, barley or oats on that acreage. *Act Sec. 1206(a)(1).*

Likewise, for the 2002 through the 2007 crop years, a producer on a farm who uses acreage planted to triticale for the grazing of livestock may receive a LDP if the producer enters into an agreement to forego any other harvesting of triticale on that acreage. *Act Sec. 1206(a)(2).*

The amount of payment is equal to the amount determined by multiplying the LDP payment rate in effect, as of the date of the agreement, for the county in which the farm is located, by the payment quantity (determined by multiplying the quantity of the grazed acreage on the farm with respect to which the producer elects to forego harvesting of wheat, barley or oats and the payment yield in effect for the calculation of direct payments with respect to that loan commodity on the farm or, in the case of a farm without a payment yield for that loan commodity, an appropriate yield established by the Secretary). *Act Sec. 1206(b)(1).* A similar formula is prescribed for the triticale LDP. *Act Sec. 1206(b)(2).*

The Conference Report states that, for purposes of determining the LDP on triticale acreage, the Secretary is to take into account the predominant class of wheat grown in the county in which the farm is located. *Conf. Report Under Act Sec. 1206(b)(2).*

The legislation makes it clear that, for the 2002 through the 2007 crops of wheat, barley, oats or triticale planted on acreage that the producer elects to use for the grazing of livestock, the producer is not eligible for a Federal Crop Insurance Act indemnity. *Act Sec. 1206(d).*

**Special marketing loan for upland cotton.** Through July 31, 2008, the special marketing loan provisions for upland cotton remain unchanged including provisions relating to cotton user marketing certificates, special impact quota and the limited global import quota for upland cotton. *Act Sec. 1207.*

**Special competitive provisions for extra long staple cotton.** Through July 31, 2008, the special competitive provisions for extra long staple cotton remain unchanged including provisions relating to the competitiveness program, payments under the program, eligibility and the amount and form of payment. *Act Sec. 1208.*

**Recourse loans for high moisture feed grains and seed cotton and other fibers.** The availability of recourse loans for high moisture feed grains and seed cotton remains unchanged for the 2002 through 2007 crops. Loans are determined by multiplying the acreage in a high moisture state on the farm by the lower of the farm program payment yield used for counter-cyclical payments or the actual yield. *Act Sec. 1209.*

**Dairy.**

**Milk Price Support Program.** The Milk Price Support Program is authorized from June 1, 2002, through December 31, 2007, at a rate of $9.90/cwt on a 3.67 percent milk fat basis. *Act Sec. 1501(a), (b).*

The purchase prices for butter and nonfat dry milk powder may be allocated so as to minimize expenditures from the Commodity Credit Corporation. The Secretary may modify purchase prices for butter and nonfat dry milk not more than twice per year. *Act Sec. 1501(d).*

**National dairy market loss payments.** The legislation establishes a national payment program using a payment formula under which participating dairy producers will receive monthly payments equal to 45 percent of the difference between $16.94 and the price per hundredweight of Class I fluid milk in Boston under the applicable federal milk marketing order. No payments will be made for months during which the fluid milk price in Boston is $16.94 or higher. *Act Sec. 1502(b), (c).*

Producers on a “single dairy operation” may receive payments on no more than 2.4 million pounds of milk marketed per year. *Act Sec. 1502(d)(2).* The Secretary is to issue regulations to insure that a producer does not “reconstitute” a dairy operation for the sole purpose of receiving additional payments. *Act Sec. 1502(d)(3).*

On that point, the Conference Report states that previous Dairy Market Loss Assistance Programs provided discretion to the Secretary to limit payments to individual dairy operations. It is the intent of the Managers that this program be administered in the same manner, thereby limiting payments on an operation-by-operation basis. Accordingly, a producer might qualify for separate limits on separate operations. The Managers intend that, in carrying out this section, the Secretary utilize information available through the Agricultural Marketing Service monthly milk marketings by producers. *Conf. Report Under Act Sec. 1502(d).*

Payments will be made not later than 60 days after the end of each month for which a payment is made. Retroactive payments will be made covering market losses due to low prices since December 1, 2001. *Act Sec. 1502(e), (f).* Producers are to enter into contracts covering eligible production marketed by the producers on the dairy farm during the period starting with the first day of the month the contract is entered into and ending on September 30, 2005. *Act Sec. 1502(g)(1).*
Violations may result in contract termination or repayment of a portion of the payments received. **Act Sec. 1502(g)(2).**

The Secretary is charged with conducting a study of the effects of terminating all federal programs relating to price support and supply management for milk and granting the consent of Congress to cooperative efforts by states to manage milk prices and supply. **Act Sec. 1508(a).**

**Administration of programs (selected provisions)**

Effect of 1938 and 1949 legislation. The legislation suspends the relevant provisions of the Agricultural Adjustment Act of 1938 and the Agricultural Act of 1949 applicable otherwise to the 2002 through 2007 crops of covered commodities. **Act Sec. 1602.**

**Payment limitations.** Under the 2002 Act, the total direct and counter-cyclical payments to a “person” for corn, grain sorghum, barley, oats, wheat, soybeans, minor oilseeds, cotton and rice per crop year may not exceed $40,000 and $65,000, respectively. **Act Sec. 1603(a), amending 7 U.S.C. § 1308.** The payment limitation for peanuts for direct and counter-cyclical payments is also $40,000 and $65,000, respectively. **Act Sec. 1603(a), amending 7 U.S.C. § 1308.** The limit on marketing loan gain and loan deficiency payments for corn, grain sorghum, barley, oats, wheat, soybeans, minor oilseeds, cotton, rice, lentils, dry peas and small chickpeas that a “person” is entitled to receive is $75,000. **Act Sec. 1603(a), amending 7 U.S.C. § 1308.**

The legislation provides for a separate marketing loan gain and loan deficiency payment limitation for peanuts, wool, mohair, and honey of $75,000 per person. **Act Sec. 1603(a), amending 7 U.S.C. § 1308.**

The 2002 Act contains a limitation based on “adjusted gross income” which specifies that an individual or entity is not eligible for any program benefit during a crop year if the average adjusted gross income of the individual or entity exceeds $2,500,000 unless not less than 75 percent of the average adjusted gross income of the individual or entity is derived from farming, ranching or forestry operations. **Act Sec. 1604, adding 7 U.S.C. § 1308-4.**

The benefits limited by the adjusted gross income limit are direct payments, counter-cyclical payments, marketing loan gains, LDPs and conservation (Title II of the 2002 Act and Title XII of the Food Security Act of 1985 (conservation)). **Act Sec. 1604, adding 7 U.S.C. § 1308-4.** Note that the reference in the Act to Sec. 1001(d) of the Food Security Act of 1985 appears to be in error. It is believed to be Sec. 1001(1)(D) of the Food Security Act of 1985.

For benefits made in a crop year to an entity, general partnership or joint venture, the amount of the benefit is to be reduced by an amount which is commensurate with the direct and indirect ownership interest in the entity, general partnership or joint venture of each individual who has an average adjusted gross income in excess of the $2,500,000 limitation for the average of the three preceding crop years. **Act Sec. 1604, adding 7 U.S.C. § 1308-4.**

To comply with the limitation, an individual or entity must provide to the Secretary a certification by a certified public accountant “or another third party that is acceptable to the Secretary” that the average adjusted gross income of the individual or entity does not exceed the limitation. **Act Sec. 1604, adding 7 U.S.C. § 1308-4.**

Note, however, that this limitation applies only during the 2003 through 2007 crop years. **Act Sec. 1604, adding 7 U.S.C. § 1308-4.**

**Commission on Payment Limits.** The legislation provides for a “Commission on the Application of Payment Limitations for Agriculture.” The Commission is to report not later than one year after enactment of the 2002 Act. **Act Sec. 1605.**

**Assignment of payments.** Under the 2002 Act, producers may assign any payments received under the Act by providing notice in the manner prescribed by the Secretary. **Act Sec. 1612.**

**Hard white wheat incentive payments.** The legislation provides for the 2003 through 2005 crop years a total of $20 million in incentive payments to growers who demonstrate that buyers and end-users are available for the wheat to be covered by the incentive payment. **Act Sec. 1616.**

**Market loss assistance for apple and onion producers.** The legislation provides $94 million to apple producers for the loss of markets during the 2000 crop year and $10 million as a grant to onion producers in Orange County, New York, who suffered losses to onion crops during one or more of the 1996 through 2000 crop years. **Act Secs. 10105, 10106.**

**Assistance for livestock producers.** Authorization is included (but funds are not appropriated) for assistance to livestock producers in the form of indemnity payments for mortality losses, livestock feed assistance for feed shortages, compensation for sudden increases in production costs and such other assistance as the Secretary considers appropriate. **Act Sec. 10104.**

**Availability of market loss assistance and emergency assistance to persons who failed to receive assistance.** The legislation provides authority to use CCC funds for paying market loss assistance and emergency assistance to persons who failed to receive assistance before October 1, 2001. **Act Sec. 1617.**

**Title II—Conservation**

**Conservation Security Program.** The legislation establishes the Conservation Security Program (CSP) for fiscal years 2003 through 2007 to assist producers in implementing various conservation practices as applicable for each individual operation. **Act Sec. 2001, adding Food Security Act of 1985, Sec. 1238A(a).**

**Eligible lands.** Eligible lands include private cropland, grassland, prairie land, pasture land, private forest land that is an incidental part of a farming operation and land under the jurisdiction of an Indian tribe. **Act Sec. 2001, adding Food Security Act of 1985, Sec. 1238A(b)(2).** Lands enrolled in the CRP, WRP or the Grasslands Reserve Program (GRP) are not eligible for enrollment nor are lands that have not been cropped for more than four out of the past six years. **Act Sec. 2001, adding Food Security Act of 1985, Sec. 1238A(b)(3).**

**Allowed economic use.** Producers are allowed to make economic uses of the land that—(1) maintain the agricultural nature of the land and (2) are consistent with the natural resource and conservation objectives of the program. **Act Sec. 2001, adding Food Security Act of 1985, Sec. 1238A(b)(4).**

**Tiers of conservation security contracts.** The Secretary is to establish and offer to producers three tiers of conservation contracts under which payments may be received. **Act Sec. 2001, adding Food Security Act of 1985, Sec. 1238A(d)(1)(A).**

The tiers are specified in the 2002 Act as follows—
- A tier I CSP contract is to be for a period of five years and includes conservation practices appropriate for the agricultural operation that, at a minimum, address at least one “significant resource of concern for the enrolled portion of the agricultural operation at a level that meets the appropriate non degradation standard” and covers “active management of the conservation...
practices that are implemented or maintained under the conservation security contract.”

- A tier II CSP contract is to be for a period of not less than five nor more than 10 years and includes conservation practices appropriate for the agricultural operation that, at a minimum, address at least one significant resource of concern for the entire agricultural operation at a level that meets the appropriate non-degradation standard and covers active management of conservation practices that are implemented or maintained under the conservation security contract.

- A tier III CSP contract is to be for a period of not less than five nor more than 10 years and includes conservation practices appropriate for the agricultural operation that, at a minimum, apply a resource management system that meets the appropriate non-degradation standard for all resources of concern of the entire agricultural operation and covers active management of conservation practices that are implemented or maintained under the conservation security contract. Act Sec. 2001, adding Food Security Act of 1985, Sec. 1238A(d)(5).

**Permissible practices.** Conservation practices that may be implemented by a producer under a conservation security contract include—(a) nutrient management; (b) integrated pest management; (c) water conservation and water quality management; (d) grazing, pasture and rangeland management; (e) soil conservation, quality and residue management; (f) invasive species management; (g) fish and wildlife habitat conservation, restoration and management; (h) air quality management; (i) energy conservation measures; (j) biological resource conservation and regeneration; (k) contour farming; (l) strip cropping; (m) cover cropping; (n) controlled rotational grazing; (o) resource-conserving crop rotation; (p) conversion of portions of cropland from a soil-depleting use, including production of cover crops; (q) partial field conservation practices; (r) native grassland and prairie protection and restoration; and (s) any other conservation practices determined by the Secretary to be appropriate and comparable to other conservation practices listed. Act Sec. 2001, adding Food Security Act of 1985, Sec. 1238A(d)(4).

**Contract renewals.** A conservation security contract may be renewed for an additional term of not less than five nor more than 10 years except that, in the case of Tier I renewals, the producer may renew the contract only if the producer agrees—

- To apply additional conservation practices that meet the non-degradation standard on land already enrolled in the conservation security program, or
- To adopt new conservation practices with respect to another portion of the agricultural operation that address resource concerns and meet the non-degradation standard under the terms of the Tier I conservation security contract. Act Sec. 2001, adding Food Security Act of 1985, Sec. 1238A(e)(4).

**Violations.** A producer will not be considered in violation of a conservation security contract for failure to comply due to circumstances beyond the control of the producer including a disaster or related condition. Act Sec. 2001, adding Food Security Act of 1985, Sec. 1238A(f).

**Producer responsibilities.** A producer, under the terms of a conservation security contract, must agree—

- To implement the conservation security plan as approved by the Secretary;
- Maintain and make available appropriate records showing the effective and timely implementation of the conservation security contract;
- Not engage in any activity that would interfere with the purposes of the program; and
- On violation of a term or condition of the contract, forfeit all rights to payments and refund payments as determined by the Secretary. Act Sec. 2001, adding Food Security Act of 1985, Sec. 1238B.

**Payment guidelines.** The guidelines for payment include the following—

- For Tier I contracts, an amount equal to five percent of the “applicable base payment for land covered by the contract,” an amount not exceeding 75 percent (90 percent for a beginning farmer) of the average county costs of practices and an “enhanced payment” for additional enumerated practices;
- For Tier II practices, an amount equal to 10 percent of the “applicable base payment for land covered by the conservation security contract,” an amount not exceeding 75 percent (90 percent for a beginning farmer) of the average county cost of adopting or maintaining practices and an enhanced payment for additional enumerated practices; and
- For Tier III contracts, an amount equal to 15 percent of the “base payment for land covered by the conservation security contract,” an amount that does not exceed 75 percent (90 percent for a beginning farmer) of the average county cost of adopting or maintaining practices and an enhanced payment for additional enumerated practices. Act Sec. 2001, adding Food Security Act of 1985, Sec. 1238C(b)(1)).

The annual payments to an individual or entity cannot exceed $20,000 under a tier I contract, $35,000 under a tier II contract or $45,000 under a tier III contract. Act Sec. 2001, adding Food Security Act of 1985, Sec. 1238C(b)(2).

**Prohibited payments.** A payment to a producer is not to be provided for construction or maintenance of animal waste storage or treatment facilities or associated waste transport or transfer devices for animal feeding operations or the purchase or maintenance of equipment or a non-land based structure that is not integral to a land-based practice. Act Sec. 2001, adding Food Security Act of 1985, Sec. 1238C(b)(3).

**Safeguards for tenants and sharecroppers.** Regulations are to be promulgated to provide adequate safeguards to protect the interests of tenants and sharecroppers on a fair and equitable basis. Act Sec. 2001, adding Food Security Act of 1985, Sec. 1238C(d).

**Transfer of interests in land.** Unless duties and rights are transferred to and assumed by the transferee, a transfer or change in interest of a producer in land results in the termination of a conservation security contract. Act Sec. 2001, adding Food Security Act of 1985, Sec. 1238C(e).

**Beginning farmers and ranchers.** Incentives may be provided to beginning farmers and ranchers, Indian tribes and limited resource agricultural producers to participate in conservation programs to (a) foster new farming and ranching opportunities and (b) enhance environmental stewardship over the long-term. Act Sec. 2004, adding Food Security Act of 1985, Sec. 1244(a).

**Privacy of personal information relating to natural resources conservation programs.** The 2002 Act specifies that information received for technical and financial assistance with respect to any natural resources conservation program that is considered proprietary to the agricultural operation or land is not considered to be public information except for the availability of payment information under 5 U.S.C. § 552. Act Sec. 2004, adding Food Security Act of 1985, Sec. 1244(b).
CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr.

BANKRUPTCY

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 trial and appellate courts 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, 2002-1 U.S. Tax Cas. (CCH) § 50,257 (S. Ct. 2002), aff'd, 233 F.3d 56 (1st Cir. 2000). The IRS has issued a notice that the three year period should not include an additional six months, based on I.R.C. § 6503(h), as the IRS has claimed in several prior bankruptcy cases. CC-2002-023.

CORPORATIONS


FEDERAL AGRICULTURAL PROGRAMS

COTTON. The CCC has issued proposed regulations for the upland cotton non-recourse loan and loan deficiency payment programs and the seed cotton loan program that would: (1) require that lists of cotton bales provided to the CCC as the basis for loan deficiency payments be submitted in an electronic format provided by CCC; (2) require that cotton classification information be provided to CCC as a condition of eligibility for a marketing assistance loan or loan deficiency payment for such cotton; (3) change the effective time of the announced world market price for upland cotton from 5 p.m. eastern time each Thursday to 12:01 a.m. eastern time each Friday; (4) provide for CCC to use Electronic Agent Designations when authorized by a producer as the basis for loan redemptions and release of loan collateral; (5) establish that any quantity of cotton for which a seed cotton loan is requested cannot be subject at the same time to a request for a loan deficiency payment or lock-in of the adjusted world price; (6) establish that for a bale of cotton to be eligible for a loan or loan deficiency payment it shall not be compressed to a density defined as a flat or modified flat bale by the Joint Cotton Industry Bale Packaging Committee; and (7) remove and reserve all regulations that provide for the Upland Cotton First Handler Marketing Certificate Program. 67 Fed. Reg. 31151 (May 9, 2002).

FEDERAL ESTATE AND GIFT TAX

CREDIT FOR TAX ON PRIOR TRANSFERS. The decedent received an interest in trust in property from the estate of a predeceased spouse who died within two years before the death of the decedent. The predeceased spouse’s executor elected to treat a portion of the trust as QTIP and claimed a marital deduction for the value of the QTIP interest. The decedent’s executor claimed a credit for the tax on the value of the portion of the trust for which a QTIP election was not made and no marital deduction was claimed. In a Chief Counsel Advice letter, the IRS ruled that, for purposes of calculating the tax on prior transfers credit, the value of property transferred by one spouse to the other included the entire value of the QTIP portion of the marital trust plus the value of the spouse’s life income interest in the non-QTIP portion of the marital trust. CCA Ltr. Rul. 200218003, Jan. 7, 2002.

DISCLAIMERS. The decedent had received money from a predeceased brother’s estate and used the money to purchase certificates of deposit. The decedent executed a disclaimer of the remainder interest in the money and retained an interest in the income from the money. The decedent received the income from the CDs and did not receive any of the principal. The decedent’s estate excluded the CDs from the decedent’s gross estate, but the IRS ruled that the disclaimer was invalid, under Treas. Reg. § 25.2518-3(b), because the decedent retained an income interest in the property disclaimed. The decedent’s executor argued that the regulation was invalid because the statute, I.R.C. § 2518(a), allows disclaimers of “any interest in property” and I.R.C. § 2518(c) allows disclaimers of undivided portions of property, both of which would include a remainder interest. The court disagreed, holding that the regulation was a valid interpretation of the statute. The court noted that the disclaimer of the remainder did not remove the property from the decedent’s control because the remainder property still produced income which was received by the decedent. Walshire v. United States, 2002-1 U.S. Tax Cas. (CCH) ¶ 60,439 (8th Cir. 2002).
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 fixtures included a the lunchroom, pole barn, cold storage units, elb scan room, well, nut bin, shop and storage building, steel equipment cover, fumigation chamber, water tanks, and asphalt paving. The Tax Court originally held that, under California law, a tenant had the right to remove business fixtures during the term of the lease. The Tax 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 Tax 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. On remand, the Tax Court held that the improvements were trade fixtures if the improvements could be removed without injury to the premises and the improvements had become an integral part of the premises. The court held that the lunchroom, pole barn, cold storage units, elb scan room, well, nut bin, shop and storage building, steel equipment cover, and asphalt paving were all not trade fixtures because the items had become integral parts of the premises. The court also held that the fumigation chamber and water tanks were removable trade fixtures and not included in the decedent’s estate. Estate of Frazier v. Comm’r, T.C. Memo. 2002-120, on rem from, 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]. The IRS has issued the 2002 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>
</tr>
</thead>
<tbody>
<tr>
<td>Omaha/Spokane</td>
<td>7.77</td>
</tr>
<tr>
<td>Sacramento</td>
<td>7.66</td>
</tr>
<tr>
<td>St. Paul</td>
<td>7.88</td>
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<tr>
<td>Springfield</td>
<td>8.16</td>
</tr>
<tr>
<td>Texas</td>
<td>7.80</td>
</tr>
<tr>
<td>Wichita</td>
<td>7.96</td>
</tr>
</tbody>
</table>


FEDERAL INCOME TAXATION

ACCOUNTING METHOD. The IRS has issued procedures for some corporations to obtain expeditious approval of a change in annual accounting period from or to a 52-53 week tax year. Changes from the previous revenue procedure, Rev. Proc. 2000-11, 2000-3 CB 309, include (1) waiver of only certain scope restrictions for changes to (or from) a 52-53-week taxable year that references the same calendar month; (2) reduction of the period of time required between a prior accounting period change and a change effected under this revenue procedure from 6 calendar years to 48 months; (3) addition to the list of accounting period changes that will not be considered prior changes for purposes of the 48-month rule: (a) a change to comply with Treas. Reg. § 1.1502-75, (b) any prior change made by a corporation whose majority shareholder has changed its taxable year within the last 12 months if the corporation wants to change to that shareholder's taxable year in order to file consolidated financial statements, and (c) a change to a required taxable year or an ownership taxable year; (4) provision that, in certain cases in which a partnership is owned 50 percent by each of two partners, the corporate partner's interest in the partnership will be disregarded; and (5) addition of a term and condition to prevent the carryback of capital losses generated in the short period. Rev. Proc. 2002-37, I.R.B. 2002-22.

The IRS has issued procedures for certain partnerships, S corporations, electing S corporations and personal service corporations (PSCs) to obtain automatic approval to adopt, change, or retain their annual accounting period under I.R.C. § 442 and Treas. Reg. § 1.442-1(b). Entities complying with these guidelines will be deemed to have established a business purpose for the adoption, change, or retention to the satisfaction of the IRS. Changes from the previous revenue procedure, Rev. Proc. 87-32, 1987-2 C.B. 396, include (1) allowing, in appropriate circumstances, a partnership, S corporation, electing S corporation, or PSC to adopt, change to, or retain a 52-53-week taxable year ending with reference to the required taxable year, natural business year, or ownership taxable year; (2) allowing any partnership, S corporation, electing S corporation, or PSC to automatically change from a 52-53-week taxable year to a non-52-53-week taxable year that ends with reference to the same calendar month, and vice versa; (3) allowing a partnership that would be required to change its taxable year because of a minor percentage change in ownership to retain its current taxable year for one year, subject to certain circumstances; and (4) reducing the period of time required between a prior accounting period change and a change effected under this revenue procedure from 6 calendar years to 48 months, and provides that a change to a required or ownership taxable year, and a change to (or from) a 52-53-week taxable year from (or to) a non-52-53-week taxable year ending with reference to the same calendar month, will not be considered changes within the most recent 48-month period. Rev. Proc. 2002-38, I.R.B. 2002-22.

The IRS has issued a revenue procedure that provides guidance on the general methods under I.R.C. § 442 and Treas. Reg. § 1.442-1(b) for establishing a business purpose and obtaining IRS approval to adopt, change or retain an annual accounting period for federal income tax purposes. Rev. Proc. 2002-39, I.R.B. 2002-22.

The IRS has a revenue procedure with a safe harbor method of accounting for capital cost reduction (CCR) payments with

The IRS has adopted as final regulations which include the general rules for the period for computing tax 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 rules also define “required taxable year,” identify entities that have such a year and clarify the applicable exceptions. In addition, the 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. 67 Fed. Reg. 35009 (May 17, 2002).

COURT AWARDS AND SETTLEMENTS. The taxpayer was hired by a new employer and resigned from the taxpayer’s current employment. The new employer rescinded the employment offer and the old employer refused to rehire the taxpayer. The taxpayer negotiated with the new employer for compensation and received nine months’ salary and a positive employment reference from the new employer. The court held that the payment was in the nature of severance pay and was included in the taxpayer’s income. Collins v. Comm’r, T.C. Memo. 2002-115.

The taxpayers were partners in a partnership which owned a fishing corporation. The corporation had filed a claim with its insurance company over the loss of a boat. Before the claim was settled, the taxpayers sold the corporation. The sales agreement assigned the insurance claim to the taxpayers. After the sale was competed, the insurance claim was settled and the taxpayers reported the proceeds as capital gain because the proceeds were received as part of the sale of the corporation. The court held that the insurance claim was separate from the sale of the corporation and was to be reported as ordinary income. Steel v. Comm’r, T.C. Memo. 2002-113.

DISASTER PAYMENTS. On May 1, 2002, the president determined that certain areas in Maryland were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of a storm on April 28, 2002. FEMA-1409-DR. On May 6, 2002, the president determined that certain areas in West Virginia were eligible for assistance under the Act as a result of severe storms, flooding and landslides on May 2, 2002. FEMA-1410-DR. On May 5, 2002, the president determined that certain areas in Virginia were eligible for assistance under the Act as a result of severe storms, tornadoes and flooding on April 28, 2002. FEMA-1411-DR. On May 6, 2002, the president determined that certain areas in Missouri were eligible for assistance under the Act as a result of severe storms and tornadoes on April 24-28, 2002. FEMA-1412-DR. On May 6, 2002, the president determined that certain areas in Michigan were eligible for assistance under the Act as a result of flooding on April 15, 2002. FEMA-1413-DR. Accordingly, a taxpayer who sustained a loss attributable to these disasters may deduct the loss on his or her 2001 federal income tax return.

EMPLOYEE BENEFITS. The IRS has issued proposed regulations that would provide guidance on compensation deferred under eligible I.R.C. § 457(b) deferred compensation plans of state and local governmental and tax-exempt entities. The regulations reflect the changes made to I.R.C. § 457 by the Tax Reform Act of 1986, the Small Business Job Protection Act of 1996, the Taxpayer Relief Act of 1997, the Economic Growth and Tax Relief Reconciliation Act of 2001, the Job Creation and Worker Assistance Act of 2002, and other legislation. 67 Fed. Reg. 30826 (May 8, 2002).

REPORTING. The IRS has issued proposed regulations relating to the changes made by the Taxpayer Relief Act of 1997 in reporting of payments of $600 or more of gross proceeds to attorneys. The regulations will affect attorneys who receive payments of gross proceeds on behalf of their clients and certain payors (for example, defendants in lawsuits and their insurance companies and agents) that, in the course of their trades or businesses, make payments to these attorneys. 67 Fed. Reg. 35064 (May 17, 2002).

RETURNS. The IRS has released a revenue ruling reaffirming its position in Rev. Rul. 80-218, 1980-2 CB 386, that it will accept as timely a federal tax return, claim for refund, statement or other document required or permitted to be filed with the IRS that is either mailed from and officially postmarked in a foreign country on or before the last date prescribed for filing, or postmarked on or before the next succeeding day which is not a Saturday, Sunday, or legal holiday. Similarly, such items that are required or permitted to be filed with the IRS that are given to a designated international delivery service before midnight on the last prescribed date for filing or given to a designated international delivery service before midnight on the next succeeding day which is not a Saturday, Sunday, or legal holiday will be considered timely filed. Rev. Rul. 2002-23, I.R.B. 2002-18, 812.

STATE REGULATION OF AGRICULTURE

LIVESTOCK CONFINEMENT FACILITIES. The Iowa General Assembly has passed and the Governor has signed SF 2293 which revamps the livestock confinement law in Iowa. It is landmark legislation, tightening up the environmental rules but stopping short of local control.
AGRICULTURAL TAX AND LAW SEMINARS
by Neil E. Harl and Roger A. McEowen

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- Income tax aspects of property transfer, including income in respect of decedent, installment sales, private annuities, self-canceling installment notes, and part gift/part sale transactions.
- Taxation of debt, taxation of bankruptcy, the latest on SE tax of rental of land to a family-owned entity; income averaging; earned income credit; commodity futures transactions; paying wages in kind; new depreciation rules.
- Farm estate planning, 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.
- Organizing the farm business--one entity or two, corporations, general and limited partnerships and limited liability companies.
- **New this year:** Farm and ranch contracts. Also, patents, antitrust issues and regulation of production.

Special room discounted rates are available at the hotels for seminar attendees.

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Registration brochures will be mailed in June and July. However, complete information and a registration form are available now on our web site at http://www.agrilawpress.com. For more information, call Robert Achenbach at 1-541-302-1958, or e-mail to robert@agrilawpress.com
FARM SECURITY AND RURAL INVESTMENT ACT OF 2002
PUB. L. NO. 107-171 (MAY 13, 2002) (SUMMARY OF SELECTED PROVISIONS) PART II
—by Neil E. Harl*

Title II continued

Conservation Reserve Program

The 2002 Act reauthorizes the CRP program through the 2007 calendar year. Act Sec. 2101, amending Food Security Act of 1985, Sec. 1231(a).

Enrollment. The legislation adds marginal pastureland devoted to appropriate vegetation, including trees, in or near riparian areas or for similar water quality purposes, including marginal pastureland converted to wetlands or established as wildlife habitat. Act Sec. 2101, amending Food Security Act of 1985, Sec. 1231(b)(2), (3). The legislation also allows enrollment of land which would contribute to degradation of soil, water or air quality if permitted to remain in production and land where enrollment would contribute to the conservation of ground or surface water where the result is a net savings in ground or surface water resources on the agricultural operation of the producer. Act Sec. 2101, amending Food Security Act of 1985, Sec. 1231(b)(4).

Eligibility and cropping history. To be eligible, the land must have a cropping history or be considered to have been planted for four of the six years preceding the enactment of the 2002 Act. Act Sec. 2101, amending Food Security Act of 1985, Sec. 1231(b)(1). The Conference Report states that the Managers are concerned about reports that producers are planting crops on non-cropped lands as a means of being eligible to participate in CRP. This language is intended to prevent the enrollment of these lands under CRP. The Managers understand the Secretary is currently reviewing the land eligibility criteria, including the eligibility of non-cropland that could be restored to serve as buffers. The Managers expect the Secretary to do this examination expeditiously. Conf. Report Under Act Sec. 2101.

The legislation allows producers to enroll entire fields through the continuous CRP as buffers in cases in which more than 50 percent of the field is eligible for enrollment and the remainder of the field is infeasible to farm. The modification restricts payments on the remaining acreage to general sign-up rates. Act Sec. 2101, amending Food Security Act of 1985, Sec. 1231(b)(5).

The Conference Report intends that USDA allow prescribed burning and other measures that are intended to enhance forage for the benefit of pheasants and other wildlife species on land enrolled in CRP.

In carrying out the CRP, the Managers direct the Secretary to evaluate qualifications and criteria relating to spring wind erosion of sandy soils not currently recognized by the

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

The Managers expect the Secretary to develop ways to make land prone to frequent seasonal flooding, such as three out of the last five years, eligible for enrollment in the CRP, including, but not limited to, designating the area as a conservation priority area. Conf. Report Under Act Sec. 2101.

Acreage limitations. The 2002 legislation raises the acreage cap to 39.2 million acres at any one time during the 2002 through 2007 calendar years including contracts that are extended. Act Sec. 2101, amending Food Security Act of 1985, Sec. 1231(d).

Duration of contracts. The 2002 Act authorizes CRP contracts of not less than 10 and not more than 15 years. Act Sec. 2101, amending Food Security Act of 1985, Sec. 1231(e)(1).

Signing and Practice Incentive Payments (SIPs and PIPs). The Senate proposal directing the Secretary to provide signing and practice incentive payments for landowners who implement a practice under the conservation buffer or CREP programs at the highest rate currently provided was deleted. However, the Conference Report addresses the issue by stating that the Managers are concerned that the payments for practices may not reflect the conservation benefits of the practices. Grass wind strips, shelter belts, living snow fences and wellhead protection are particular activities that should receive serious consideration for signing and practice incentive payments. The Managers strongly encourage the Secretary to re-examine the procedures used to determine the incentive payment. The Managers intend that the Secretary should continue current signing and practice incentive payments throughout the duration of this legislation. Conf. Report Under Act Sec. 2101.

Duties of owners and operators. Under the 2002 Act, USDA is to permit, consistent with the conservation of soil, water quality and wildlife habitat, managed harvesting and grazing on the land at a reduced rate. Harvesting and grazing or other commercial use of the forage are permitted in response to a drought or other emergency. The Secretary is to insure that all precautions are taken to protect against over grazing or haying or use of land during a period that may adversely impact wildlife habitat or wildlife directly, especially insuring that activities take place after the nesting season is completed. Act Sec. 2101, amending Food Security Act of 1985, Sec. 1232(a)(7). The Secretary is to permit wind turbines on CRP land, whether commercial in nature or not, in a manner that does not interfere with wildlife. Act Sec. 2101, amending Food Security Act of 1985, Sec. 1232(a)(7).

It is noted that the Conference Committee deleted the House provision to replace the term “rental payment” with the term “conservation reserve payment.” The House language appears to have stemmed from the treatment of CRP payments for self-employment tax purposes. The Tax Court in 1998 held that CRP payments were rental payments and not subject to the 15.3 percent self-employment tax. Fredrick J. Wuebker, 110 T.C. 431 (1998). However, that case was reversed on appeal in 2000. Wuebker v. Commissioner, 205 F.3d 897 (6th Cir. 2000).

Expansion of CRP Wetland Pilot Program. The 2002 Act expands the CRP Wetland Pilot Program nationwide, limiting enrollment to 100,000 acres in any state and 1,000,000 acres nationwide, during the 2002 through 2007 calendar years. Act Sec. 2101, amending Food Security Act of 1985, Sec. 1231(b)(1)(C).

An owner or operator may enroll in CRP a wetland that was cropped during at least three of the immediately preceding 10 crop years (including a converted wetland) and buffer acreage that is contiguous to the wetland, used to protect the wetland and of such width as necessary to protect the wetland, taking into consideration and accommodating the farming practices used with respect to the cropland surrounding the wetland. Act Sec. 2101, amending Food Security Act of 1985, Sec. 1231(b)(2)(A).

The Conference Report states that, in expanding the CRP Wetland Pilot Program nationwide, the Managers recognize that the playa lakes found throughout the Southern Great Plains states of Kansas, Oklahoma, Colorado, New Mexico and Texas, are also worthy of protection as they function as recharge points for the Ogallala Aquifer, help in containing flood waters and provide habitat for hundreds of bird species. Playa lakes are the most significant topographical and hydrological attribute in the Southern Great Plains. Playa lakes are often dry enough to be farmed due to the annual precipitation rates and high evaporation rates that occur in the high plains. Conf. Report Under Act Sec. 2101.

The Conference Committee struck a Senate proposal to require the Secretary to provide up to 500,000 acres for CREP (Conservation Reserve Enhancement Program, 7 C.F.R. Pt. 1410) but the Conference Report states that the Managers encourage the Secretary to allow states to have flexibility in creating CREP programs. Conf. Report Under Act Sec. 2101.

Wetlands Reserve Program (WRP) The 2002 Act extends the Wetlands Reserve through 2007. Act Sec. 2201. The legislation clarifies that technical assistance is provided under the WRP and allows the Secretary to raise the acreage cap to 2,275,000 acres. The Secretary is required to enroll 250,000 acres per year “to the maximum extent practicable.” Act Sec. 2202, amending Food Security Act of 1985, Sec. 1237(b)(1). The Secretary is to enroll acreage into the WRP through the use of permanent easements, 30-year easements, restoration cost-share agreements or any combination. Act Sec. 2202, amending Food Security Act of 1985, Sec. 1237(b)(1).

Environmental Quality Incentives Program (EQIP) The 2002 Act continues the EQIP program through 2007. Act Sec. 2301, amending Food Security Act of 1985, Sec. 1240B(a)(1). In a disagreement between the House and Senate over the stated purpose of EQIP, the Senate prevailed in its statement that the purposes of QTIP are to promote agricultural production and environmental quality as compatible national goals and to (1) assist producers in complying with federal, state and local environmental laws; (2) avoid the need for regulatory programs; (3) provide assistance to producers for installing and maintaining conservation systems; (4) assist producers in making certain conservation changes; (5) facilitate partnerships between producers, government and non government organizations;
and (6) consolidating and streamlining conservation planning. The 2002 Act states also that air quality is a component of EQIP. Act Sec. 2301, amending Food Security Act of 1985, Sec. 1240. The Conference Report states that the Managers expect the Secretary to continue carrying out EQIP with the goal of optimizing environmental benefits. Conf. Report Under Act Sec. 2301.

The 2001 Act contains several other changes—(a) incentive payments for comprehensive nutrient management plans; (b) minimum term of one year for contracts beyond the date of project completion; (c) removal of the “bidding down” procedure that assigns a higher priority to an application because it costs less; and (d) increased cost-share payments for beginning and limited-resource farmers. Act Sec. 2301, amending Food Security Act of 1985, Sec. 1240(b).

In terms of payment limitations, an individual or entity may not receive, directly or indirectly, cost-share or incentive payments that, in the aggregate, exceed $450,000 for all contracts entered into during the period of fiscal years 2002 through 2007, “regardless of the number of contracts entered into…by the individual or entity.” Act Sec. 2301, amending Food Security Act of 1985, Sec. 1240G.

The 2002 Act rewrites the provision on ground water and surface water conservation. Water conservation activities that are eligible for incentive payments and cost-share include the lining of ditches and installation of piping, tail water return systems, low-energy precision irrigation systems, low-flow irrigation systems, off-stream and groundwater storage and conversion from gravity or flood irrigation to higher efficiency systems. Act Sec. 2301, amending Food Security Act of 1985, Sec. 1240I.

The Secretary may provide cost-share and incentive payments under this provision only if the assistance will facilitate a conservation measure that results in a net savings in ground or surface water resources on the agricultural operations of the producers. Act Sec. 2301, amending Food Security Act of 1985, Sec. 1240I(b).

An amount of $50,000,000 is made available for the Klamath Basin in Oregon and California. Act Sec. 2301, amending Food Security Act of 1985, Sec. 1240I(c)(2).

Grassland Reserve Program

The 2002 Act establishes a Grassland Reserve Program (GRP) to assist owners “in restoring and conserving eligible land.” Act Sec. 2401. The total number of acres is not to exceed 2,000,000 acres under 10, 15, 20 and 30-year contracts as well as 30-year and permanent easements. Act. Sec. 2401, adding Food Security Act of 1985, Secs. 1238N(b), (c). The Conference Report states that the Managers intend that the Secretary is to permit common grazing practices. In permitting such activities, the Managers intend that the Secretary will allow for maintenance and necessary cultural practices common to grazing systems utilized throughout the various regions of the country. These management practices may include such things as: controlled burning, aeration, over-seeding, reseeding, planting of new native species or any other practice as determined by the Secretary to be necessary for grazing management. Beyond maintenance, the Managers intend that the Secretary will permit haying, mowing, or harvesting for seed production, subject to appropriate restrictions for completion of the nesting season for birds in the local area which are in significant decline or are conserved pursuant to state or federal law, as determined by the NRCS state conservationist. Conf. Report Under Act Sec. 2401.

The annual payments to the owner during the term of the rental agreement are not to exceed 75 percent of the grazing value of the land covered by the contract. Act. Sec. 2401, adding Food Security Act of 1985, Sec. 1238P(b)(2).

Other Conservation Programs

The other conservation programs funded under the Act are shown in Table 2.

<table>
<thead>
<tr>
<th>Program</th>
<th>Notes</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conservation Reserve Program (CRP)</td>
<td>Increases acreage cap from 36.4 million to 39.2 million acres. Retains priority areas. Expands wetlands pilot to 1 million acres with all states eligible.</td>
<td>$1.517 billion</td>
</tr>
<tr>
<td>Wetlands Reserve Program (WRP)</td>
<td>Increases acreage cap to 2,275 million acres.</td>
<td>$1.5 billion</td>
</tr>
<tr>
<td>Grasslands Reserve Program (GRP)</td>
<td>A new program to enroll up to 2 million acres of virgin and improved pastureland. Program would be divided 40/60 between agreements of 10, 15, or 20- years and agreements and easements for 30-years and permanent easements.</td>
<td>$254 million</td>
</tr>
<tr>
<td>Farmland Protection Program (FPP)</td>
<td>Since 1996, the program has provided $53.4 million to protect 108,000 acres. The new funding is a nearly 20-fold increase over amount committed to this program since the last farm bill.</td>
<td>$985 million</td>
</tr>
<tr>
<td>Wildlife Habitat Incentives Program (WHIP)</td>
<td>Since 1996, approximately $62.5 million has been spent through this program to provide cost-share payments on 1.6 million acres. The new funding is greater than a 10-fold increase over amount committed to this program since the last farm bill.</td>
<td>$100 million</td>
</tr>
<tr>
<td>Environmental Quality Incentives Program (EQIP)</td>
<td>Phased up to achieve a $1.5 billion annual funding level. Priority areas are eliminated. Funds are split 60/40 between livestock and crop producers.</td>
<td>$9 billion</td>
</tr>
<tr>
<td>Water Conservation Program</td>
<td>Water Conservation Program provides cost-share incentives and assistance for efforts to conserve ground and surface water. $50 million is reserved specifically to assist producers in the Klamath Basin</td>
<td>$600 million</td>
</tr>
<tr>
<td>Conservation Security Program (CSP)</td>
<td>A new national incentive payment program for maintaining and increasing farm and ranch stewardship practices.</td>
<td>$2 billion</td>
</tr>
<tr>
<td>Small Watershed Rehabilitation Program</td>
<td>Provides essential funding for the rehabilitation of aging small watershed impoundments that have been constructed over the past 50 years.</td>
<td>$275 million</td>
</tr>
<tr>
<td>Underserved States</td>
<td>Continues program begun in Agricultural Risk Protection Act of 2000.</td>
<td>$50 million</td>
</tr>
<tr>
<td>Desert Terminal Lakes</td>
<td>Provides funding to help conserve desert terminal lakes.</td>
<td>$200 million</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>$17.1 billion</strong></td>
</tr>
</tbody>
</table>

V. Credit

Eligibility of LLCs

Eligibility of entities for loans. The 2002 Act includes limited liability companies, joint operations and trusts as eligible entities for purposes of USDA farmer loan programs (farm ownership loans, farm operating loans and emergency loans).
loans). **Act Sec. 5302.** It is noted that the legislation does not define “joint operation” or “joint operations.” Those terms are arguably less well known and less precise in meaning than “joint venture” which is a form of general partnership. The legislation, surprisingly, does not include limited liability partnerships (LLPs) in the amendment.

**Bridge loans.** The legislation contains authority to refinance bridge loans made by a commercial or cooperative lender to borrowers who have a direct farm ownership loan approved for the acquisition of land for a farm or ranch and for which funds were not available at the time of the application was approved. **Act Sec. 5002,** amending Sec. 303(a)(1) of the Consolidated Farm and Rural Development Act (CFRD).

**Tribal operating loan guarantees.** The 2002 Act requires the Secretary to guarantee 95 percent of the amount of operating loans made to a farmer or rancher whose operation is subject to the jurisdiction of an Indian tribe if the loan is secured by one or more “security instruments” which are subject to the jurisdiction of an Indian tribe. **Act Sec. 5003,** amending Sec. 309(h) of CFRD.

**State beginning farmer or rancher program.** The legislation authorizes the Secretary (“The Secretary may guarantee…”) loans made under a state beginning farmer or rancher program, including a loan financed by the net proceeds of a qualified small issue agricultural bond for land or property pursuant to Section 144(a)(12)(B)(ii) of the Internal Revenue Code. **Act Sec. 5004,** amending Sec. 309 of CFRD.

**Down payment loan program.** The 2002 Act increases the principal amount of the down payment loan on land to equal 40 percent of the purchase price of the land acquisition and increases the repayment period from 10 to 15 years. **Act Sec. 5005,** amending Sec. 310E of CFRD. The Conference Report states that the Managers are aware that, on an average per dollar basis, funds used for down payment loans serve over three times as many borrowers as regular farm ownership loans, and thus help to stretch limited loan funds and increase new farming and ranching opportunities. The Managers encourage the Secretary to publicize widely the availability of loans under this section as amended among potentially eligible recipients of the loans, retiring farmers and ranchers, and applicants for farm ownership loans under this subtitle and to coordinate the loan program established by this section with state programs that provide farm ownership or operating loans for beginning farmers and ranchers. The Managers strongly encourage the Secretary to establish performance goals for each state with a significant volume of real estate loans under this subtitle, with a goal of attaining down payment loan volumes consistent with the loan reservation percentage for down payment loans.

**Beginning farmer and rancher contract land sales program.** The legislation directs that a new pilot program be developed by October 1, 2002, in at least 10 geographically dispersed states, involving guarantees of at least five loans per state in each of the fiscal years 2003 through 2006. The loans may be guaranteed if made by a private seller of a farm or ranch to a qualified beginning farmer or rancher on a contract land sale basis provided the loan meets applicable underwriting standards and a commercial lending institution agrees to serve as escrow agent. The Secretary is to make a determination on whether guarantees of contract land present a risk comparable to the risk presented in the case of guarantees to commercial lenders not later than October 1, 2002. **Act Sec. 5006,** enacting Sec. 310F of CFRD.

The Conference Report states, in going beyond the statute, that “the Secretary shall start the program on making a determination that guarantees of contract land sales present a risk comparable to the risk presented in the case of guarantees to commercial lenders.” The Conference Report also states that the Managers are aware that contract land sales are prevalent in many states and encourage the Secretary to create a pilot program for guaranteeing the financing of such contract land sales. The Managers intend for the Secretary to approve any loan guarantee under this pilot program using its normal underwriting criteria. The Managers envision that land contracts between the seller and buyer will contain a side escrow agreement that outlines the duties and responsibilities of the escrow agent. **Conf. Report Under Act Sec. 5006.**

**Direct loans.** The legislation deletes the requirement that a direct loan may not be made to a farmer or rancher who has operated a farm or ranch for five years or more. **Act Sec. 5101,** amending Sec. 311(c)(1)(A) of CFRD.

**Suspension of effectiveness of provision affecting loan eligibility.** The 2002 Act contains a provision that the law limiting loan eligibility of borrowers with Farm Service Agency loan guarantees will have no effect through December 31, 2006. **Act Sec. 5102.**

The legislation also amends the operating loan eligibility limitations by adding several new provisions—

- To require the Secretary to waive the direct operating loan eligibility limitations to a farmer or rancher whose farm or ranch land is subject to the jurisdiction of an Indian tribe and whose loan is secured by one or more “security instruments” subject to the jurisdiction of an Indian tribe if the Secretary determines that commercial credit is not generally available for such farm or ranch operations;
- To authorize the Secretary, on a case-by-case basis, to grant a waiver for a direct operating loan to a borrower one time for a period of two years if the borrower demonstrates—(1) the borrower has a viable farm or ranch operation; (2) the borrower has applied for commercial credit from two commercial lenders; (3) the borrower was unable to obtain a commercial loan, including a loan guarantee; and (4) the borrower has successfully completed or will complete within one year the required borrower’s training course. **Act Sec. 5101,** amending CFRD, Sec. 311(c)(4).

**Emergency loans necessitated by quarantines.** The 2002 Act authorizes emergency loans where a quarantine was imposed by the Secretary under the Plant Protection Act or the animal quarantine laws. **Act Sec. 5201,** amending Sec. 321(a) of CFRD.

**Interest rate options for loans in servicing.** The legislation amends CFRD to require the Secretary, when restructuring a farmer program loan, to charge the lowest of—(a) the rate of the original loan; (b) the rate being charged when the borrower applies for restructuring the loan or (c) the rate being charged when the borrower restructuring the loan. **Act Sec. 5305,** amending Sec. 331B of CFRD.
Elimination of certification by county committee. The legislation eliminates the requirement that local or area FSA committees must certify in writing that they have reviewed the credit histories, business operations and continued eligibility of all borrowers. Language is retained requiring that the annual reviews be conducted but certification in writing is eliminated. Act Sec. 5306, amending Sec. 333(2) of CFRD.

Simplified loan guarantee application. The 2002 Act replaces the 25 percent limitation on ownership of the median ownership acreage within a county for purposes of determining who is a beginning farmer or rancher; with a 30 percent acreage limitation. Act Sec. 5310,(a), amending Sec. 343(a)(11)(F) of CFRD.

Disposition of inventory property. The 2002 Act amended the rules governing the disposition of inventory property by—

• Increasing from 75 to 135 days the period inventory property must be held and offered for sale to beginning farmers and ranchers;
• Authorizing the Secretary to bundle or parcel real estate in such ways as to maximize the sale to beginning farmers and ranchers; and
• Authorizing the Secretary to sell farm real estate that has been acquired and leased before April 4, 1996, to beginning farmers and ranchers within 60 days of the expiration of the lease agreements. Act Sec. 5308, amending Sec. 335(c) of CFRD.

Administration of Certified Lenders and Preferred Lenders Programs. The 2002 Act replaces the 25 percent limitation on ownership of the median ownership acreage within a county for purposes of determining who is a beginning farmer or rancher; with a 30 percent acreage limitation. Act Sec. 5309, amending Sec. 339 of CFRD.

Definition of beginning farmer or rancher. The 2002 Act replaces the 25 percent limitation on ownership of the median ownership acreage within a county for purposes of determining who is a beginning farmer or rancher with a 30 percent acreage limitation. Act Sec. 5310,(a), amending Sec. 343(a)(11)(F) of CFRD.

The legislation also defines “debt forgiveness” as not including consolidation, rescheduling, reamortization or deferral of a loan or any write-down provided as part of a resolution of a discrimination complaint against the Secretary. Act Sec. 5310(b), amending Sec. 343(a)(12)(B) of CFRD.

Authorization levels for loans. The 2002 legislation authorizes the Secretary to make or guarantee loans by providing not more than $3,796,000,000 for each of the fiscal years 2002 through 2007. Of that amount, $770,000,000 will be for direct loans of which $205,000,000 is for farm ownership loans and $565,000,000 for operating loans. Of the remainder, $3,026,000,000 is for guaranteed loans of which $1,000,000,000 is for guaranteed farm ownership loans and $2,026,000,000 is for guaranteed operating loans. Act Sec. 5311, amending Sec. 346(b)(1) of CFRD.

Reservation of funds for direct operating loans for beginning farmers and ranchers. The 2002 Act reauthorizes the reservation of beginning farmer and rancher loan amounts at 35 percent of the funds for 2003 through 2007. Act Sec. 5312, amending Sec. 346(b)(2)(A)(ii)(III) of CFRD.

Extension of interest rate reduction program. The legislation reauthorizes the interest rate buy-down program retaining current law on the interest rate, but reserving 15 percent of the funds in a fiscal year for beginning farmers and ranchers (until March 1 of the fiscal year) and providing for a permanent authorization of $750,000,000 annually. Act Sec. 5313, amending Sec. 351 of CFRD.

Reamortization of recapture payment—shared appreciation agreements. The legislation authorizes the Secretary to modify the recapture consequences of a shared appreciation agreement loan which has become delinquent by using loan servicing tools under section 343(b)(3) of CFRD if the default was beyond the control of the borrower and the borrower acted in good faith in attempting to repay the recapture amount. Act Sec. 5314, amending Sec. 353(e)(7) of CFRD. A reamortized loan may not exceed 25 years from the date of the original amortization agreement or provide for reducing the outstanding principal or unpaid interest that is due on the obligation. Act Sec. 5314, amending Sec. 353(e)(7) of CFRD. The Conference Report goes on to state that the Managers expect the Secretary to review USDA appeal policies regarding appraisals used for shared appreciation agreements. The Managers expect the Secretary to establish policies that will result in the use of the most accurate appraisal of assets including the use of independent appraisals provided on appeal by the borrower that are consistent with federal appraisal standards. Conf. Report Under Act Sec. 5314.

It is interesting to note that the Senate had proposed to allow shared appreciation agreement debtors to grant the Secretary an easement on the property which is subject to the shared appreciation arrangement under a conservation program which would replace the recapture obligation. The House conference objected, reportedly because of a dislike for easements (which, ironically, are part of several provisions in the 2002 Act).

Allocation of funds for socially disadvantaged farmers and ranchers. The 2002 Act authorizes the Secretary to provide unused funds allocated for socially disadvantaged farmers and ranchers within a state to other states where there are pending applications for socially disadvantaged (SDA) farmers and ranchers. Any remaining unused SDA funds within a state may be reallocated to other applicants in that state. Act Sec. 5315, amending Sec. 355(e)(2) of CFRD.

Waiver of borrower training certification requirement. The legislation authorizes the Secretary to waive the educational training requirements of Section 359 of CFRD if the Secretary determines that the borrower demonstrates adequate knowledge of financial and farm management. Standards are to be established by the Secretary for this waiver to be implemented consistently in all counties nationwide. Act Sec. 5316, amending Sec. 359(f) of CFRD.

Loan approvals. The 2002 Act strikes language requiring the local county committee to approve a borrower’s eligibility for farmer program loans. This conforms the CFRD to 1994 legislation. Act Sec. 5317, amending Sec. 360(a) of CFRD.
Annual review of borrowers. The legislation changes the review of borrowers from biannual to annual. Act Sec. 5318, amending Sec. 360(d)(1) of CFRD.

Loan eligibility for borrowers with prior debt forgiveness. The 2002 Act authorizes the Secretary to make an operating loan to a borrower who has received debt forgiveness on not more than one occasion that was “directly and primarily” from a major disaster or emergency designated as a disaster by the President on or after April 4, 1996. Act Sec. 5319, amending Sec. 373(b)(2)(A) of CFRD.

Making and servicing of loans by personnel of state, county or area committees. Under the 2002 legislation, the Secretary is required (“The Secretary shall . . .”) to use Farm Service Agency state, area or county office employees to make and service farmer program loans if the personnel are trained to do so. This overrides the 90-day “finality” rule of FSA employees in Sec. 281(a)(1) of the USDA Reorganization Act so that the finality rule does not apply to an agricultural credit decision made by a state, area or county FSA employee. Act Sec. 5320, adding Sec. 376 to CFRD. The Conference Report goes on to state that the Managers believe that the Secretary should provide that these individuals have been adequately trained in these areas in a comparable manner as USDA Farm Service Agency employees with the same job responsibilities. Furthermore, the Secretary should insure that the credit decisions of these individuals are subject to the same USDA loan review as any USDA employee making credit decisions, including internal control review and disciplinary action to protect against the misuse of government funds. Conf. Report Under Act Sec. 5320.

Eligibility of employees of state, county or area committee for loans and loan guarantees. The 2002 Act states that the Secretary is not to prohibit an employee of a state, county or area committee or a USDA employee from obtaining a loan or loan guarantee. Loan applications from an employee of a county or area office must be reviewed and approved by the state office; loan applications from an employee of a state office must be reviewed and approved by the national office. Act Sec. 5321, adding Sec. 377 to CFRD.

The Conference Report states that the Managers believe it is important for these employees, many of whom are farmers in their communities, to have access to the same farm loan programs as other producers. Nevertheless, the Managers believe that a higher level of review is appropriate to alleviate concerns regarding the eligibility of those individuals for the farm loan programs. Conf. Report Under Act Sec. 5321.

Banks for Cooperatives. The Farm Credit Act of 1971 is amended to replace the words “farm supplies” with “agricultural supplies” and to add a definition of an agricultural supply to include farm supply, agriculture-related processing equipment, agriculture-related machinery and other capital goods related to the storage or handling of agricultural commodities or products. Act Sec. 5402, amending Sec. 3.7(b) of the Farm Credit Act of 1971.

Restriction on loan participation activities by a Bank for Cooperatives. The 2002 Act amends the Farm Credit Act of 1971 to delete a provision that restricts without prior approval the loan participation activities of a Bank for Cooperatives in the lending territory of a Farm Credit Bank or association. The amendment also makes conforming changes to loan participation activities of Banks for Cooperatives and Farm Credit System institutions that operate under separate titles of the Farm Credit Act. Act Sec. 5401, amending Sec. 3.1(11)(B) of Farm Credit Act of 1971.

The Conference Report states that the Managers understand that, this provision eliminates certain territorial concurrence requirements on Farm Credit System lenders so that lenders may participate in loan syndications or other multiple-lender arrangements for “similar entity” loans originated in other Farm Credit System geographic territories without seeking the permission of the Farm Credit System lender in that territory. Current law requires system institutions to obtain permission from one another when participating in similar entity transactions in which a commercial bank originates the loan and then sells the loan to a group of lenders (including the System institution). The change eliminates these requirements only as they pertain to similar entity loans that the System does not originate. Territorial concurrence for loans other than similar entity loans are not affected by this change. The Managers are expressing no opinion with this provision on pending litigation regarding participation regulations issued by the Farm Credit Administration on April 25, 2000. Conf. Report Under Act Sec. 5401.

Insurance Corporation premiums. The 2002 Act amends the Farm Credit Act of 1971 to include government sponsored enterprise-guaranteed loans or credits and establishes the rate at which these loans or credits in accrual or non-accrual status are used to fund the Insurance Fund for calendar year 2002. Act Sec. 5403, amending Sec. 5.55 of the Farm Credit Act of 1971.

VI. Rural Development

Funding for rural local television broadcast signal loan guarantees. The 2002 Act provides from CCC funds $80,000,000 of loan guarantees from the date of enactment through December 31, 2006, under the Launching Our Communities’ Access to Local Television Act of 2000. Act Sec. 6404, amending Sec. 1011(a) of the Launching Our Communities’ Access to Local Television Act of 2000.

Expanded eligibility for value-added agricultural product market development grants. The legislation amends the Agricultural Risk Protection Act of 2000 to spend $40,000,000 each fiscal year 2000-2007 for value-added grants from CCC funds. Act Sec. 6401, amending Sec. 231 of the Agricultural Risk Protection Act of 2000. The legislation defines “value added” as undergoing a change in the physical state or produced in a manner that enhances its value to consumers as a result of which a greater part of the revenue derived is available to the producer. Act Sec. 6401(a), amending Sec. 231(a) of the Agricultural Risk Protection Act of 2000. Five percent of the funds are to be used for the Agricultural Marketing Resource Center. Act Sec. 6401(a)(2), amending Sec. 231(a)(3) of the Agricultural Risk Protection Act of 2000.

The Conference Report states that the Managers intend that the Department of Agriculture, in administering the program, will seek to fund a broad diversity of projects that help increase agricultural producers’ share of the food and agricultural system profit, including projects likely to
increase the profitability and viability of small and medium-sized farms and ranches. The Managers intend for the Department to consider a project’s potential for creating self-employment opportunities in farming and ranching and the likelihood that the project will contribute to conserving and enhancing the quality of land, water and other natural resources.

When making these grants, the Managers expect the Secretary to consider applications from a variety of agricultural sectors, such as renewable energy, wineries, high value products from major crops, agri-marketing ventures, and community supported agricultural projects. The inclusion of renewable energy includes farm or ranch based wind, solar, hydrogen, and other renewable energy.

An exception from the normal rural area requirement is made for majority controlled producer-based business ventures. It is the Managers’ intent that the Department award grants, to the maximum extent practicable, to projects located in rural areas. However, state rules and regulations and other circumstances may hinder some worthy value-added agricultural projects from meeting the Department’s specific definition of “rural.” One such example is wineries in certain areas. In this instance, the Managers expect the Department to consider the importance and value of the project to area agriculture producers who will be the ultimate beneficiaries of the project, including the consistency of the project with the intent of the program. Conf. Report Under Act Sec. 6401.

Agriculture Innovation Center Demonstration Program. The 2002 Act provides authority for the Secretary to make grants to establish centers for value-added agricultural businesses. The Secretary is to use not less than $3,000,000 for fiscal year 2002 and not less than $6,000,000 for fiscal years 2003 and 2004. Act Sec. 6402.

IX. Energy

Federal procurement of bio-based products. The 2002 Act establishes a new program for the purchase of bio-based products by federal agencies. The program is modeled after the existing program for the purchase of recycled materials. The intent is to stimulate the production of new bio-based products and to encourage the development of markets for those products. An amount of $1,000,000 from CCC annually for each of the fiscal years 2002-2007 is provided for testing bio-based products. Act Sec. 9002.

Bio-refinery development grants. A competitive grant program is established to support the development of bio-refineries for the conversion of biomass into products such as fuels, chemicals and electricity. An amount of $15,000,000 is provided annually subject to appropriation. Act Sec. 9003.

Bio-diesel fuel education program. The legislation establishes a competitive grant program to educate governmental and private entities with vehicle fleets (and the public) about the benefits of bio-diesel fuel use. An amount of $1,000,000 is provided annually out of CCC funds in each of fiscal years 2003-2007. Act Sec. 9004.

Renewable energy development loan and grant program. The 2002 Act amends the CFRD Act by adding other renewable energy systems including wind energy and anaerobic digesters to the list of purposes for which loans and loan guarantees are available. Also, the value-added grant program in the Rural Development title has been expanded. The objective is to encourage more farmers and ranchers to become involved in the ownership of renewable energy systems. Act Sec. 6013, amending Sec. 310B(a)(3) of CFRD; Act Sec. 6401, amending Sec. 231 of the Agricultural Risk Protection Act of 2000.

Energy audit and renewable energy development program. The legislation establishes a competitive grants program for entities to administer energy audits and renewable energy development assessments for farmers, ranchers and rural and small businesses. “Such funds as are necessary” are subject to appropriation. Act Sec. 9005.

Renewable energy systems and energy efficiency improvements. The 2002 Act establishes a loan, loan guarantee and grant program to assist eligible farmers, ranchers and rural businesses in purchasing renewable energy systems and making energy efficiency improvements. An amount of $23,000,000 is provided annually in each of fiscal years 2003-2007. Act Sec. 9006.

Hydrogen and fuel cell technologies. The legislation directs the Secretary of Agriculture and the Secretary of Energy to enter into a memorandum of understanding regarding hydrogen and fuel cell technology applications for agricultural producers and rural communities. Act Sec. 9007(a).

The section also directs the Secretary of Agriculture to disseminate information to rural communities and agricultural producers on potential application of hydrogen and fuel cell technologies. Act Sec. 9007(b).


Cooperative research and extension projects. The legislation establishes a carbon sequestration research and development program to promote understanding of the net sequestration of carbon in soil and emissions of other greenhouse gasses from agriculture. The section authorizes an appropriation of “such sums as are necessary” annually. Act Sec. 9009.

Continuation of bio-energy program. The 2002 Act authorizes the continuation of the Commodity Credit Corporation Bio-energy Program and includes animal byproducts and fats, oils and greases (including recycled fats, oils and greases) as eligible commodities. The legislation provides not more than $150,000,000 for each of fiscal years 2003-2006 out of CCC funds. Act Sec. 9010. The Conference Report encourages the Secretary to investigate the feasibility of utilizing wheat that has been infested with Karnal bunt spores, and for which a market is not readily available, in the operation of the CCC Bio-energy Program. Conf. Report Under Act Sec. 9010.

X. Miscellaneous

Animal welfare

Definition of “animal.” The 2002 Act excludes, from the definition of “animal” under the Animal Welfare Act of 1966, 7 U.S.C. § 2132(g), the following—birds, rats of the
genus Rats and mice of the genus Mus, bred for use in research. Act Sec. 10301, amending Sec. 2(g) of the Animal Welfare Act of 1966.

Interstate movement of animals for fighting. The legislation makes it unlawful to knowingly sponsor or exhibit an animal in an animal fighting venture if any animal in the venture was moved in interstate or foreign commerce. Act Sec. 10302(a), amending 7 U.S.C. § 2156. For fighting ventures involving live birds in a state where it would not be in violation of the law, the 2002 Act makes it unlawful to sponsor or exhibit a bird in the fighting venture only if the person knew that any bird in the fighting venture was knowingly bought, sold, delivered, transported or received in interstate or foreign commerce for the purpose of participating in the fighting venture. Act Sec. 10302, amending 7 U.S.C. § 2156 (effective one year after enactment).


Livestock

Packer ban on ownership and control of livestock. The Conference Committee deleted a Senate provision banning packer ownership and control prior to 14 days before slaughter with exemptions for cooperatives and packers killing less than two percent of the U.S. annual slaughter for that type of livestock. The Conference Report states that the Managers recognize the importance of Congress holding hearings to address issues affecting livestock producers, such as agribusiness consolidation and livestock marketing issues. Conf. Report Under Subtitle F., Title X, of the Farm Security and Rural Investment Act of 2002.

Swine contracts and contractors. The 2002 Act includes “swine contractors” as a covered entity under the Packers and Stockyards Act of 1921 and defines swine contractor to include—

“…any person engaged in the business of obtaining swine under a swine production contract for the purpose of slaughtering the swine or selling the swine for slaughter, if—

“(A) The swine is obtained by the person in commerce; or

“(B) The swine (including products from the swine) obtained by the person is sold or shipped in commerce.”

The term “swine production contract” is defined as “…any growout contract or other arrangement under which a swine production contract grower raises and cares for the swine in accordance with the instructions of another person.” The term “swine production contract grower” means “…any person engaged in the business of raising and caring for swine in accordance with the instructions of another person.” Act Sec. 10502, amending Sec. 2(a) of the Packers and Stockyards Act of 1921, 7 U.S.C. § 182(a).

The legislation also enacted a provision addressing confidentiality provisions in “any contract between a producer and a processor for the production of livestock or poultry, or in any marketing agreement between a producer and a processor for the sale of livestock or poultry for a term of 1 year or more....” Under that provision, a party to the contract cannot be prohibited from discussing any terms or details of the contract with—a federal or state agency, a legal advisor to the party, a lender to the party, an accountant hired by the party, an executive or manager of the party, a landlord of the party or a member of the immediate family of the party. That provision, however, does not pre-empt any state law that “addresses confidentiality provisions in contracts for the sale or production of livestock or poultry, except any provision of State law that makes unlawful a contract provision that prohibits a party from, or limits a party in, engaging in discussion that [the above provision] requires to be permitted; or...deprive any State court of jurisdiction under such State law.”

The provisions are effective for contracts entered into, amended, reviewed or extended after the date of enactment. Act Sec. 10503. Note that this provision is apparently not added to the U.S. Code.

Organic products promotion. The 2002 Act allows a person who produces and markets only 100 percent organic products and does not produce any conventional or non-organic products, to be exempt from the payment of an assessment under a commodity promotion law for products produced on a certified organic farm. Act Sec. 10607, amending Sec. 501 of the FAIR Act of 1996.


Country-of-origin labeling. The 2002 Act requires, effective for retail sales of a commodity beginning September 30, 2004, country-of-origin labeling for “covered commodities” (muscle cuts of beef, lamb and pork; ground beef, ground lamb and ground pork; farm-raised fish; wild fish; perishable agricultural commodities; and peanuts). A retailer of a covered commodity is required to inform consumers, at the final point of sale of the covered commodity to consumers, of the country of origin of the covered commodity.

A commodity may be designated as having a United States country of origin only if the covered commodity—

1. In the case of beef is exclusively from an animal that is exclusively born, raised and slaughtered in the U.S. (including animals born and raised in Hawaii or Alaska and transported for a period not to exceed 60 days through Canada to the U.S. for slaughter in the U.S.).

2. In the case of lamb and pork, is exclusively from an animal exclusively born, raised and slaughtered in the U.S.

3. In the case of farm-raised fish, is hatched, raised, harvested and processed in the U.S.

4. In the case of wild fish is harvested in waters of the United States, a U.S. territory or a state and processed in the U.S., a U.S. territory or a state “including the waters thereof.”
5. In the case of a perishable agricultural commodity or peanuts, is exclusively produced in the U.S.

The rules do not apply to a covered commodity if the commodity is prepared or served in a food service establishment and offered for sale or sold at the food service establishment in normal retail quantities or served to consumers at the food service establishment. Act Sec. 10816, adding Secs. 281 and 282 to the Agricultural Marketing Act of 1946.

Financing statements. The legislation makes numerous changes in Sec. 1324 of the Food Security Act of 1985 relative to financing statements. Act Sec. 10604, amending Secs. 1324(c)(4), 1324(e) and 1324(g)(2)(A) of the Food Security Act of 1985.

CONSTRUCTIVE RECEIPT OF PROGRAM PAYMENTS. In the discussion in the last Digest issue, page 83 supra, on Direct Payments, disregard the last sentence and replace it with the following:

Similar legislation was passed in 1999 (Pub. L. 106-170). The 2002 Act in an attempt to avoid the constructive receipt of income referred to Pub. L. 106-170 but not to Pub. L. 105-277. The Senate Committee believes the present language is adequate and this author is now inclined to agree. Income under the 2002 Act will be reportable into income in the year of receipt.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

FEDERAL AGRICULTURAL PROGRAMS

COTTON. The CCC has requested proposals from federally recognized Indian tribes, states, units of local government, and nongovernmental organizations to cooperate in the acquisition of conservation easements or other interests in farms and ranches as part of the Farmland Protection Program. Eligible land includes farm and ranch land that has prime, unique, or other productive soil, or that contains historical or archaeological resources. These lands must also be subject to a pending offer from eligible entities for the purpose of protecting topsoil by limiting conversion of that land to nonagricultural uses. 67 Fed. Reg. 37756 (May 30, 2002).

FEDERAL ESTATE AND GIFT TAX

GIFTS. The taxpayer owned a 1 percent interest in an LLC taxed as a partnership. The taxpayer acquired an additional 19 percent interest in the LLC on one day and transferred the interest to a generation-skipping trust the next day along with the 1 percent interest to a family trust. The taxpayer filed a gift tax return and identified the LLC, the type of interest conveyed and the claimed value of the interests. The IRS claimed that the gifts were substantially undervalued. In a Chief Counsel Advice letter, the IRS ruled that the substantial undervaluing of the gift and the failure to provide sufficient information about the value of the LLC and the nature of the interests conveyed were sufficient omissions to allow avoidance of the statute of limitations on the gifts. CCA Ltr. Rul. 200221010, Feb. 12, 2002.

IRA. The decedent owned an IRA at death and the IRA passed to the estate. The IRS ruled that the amount in the decedent’s IRA, less any nondeductible contributions, would be income in respect of decedent to the estate, and that this amount would be considered as gross income permanently set aside which is deductible by the estate in the year of receipt under I.R.C. § 642(c)(2). Ltr. Rul. 200221011, Feb. 12, 2002.

FEDERAL INCOME TAXATION

BAD DEBT. The taxpayers, husband and wife, were shareholders in an S corporation which owned and operated a used car dealership. The taxpayers contributed money to the corporation for operating funds and to purchase inventory. The contributions were treated as loans on the corporation’s books. However, no promissory notes were executed, no repayment schedule was set and no interest was set or paid. The corporation could not obtain financing from independent lenders without personal guarantees from the taxpayers. The corporation eventually terminated without paying back $700,000 of the contributions and the taxpayers claimed that amount as a bad debt deduction. The court held that the contributions were capital contributions and not loans; therefore, the contributions were not eligible for the bad debt deduction. Dunnegan v. Comm’r, T.C. Memo. 2002-119.

C CORPORATIONS—ALM § 7.02.

EMPLOYEE. The taxpayer was a professional corporation owned by a dentist and the dentist’s spouse who worked for the corporation. The dentist provided management services for the corporation in addition to dental services and the wife was a dental hygienist. The corporation paid the dentist a management fee as an independent contractor but did not pay any wages or withhold employment taxes. The taxpayer argued that the corporate form should be ignored and it should be treated as a sole proprietorship which would not be considered the employer of the dentist. The court held that the corporate form could not be ignored because the dentist did not treat the corporation as a mere agent of the dentist and the corporation performed
business services for over 30 years. **Katz v. Comm’r, T.C. Memo. 2002-118.**

**COURT AWARDS AND SETTLEMENTS.** The taxpayer was employed as a gas station attendant and claimed to be injured while working. After the taxpayer’s employment was terminated the taxpayer filed a suit against the employer for wrongful discharge, intimidation, coercion, and harassment in violation of Fla. Stat. Ann. § 440.205. The parties settled for $5,000 which the taxpayer did not include in income. The court held that the settlement proceeds were includible in gross income because the suit did not involve any claims for personal injury. **Reid v. Comm’r, T.C. Summary Op. 2002-55.**

The taxpayers were defrauded by an insurance agent who sold them health insurance for their daughter and claimed that the daughter’s existing medical condition was covered by the insurance. The taxpayers sued the insurance company for breach of contract when the company refused to pay any claims because of the pre-existing medical condition. The parties settled and the taxpayers excluded the proceeds from income. The court held that the proceeds were gross income because the claim against the insurance company did not include any claim for personal injuries. **Ervin v. Comm’r, T.C. Memo. 2002-134.**

**DEPRECIATION.** The IRS has published a supplement to Form 946, “How to Depreciate Property” for use in preparing 2001 returns. As for the additional depreciation allowance authorized by the law enacted this past March, the IRS states the following on the ordering issue concerning section 179: “The allowance is an additional deduction of 30% of the property's depreciable basis. To figure the depreciable basis, you must first multiply the property's cost or other basis by the percentage of business/investment use and then reduce that amount by any section 179 deduction. . . .” Thus, it looks like the IRS is following the Joint Committee on Taxation interpretation. The IRS provides the following example: “On November 1, 2001, you bought and placed in service in your business qualified property that cost $100,000. You choose to deduct $24,000 of the property's cost as a section 179 deduction. You use the remaining $76,000 of cost to figure your special depreciation allowance of $22,800 ($76,000 x 30%). You use the remaining $53,200 of cost to figure your regular depreciation deduction for 2001 and later years.” See also Harl, “Additional Guidance on the 30 Percent Depreciation Allowance, p. 73 supra.”

**DISASTER PAYMENTS.** On May 7, 2002, the president determined that certain areas in Kentucky were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of severe storms, tornadoes and flooding on April 27, 2002. **FEMA-1414-DR.** Accordingly, a taxpayer who sustained a loss attributable to these disasters may deduct the loss on his or her 2001 federal income tax return.

**EARNED INCOME CREDIT.** The taxpayer was the sole wage earner in a household which included the taxpayer’s mother and two siblings. The taxpayer provided all support for the household and provided various parenting services for the younger siblings. The court held that the taxpayer was eligible for the earned income credit with the two siblings as qualifying children because the taxpayer cared for the siblings in a parental capacity. **Barajas v. Comm’r, T.C. Summary Op. 2002-59.**

**EDUCATOR’S EXPENSE DEDUCTION.** Eligible educators are eligible, under I.R.C. § 62, in 2002 and thereafter for a deduction of up to $250 for costs incurred for books and classroom supplies. The IRS has issued advice that educators should maintain accurate records and receipts of those costs to substantiate the deduction. **IR-2002-65.**

**EMPLOYEE BENEFITS.** The IRS has ruled that for purposes of the requirements for the exclusion from gross income of group health coverage for cafeteria plans, contributions used to purchase group health coverage under I.R.C. § 125 are not includible in the gross income of an employee solely because a plan uses an automatic enrollment process in which the employee’s salary is reduced each year to pay a portion of the group health coverage unless the employee affirmatively elects cash. Contributions used to purchase group health coverage under Section 125 are not includible in the gross income of the employee to the extent that an employee can elect cash. The IRS also ruled that the lack of a choice between cash and a qualified benefit for employees does not affect whether the plan satisfies the requirements for the I.R.C. § 106(a) exclusion from gross income. **Rev. Rul. 2002-27, I.R.B. 2002-20, 925.**

**HOBBY LOSSES.** The taxpayer was a college professor and bred Appaloosa horses on a farm. The court held that the activity was not engaged in for profit because (1) the taxpayer did not keep sufficient records to form a business plan to make the operation profitable; (2) the taxpayer did not have expertise in operating a profitable breeding operation; (3) although the taxpayer spent considerable time at the activity, much of it was for pleasure; (4) the breeding activity did not appreciate in value; (5) the taxpayer did not have success at other similar activities; (6) the activity had only losses; (7) the losses offset income from other sources; and (8) the taxpayer’s principal interest in the activity was pleasure since the activity was not profitable. **Harrington v. Comm’r, T.C. Summary Op. 2002-58.**

**IRA.** The taxpayer owned an IRA and was jailed for failure to pay child support and alimony. The taxpayer decided to get out of jail by making a payment by withdrawing money from the IRA but did not include the distribution in income. The court held that the limited exception for withdrawals forced by the government, including an IRS levy, did not apply and required the taxpayer to include the distribution in income and pay the early withdrawal penalty. **Baas v. Comm’r, T.C. Memo. 2002-130.**

**LETTER RULINGS.** The IRS has issued a revenue procedure which provides for a pilot program that will test whether the process for issuing Technical Advice Memoranda (TAMs) can be streamlined. The new advice will be known as a Technical Expedited Advice Memorandum (TEAM) during the TEAM pilot program, only issues under the jurisdiction of the Associate Chief Counsel (Income Tax & Accounting) will be eligible for a TEAM. The purpose of the new TEAM pilot program is to expedite certain aspects of the TAM process and to eliminate certain requirements (taxpayer and field agreement on facts) that may delay or frustrate the process. Accordingly, the Office of Chief Counsel will provide an answer even if the taxpayer and the field disagree on the facts. The Office of Chief

*®Agricultural Law Manual (ALM).
Counsel, in appropriate circumstances, may issue two separate answers: one based on the field's factual submission and the other based on the taxpayer's. Rev. Proc. 2002-30, I.R.B. 2002-__.

NET OPERATING LOSSES. The Job Creation and Worker Assistance Act of 2002 added I.R.C. § 172(h)(1)(H) which provides a five-year carryback period for net operating losses (NOLs) for any taxable year ending during 2001 and 2002. Pub. L. No. 107-147, § 102(a), 116 Stat. 21 (2002). The IRS has issued a revenue procedure which provides qualifying taxpayers who filed returns for a taxable year ending during 2001 and 2002 without taking advantage of the new five-year carryback with a limited opportunity to do so and to apply for a tentative carryback adjustment if they file an application on or before October 31, 2002. The revenue procedure allows taxpayers that incurred an NOL in a taxable year during 2001 or 2002 and elected under Section 172(b)(3) to forgo the NOL carryback period to revoke their elections in order to apply the five-year carryback period. The revenue procedure also allows such taxpayers, as well as taxpayers who used a two-year carryback period for an NOL in a taxable year ending during 2001 or 2002, to file an application for a tentative carryback adjustment under I.R.C. § 6411(a) based on a five-year NOL carryback period even if the 12-month period for filing such an application has expired. A revocation and/or application for tentative carryback adjustment under this revenue procedure must be made on or before October 31, 2002. The revenue procedure allows taxpayers that filed returns for a taxable year ending in 2001 or 2002, and who neither elected to forgo the carryback period, nor used the two-year carryback period, to elect to relinquish the five-year carryback period (and thereby retain the ability to use the two-year carryback period) if they act on or before October 31, 2002. Rev. Proc. 2002-40, I.R.B. 2002-23.

PARSONAGE EXCLUSION. The Congress passed and the President signed the Clergy Housing Allowance Clarification Act of 2002, Pub. L. No. 107-181, which provides that ministers may deduct the fair market value of their homes from their church income, including costs incurred for furniture and utilities. See McEowen, The Parsonage Exclusion – First Amendment Concerns? supra p. 75 supra.

PASSIVE ACTIVITY LOSSES. The taxpayers, husband and wife, owned a condominium which was rented to third parties through a management company. The management company handled all of the administration and maintenance of the unit except for two weeks per year that the taxpayers claimed to spend on maintaining the unit. The court held that the taxpayers did not materially participate in the operation of the condominium because the taxpayers spent less than 100 hours annually on the operation of the unit. Patterson v. Comm’r, T.C. Summary Op. 2002-57.

PENSION PLANS. The IRS has issued a revenue procedure which provides that qualified retirement plans generally must be amended by the end of the first plan year beginning on or after January 1, 2003 to the extent necessary to comply with final and temporary regulations under I.R.C. § 401(a)(9), relating to required minimum distributions. The revenue procedure contains model plan amendments that sponsors of master and prototype volume submitter and individually designed plans may adopt to satisfy this requirement. The revenue procedure also provides that determination letter applications filed on or after the first day of the 2003 plan year will be reviewed with respect to whether the form of the plan satisfies the requirements of the final and temporary regulations under I.R.C. § 401(a)(9). Rev. Proc. 2002-29, I.R.B. 2002-__.

RETURNS. The IRS has announced that it is providing relief from interest and penalties to various taxpayers affected by the September 11, 2001, terrorist attacks who previously received extra time in which to file returns or pay taxes. Generally, taxpayers will not owe interest or penalties for the amount of time that the IRS earlier extended their filing or payment deadline, and the IRS will refund such amounts to affected taxpayers who have already paid them. The relief is provided under a new authority granted to the IRS by the Victims of Terrorism Tax Relief Act of 2001 (Pub. L. No. 107-134), Notice 2002-40, I.R.B. 2002-24.

SAFE HARBOR INTEREST RATES

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SALE OF RESIDENCE. The taxpayers, husband and wife, owned a residence and purchased another parcel of property. The taxpayer eventually moved to the new property and placed the old residence for sale. The old residence did not sell and the taxpayers decided to renovate the property to make it more attractive to buyers. After the renovation, the property was again offered for sale and sold quickly. The taxpayers sought tax advice from a tax accountant who advised that the taxpayers could claim a business loss deduction on the property as rental property. The court held that the property was never converted to rental use; therefore, no business deduction could be claimed for the loss on the sale. The court did not uphold assessment of the I.R.C. § 6662(a) accuracy penalty because the taxpayers relied on professional advice in claiming the deduction. Turner v. Comm’r, T.C. Summary Op. 2002-60.

THEFT LOSS. The taxpayer rented an apartment building to a nonprofit organization which used the building for a homeless shelter. The property was returned to the taxpayer in 1996 and the taxpayer discovered that all the appliances and plumbing fixtures were removed. The taxpayer lost the property to foreclosure in 1997. The taxpayer claimed a theft loss in 1997, arguing that the loss occurred when the title to the building was lost. The court held that the theft loss deduction had to be claimed in 1996, the year the theft loss was discovered. Waters v. Comm’r, T.C. Summary Op. 2002-62.
AGRICULTURAL TAX AND LAW SEMINARS
by Neil E. Harl and Roger A. McEowen
August 13-16, 2002  Holiday Inn I-25, Fort Collins, CO
September 24-27, 2002  Interstate Holiday Inn, Grand Island, NE
For our west coast subscribers: Plans are underway for a two-day seminar in the Palm Springs, CA area on October 17-18, 2002 on Farm & Ranch Income Tax and Farm & Ranch Estate and Business Planning. Mark your calendars and watch this space for details.

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GIFTS OF FUTURE INTERESTS
— by Neil E. Harl* and Roger A. McEown**

For many years, the problem of a gift of assets or interests in businesses being deemed to be a gift of a future interest has haunted estate planners. Gifts considered to be future interests are not eligible for the federal gift tax annual exclusion and, therefore, reduce the applicable credit amount ($1,000,000 in 2002). A late March, 2002, Tax Court case has focused attention once again on the risks of gifts of business interests being held to be gifts of future interests.

**Facts in Hackl v. Commissioner**

In Hackl v. Commissioner, a full, reviewed opinion of the Tax Court, the taxpayers gave their children and grandchildren membership units in a limited liability company formed by the taxpayers to hold and operate tree farming properties. Tracts of land which had been purchased by the taxpayer and conveyed to the LLC had little or no existing stands of timber. The timber management plan pursued by the taxpayers assured that income from the venture would commence several years in the future.

The LLC arrangement contained several provisions that led the Tax Court to hold that the transfers were gifts of future interests—(1) the LLC operating agreement prohibited the donees from selling their ownership interests without the donor’s approval; (2) the LLC operating agreement gave the donor, as the LLC’s manager, discretion to make or not make cash distributions to the owners; (3) the LLC operating agreement prevented the donees as LLC owners from withdrawing their capital accounts or redeeming their interests without the donor’s approval; and (4) the LLC operating agreement specified that no single owner could dissolve the LLC. Under the LLC operating agreement, the members of the LLC had several rights—(1) the voting members had the right to remove the manager and elect a successor by majority vote; (2) voting members had the right to amend the operating agreement by an 80 percent vote; (3) voting and non-voting members had the right to access the books and records of the LLC; (4) voting and non-voting members had the right jointly to decide whether the LLC would be continued following dissolution; and (5) if the donor was no longer manager of the LLC, voting members could dissolve the LLC by an 80 percent vote. The Tax Court said the taxpayer had to show: (1) that the LLC would receive income; (2) that an “unascertainable portion” of the income would flow to the holders of the LLC ownership units; and (3) that a value can be

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The next issue will be e-mailed on July 8, 2002
placed on the income flowing to the holders. The Tax Court held that, because the gifts failed to confer a substantial present economic benefit on the donees, the gifts failed to qualify for the federal gift tax annual exclusion. The court specifically rejected the taxpayer’s argument that when a gift takes the form of an outright transfer of an equity interest in property or a business entity, no further analysis is needed or justified. Rather, the court noted that the federal gift tax regulations specify that a present interest requires an “unrestricted right to the immediate use, possession, or enjoyment of property or the income from property.” The court recognized that cases involving both transfers in trust and transfers made to a business entity have established the proposition that where the use, possession or enjoyment is postponed to some contingent or uncertain future event, or when there is no assurance of a steady flow of funds from the trust or business entity, the gift fails to qualify for the federal gift tax annual exclusion. The court further noted that the taxpayer bears the burden of showing that a gift “is other than of a future interest.”

Implications of the decision

The decision in Hackl v. Commissioner clearly poses a threat to many gifts of interest in business entities whether organized as a general or limited partnership, LLC, LLP or corporation. Although an appeal of Hackl apparently is planned, business and estate planners are left with a substantial amount of uncertainty on what will assure the outcome of a present interest for gifts of entity interests. Of course, in smaller estates, where loss of the applicable credit amount from a gift of a future interest would not pose a serious problem for the taxpayer, the outcome in Hackl v. Commissioner may not lead to an unacceptable result.

Where inability to qualify for the federal gift tax annual exclusion is unacceptable, the focus turns to a limited number of ways to relax the limitations on owner rights in the entity. Those possibilities include—(1) a provision for mandatory distribution of earnings from the entity; (2) allowing unit owners to sell their interests without restriction (a right of first refusal granted to the entity may be acceptable); (3) an assured right on the part of donees to sell their ownership interest back to the entity or to have the interest redeemed for a stated period after the gift; or (4) the right to sell ownership interests for a limited time to anyone. The last two are similar to the widely-used right under the so-called “Crummey” powers.

It is the practice of many practitioners, for value discount purposes, to permit an assignment of an LLC (or family limited partnership) interest, but not allow the assignee to obtain full membership without the consent of the managing member (or general partner). If the court is saying that an assignee must have the right to be admitted as a member or partner for the interest to qualify as a present interest, that could pose a drafting problem.

In conclusion

The Tax Court decision suggests strongly that planners would be well advised to review all files involving active gifting programs of ownership interests as well as to review with clients creating entities the alternatives for assuring a present-interest outcome where that is desirable.

FOOTNOTES

2. I.R.C. § 2503(b).
3. I.R.C. § 2010(c).
4. Id.
6. Id.
7. Ltr. Rul. 9751003, August 28, 1997 (gifts of limited partnership interests were gifts of future interests where general partner could retain funds for any reason).
9. Id.
10. Id.
11. Id.
14. See, e.g., Estate of Stinson v. United States, 214 F.3d 846 (7th Cir. 2000) (see note 1 supra); Chanin v. United States, 393 F.2d 972 (Cl. Ct. 1968).
16. Id.
17. Id.
21. Crummey v. Comm’r, 397 F.2d 82 (9th Cir. 1968); Cristofani v. Comm’r, 97 T.C. 74 (1991), acq. in result only, 1992-1 C.B. 1. See Rev. Rul. 75-415, 1975-2 C.B. 374; Ltr. Rul. 200123034, March 8, 2001 (transfers to irrevocable trusts were present interests (Crummey power)).

FARM ESTATE & BUSINESS PLANNING
15th EDITION
By Neil E. Harl

## BANKRUPTCY

### EXEMPTIONS

RESIDENCE. The debtors claimed a homestead exemption for a house and horse sheds on 10.33 acres. The title to the property was in the name of a family limited partnership in which the debtors were minority partners. Although the court recognized some authority in Texas law that a partner could exempt specific partnership property from attachment by creditors when the debtor remained a partner, the court held that, in bankruptcy, the partnership interests passed to the bankruptcy estate. Because the debtor’s partnership interest was bankruptcy estate property, the debtor could no longer claim the homestead partnership property as a personal exemption in bankruptcy. *In re Monsivais*, 274 B.R. 263 (Bankr. W.D. Tex. 2002).

PREFERENTIAL TRANSFERS. The debtor had purchased cattle from an auction facility since 1997. For over 40 purchases, the debtor paid for the cattle with a personal check. Three of the checks were returned for insufficient funds and the debtor covered the check with a cashier's check. Two of the cashier check payments occurred during the 90 days before the filing of the bankruptcy petition and the trustee sought recovery of the payments as preferential transfers. The debtor argued that the cashier’s checks were payment for the cattle and not preferential transfers. The court held that the return of the personal checks created a claim against the debtor, separate from the purchase of the cattle; therefore, if no exception applied, the cashier’s checks were preferential transfers. The debtor claimed that either the contemporaneous exchange for new value or ordinary course of business exception applied. The court held that the contemporaneous exchange exception did not apply because, under the Missouri UCC, title to the cattle passed upon the date of the sale, delivery and presentation of the personal checks. The personal checks were the contemporaneous exchange for the cattle. The court held that the return of the checks created new claims which were satisfied by the cashier’s checks. The court also held that the ordinary course of business exception did not apply because the debtor and auction facility had not set up a course of dealing in which the personal checks were returned and payment was made by cashier’s checks. The court noted that only three of the 47 total purchases had returned checks, and two of those were the last two purchases. *In re Stewart*, 274 B.R. 503 (Bankr. W.D. Ark. 2002).

## FEDERAL AGRICULTURAL PROGRAMS

### DISASTER ASSISTANCE PAYMENTS

The plaintiffs operated a catfish farm and suffered a loss of almost 60 percent of their fish in one crop year due to hot weather. The plaintiffs applied for disaster assistance under the Crop Loss Disaster Assistance Program (CLDAP). The CLDAP, however, required the CCC to determine the “normal mortality” associated with losses of crop under normal conditions so that losses incurred under natural disasters would be reduced by the normal mortality rate. For catfish farms, the normal mortality rate was set at 20 percent; therefore, the plaintiffs received compensation only for 40 percent of their losses. The plaintiffs challenged the 20 percent normal mortality factor as arbitrary and determined without due process. The normal mortality factor was determined by the CCC after consulting with experts in the various covered crops, including catfish farming. The court held that the CCC acted properly in determining the normal mortality factor and that the regulation was interpretative, which did not require public comment. *Belgard v. U.S.D.A.*, 185 F. Supp.2d 647 (W.D. La. 2001).

### TUBERCULOSIS

The APHIS has issued interim regulations which amend the bovine tuberculosis regulations regarding state and zone classifications by removing the split-state status of Texas and classifying the entire state as modified accredited advanced. 67 Fed. Reg. 38841 (June 6, 2002).

### WETLANDS

Under the Wetlands Reserve Program established by the Food Security Act of 1985, the CCC had issued regulations which, based upon statutory mandate, prohibited the Secretary from creating an easement on land that had changed ownership within the 12 months preceding the application for enrollment in the program. However, the Secretary could waive this ownership requirement if the new ownership was acquired by will or succession, or if the Secretary determined that the land was acquired under circumstances that gave adequate assurances that such land was not acquired for the purposes of placing it in the program. The Farm Security and Rural Investment Act of 2002, Public Law 107-171, expanded the ability of the Secretary to grant a waiver if the “ownership change occurred due to foreclosure on the land and the owner of the land immediately before the foreclosure exercises a right of redemption from the mortgage holder in accordance with State law.” The CCC has issued final regulations which comply with the statutory change. 67 Fed. Reg. 39254 (June 7, 2002).
FEDERAL ESTATE AND GIFT TAX

ACCIDENTAL DEATH BENEFITS. The IRS has ruled that accidental death benefits payable pursuant to New York City and New York state laws to specified beneficiaries of a deceased N.Y.C. firefighter or police officer who died in the line of duty are not includible in the decedent’s gross estate, except to the extent the benefits represent a return of the decedent’s contributions to the pension fund. The benefits were payable only to the decedent’s beneficiaries named by the decedent or determined by law and were not payable to the decedent’s estate. Rev. Rul. 2002-39, I.R.B. 2002-23.

MARITAL DEDUCTION. The decedent received property in trust from the estate of a predeceased spouse. The predeceased spouse’s will provided for a family trust and a marital trust and authorized the executor to elect QTIP treatment for the marital trust. The executor listed the marital trust on the estate tax return for the predeceased spouse but listed the value as the amount of both trusts. The executor eventually filed an amended return with the proper value of the marital trust. The confusion resulted in some marital trust property being used to fund the family trust. Upon the decedent’s death, the current value of the marital trust was included in the decedent’s estate. The IRS ruled that the current value of the marital trust was included in the decedent’s estate. Ltr. Rul. 200223020, Feb. 21, 2002.

FEDERAL INCOME TAXATION

APPEALS. The IRS has modified and extended its test of the arbitration procedure set forth in Announcement 2000-4, 2000-1 C.B. 317, for an additional one-year period beginning on July 1, 2002. This procedure allows taxpayers to request binding arbitration for factual issues that are already in the appeals process. As a first step, the taxpayer and IRS must attempt to negotiate a settlement; if the negotiations prove unsuccessful, the parties may jointly request binding arbitration. The IRS is modifying the initial test program in the following ways: (1) issues involving substantiation of expenses under I.R.C. §§ 162, 274 will now be eligible for arbitration; (2) issues for which taxpayers intend to seek competent authority assistance has not yet been filed; (3) timelines have been imposed for completing the agreement to arbitrate and proceeding to arbitration; and (4) collection cases, issues for which arbitration would be inconsistent with sound tax administration, frivolous issues, and cases in which the taxpayer failed to act in good faith during settlement negotiations are excluded from the arbitration procedure. The arbitration program is handled by the Appeals Large Business and Specialty Programs-Operations in the IRS. Ann. 2002-60, I.R.B. 2002-24.

CHARITABLE DEDUCTION. The taxpayers, husband and wife, formed a family trust which reached an agreement with a charitable organization for the organization to acquire a life insurance policy on the life of the wife. The trust made payments to the charity without restrictions but the charity used the contribution to pay the premium on the insurance policy. The trust made another payment the following year and the charity again made the premium payment. The trust and charity agreed to split the proceeds of the insurance upon the death of the wife. The agreement and insurance policy was terminated the third year. The court held that the taxpayers were not entitled to a charitable deduction for the contributions to the charity because the taxpayers received something of value in exchange. When the payments were made, the charity supplied the taxpayers with a receipt stating that no consideration was paid for the contributions, which was false. The court held that the false receipt resulted in the taxpayers failing to have sufficient substantiation of the contributions to support a deduction. Addis v. Comm’r, 118 T.C. No. 32 (2002).

CORPORATIONS-ALM § 7.02.*

GOLDEN PARACHUTE PAYMENTS. The IRS has issued guidance on valuing stock options for nonpublicly traded stock and publicly traded stock for purposes of I.R.C. §§ 280G, 4999. The new revenue procedure provides that a stock option for stock that is publicly traded (that is, an option that is a compensatory stock option as defined in Rev. Proc. 98-34) will be considered properly valued if the valuation method satisfies the standard set forth in Rev. Proc. 2002-13 for stock options that are not compensatory stock options. Accordingly, the value of a compensatory stock option will be considered properly determined if its value is determined in accordance with Rev. Proc. 98-34, with the safe harbor valuation method in Rev. Proc. 2002-13, or with a valuation method that is consistent with generally accepted accounting principles and that takes into account the factors provided in the proposed regulations. Rev. Proc. 2002-45, I.R.B. 2002—__, modifying, Rev. Proc. 2002-13, I.R.B. 2002-8, 549.

SHAREHOLDER LOANS. The taxpayer was the sole shareholder of a corporation which provided acting services. The taxpayer made several contributions to the corporation which were labeled as loans from the taxpayer on the corporation’s tax returns. The taxpayer did not execute any promissory notes or otherwise provide evidence of any repayment terms, interest or enforcement terms. The corporation made several payments for expenses which were not related to the business but were the taxpayer’s personal expenses. The taxpayer argued that, because the expenses paid by the corporation were less than the amount owed to the taxpayer, the corporation’s payments were repayment of the loans. The court held that the contributions were capital contributions and not bona fide loans and that the corporation’s payment of the taxpayer’s personal expenses was constructive dividends. Noble v. Comm’r, T.C. Summary Op. 2002-68.

COURT AWARDS AND SETTLEMENTS. The U.S. Supreme Court has denied certiorari in the following case. 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), aff’g, T.C. Memo. 1998-364.

The taxpayer was a shareholder and employee of a corporation. The taxpayer’s employment was terminated and the taxpayer sued the corporation for wrongful termination. The parties reached a settlement in which the corporation paid the taxpayer’s attorney’s fees, paid compensation for the wrongful termination and repurchased the taxpayer’s stock. The taxpayer argued that the attorney’s fees payment was excludible from income under I.R.C. § 62(c) as a reimbursement or other expense allowance arrangement. The court held that the payment did not qualify for I.R.C. § 62(c) treatment because the payment was not made under an accountable plan since the payments were not related to the performance of services for the corporation. Bielh v. Comm’r, 118 T.C. No. 29 (2002).

DISASTER PAYMENTS. On May 21, 2002, the president determined that certain areas in Illinois were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of severe storms, tornadoes, and flooding on April 21, 2002. FEMA-1416-DR. Accordingly, a taxpayer who sustained a loss attributable to these disasters may deduct the loss on his or her 2001 federal income tax return.

DISCHARGE OF INDEBTEDNESS. The IRS has issued proposed regulations relating to the information reporting requirement under I.R.C. § 6050P for cancellation of indebtedness. The proposed regulations reflect the enactment of I.R.C. § 6050P(c)(2)(D) by the Ticket to Work and Work Incentives Improvement Act of 1999 which requires lenders to report discharges of indebtedness. In addition, under the proposed regulations, if an organization that is required to report under Section 6050P (an applicable entity) forms, or avails itself of, some other entity for the principal purpose of holding loans acquired by the applicable entity, then, for purposes of Section 6050P, the entity so formed or availed of is treated as having a significant trade or business of lending money. 67 Fed. Reg. 40629 (June 13, 2002).

EDUCATION EXPENSES. The taxpayers, husband and wife, claimed a deduction for the wife’s law school expenses. The wife was employed as a law librarian and continued in those duties after receiving the law degree and admission to the state bar. The wife claimed that she had no intention of ever practicing law. The law school degree was not required by the wife’s employer. The court held that the law school expenses were not deductible because the education prepared the wife for a new trade or business. Galligan v. Comm’r, T.C. Memo. 2002-150.

INTEREST RATE. The IRS has announced that, for the period July 1, 2002 through September 30, 2002, the interest rate paid on tax overpayments remains at 6 percent (5 percent in the case of a corporation) and for underpayments at 6 percent. The interest rate for underpayments by large corporations remains at 8 percent. The overpayment rate for the portion of a corporate overpayment exceeding $10,000 remains at 3.5 percent. Rev. Rul. 2002-33, I.R.B. 2002-22.

PARTNERSHIPS-ALM § 7.03.* ADMINISTRATIVE ADJUSTMENTS. The IRS has issued a notice of deficiency based upon the taxpayer’s share of partnership discharge of indebtedness income. The taxpayer argued that the notice was barred by the statute of limitations for personal income tax returns because the taxpayer was not a partner in the partnership. The court held that the issue of the taxpayer’s status as a partner was a partnership item, subject to the longer limitation period of I.R.C. § 6229 for administrative adjustment proceedings. Bleonien v. Comm’r, 118 T.C. No. 34 (2002).

PENSION PLANS. For plans beginning in June 2002, the weighted average is 5.68 percent with the permissible range of 5.11 to 6.24 percent (90 to 120 percent permissible range) and 5.11 to 6.81 percent (90 to 110 percent permissible range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). Notice 2002-38, I.R.B. 2002-25.

RETURNS. The IRS has advised newly married taxpayers of the possible need to file name and address changes with the IRS. A taxpayer who changes his or her last name upon marrying should notify the Social Security Administration and should update his or her social security card so that the number matches the new name. Form SS-5, “Application for a Social Security Card,” is available through the SSA website at www.ssa.gov or by calling toll-free 1-800-772-1213. If one or both spouses are changing their address, they should notify the IRS using Form 8822. “Change of Address Form,” to be sure that they receive any tax refunds or IRS correspondence. IR-2002-74.

S CORPORATIONS MERGER. An S corporation, merged into a C corporation in a merger qualifying as an "A" reorganization under I.R.C. § 368(a)(1)(A). Prior to the merger, an individual shareholder owned stock in the S corporation and stock in the C corporation. The shareholder has suspended losses under I.R.C. § 1366(d) at the time of the merger. After the merger, the shareholder has two blocks of stock in the C corporation, the stock received in the merger and the original stock. The shareholder made no contributions to, and received no distributions from, the C corporation with respect to the stock during the post-termination transition period. In a Field Service Advice letter, the IRS ruled that the shareholder was permitted to apply losses suspended under I.R.C. § 1366(d) against the shareholder’s historic basis in the C corporation stock. The shareholder was required to reduce the shareholder's historic basis in the C corporation stock for the losses taken. FSA Ltr. Rul. 200223052, May 7, 2002.
SALE OF RESIDENCE. The taxpayers, husband and wife, owned a residence in one city. The husband obtained employment in another city and the couple placed the original house for rent. The house was rented for six months, after which it was placed for sale. The house did not sell for almost two years. The taxpayers claimed maintenance and tax expenses as deductions related to property held for the production of income. The court held that the temporary rental of the house did not convert the house to property held for the production of income and denied the deductions. Saunders v. Comm’r, T.C. Memo. 2002-143.

TAX ON SOCIAL SECURITY BENEFITS. The taxpayer was married and resided in the same residence as the spouse for at least 30 days during the taxable year. The taxpayer received social security income of $11,181, filed a return as “married filing separately,” and did not include any of the social security benefits as taxable income. The taxpayer argued that the taxpayer and spouse lived apart; therefore, the taxpayer was eligible to claim a base amount of $25,000 under I.R.C. § 86(c)(1), resulting in exclusion of all social security income. The court held that, because the taxpayer resided with the spouse for some part of the taxable year and did not file a joint return, the taxpayer’s base amount was zero and all of the social security income was taxable. McAdams v. Comm’r, 118 T.C. No. 24 (2002).

SECURED TRANSACTIONS

FEDERAL FARM PRODUCTS RULE. By Roger A. McEowen. The Farm Security and Rural Investment Act of 2002, Pub. L. No. 107-171, ___ Stat. ___ (2002) made several changes in the federal farm products rule. Section 10604(a) of the Act modifies the requirement of 7 U.S.C. § 1631(c)(4) that an effective financing statement (other than electronically filed financing statements) be signed by the debtor by specifying that the statement is effective if it is signed, authorized or otherwise authenticated by the debtor. The same section also clarifies that a financing statement securing farm products needs to describe the farm products and specify each county or parish in which the farm products are produced or located. Any amendment to a financing statement made to reflect material changes must be made in writing within three months and be signed, authorized or otherwise authenticated by the debtor.

Section 10604(a) of the Act also changes the requirement that a notice of lapse of the financing statement be signed by the secured party to a requirement that the secured party sign, authorize or otherwise authenticate the filed notice of lapse of the financing statement. Section 10604(c) of the Act makes the same changes to 7 U.S.C. § 1631(g)(2)(A) with respect to a commission merchant or selling agent who sells a farm product for others.

Section 10604(b) of the Act also states that the notice sent to the buyer of farm products by the secured party within a year before the sale of the farm products be amended in writing within three months of the occurrence of any material changes be signed to “changed, authorized or otherwise authenticated”. Section 10604(c) of the Act makes the same changes to 7 U.S.C. § 1631(g)(2)(A) with respect to a commission merchant or selling agent who sells a farm product for others.

PERFECTION. The debtor had several loans with a bank for operating and ownership loans. Some loans were consumer loans perfected with UCC-1 financing statements and some were farm products loans perfected with UCC-1F financing statements. Each loan was secured by perfected security interests. The name of the bank and its address on the financing statements were accurate when made, but the bank was merged into another bank without changing or amending the financing statements. To complicate the matter more, Idaho adopted the Revised UCC Article 9. The debtor sought to have the security interests be declared unperfected because the financing statements had the wrong creditor name and address. The court held that the Revised Article 9 applied but provided that security interests perfected under the old version would be considered perfected under the revised version. However, the Revised Article 9, Idaho Code § 28-9-704(3)(A), provided that unperfected security interests automatically become perfected under the Revised Article 9 if they meet the new criteria. As to the UCC-1 financing statements, the court held that the name and address changes did not render the security interests unperfected under the old Article 9; therefore, the security interests remained perfected under the Revised Article 9. As to the UCC-1F financing statements, the court held that the incorrect name and address may have rendered the security interests unperfected under the old Article 9 but were not sufficient to prevent perfection under the Revised Article 9; therefore, the security interests were perfected under the Revised Article 9. In re Hergert, 275 B.R. 58 (Bankr. D. Idaho 2002).

CITATION UPDATES

Estate of Schuler v. Comm’r, 282 F.3d 575 (8th Cir. 2002), aff’g, T.C. Memo. 2000-392 (reciprocal gifts) see p. 52 supra.


Shepherd v. Comm’r, 283 F.3d 1258 (11th Cir. 2002), aff’d, 115 T.C. 376 (2000) (gifts) see p. 44 supra.


IN THE NEWS

ENVIRONMENTAL LAW. The Ninth Circuit Court of Appeals has ruled that the EPA can set limits on pollution of rivers from logging and agricultural runoff. The ruling upholds a federal judge’s interpretation of certain provisions of the 1972 Clean Water Act that the EPA began enforcing in 1991 because of pressure from environmental groups. Those provisions allow the EPA to force states to come up with ways to reduce pollution in rivers and waterways contaminated solely by runoff, as opposed to industrial waste or sewage. Before 1991, the EPA set pollutant limits only on discharges from “point sources,” such as drain pipes from sewage systems and industrial plants. States decide how to achieve the limits, through restrictions on logging, road-building and other practices that cause erosion and chemical runoff. States can lose federal funds if they fail to require reductions. Farming groups argued that the government was only authorized to limit pollution from industrial waste and sewage systems. The suit was filed by two Mendocino County landowners who were joined by the American Farm Bureau Federation and state and local farm organizations. Las Vegas Sun, May 31, 2002.

POULTRY PRODUCTION CONTRACTS. About 400 Oklahoma poultry farmers have sued an Arkansas chicken company for roughly $30 million, alleging the company made millions of dollars at their expense. The farmers charged fraud and breach of contract in the lawsuit filed in federal court against O.K. Industries Inc., in Fort Smith, Ark. The lawsuit asks for O.K. Industries and its subsidiaries to give $75,000 to each farmer for compensation and punitive damages. The lawsuit alleged that chicken houses deteriorate quickly and farmers are not aware of that or of how their pay is tied to the condition of their houses. “Unfortunately, the farmers, who have invested hundreds of thousands of dollars to build their chicken houses, are then forced to choose between losing everything or staying with the company,” Goodwin said. The lawsuit also seeks to resolve the issue of whether the company, rather than farmers, should be responsible for the litter that can damage water quality. The Oklahoman, May 31, 2002.

SHARED APPRECIATION AGREEMENTS. A federal judge has thrown out a lawsuit filed by farmers across the country over the government’s attempt to recoup millions of dollars from bailouts written in the late 1980s. While the bailout contracts are “poorly drafted and confusing,” they do say the farmers owe the government at least some of the amount by which their land increased in value since the deals were struck. U.S. District Judge Rodney Webb wrote. The dispute hinges on a 1987 law that restructured or wrote off billions of dollars in farm loans. It has been credited with saving 23,000 farmers from foreclosure during the 1980s. The lawsuit said the federal Farm Service Agency (FSA) began asking for a total of $4.3 million from farmers in 1999. The agency asked each farmer for half the amount of money by which that farmer’s land increased in value from 1989, the year it agreed to write off loans above the actual value of the land. The farmers contended they had to share only appreciation money if they sold their land or quit farming within the 10-year term of the contracts; otherwise, the deals would simply expire and they would owe nothing. The Agriculture Department, which oversees the FSA, said the contracts, called shared appreciation agreements, came due 10 years after they were signed - or sooner, if the farmers left the land. In his decision, Webb said the 1987 Agricultural Credit Act was intended to help struggling farmers write down debt “and in return USDA would receive a portion of the increased value of the land.” Webb also agreed with the government that it should be paid if a farmer quit the land or when the contract came due. “In either event, recapture will take place; the only question is when,” he wrote. He also said there was nothing to support the farmers’ argument that the amount owed could be capped. The lawsuit lists as plaintiffs more than 100 farmers from Idaho, Illinois, Indiana, Iowa, Kentucky, Louisiana, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, North Dakota, South Dakota, Tennessee and Wisconsin. Jack Sullivan, Associated Press.
AGRICULTURAL TAX AND LAW SEMINARS

by Neil E. Harl and Roger A. McEowen

August 13-16, 2002  Holiday Inn I-25, Fort Collins, CO
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“DEEMED SALES” OF CAPITAL AND SECTION 1231(b) ASSETS

— by Neil E. Harl

The Taxpayer Relief Act of 1997,1 in reducing the rates on long-term capital gains,2 reduced the rates further from 10 percent to 8 percent and from 20 percent to 18 percent for assets held for more than five years.3

Nature of the “deemed sale”

Except for those in the 15 percent bracket, the holding period had to begin after December 31, 2000.4 That meant that, in general, the provision authorizing an 18 percent rate did not take effect until 2006. However, Section 311(e) of The Taxpayer Relief Act of 1997,5 which was not added to the Internal Revenue Code, contains a “deemed sale” provision which permits taxpayers effectively to sell and repurchase eligible assets effective January 1, 2001, with the eligible assets deemed sold on January 1, 2001, and immediately repurchased at the same value with a triggering of gain (but not loss). That maneuver starts the holding period for the reduced long-term capital gain rate of 18 percent.6

The statutory guidance for deemed sales states as follows—

“For purposes of the Internal Revenue Code of 1986—

“(1) In General.—A taxpayer other than a corporation may elect to treat

“(A) Any readily tradable stock (which is a capital asset) held by such taxpayer on January 1, 2001, and not sold before the next business day after such date, as having been sold on such next business day for an amount equal to its closing market price on such next business day (and as having been reacquired on such next business day for an amount equal to such closing market price), and

“(B) Any other capital asset or property used in the trade or business (as defined in section 1231(b) of the Internal Revenue Code of 1986) held by the taxpayer on January 1, 2001, as having been sold on such date for an amount equal to its fair market value on such date (and as having been reacquired on such date for an amount equal to such fair market value).

“(2) Treatment of gain or loss—

“(A) Any gain resulting from an election under paragraph (1) shall be treated as received or accrued on the date the asset is treated as sold under paragraph

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
(1) and shall be included in gross income notwithstanding any provision of the Internal Revenue Code of 1986. “(B) Any loss resulting from an election under paragraph (1) shall not be allowed for any taxable year.

“(3) Election.—An election under paragraph (1) shall be made in such manner as the Secretary of the Treasury or his delegate may prescribe and shall specify the assets for which such election is made. Such an election, once made with respect to any asset, shall be irrevocable. Such an election shall not apply to any asset which is disposed of (in a transaction in which gain or loss is recognized in whole or in part) before the close of the 1-year period beginning on the date that the asset would have been treated as sold under such election.

“(4) Readily tradable stock.—For purposes of this subsection, the term ‘readily tradable stock’ means any stock which, as of January 1, 2001, is readily tradable on an established securities market or otherwise.

“(5) Disposition of interest in passive activity—Section 469(g)(1)(A) of the Internal Revenue Code of 1986 shall not apply by reason of an election under paragraph (1).”

**Eligible property**

As noted, capital assets are eligible for the deemed sale election and depreciable property and real estate used in a trade or business and held for more than one year, are also eligible. That is the case even though much or all of the gain on depreciable property may be subject to recapture as ordinary income.

**Making the election**

The election is made by reporting the deemed sale on Form 4797 and Schedule D, for the respective types of property, and attaching a statement indicating that an election is being made under Section 311(e) of the Tax Reform Act of 1997. The statement is to include a listing of the assets for which the election is being made. As noted above, the election, once made, is irrevocable.

The tax return must be filed not later than the due date (including extensions). For those who have already filed their returns for 2001, an election can be made on an amended return filed within six months of the due date for the tax return (excluding extensions). Taxpayers are directed to write “Election Under Section 311 of the Taxpayer Relief Act of 1997” at the top of the amended return.

**Recent developments**

In 2000, Congress amended the deemed sale provision to specify that the election to recognize gain and start a new five-year holding period for the 18 percent capital gain rate does not apply to property sold within one year of the election. In 2001, IRS ruled that if the election was made with respect to a principal residence, the $250,000 exclusion ($500,000 on a joint return) is not available. In 2002, the Congress added that any gain triggered in a deemed sale must be included in gross income regardless of any other provision of the Internal Revenue Code. In the same legislation, Congress specified that a deemed sale of an asset with passive activity losses does not result in a deduction of those losses. The election, however, does not affect I.R.C. § 469 as to “dispositions.”

Gains that are passive can be offset by passive activity deductions but the election does not affect disallowed losses.

**In conclusion**

A major question is whether a deemed sale election is likely to be advantageous. That is heavily a facts and circumstances question for each taxpayer.

**FOOTNOTES**


2 I.R.C. § 1(h)(1).

3 I.R.C. § 1(h)(2), (9).

4 I.R.C. § 1(h)(2)(B).

5 See n. 1 supra.

6 Id. See I.R.C. § 1(h)(2)(B), (9).

7 TRA-97, Sec. 311(e), as amended by H.R. 4577, Sec. 134(c), 106th Cong., 2d Sess. (2000) and Pub. L. No. 107-147, Sec. 414(a).

8 Id.

9 I.R.C. § 1231(b).

10 See n. 7 supra and accompanying text.

11 Id.

12 See Instructions to 2001 Form 4797 and 2001 Schedule D.

13 TRA-97, Sec. 311(e)(3). See n. 7 supra and accompanying text.

14 See note 12 supra.

15 2001 Schedule D Instructions, p. D-2; 2001 Form 4797 Instructions, p. 3.

16 Pub. L. No. 106-554, Sec. 134(c), 106th Cong., 2d Sess. (2000) (the provision effectively eliminated the ploy of generating short-term capital losses by selling assets within one year of the deemed disposition date).

17 I.R.C. § 121.


19 Pub. L. No. 107-147, Sec. 414(a)(2).


21 Id.

BANKRUPTCY

FEDERAL TAXATION-ALM § 13.07.*

DISCHARGE. The debtor did not file timely returns for 1988 and 1989. The IRS constructed 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, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,478 (D. Minn. 2002), aff’g, 260 B.R. 142 (Bankr. D. Minn. 2001).

FEDERAL AGRICULTURAL PROGRAMS

BEEF CHECK-OFF. The plaintiffs were livestock producers subject to the assessment of one dollar per head of cattle to be used by the USDA and the Cattlemen’s Beef Board for promotion of the beef industry, as provided by the Beef Promotion and Research Act, 7 U.S.C. § 2901 et seq. The plaintiffs challenged the law as an unconstitutional violation of the First Amendment. The plaintiffs objected to the assessment because it paid for advertising for beef products, such as steak, which is not the product which the plaintiffs sold, live cattle. The court held that, under United States Department of Agriculture v. United Foods, Inc., 533 U.S. 405, aff’g, 197 F.3d 221 (6th Cir. 2000), the assessment was a violation of the plaintiffs’ first amendment rights of free speech and association. The court made its temporary injunction permanent and prospective from July 15, 2002. The court also refused to issue a stay pending appeal to the Eighth Circuit or the Supreme Court, citing the continuing harm to the producers who are under stress from economic and environmental conditions. See Harl, “Future of Commodity Check-Offs,” 12 Agric. L. Dig. 113 (2001). Livestock Marketing Ass’n v. USDA, CIV 00-1032, 2002 U.S. Dist. LEXIS 11625 (D. S.D. June 21, 2002).

DISASTER PAYMENTS. The FSA has issued proposed regulations which would amend its regulations for the Disaster Set-Aside program to provide the disaster set-aside more quickly to those who can benefit most from the program. 67 Fed. Reg. 41869 (June 20, 2002).

GUARANTEED LOANS. The FSA has adopted as final regulations which provide that the specific dollar amount of guaranteed loan limits will be increased annually based on an annual index of prices paid by farmers. 67 Fed. Reg. 41311 (June 18, 2002).

TOBACCO. The FSA has adopted as final regulations which amend the regulations that govern tobacco quotas and allotments to allow the transfer by sale of a flue-cured quota in either Georgia or Florida to another farm, for production on that farm, in another county in that state. The FSA held a referendum of producers to determine their opinion on the sale of allotments across county lines who voted to permit transfers across county lines and this rule implements those results. 67 Fed. Reg. 41310 (June 18, 2002).

FEDERAL ESTATE AND GIFT TAX

ADJUSTED TAXABLE GIFTS. The decedent had owned property separate from the decedent’s spouse under an antenuptial agreement which provided that the spouse would assist in any conveyance of the property as required. The property was sold to the decedent’s children in exchange for a promissory note. The decedent’s estate included only half of the promissory note in the decedent’s estate, claiming that the other half belonged to the spouse. The court held that the entire promissory note was included in the decedent’s estate because the decedent was the sole owner of the property exchanged for the note. Estate of Bailey v. Comm’r, T.C. Memo. 2002-152.

ADMINISTRATIVE EXPENSES. The decedent had created two trusts, one for each of the decedent’s two heirs. Most of the estate passed under the trusts. The estate claimed $48,000 in administrative expenses, including $16,000 in personal representative fees. The expenses were all allowed under state law, but the IRS objected to deduction for personal representative fees as to the trust assets and for much of the administrative expenses as not necessary to the administration of the estate. The court first held that, although an administrative expense had to be allowed under state law in order to be deductible for federal estate tax purposes, the validity under state law did not mean that the expenses was deductible under federal estate tax law. The appellate court agreed with the Tax Court that the passage of the trust assets was not part of the administration of the estate; therefore, no deduction was allowed for costs of administering the trusts.
The taxpayer created two limited partnerships and transferred limited partnership interests to a charitable organization and a grantor retained annuity trust (GRAT). The taxpayers children received general partnership interests. The partnership agreement had a provision that the partnership was to liquidate in January 2043 unless an earlier termination was agreed to by all partners. The taxpayer argued that the partnership interests were only assigned and not fully transferred because the partners did not agree to the transfers; the value of the limited partnership interests were to be discounted for lack of liquidity; and the interests were not subject to I.R.C. § 2704 because there were no applicable restrictions on liquidations. The court held that the partnership interests were fully transferred, the interests had to be valued at fair market value and the transfers were not subject to Section 2704 because the restrictions on liquidation did not exceed the restrictions provided by state law. **Kerr v. Comm’r**, 2002-1 U.S. Tax Cas. (CCH) ¶ 60,440 (5th Cir. 2002), aff’d, 113 T.C. 450 (1999).

The decedent’s estate consisted of 25 percent of the stock in a closely-held corporation which owned two motels. The decedent’s estate also included an interest in a QUITR trust established by a predeceased spouse which consisted of another 25 percent ownership of the corporation. The court held that interests in the corporation were valued by first valuing the assets of the corporation and applying a 50 percent minority and lack of marketability discount to each 25 percent interest. **Estate of Bailey v. Comm’r**, T.C. Memo. 2002-152.

**FEDERAL INCOME TAXATION**

**BAD DEBTS.** The taxpayer contributed money to a corporation in exchange for a promissory note. The corporation filed for Chapter 11 bankruptcy a year later. The bankruptcy reorganization created a new corporation and distributed stock to the taxpayer in exchange for the note. The corporation, before and after bankruptcy, had assets in excess of its liabilities. The court held that the taxpayer could not claim a bad debt deduction for the promissory note because the taxpayer failed to prove that the note was worthless. **Favia v. Comm’r**, T.C. Memo. 2002-154.

**CAPITAL GAINS AND LOSSES.** The taxpayer sold stock “short” by borrowing shares in January of one taxable year. On December 31 of that year, the taxpayer placed an order to purchase shares to cover the short position and close out the short sale. The purchased stocks were settled with the lender in the second taxable year. If the stock appreciates in value, the gain is recognized on the date of the order of covering purchase. **Rev. Rul. 2002-44, I.R.B. 2002-28.**

**CHARITABLE DEDUCTION.** The taxpayer was a dentist and made contributions to a charitable organization. The charitable organization used the funds to purchase split-dollar life insurance policies on the taxpayer and agreed to split any proceeds with trusts established by the taxpayer. The organization provided receipts for the contributions but did not state that any benefits were received by the taxpayer. The court held that the taxpayer was not entitled to a charitable deduction based on the receipts which were not based on a good faith estimate of the value of the benefits received by the taxpayer. **Weiner v. Comm’r**, T.C. Memo. 2002-153.

**COOPERATIVES.** The taxpayer was a marketing cooperative with all capital supplied by member patrons and all
income distributed on a patronage basis. The IRS ruled that the taxpayer was taxable as a cooperative under I.R.C. § 1381. Ltr. Rul. 200224017, March 15, 2002.

A non-tax exempt cooperative charged its members annual dues. The cooperative changed its bylaws to provide that the annual dues could be charged against the annual patronage dividend allocated or paid to members. The cooperative made the change in order to reduce the administrative costs of the dues. Members had the ability to elect not to have the dues charged against the dividends. The IRS ruled that the portion of the dividends used to pay the annual dues would be qualified dividends as patronage dividends “paid in money.” Ltr. Rul. 200226037, March 28, 2002.

CORPORATIONS-ALM § 7.02.*

SHAREHOLDER LOANS. The court held that distributions to a shareholder were constructive dividends and not loans where (1) the promissory note was signed by the shareholder as lender and debtor; (2) the note was not the result of arm’s-length negotiations; (3) and the note provide no fixed payment schedule or maturity date. Boler v. Comm’r, T.C. Memo. 2002-155.

DISASTER PAYMENTS. On June 12, 2002, the president determined that certain areas in Indiana were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of severe storms, tornadoes and flooding on April 28, 2002 through June 7, 2002. FEMA-1418-DR. On June 14, 2002, the president determined that certain areas in Minnesota were eligible for assistance under the Act as a result of severe storms, tornadoes and flooding on June 9, 2002. FEMA-1419-DR. On June 19, 2002, the president determined that certain areas in Iowa were eligible for assistance under the Act as a result of severe storms and flooding on June 3, 2002. FEMA-1420-DR. On June 19, 2002, the president determined that certain areas in Colorado were eligible for assistance under the Act as a result of wildfires beginning on June 3, 2002. FEMA-1421-DR. On June 25, 2002, the president determined that certain areas in Arizona were eligible for assistance under the Act as a result of wildfires beginning on June 18, 2002. FEMA-1422-DR. Accordingly, a taxpayer who sustained a loss attributable to these disasters may deduct the loss on his or her 2001 federal income tax return.

DISCHARGE OF INDEBTEDNESS. The taxpayer was the sole shareholder of two S corporations which operated a marina and a mobile home park. Both businesses eventually failed, with the corporations both owing money to the taxpayer. The taxpayer admitted that, in 1992, the taxpayer no longer owed the money to the corporations. However, the taxpayer provided no evidence of payment of the loans and provided no other evidence of the loan transactions with the corporations. The taxpayer also failed to prove that the taxpayer was insolvent when the loans were discharged; therefore, the court held that the taxpayer had discharge of indebtedness income which was not excluded from the taxpayer’s income. Toberman v. Comm’r, 2002-2 U.S. Tax Cas. (CCH) ¶ 50,472 (8th Cir. 2002), aff’d, T.C. Memo. 2000-221.

The taxpayer had obtained a credit card in 1986 and had an outstanding balance when the taxpayer moved to a new address in another state several years later. The credit card company attempted to collect on the balance but was unable to contact the debtor until 2001 when the company sent a letter saying that a Form 1099-C was filed for 1998 listing discharge of indebtedness income. However, no Form 1099-C was presented as evidence by the IRS, and the IRS failed to provide any evidence of the date or amount of indebtedness discharged. The only identifiable event which occurred as to the debt was the company’s cessation of collection efforts in 1996 and the issuance of the Form 1099-C for 1998. The court held that this was insufficient to prove any discharge of indebtedness occurred in 1998. Sims v. Comm’r, T.C. Summary Op. 2002-76.

EARNED INCOME CREDIT. The taxpayer’s child lived with the child’s grandmother from May 1999 to the end of 1999, except when on vacation from school. The taxpayer usually visited the grandchild on weekends and paid rent to the grandmother for the child. The court held that, because the child lived less than 50 percent of the tax year with the taxpayer, the child was not a qualifying child for earned income credit purposes. Chandler v. Comm’r, T.C. Summary Op. 2002-73.

ELECTRICITY PRODUCTION CREDIT. The IRS has announced the 2002 inflation adjustment factor (1.1908) and reference prices used in determining the availability of the renewable electricity production credit to taxpayers producing electricity using wind (5.54 cents per kilowatt hour) or closed-loop biomass and poultry waste (10 cents per kilowatt hour). The inflation adjustment factor and reference prices apply to calendar year 2002 sales of kilowatt hours of electricity produced in the U.S. and its possessions from qualified energy resources. The renewable electricity production credit for calendar year 2002 is 1.8 cents per kilowatt hour on the sale of electricity produced from wind, closed-loop biomass, and poultry waste energy resources. Notice 2002-39, I.R.B. 2002—.

EMPLOYEE BENEFITS. The taxpayer adopted a plan for reimbursement of a portion of laser surgery (radial keratotomy) for employees who have been employed for at least one year. No employee contributions are made and the benefit may not be exchanged for other employee benefits. The IRS ruled that the amounts received as reimbursements under the plan were not included in the employees’ income and did not affect the taxation of other employee benefits of the employees. Ltr. Rul. 200226003, March 7, 2002.

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, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,471 (6th Cir. 2002), aff’g, T.C. Memo. 2001-68.

The taxpayers purchased a lake front lodge, restored the lodge and formed an S corporation to operate the lodge. Although the taxpayer claimed that the lodge was a business property which was to be rented to the public, the lodge was renovated for use as a vacation home and was never rented to the public. The court held that the taxpayer and corporation could not claim any deductions for renovation or operation of the lodge because it was not operated with the intent to make a profit but was used solely for personal recreation. Baldwin v. Comm’r, T.C. Memo. 2002-162.

IRA. In the summer of 1997 Congress created the so-called Roth IRA and provided that ordinary IRAs could be “rolled over” into Roth IRAs. The form that the legislation took, however, meant that if funds from a regular IRA were rolled over into a Roth IRA and then immediately withdrawn, the I.R.C. § 72 10 percent addition to tax would not apply. After Congress discovered this situation, in July 1998, it subjected such withdrawals to the 10 percent tax, effective January 1, 1998. The taxpayer had made a rollover distribution from an IRA to a Roth IRA and distributed funds from the Roth IRA prior to passage of the corrective legislation. Because the legislation was made retroactive, the taxpayer was assessed the 10 percent addition to tax on the withdrawal from the Roth IRA. The taxpayer challenged the retroactive application of the 10 percent tax to the withdrawal as unconstitutional because it was (1) a retroactive imposition of a penalty that denies the taxpayer due process, in violation of the Fifth Amendment, (2) a taking of the taxpayer’s property, for which the taxpayer was entitled to just compensation under that amendment, and (3) the imposition of an excessive fine, in violation of the Eighth Amendment. The court held that the retroactive application of the amendment was constitutional. Kitt v. United States, 288 F3d 1355 (Fed. Cir. 2002), aff’g on rehearing, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,167 (Fed. Cir. 2002).

PARTNERSHIPS-ALM § 7.03.*

DISTRIBUTIVE SHARE. The decedent and brother had orally agreed to combine their farming and oil exploration businesses as a partnership with each partner receiving 50 percent of the partnership. However, one brother operated the farm and the other operated the oil business and the partners agreed that the farm income was to be allocated to the brother and the oil profits allocated to the decedent. The primary issue in the case was the allocation of gain from the sale of grain by the partnership in the year of the decedent’s death. The estate argued that the partnership agreement allocated all of the income to the brother. The court rejected the oral agreement to allocate the profits from the individual business because the agreement lacked economic substance. The court held that the decedent was a 50 percent partner and that the grain was partnership property when it was sold; therefore, the decedent and the decedent’s estate received a 50 percent distributive share of the income from the grain sale. Estate of Ballantyne v. Comm’r, T.C. Memo. 2002-160.

PASSIVE ACTIVITY LOSSES. The taxpayer owned several residential rental properties and was employed full-time with a state agency. The taxpayer claimed losses from the rental activities and characterized the losses as nonpassive because the taxpayer claimed to have spent 2,440 hours on the activity and qualified for the real estate professional exception to the passive loss rules. The taxpayer claimed that 1,440 hours was spent as “phone-in office hours 360 days a year” in which the taxpayer was available for phone calls from tenants for four hours each day. The taxpayer did not claim that the taxpayer spent four hours each day on the phone with tenants. The court held that the 1,440 hours could not be included because the taxpayer was not actually involved with the properties during those hours; therefore, the losses were passive losses. Monroe v. Comm’r, T.C. Summary Op. 2002-79.

PENSION PLANS. The taxpayer was a C corporation that sponsored a calendar year profit sharing plan qualified under I.R.C. § 401(a). The plan year is the calendar year. On April 1, 1997, a disqualified person with respect to the plan obtained a two-year loan in the amount of $10,000 from the plan's tax-exempt trust. The loan was secured solely by the person's account balance in the plan. At the time of the loan, the person’s account balance was $12,000. According to the terms of the loan, the person was to make substantially equal payments of principal and interest to the plan's trust on the first business day of every calendar quarter. The interest rate of the loan was 11 percent, compounded annually, which was equal to or greater than a fair market rate of interest for such a loan at that time. The person made no payments on the loan until December 31, 1999, at which time the person repaid the loan, including principal and accrued interest. The repayment constituted a "correction" within the meaning of I.R.C. § 4975(f)(5). None of the Forms 5500 that were filed for the plan for 1997, 1998, or 1999 reflected a loan to the person. The IRS ruled that, when a loan from a qualified plan that is a prohibited transaction spans successive taxable years, and thus constitutes multiple prohibited transactions, and during those years the first tier prohibited transaction excise tax rate changes, the first tier excise tax liability for each prohibited transaction is the sum of the products resulting from multiplying the amount involved for each year in the taxable period for that prohibited transaction by the excise tax rate in effect at the beginning of that taxable period. Rev. Rul. 2002-43, I.R.B. 2002__.

RETURNS. The IRS has released specifications for filing Forms 1098, 1099, 5498 and W-2G with the IRS electronically through the IRS FIRE System or magnetically, using IBM 3480, 3490, 3490E, 3590, 3590E, or AS400 compatible tape cartridges, or 3.5 inch diskettes. The IRS/Martinsburg Computing Center (IRS/MCC) no longer accepts one-half-inch 9-track magnetic tape for the processing of information returns. This procedure must be used for the preparation of 2002 tax year information returns and information returns for tax years prior to 2002 filed beginning January 1, 2003, and received by

SAFE HARBOR INTEREST RATES

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TAX ON SOCIAL SECURITY BENEFITS. In 1997 the taxpayer received social security benefits for 1997, 1996, 1995 and 1994. The taxpayer erroneously did not include any of the payments in income. An election under I.R.C. § 86(e) provides that, if the election is made, the amount included in gross income for the taxable year of receipt must not exceed the sum of the increases in gross income for those previous taxable years that would result from taking into account the portion of the benefits attributable to the previous taxable years. The taxpayer did not make this election and the court held that all of the disability payments received in 1997 were taxable in 1997. Nicholas v. Comm’r, T.C. Summary Op. 2002-77.

WITHHOLDING TAXES. The IRS has announced that until IRS issues further guidance, in the case of a statutory stock option, i.e., an incentive stock option (ISO) described in I.R.C. § 422(b) or an option granted under an employee stock purchase plan (ESPP) described in I.R.C. § 423(b), the IRS will not assess the FICA tax or FUTA tax, or apply federal income tax withholding obligations, upon either the exercise of the option or the disposition of the stock acquired by an employee pursuant to the exercise of the option. The IRS anticipates that any final guidance that would apply employment taxes to statutory stock options will not apply to any exercise of a statutory stock option that occurs before January 1 of the year that follows the second anniversary of the publication of the final guidance. Notice 2002-47, I.R.B. 2002-__.

IN THE NEWS

CONSERVATION RESERVE PROGRAM. Farmers and ranchers in parts of drought-hit Montana and South Dakota are allowed to harvest hay from land enrolled in the Conservation Reserve, the Agriculture Department said. USDA also provided $1.9 million for South Dakota and $90,000 to Montana in Emergency Conservation funds to construct or deepen wells, develop seeps and springs, install pipelines and haul water for livestock. Up to $2 million in additional funds was earmarked from Montana if needed. Haying on land idled in the long-term Conservation Reserve will provide a source of feed for livestock, USDA said. Haying was authorized until Aug. 28. Landowners without livestock can rent or lease the haying privilege to livestock producers in their county. Emergency haying was authorized for 33 counties in Montana - Big Horn, Blaine, Broadwater, Carbon, Carter, Cascade, Chouteau, Custer, Dawson, Fallon, Fergus, Garfield, Glacier, Golden Valley, Hill, Jefferson, Judith Basin, Lewis and Clark, Liberty, Meagher, Musselshell, Phillips, Pondrera, Powder River, Prairie, Rosebud, Sheridan, Stillwater, Teton, Toole, Treasure, Wheatland and Yellowstone. The counties also have been approved for emergency grazing of Conservation Reserve land.

In South Dakota, 28 counties were approved for emergency haying - Aurora, Bon Homme, Brown, Butte, Campbell, Corson, Dewey, Edmunds, Faulk, Haakon, Hand, Harding, Hughes, Hyde, Jackson, Jones, Lyman, Marshall, McPherson, Pennington, Perkins, Potter, Spink, Stanley, Sully, Walworth and Ziebach. They also were authorized for emergency grazing.

Reuters News Service.

SELF-EMPLOYMENT INCOME. In a Tax Court petition filed December 4, 2001, the taxpayers owned a 16.66% interest in a general partnership, which rented farmland on a cash rent basis to a corporation. The taxpayers reported their shares of rental income on Schedule E for each year. However, the IRS determined that the income derived from this partnership was self-employment income subject to self-employment tax. The taxpayers claimed that the cash rents at issue were determined independently of their participation and were consistent with the fair rental value for similar land at that time. The rental amounts were also determined to be fair by a third-party credit company. The rental income was not received pursuant to a lease agreement and material participation in the production or management of crops by the petitioners was not required. The corporation also rented land on a cash rent basis from unrelated third parties and only one of these leases contemplated participation by the owners. The petitioners assert that the IRS erred in determining that they are subject to self-employment tax on their portion of cash rental income received from the partnership. In addition, the taxpayers claim that the IRS erroneously included a gain from the sale of equipment by the farming partnership in its calculation of the self-employment income of the taxpayers. CCH Federal Taxday, June 20, 2002.

WATER. Mexico will send to U.S. farmers 6 percent of the water it owes them and get funding for water-conservation projects as part of an agreement unveiled on June 29 to end a simmering dispute between the border neighbors. Texas water officials criticized the deal, saying it fell far short of what the state's farmers need. Drought-hit Mexico has built up a huge water debt to parched farms in Texas under a 1944 treaty governing flows from the Rio Grande River, called Rio Bravo in Mexico, which serves as a border between the countries. Under the agreement, Mexico will release about 90,000 acre-feet (111 million cubic meters) of water, of the 1.5 million acre-feet (185 billion cubic meters) owed, into the Rio Grande River for use by Texas farmers. The two countries said they would invest some $210 million over the next four years in irrigation, water-conservation and infrastructure projects, mainly in the Mexican states of Coahuila, Chihuahua and Tamaulipas, which border on Texas. Richard Jacobsen, Reuters News Service.
AGRICULTURAL TAX AND LAW SEMINARS
by Neil E. Harl and Roger A. McEowen

August 13-16, 2002  Holiday Inn I-25, Fort Collins, CO
September 24-27, 2002   Interstate Holiday Inn, Grand Island, NE

Come join us for expert and practical seminars on the essential aspects of agricultural tax and law. Gain insight and understanding from two of the nation’s top agricultural tax and law instructors.

The seminar are held on Tuesday, Wednesday, Thursday, and Friday. Registrants may attend one, two, three or all four days, with separate pricing for each combination. On Tuesday, Dr. Harl will speak about farm and ranch income tax. On Wednesday, Dr. Harl will cover farm and ranch estate planning. On Thursday, Roger McEowen will cover farm and ranch business planning.

NEW THIS YEAR: On Friday, Roger McEowen will cover agricultural contracts. Your registration fee includes comprehensive annotated seminar materials for the days attended which will be updated just prior to the seminar. The seminar materials will also be available on CD-ROM for a small additional charge.

The seminar registration fees for current subscribers to the Agricultural Law Digest, the Agricultural Law Manual, or Principles of Agricultural Law (and for multiple registrations from one firm) are $185 (one day), $360 (two days), $525 (three days), and $670 (four days). The registration fees for nonsubscribers are $200, $390, $570 and $720, respectively.

Registration brochures will be mailed in June and July. However, complete information and a registration form are available now on our web site at http://www.agrilawpress.com. For more information, call Robert Achenbach at 1-541-302-1958, or e-mail to robert@agrilawpress.com

October 17-18, 2002  Spa Resort, Palm Springs, CA

“Farm & Ranch Income Tax” and “Farm & Ranch Estate and Business Planning.”

The seminars are held on Thursday, and Friday. Registrants may attend one or both days, with separate pricing for each combination. On Thursday, Dr. Harl will speak about farm and ranch income tax. On Friday, Roger McEowen will cover farm and ranch estate and business planning. The registration fee includes comprehensive annotated seminar materials for the days attended which will be updated just prior to the seminar.

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SUBSCRIPTION RATE INCREASE

The recent increase in postage rates and increased printing costs over the years have finally forced us to increase the annual subscription rate for the print version of the Agricultural Law Digest to $110 per year. This is the first price increase for the Digest since it began in 1989. The new rates will take effect with the next billing date for each subscriber. Each billing offers subscribers the option to subscribe to our e-mail version of the Digest which remains at $90 per year and which is e-mailed on the Monday before the print version is published. You can beat the rush and change your subscription now to the e-mail version and we will credit your account with an additional issue for each three print issues remaining on your subscription. Send an e-mail to robert@agrilawpress.com for a free sample or to order the change in subscription.
PRICE FIXING IN AGRICULTURE
— by Neil E. Harl*

For decades after the emergence of price fixing as a per se offense under federal antitrust law, the major concern about price fixing in agriculture was the scope of the agricultural immunity from antitrust challenge in the face of efforts to combine to fix the prices at which agricultural products are marketed. In more recent years, however, the focus has shifted to price fixing by increasingly concentrated input suppliers and output processors, handlers and shippers. The recent high profile case involving price fixing for lysine and citric acid is an example of recent antitrust concerns in this area and involved criminal charges. A decision handed down on June 18, 2002, by the same court (the Seventh Circuit Court of Appeals) is an example of a recent civil action for price fixing.

The significance of cases that certain practices are illegal per se is evidentiary in that it is only necessary to prove that price fixing has occurred. The recent case involving high fructose corn sweetners (HFCS) provides a useful analysis of what is required to show that price fixing has occurred for purposes of a civil case where the standard is a preponderance of the evidence.

The HFCS case

In the June 18, 2002, decision, In re High Fructose Corn Syrup Antitrust Litigation, the defendants were the principal manufacturers of high fructose corn syrup—Archer-Daniels-Midland (ADM), A.E. Staley, Cargill, American Maize Products and CPC International. CPC International had settled out of court and was no longer a party to the action. The plaintiffs were a certified class consisting of direct purchasers of the product from the defendants. The plaintiffs claimed that the defendants secretly agreed, in 1988, to raise the prices of HFCS with the conspiracy continuing from 1989 until mid-1995 when the Federal Bureau of Investigation raided ADM offices in search of evidence in the lysine/citric acid price fixing case brought by the Department of Justice. The district court concluded that “no reasonable jury could find in [the plaintiff’s] favor on the record presented in this case without resorting to pure speculation or conjecture” and granted summary judgment for the defendants. The plaintiffs appealed the district court decision on several grounds.

The Court of Appeals pointed out that the statutory language in Section 1 of the Sherman Act is broad enough to encompass a price fixing agreement that did not

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
involve any actual communication among the parties to the agreement.\textsuperscript{15} As the court noted, “if a firm raises price in the expectation that its competitors will do likewise, and they do, the firm’s behavior can be conceptualized as the offer of a unilateral contract that the offerees accept by raising their prices.”\textsuperscript{16}

The court noted that, in the absence of an admission by the defendants that they agreed to fix prices, evidence must be presented from which the existence of such an agreement can be inferred.\textsuperscript{17} The court explained that the evidence generally takes the form of—(1) a showing that the structure of the market was such as to make price fixing feasible and (2) evidence that the market behaved in a non-competitive manner.\textsuperscript{18} In addressing the defense argument that some of the transactions occurred at a lower price than the level pegged by the alleged price fixing activity, the court echoed Justice Stone’s comments in \textit{United States v. Trenton Potteries Co.}\textsuperscript{19} in stating that—

“The reasonable price fixed today may through economic and business changes become the unreasonable price of tomorrow.”

The court agreed with the plaintiffs that the structure of the market was conducive to price fixing behavior and that, during the period of the alleged conspiracy, the defendants avoided or at least limited price competition.\textsuperscript{20} Moreover, there was testimony involving statements by one of the defendants’ plant managers that, “We have an understanding within the industry not to undercut each other’s prices.”\textsuperscript{21}

The Seventh Circuit Court of Appeals reversed the grant of summary judgment and sent the case back for trial to establish whether there was a price fixing violation.

\textbf{In conclusion}

The June 18 decision breathes new life into price fixing litigation. Proving an explicit agreement to fix prices is difficult; proving that the parties avoided or limited price competition in a setting that is favorable for price fixing is substantially more attainable. This decision could have important implications for cases arising in the future. The prospect of treble damages in a civil case\textsuperscript{22} provides an economic incentive to challenge such practices.

\textbf{FOOTNOTES}

\begin{itemize}
  \item See \textit{United States v. Andreas}, 216 F.3d 645 (7th Cir. 2000).
  \item \textit{In re High Fructose Corn Syrup Antitrust Litigation}, No. 01-3565, ___ F.3d ___ (7th Cir. 2002).
  \item Id.
  \item Id.
  \item Id. at 1.
  \item Id.
  \item Id. at 2.
  \item Id.
  \item N. 6 supra at 2.
  \item Id.
  \item Id. at 3.
  \item Id. at 4.
  \item 273 U.S. 392 (1927).
  \item \textit{In re High Fructose Corn Syrup Antitrust Litigation}, n. 6 supra at 7.
  \item Id. at 17.
  \item Sherman Act § 7, supra n. 14.
\end{itemize}

\textbf{CASES, REGULATIONS AND STATUTES}

\textit{by Robert P. Achenbach, Jr.}

\textbf{ADVERSE POSSESSION}

\textbf{FENCE.} The disputed land was located between the parties’ lands. An unknown previous owner of one of the properties erected a barbed-wire fence between the properties but 45 to 60 feet on the plaintiff’s side of the actual boundary. The defendants presented no evidence of why the fence was located there. The evidence demonstrated that the several owners of the two properties did not discuss or object to the fence and no one had claimed that the fence was the true boundary. The court noted that the defendants did not provide any evidence that the boundary was in dispute or that the fence was erected to determine the boundary. The evidence showed that the defendants’ predecessors in interest made only sporadic use of the disputed land and only as incidental to the use of the whole property. The court held that the defendants did not acquire title to the disputed land by
adverse possession because neither they nor their predecessors ever made continuous use of the land for at least ten years. The court also held that the boundary was not determined by building the fence under an agreement or by acquiescence because the boundary was not in dispute before the fence was erected and no evidence was presented that the fence was erected to establish a boundary. Gibbons v. Lettow, 42 P.3d 925 (Or. Ct. App. 2002).

**BANKRUPTCY**

**GENERAL-ALM § 13.03.**

**DISCHARGE.** The debtor purchased two cotton pickers from a dealer with an installment loan. The debtor defaulted on the loans but provided two post-dated checks to cover the deficit on the loan. However, the checks were not honored and the debtor continued to use the pickers for another two months. The creditor argued that the loss of value of the pickers during those two months created a nondischargeable debt. The creditor sought to have the debt declared nondischargeable under Section 523(a)(2) for a debt obtained through false representation. In a motion for summary judgment, the debtor argued that the unpaid checks were not representations but mere promises. The debtor also argued that the damages resulting from the continued possession and use of the pickers did not create a debt. The court held that the loss of value of the pickers occurring after the checks were given and not paid was a debt which could be nondischargeable under Section 523. Although the court held that most of the elements of false representation were demonstrated by the unpaid checks, the court held that summary judgment was not proper because evidence was needed to determine whether the debtor had the intent to use the checks as a method to deceive the creditor. *In re Ellington*, 276 B.R. 470 (Bankr. N.D. Minn. 2000).

The debtor borrowed money for the financing of the debtor’s farming operation. The debtor defaulted on the loans and sold some of the collateral to pay off most of the loans. However, the debtor sold some of the collateral and did not use the proceeds to pay off the remainder of the loans. The creditor sought to have the remainder of the loans declared nondischargeable under Section 523(a)(6) for willful and malicious harm to the creditor. The court held that the debtor’s experience as a farmer and the clear indication that the debtor’s property served as collateral for the loans proved that the sale of the collateral was willful and malicious and the unpaid loan amount was nondischargeable. *In re Jones*, 276 B.R. 797 (Bankr. N.D. Ohio 2001).

**CHAPTER 12-ALM § 13.03[8].**

**ELIGIBILITY.** The debtor was a corporation solely owned by a farmer. The farmer had individually incurred debts to the FSA. When the FSA attempted to foreclose on the collateral securing the debt, the farmer transferred all property and debt to a corporation in exchange for stock and a promissory note. The issue was whether the debt was an obligation of the corporation such that it would have sufficient debt from farming operations to be eligible for Chapter 12. The court found that the FSA regulations prohibited the assignment or transfer of FSA debt by the farmer; therefore, the court held that the FSA debt was not an obligation of the corporation and the corporation had insufficient debt from farming to qualify as a Chapter 12 debtor. *In re McSwine Creek Farms, Inc.*, 276 B.R. 461 (Bankr. N.D. Minn. 2000).

**CONTRACTS**

**REVOCAITION.** The plaintiff purchased a used tractor from the defendant dealer. The tractor was used for fall farm work but had to be repaired after it stalled. The tractor was also used the following spring until it stalled again. The plaintiff had the tractor inspected and discovered that the wrong o-rings were installed in the hydraulic system. The plaintiff sued for breach of express and implied warranties, fraud, misrepresentation and deceit. The defendant argued that the plaintiff waited too long to report the defect in the tractor in that the tractor was used more than 160 hours before the plaintiff claimed a defect. The court noted that N.D. C.C. § 41-02-70(3)(a) allowed a purchaser a reasonable time to notify a seller of a defect. The court reviewed several cases involving the reasonable time to report a defect in a farm tractor and determined that the trial court was not in clear error to rule that the plaintiff reported the alleged defect within a reasonable time. *Eggl v. Letvin Equipment Co.*, 632 N.W.2d 435 (N.D. 2001).

**FEDERAL AGRICULTURAL PROGRAMS**

**APPLES.** The CCC has issued proposed regulations which establish the Apple Market Loss Assistance Payment Program II which provides direct payments to apple producers to provide relief due to the low prices received for the 2000 crop. *67 Fed. Reg. 47477 (July 19, 2002).*

**FEDERAL ESTATE AND GIFT TAX**

**ADMINISTRATIVE EXPENSES.** The decedent’s estate claimed deductions for interest on overpayment of estate tax, attorney’s fees, executor’s fees, and miscellaneous expenses. The IRS argued that the interest was not deductible because the interest would eventually be returned as a refund. The court held that the interest was deductible because it was already paid and any refunded portion would be included in income when refunded. The other expenses were approved by...
the probate court but the IRS challenged the expenses for lack of substantiation. The court held that the acceptance of the validity of the expenses by the state court was sufficient evidence to support the deductions. Helis v. United States, 2002-2 U.S. Tax Cas. (CCH) ¶ 60,445 (Fed. Cls. 2002).

**FEDERAL INCOME TAXATION**

**AUTOMOBILE EXPENSES.** The taxpayer was self-employed in the hardwood flooring business and used a pickup truck in the business. The taxpayer claimed deductions for the actual expenses of the pickup for one year, but did not keep sufficient record of all the expenses to meet the substantiation requirements of I.R.C. § 7491. Therefore, the court held that the taxpayer was eligible only for a deduction based on the standard mileage rate. The court upheld the IRS determination of the number of miles, based on a reconstruction of the use of the pickup. Nobles v. Comm’r, T.C. Summary Op. 2002-86.

**BAD DEBTS.** The taxpayer loaned money to the taxpayer’s child to enable the child to purchase a residence. The loan was evidenced by a promissory note with interest above the federal rate and was secured by a second deed of trust. The child made payments on the loan but eventually had to sell the residence. The taxpayer received the proceeds in excess of the first mortgage. The court held that the taxpayer was entitled to a nonbusiness bad debt deduction for the amount of the loan less the amount recovered in the sale. McFadden v. Comm’r, T.C. Memo. 2002-166.

**COOPERATIVES.** February 1, 2002, the IRS Appeals Division has de coordinated the Industry Specialization Program (ISP) Coordinated Issue Settlement Guidelines for farmers cooperatives dealing with the disposition of capital stock. IRPO ¶ 180,245.

**DISASTER PAYMENTS.** On June 26, 2002, the President determined that certain areas in Alaska were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of flooding on April 27, 2002 through June 7, 2002. FEMA-1423-DR. On July 3, 2002, the president determined that certain areas in Montana were eligible for assistance under the Act as a result of severe storms and flooding on June 8, 2002. FEMA-1426-DR. On July 4, 2002, the president determined that certain areas in Texas were eligible for assistance under the Act as a result of severe storms and flooding on June 29, 2002. FEMA-1425-DR. Accordingly, a taxpayer who sustained a loss attributable to these disasters may deduct the loss on his or her 2001 federal income tax return.

**EMPLOYEE BENEFITS.** The taxpayer was a corporation which manufactured and sold a printing press attachment. The taxpayer held an annual fishing trip which was attended by employees, although not all employees attended. The fishing trip was planned so as to encourage employees to freely discuss the manufacturing and sales business and included formal meetings as well as informal conversations during the fishing activities. The court found that the employees spent from one to three hours each day discussing taxpayer business. The IRS assessed a deficiency of employment taxes based on the value of the fishing trip as recreation expenses for the employees. The IRS sought a summary judgment that the assessment was proper because the taxpayer could not meet the standards of I.R.C. § 274. The taxpayer argued that Section 274 did not apply because the taxpayer was not seeking a deduction for the trip expenses. The court held that the issue was whether the expenses were deductible by the employees because if the employees were entitled to deductions, the expenses would be ordinary and necessary business expenses and not wages from the taxpayer. The court held that summary judgment was not proper because assuming that the taxpayer could show that the fishing trips constitute ordinary and necessary business travel expenses, a material issue of fact remained regarding whether the taxpayer could meet the heightened standard set by I.R.C. § 274. Townsend Industries, Inc v. United States, 2002-2 U.S. Tax Cas. (CCH) ¶ 50,518 (S.D. Iowa 2002).

**HOME OFFICE.** The taxpayer was a medical doctor who also made movies for use in the taxpayer’s medical practice, provided religious and spiritual guidance to patients, marketed music written by the taxpayer’s father, and composed music. The taxpayer stored equipment and materials for these nonmedical activities in the taxpayer’s residence and claimed a deduction for two-thirds of the residential expenses as business expenses. The IRS and the court denied these deductions because the taxpayer failed to substantiate the extent of the exclusive use of the residence for these activities, the amount of income from these activities and that the residence was the principal place of business for these activities. Edwards v. Comm’r, T.C. Memo. 2002-169.

The taxpayer operated a small after-hours school, gave private violin lessons and composed music. The school classes were given in rented school buildings and the lessons and composing took place in one bedroom (the studio) of the taxpayer’s residence. The taxpayer claimed home office deductions for that bedroom and one other bedroom. The other bedroom was used only incidentally for the taxpayer’s businesses and the court denied all home office deductions for that room. The court found that the taxpayer used three-quarters of the studio bedroom exclusively for the taxpayer’s composing and private lessons; therefore, the taxpayer was entitled to deduct three-quarters of the residential expenses associated with the studio room. Huang v. Comm’r, T.C. Summary Op. 2002-93.

**INCOME AVERAGING.** The IRS has requested comments, as required by the Paperwork Reduction Act of 1995, concerning final regulations issued under I.R.C. § 1301 which allows an individual engaged in a farming business to elect to reduce regular tax liability by treating all or a portion of the current year’s farming income as if it had been earned in equal proportions over the prior three years. See 13 Agric.
L. Dig. 14 (Jan. 18, 2002). Written comments should be submitted on or before September 6, 2002, to Glenn P. Kirkland, IRS, Room 6411, 1111 Constitution Ave., NW., Washington, D.C. 20224.

LOTTERY WINNINGS. The taxpayer won the Oregon Lottery and was to receive annual payments for 20 years. After five years, the taxpayer decided to assign the remaining payments to a third party in exchange for a lump sum payment. The taxpayer characterized the lump sum as long-term capital gain. The court acknowledged that the case was without precedent and needed a decision by an appellate court, but held that, because the original proceeds were classified as ordinary income, the lump sum payment was also ordinary income, even though received from an assignment of the right to receive the annual payments. McGinnis v. United States, 2002-2 U.S. Tax Cas. (CCH) ¶ 50,494 (D. Or. 2002).

The taxpayer won the California State Lottery and was to receive annual payments for 20 years. The taxpayer decided to assign a portion of the remaining payments to a third party in exchange for a lump sum payment. The taxpayer characterized the lump sum as long-term capital gain. Under the lottery rules, the right to the winnings could not be assigned or transferred to third parties but the taxpayer obtained a court order permitting the assignment. The court held that, because the original proceeds were classified as ordinary income, the lump sum payment was also ordinary income, even though received from an assignment of the right to receive the annual payments. Davis v. Comm’r, 119 T.C. No 1 (2002).

PARTNERSHIPS-ALM § 7.03.

LOANS. The partnership had a corporation as a partner and the issue was whether a loan made by a corporate partner was a liability of the partnership. The loan was made solely in the name of the corporation, the corporation was solely liable for repayment of the loan, and the corporation was not acting as an agent of the partnership in obtaining the loan. The court held, in an opinion designated as not for publication, that the loan was not a partnership obligation; therefore, the partners could not increase their bases in the partnership by the loan amount. Dynadeck Rotary Systems, Ltd. v. Comm’r, 2002-2 U.S. Tax Cas. (CCH) ¶ 50,504 (9th Cir. 2002).

PENSION PLANS. For plans beginning in July 2002, the weighted average is 5.67 percent with the permissible range of 5.10 to 6.23 percent (90 to 120 percent permissible range) and 5.10 to 6.80 percent (90 to 110 percent permissible range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). Notice 2002-49, I.R.B. 2002-28.

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. The appellate court affirmed in a decision designated as not for publication. Mueller v. Comm’r, 2002-2 U.S. Tax Cas. (CCH) ¶ 50,505 (7th Cir. 2002), aff’d, T.C. Memo. 2001-274.

The IRS has announced the publication of revised Publication 551, Basis of Assets; Publication 583, Starting a Business and Keeping Records. Ann. 2002-61, I.R.B. 2002-__ ; Ann. 2002-62, I.R.B. 2002-__ . The IRS has put its new life expectancy tables into Publication 590 SUPP. Supplement to Publication 590, Individual Retirement Arrangements (IRAs). The life expectancy tables were part of the final regulations on required distributions from retirement plans. For year 2002, taxpayers have the option of using the new life expectancy tables or the tables in the existing Publication 590. IR-2002-86 These publications can be obtained by calling 1-800-TAX-FORM (1-800-829-3676); they are also available on the IRS’s website at www.irs.gov.

S CORPORATIONS-ALM § 7.02[3][c].

ELIGIBLE SHAREHOLDERS. The decedent was the grantor and trustee of a trust which owned all the stock of an S corporation. At the death of the decedent, two of the decedent’s heirs became successor trustees and were required to distribute the stock to themselves as provided in the trust instrument. The estate made an election to pay estate tax in installments and the executor held the trust stock until the installments had all been paid, at which time the stock will be distributed to the trust and eventually to the heirs. The IRS ruled that the executor was an eligible shareholder during the administration of the estate, including the period of the installment payment of the estate tax. Ltr. Rul. 200226031, March 26, 2002.

SAFE HARBOR INTEREST RATES

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SPLIT-DOLLAR LIFE INSURANCE. The IRS has issued proposed regulations relating to the income, employment and gift taxation of split-dollar life insurance arrangements. The proposed regulations generally define a split-dollar life insurance arrangement as any arrangement (that is not part of a group term life insurance plan described in I.R.C. § 79) between an owner of a life insurance contract.
and a non-owner of the contract under which either party to
the arrangement pays all or part of the premiums, and one of
the parties paying the premiums is entitled to recover (either
conditionally or unconditionally) all or any portion of those
premiums and such recovery is to be made from, or is
secured by, the proceeds of the contract. Prop. Treas. Reg. §
1.61-22(b). A special rule applies in the case of an
arrangement entered into in connection with the performance
of services. Under this special rule, a split-dollar life
insurance arrangement is any arrangement (whether or not
described in the general rule) between an owner and a non-
owner of a life insurance contract under which the employer
or service recipient pays, directly or indirectly, all or any
portion of the premiums and the beneficiary of all or any
portion of the death benefit is designated by the employee or
service provider or is any person whom the employee or
service provider would reasonably be expected to name as
beneficiary. (Like the general rule, this special rule does not
apply to any arrangement covered by I.R.C. § 79.) This
special rule also applies to arrangements between a
corporation and another person in that person's capacity as a
shareholder in the corporation under which the corporation
pays, directly or indirectly, all or any portion of the premiums
and the beneficiary of all or a portion of the death benefit is
a person designated by, or would be reasonably expected to be

A split-dollar life insurance arrangement (as defined in the
proposed regulations) is taxed under either the economic
benefit regime or the loan regime. Prop. Treas. Reg. § 1.61-
22(d). Under the economic benefit regime, the owner of the
life insurance contract is treated as providing economic
§ 1.61-22. Under the loan regime, the non-owner of the life
insurance contract is treated as loaning premium payments to
The economic benefit regime must apply (and the loan
regime may not apply) to any split-dollar life insurance
arrangement if (i) the arrangement is entered into in
connection with the performance of services, and the
employee or service provider is not the owner of the life
insurance contract, or (ii) the arrangement is entered into
during a donation or a donee (for example, a life insurance
trust) and the donor is not the owner of the life insurance

The proposed regulations provide rules for determining the
owner and the non-owner of the life insurance contract. The
owner is the person named as the policy owner. If two or
more persons are designated as the policy owners, the first-
named person generally is treated as the owner of the entire
contract. However, if two or more persons are named as the
policy owners and each such person has an undivided interest
in every right and benefit of the contract, those persons are
treated as owners of separate contracts. Prop. Treas. Reg. §

TRUSTS. The debtor owned a corporation as a sole
shareholder and provided computer consulting services for
the corporation. The taxpayer transferred the corporation to a
trust and the trust was transferred to other off-shore trusts.
The taxpayer continued to operate the business as before the
transfers and the trustees had no participation in the operation
of the business or trusts. The court held that the income from
the corporation was included in the taxpayer's income
because the trusts lacked economic substance. The appellate
court affirmed in a decision designated as not for publication.
Lund v. Comm'r, 2002-2 U.S. Tax Cas. (CCH) ¶ 50,507
(9th Cir. 2002), aff'g, T.C. Memo. 2000-334.

JUDGMENTS

EXECUTION. The plaintiff was the successor to an ethyl
alcohol processing cooperative which had entered into grain
supply agreements with the defendant. When the defendant
refused to perform on the grain supply agreements, the
plaintiff obtained judgments against the defendant. The
plaintiff sued to renew the judgments just under 10 years
after the original judgments and the defendant argued that the
judgments had expired after three years under Minn. Stat.
550.366 because the judgment involved a "debt on
agricultural property." The court held that the failure to
comply with the grain supply agreement created a debt
subject to the limitation statute and that a contract to deliver
grain in the future was agricultural property. Therefore, the
judgments expired after three years under the statute.
Westchester Fire Ins. Co. v. Hasbargen, 632 N.W.2d 754

PRODUCTS LIABILITY

FERTILIZER STORAGE SYSTEM. The plaintiff
purchased a fertilizer containment system from the defendant.
The defendant offered two types of secondary leak protection
system, one which primarily caught leakage in order for the
leak to be detected and one which was designed to contain
any leak as well as provide a means of leakage detection. The
plaintiff purchased the first secondary system but failed to
consistently monitor the system for leaks, resulting in a large
spill of fertilizer into the ground. The plaintiff sued under
several theories of contract and products liability, claiming
that the secondary system failed to contain the leak. The court
held that the purchase contract identified the secondary
system only as one which was intended to provide monitoring
of a leak and not containment of a leak; therefore, the system
was not defective and did not breach the contract. Mid-
(N.D. Ohio 2002).

HERBICIDES. The plaintiff planted an alfalfa crop
immediately after applying a herbicide to the land. The
plaintiff claimed that the herbicide caused poor germination
and growth of the alfalfa. The plaintiff claimed that an
employee of the defendant said that alfalfa could be planted
immediately after application of the herbicide and that this
information was incorrect, although the same information
was on the EPA-approved label. The plaintiff sued the
defendant under theories of breach of express warranty,
misrepresentation and strict liability. The defendant had obtained expert opinion that the alfalfa was not damaged by the herbicide. The court held that the breach of express warranty claim was preempted by FIFRA because the representations made by the defendant’s employee matched the language on the label. The court noted that the other statements made by the employee involved the herbicide’s ability to control weeds and not that the product would not damage the alfalfa; therefore, the statements did not result in any of the alleged damage and were not actionable. The court similarly disposed of the fraudulent misrepresentation claims as either preempted by FIFRA or not connected to the alleged damage. The court also held that the strict liability claim was either preempted by FIFRA to the extent it claimed the instructions for application were defective or unsupported by any evidence or theory about how the herbicide damaged the alfalfa. Dillon v. Zeneca Corp., 42 P.3d 598 (Ariz. Ct. App. 2002).

PESTICIDES. The plaintiff was an organic farmer who suffered personal injury and injury to the plaintiff’s crops from the spraying of pesticides on neighboring land. Apparently, the pesticide volatilized during and after application and drifted onto the plaintiff’s land. The plaintiff alleged that the pesticide was defectively designed. The defendant argued that the claim was pre-empted by FIFRA as involving an issue of the adequacy of the warnings on the label. The court agreed. Eriksen v. Moray Corp., 41 P.3d 488 (Wash. Ct. App. 2002).

STATE REGULATION OF AGRICULTURE

FERTILIZER. The plaintiff owned a fertilizer company in Kansas and was subject to inspection fees imposed under Kan. Stat. § 2-1205. The plaintiff argued that the fees were unconstitutional because the fees generated by the statute far exceeded the cost of the fertilizer inspection program and because the statute was unconstitutionally vague since it failed to state who must register commercial fertilizer subject to the fee. The court held that the fee was not unconstitutional because a portion of the fees was used for the State Water Fund, because the State Water Fund is used to protect the water in the state from pollution from fertilizers. The court held that the statute was not unconstitutionally vague because it identifies who would be liable for a failure to pay the fee, making it clear who must register the fertilizer involved. Bushy, Inc. v. Kansas Dept. of Agric., 29 P.3d 441 (Kan. Ct. App. 2001).

MILK. The plaintiffs were dairy farmers who sued the defendant milk and cheese processors for violations of the Wisconsin antitrust laws. The plaintiffs argued that the defendants had presented manipulated data used to determine prices under a federal milk marketing order. The defendants argued that the filed rate doctrine barred the suit because the federal milk marketing order was determined under a federal system. The plaintiffs argued that the filed rate doctrine did not apply to state law actions. The court held that the filed rate doctrine barred the action because the Wisconsin Supreme Court had ruled that the filed rate doctrine applied to actions brought under Wisconsin law. Servais v. Kraft Foods, Inc., 631 N.W.2d 629 (Wis. 2001).

STATE TAXATION

AGRICULTURAL USE. The plaintiff purchased 30 acres of rural land and prepared the land for an oat crop. The land was poorly tended and the resulting crop had an excessive amount of weeds, although the crop sold for $1,000. The plaintiff had also moved the water rights for the land to another parcel. The county assessor denied the plaintiff’s application for an agricultural tax exemption for the land, based on the transfer of the water rights. On appeal to the state Board of Tax Appeals which upheld the assessor’s ruling based on the lack of a bona fide profit making agricultural operation on the land. Under the state Tax Commission regulations, the agricultural exemption required a bona fide profit-making agricultural operation on land. However, the exemption statute, Idaho Code § 63-602(K), did not include the “bona fide profit making” standard. The court held that the regulation exceeded the statutory requirements and was invalid; therefore, the plaintiff should have been granted the exemption. Roeder Holdings, L.L.C. v. Ada County, 41 P.3d 237 (Idaho 2001).

TRESPASS

TIMBER. The plaintiff purchased 20 acres of isolated timberland with a cabin from the defendant. The plaintiff intended to use the cabin for recreation and wanted to preserve the natural environment around the cabin. The defendant reserved the right to cut timber from the property but not within 100 feet of the cabin. The defendant hired a logging company to harvest trees from the property and did not tell them about the 100 foot restriction. The logging company cut and removed 12 trees within 100 feet of the cabin. The defendant admitted that the trees were improperly cut. The trees were valued as ornamental trees and the award of the value of the trees was tripled under Wash., Code § 64.12.030 because the court found that the defendant ordered the cutting of the trees within the 100 foot restricted area. Hill v. Cox, 41 P.3d 495 (Wash. Ct. App. 2002).

CITATION UPDATES

AGRICULTURAL TAX AND LAW SEMINARS

by Neil E. Harl and Roger A. McEowen

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SUBSCRIPTION RATE INCREASE

The recent increase in postage rates and increased printing costs over the years have finally forced us to increase the annual subscription rate for the print version of the Agricultural Law Digest to $110 per year. This is the first price increase for the Digest since it began in 1989. The new rates will take effect with the next billing date after July 1, 2002 for each subscriber.

Each billing offers subscribers the option to subscribe to our e-mail version of the Digest which remains at $90 per year and which is e-mailed on the Monday before the print version is published. You can beat the rush and change your subscription now to the e-mail version and we will credit your account with an additional issue for each three print issues remaining on your subscription. Send an e-mail to robert@agrilawpress.com for a free sample or to order the change in subscription.
HEALTH REIMBURSEMENT ARRANGEMENTS (HRA)
— by Neil E. Harl*

So-called Section 105 Plans¹ have been used rather widely to provide deductible medical insurance coverage for employees or to furnish a medical reimbursement plan for employees.² If successful, costs are deductible and benefits are excludible from income.³

In late June, the Internal Revenue Service announced the creation of a new concept, the Health Reimbursement Program (HRA), with features not available in traditional Section 105 plans.⁴

Features of an HRA

Several conditions are imposed for the new form of medical reimbursement plan, the Health Reimbursement Arrangement,⁵ to be available—

• Payments must be made solely by the employer (and not made under a salary reduction election or a cafeteria plan⁶ although HRAs can be integrated with a cafeteria plan as noted below).⁷

• The HRA reimburses the employee for medical care expenses incurred by the employee and the employee’s spouse and dependents;⁸ and

• The HRA provides reimbursements up to a maximum dollar amount for a coverage period and any unused portion of the maximum dollar amount at the end of the coverage period is carried forward to increase the maximum reimbursement amount in subsequent coverage periods.⁹ This is the critical difference between a medical reimbursement plan and a Health Reimbursement Arrangement.

Qualification requirements

In order to qualify for an exclusion of benefits from income, an HRA may only provide benefits that reimburse expenses for medical care as defined in I.R.C. § 213(d).¹⁰ It is noted that reimbursements for insurance covering medical care expenses are allowable reimbursements under an HRA.¹¹

An HRA may neither reimburse a medical care expense that is incurred before the date the HRA is in existence¹² nor reimburse a medical care expense incurred before the date an employee is first enrolled under an HRA.¹³ Further, an HRA may not reimburse a medical care expenses attributable to a medical deduction for any prior taxable year.¹⁴

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
An HRA does not qualify for the exclusion if any person has the right to receive cash or any other taxable or non-taxable benefit other than the reimbursement of medical care expenses. Indeed, if any person has such a right under an HRA currently or for any future year, all distributions to all persons made from the arrangement in the current year are included in gross income, even amounts paid to reimburse medical care expenses. An example in Notice 2002-45 states that if an arrangement pays a death benefit without regard to medical care expenses, no amount paid under the HRA to any person is a reimbursement for excluded medical expenses.

Medical care expense reimbursements under an HRA are excludible to the extent reimbursements are provided to—

- Current and former employees (including retired employees), their spouses and dependents, and
- Spouses and dependents of deceased employees.

As noted above, employer contributions to an HRA may not be attributable to salary reduction or otherwise provided under a cafeteria plan. However, an HRA is not considered to be paid pursuant to salary reduction merely because it is provided in conjunction with a cafeteria plan. An HRA may be integrated into a cafeteria plan. But an arrangement is not treated as an HRA if the arrangement interacts with a cafeteria plan in such a way as to result in salary reduction indirectly to fund the HRA.

Non-discrimination rules

The statute contains non-discrimination rules for self-insured medical expense reimbursement plans. To the extent an HRA is a self-insured medical expense reimbursement plan, the non-discrimination rules apply to an HRA. For insured plans, there is no non-discrimination requirement.

Applicability to self-employed individuals

An HRA may not be set up to provide benefits directly to a self-employed individual. There is no bar to providing benefits to a self-employed individual as the dependent of an eligible employee.

In conclusion

Although neither Notice 2002-45 nor Rev. Rul. 2002-45 prescribes the formalities required to set up an HRA, it seems prudent to support such a plan with a document in writing which defines the terms of the annual reimbursement by the employer, the coverage period for the medical expense reimbursement and the eligibility requirements for employees to participate in the HRA.

FOOTNOTES


5. Id.


8. Id.

9. Id.


11. Id.


14. Id.

15. I.R.C. § 105(b).


17. Id.


19. Id.


21. See note 5 supra and accompanying text.


24. I.R.C. § 105(h).


29. Id.

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FARM ESTATE & BUSINESS PLANNING

15th EDITION

By Neil E. Harl


* * * *
ADVERSE POSSESSION

FENCE. In 1942, the plaintiff’s predecessor in interest built a fence on the boundary between the plaintiff’s property and the defendant’s property. The purpose for the fence and the choice of location, 11 feet onto the defendant’s property, was unclear; however, the fence was maintained by the predecessors in interest as a cattle fence when cattle were allowed to forage on the crop stubble after harvest. The disputed strip was used with the plaintiff’s property for crops continuously from 1942 through 1984. In 1993, the defendant had a survey done and discovered the error in the location of the fence. The plaintiff brought an action to quiet title, arguing that the plaintiff had acquired title to the strip by adverse possession or by the fence creating a practical boundary location. The trial court ruled that title did not pass by adverse possession because the plaintiff failed to show continuous, exclusive and hostile possession. The appellate court reversed, holding that planting of crops on the disputed strip for over 40 years demonstrated sufficient continuous use that was exclusive of any other party. The court held that the exclusive and continuous use also demonstrated that the plaintiff’s predecessors use of the strip in hostility to the interests of all other parties. The defendant argued that the family relationship, as cousins, between the plaintiff’s predecessor in interest and the defendant’s predecessor in interest demonstrated that the use of the disputed strip was permissive. The court held that the mere familial relationship of the parties did not raise any presumption of permissive use, especially where the defendant’s predecessors made no attempt to use the disputed land. The appellate court did not discuss the issue of the fence as a practical boundary. Ebenhoh v. Hodgman, 642 N.W.2d 104 (Minn. Ct. App. 2002).

ENVIRONMENTAL LAW

CLEAN WATER ACT. In 1998, Missouri submitted to the EPA a list of pollution-impaired waters in the state which did not meet the state’s standards for water quality. The EPA added several waters to the list and eventually approved the list for remedial treatment. The plaintiff was a nonprofit corporation of soybean farmers and sued the EPA because the list included waters for which pollution was not adequately documented. The trial court ruled that the plaintiff’s use of the list for remedial treatment was proper. The two suits were joined and the EPA sought to dismiss the suit brought by the soybean farmer organization as not ripe for adjudication because the organization and its members were not affected by the EPA’s action in a concrete way. The farmers had claimed that the list harmed them through potential changes in land management practices; limitations on crop growth; limitations on the sale and use of fertilizers, pesticides and herbicides; and the inability to rely on the use of certain waters. The court held that the potential harms listed by the farmers could not occur until the remediation plans were adopted, and because the plans were not yet adopted, the actual harms could not be determined and the suit was not ripe for adjudication. American Canoe Ass’n, Inc. v. EPA, 289 F.3d 509 (8th Cir. 2002).

FEDERAL AGRICULTURAL PROGRAMS

CONSERVATION. The FSA has issued proposed regulations which would remove the regulations for the Agricultural Conservation Program (ACP), replaced by the Environmental Quality Incentives Program and would remove the regulations for the Forestry Incentives Program, now implemented by the NRCS. Existing ACP contracts would continue, however, to be subject to the previously published regulations. The proposed regulations amend the regulations for the Emergency Conservation Program to allow cost-share assistance for confined livestock for natural disasters other than drought. 67 Fed. Reg. 49879 (Aug. 1, 2002).

SUGAR. The plaintiffs were several sugar cane growers’ organizations who sued the USDA for improper implementation of the 2001 payment-in-kind program for sugar as authorized by the Food Security Act of 1985. The USDA implemented the program through a press release without any notice and comment and the plaintiffs argued that this was improper because it did not comply with the Administrative Procedures Act notice and comment requirements, the Food Security Act of 1985 because the USDA did not make specific findings, and the Regulatory Flexibility Act because the USDA did not consider the impact on small businesses. The plaintiffs claimed two injuries from these violations, the program gave a competitive advantage to participants in providing sugar without production costs and the PIK sugar depressed prices. The USDA countered that the sugar prices went up after the program was implemented. The District Court held that the plaintiffs lacked standing because they failed to show an injury-in-fact and failed to show that the USDA would not have implemented the program after notice and comment. On a motion for summary judgment, the District Court did rule that the program implementation was subject to the APA notice and comment procedures but that the failure to follow these procedures was harmless error. The appellate court reversed on all issues except the violation of the APA. The appellate court noted that prices had risen during the program but also found that the plaintiffs had provided evidence that the prices were lower than they would have been without the program; therefore, the plaintiffs had standing as parties injured by the program. The appellate
court affirmed that the program was required to be implemented through APA rulemaking procedures of notice and comment and held that the failure to do so was not harmless because of the indicated effect on sugar prices. The appellate court also held that the failure of the USDA to make findings required by the Food Security Act also made the program implementation improper. The FSA 1985 required in general that the USDA determine that the PIK program would not adversely effect small and medium sized producers and would reduce the costs to the federal government. The press release implementation did not make these findings. Yet, the appellate court refused to vacate the 2001 PIK program because the program had started and producers and participants had relied on the program as announced. Thus, the matter was merely remanded back to the USDA for a remedy. Will that be one lump or two? *Sugar Cane Growers Co-op of Florida v. Veneman, 289 F.3d 89 (D.C. Cir. 2002).*

**TUBERCULOSIS.** The APHIS has issued interim regulations amending the regulations regarding payments made in connection with animals and other property disposed of because of bovine tuberculosis to provide that the APHIS will make payments to owners of dairy cattle and other property used in connection with a dairy business, and a dairy processing plant in the area of El Paso, TX, provided the owners agree to dispose of their herds, close their existing dairy operations, and refrain from establishing new cattle breeding operations in the area. *67 Fed. Reg. 48745 (July 26, 2002).*

### FEDERAL ESTATE AND GIFT TAX

**CHARITABLE DEDUCTION.** The IRS has issued proposed regulations which amend the existing regulations under I.R.C. §§ 170, 2055, and 2522 governing charitable guaranteed annuity interests and unitrust interests to eliminate the requirement that the charitable interest can not be preceded in point of time by a noncharitable interest that is in the form of a guaranteed annuity or unitrust interest. The proposed regulations conform the regulations to the holding in *Estate of Boeshore v. Comm’r*, 78 T.C. 523 (1982), acq. in result, 1987-2 C.B. 1, which held that a charitable deduction was allowed for unitrust and remainder interests passing to a charity where, although the initial interests in the trusts were noncharitable, all the nonremainder interests in the trust were unitrust interests. *67 Fed. Reg. 48070 (July 23, 2002), amending Treas. Reg. §§ 1.170A-6, 20.2055-2, 25.2522(c)-3.*

**GIFTS.** The IRS has issued proposed regulations relating to the amount treated as a transfer under I.R.C. § 2519 when there is a right to recover gift tax under I.R.C. § 2207A(b) and the related gift tax consequences if the right to recover the gift tax is not exercised. The proposed regulations would affect donee spouses who make lifetime dispositions of all or part of a qualifying income interest in qualified terminable interest property. I.R.C. § 2207A(b) statutorily shifts the burden for paying the gift tax imposed on a transfer under I.R.C. § 2519 from the donee spouse to the person receiving the transferred property. The payment of gift tax by the person receiving the property benefits the donee spouse because the donee spouse is liable for the payment of this tax and, absent the right of recovery, would be required to pay the tax from the donee spouse's own assets. The proposed regulations will amend the regulations under I.R.C. § 2519 to provide that the amount of the transfer under I.R.C. § 2519 is reduced by the amount of the gift tax that the donee spouse is entitled to recover under I.R.C. § 2207A(b). The amount of gift tax recoverable and the amount of the remainder interest treated as transferred under I.R.C. § 2519 are determined by using the interrelated computation applicable to other transfers in which the transferee agrees to pay the gift tax. See Rev. Rul. 81-23, 1981-2 C.B. 189. In addition, the proposed regulations will amend the regulations under I.R.C. § 2207A(b) to provide that if the donee spouse fails to exercise the right to recover the gift tax, the donee spouse makes a gift in the amount of the unrecovered gift tax to the person from whom the recovery of gift tax could have been obtained. *67 Fed. Reg. 47755 (July 22, 2002), amending Treas. Reg. §§ 25.2207A-1, 25.2519-1.*

### FEDERAL INCOME TAXATION

**AUTOMOBILE EXPENSES.** The taxpayer claimed expenses associated with use of various vehicles in transporting the taxpayer and farm equipment to a family farm. The taxpayer did not keep written records of the purpose, time, date and cost of the trips but attempted to provide oral evidence to support receipts of the expenses. The Tax Court held that the travel expenses would be disallowed for lack of substantiation because the court found the oral evidence as to the time, date and purpose of the expenses not credible. The appellate court affirmed. *Reynolds v. Comm’r*, 2002-2 U.S. Tax Cas. (CCH) (7th Cir. 2002), aff’d, T.C. Memo. 2000-20.

**CONSTRUCTIVE RECEIPT.** The taxpayers owned an apricot orchard and hired a third party to manage the orchard in return for 70 percent of the crop. The orchard was damaged by the misapplication of a pesticide and the manager attempted to negotiate a settlement with the pesticide applicator. The taxpayers disavowed any authority of the manager to negotiate a settlement but the manager was able to obtain funds from the pesticide applicator in 1999. The manager then passed on 30 percent of the proceeds to the taxpayers; however, on advice of counsel, the taxpayers did not cash the check in order to preserve their rights against the applicator. The taxpayers continued to attempt to negotiate a higher settlement but eventually cashed the check in 2000, again on the advice of counsel that litigation was too risky. The court held that the settlement proceeds were taxable in 2000 because a substantial limitation or restriction was placed on the money by the risk that cashing the check in 1999 would have terminated the taxpayers’ rights to negotiate a larger settlement. *Miller v. Comm’r*, T. C. Summary Op. 2002-94.
COURT OF APPEALS. The taxpayer was divorced and did not have custody of a son. The taxpayer's son's principal place of residence was Puerto Rico and the son lived with the taxpayer in the United States for three months in 1998. The taxpayer had not filed Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents, but filed a return as head of household and claimed a dependency exemption and a child tax credit for the son for 1998, claiming that the taxpayer provided more than one-half of the support for the son in 1998. The court held that the taxpayer could not file under the head of household status and could not claim the dependency exemption or child tax credit for the son in 1998. Ramos v. Comm'r, T.C. Memo. 2002-179.

DISASTER PAYMENTS. On July 3, 2002, the President determined that certain areas in Montana 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 June 8, 2002. FEMA-1424-DR. On July 6, 2002, the president determined that certain areas in The Territory of Guam were eligible for assistance under the Act as a result of Typhoon Chata'an on July 5, 2002. FEMA-1426-DR. On July 19, 2002, the president determined that certain areas in Wisconsin were eligible for assistance under the Act as a result of severe storms and flooding on June 21, 2002. FEMA-1429-DR. Accordingly, a taxpayer who sustained a loss attributable to these disasters may deduct the loss on his or her 2001 federal income tax return.

IRA. The taxpayer terminated employment and used the distribution from the employee pension fund to open an IRA with a bank. The taxpayer decided to move the money to a higher interest account and withdrew the money from the IRA. The taxpayer purchased two certificates of deposit, one for himself and one for his wife; however, the CDs were not placed in an IRA because the taxpayer failed to open an IRA with the second bank. The taxpayer argued that the CDs should have been treated as rollover distributions because the bank failed to place them in an IRA. The court held that the taxpayer should have been aware that no IRA was established for the CDs and the bank failed to mail a Form 5498 showing the distribution. The court distinguished the case from Wood v. Comm'r, 93 T.C. 114 (1989) where the taxpayer established an IRA but the brokerage firm failed to deposit the funds in the IRA as directed by the taxpayer. Anderson v. Comm'r, T.C. Memo. 2002-171.

The taxpayer had maintained an IRA for several years before consulting with the custodian bank about changing the account. The taxpayer closed the IRA account and the money was transferred to an annuity which did not qualify for an IRA. The taxpayer did not include the distribution from the IRA in income, although the bank issued a Form 1099-R showing a distribution. After the IRS began to investigate the distribution, the taxpayer and bank sought to correct the problem by reissuing the Form 1099-R and filing a “Traditional IRA Withdrawal Statement” which directs the bank to distribute the IRA funds to the trustee of the annuity. However, the taxpayer took no steps to change the nonqualifying annuity into a form which would qualify for an IRA. The court held that an error similar to the one in Woods v. Comm'r, 93 T.C. 114 (1989) did not occur to excuse the improper distribution because the taxpayer failed to distribute the funds in a timely manner to a qualified IRA. Crow v. Comm'r, T.C. Memo. 2002-178.

INSTALLMENT REPORTING. 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. The appellate court has denied a petition for a rehearing, en banc. Thom v. United States, 2002-2 U.S. Tax Cas. (CCH) ¶ 50,529 (8th Cir. 2002), denying pet. for rehear’g, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,293 (8th Cir. 2002), aff’g, 134 F. Supp.2d 1093 (D. Neb. 2001).

The taxpayer, an LLC, sold three real estate properties for a downpayment and installment note. The first sale occurred in one year and the taxpayer’s accountant erroneously believed that the sale was not eligible for installment reporting of the gain and claimed all of the gain as income in the year of sale. The taxpayer had discussions with the accounting firm about the second sales to determine that they were eligible for installment reporting. However, the accountant who prepared the returns for...
those sales also included all the gain from those sales in income for the year of sale. The taxpayer had the returns reviewed by another accounting firm which discovered the error. The IRS granted the taxpayer permission to revoke the election out of installment reporting, although the IRS did not rule as to whether the sales were eligible for installment reporting. Ltr. Rul. 2002340016, April 18, 2002.

LEGAL FEES. The taxpayers purchased a hotel and discovered that the seller may have misrepresented the income history of the hotel. The taxpayers sued the seller for breach of contract and misrepresentation. The parties eventually settled for an amount which was felt to be the difference in fair market value with the adjusted income figures. The taxpayers incurred legal fees from the law suit and claimed a current deduction for those expenses. The IRS disallowed the current deduction and argued that the legal fees were to be capitalized as part of the cost of the determination of the purchase price. The court looked at the main motivation of the taxpayers’ law suit and held that it was to recover the amount overpaid for the hotel; therefore, the legal fees had to be capitalized as incurred as part of the acquisition of the hotel at the lower price. Winter v. Comm’r, T.C. Memo. 2002-173.

OFFERS IN COMPROMISE. The IRS has adopted as final regulations governing offers in compromise of income tax owed. The regulations continue the traditional grounds for compromise based on doubt as to liability or doubt as to collectibility. In addition, to reflect the changes made in RRA 1998, the regulations allow a compromise where there is no doubt as to liability or as to collectibility, but where either (1) collection of the liability would create economic hardship, or (2) exceptional circumstances exist such that collection of the liability would be detrimental to voluntary compliance. Compromise based on these hardship and equity bases may not, however, be authorized if it would undermine compliance. Although the regulations set forth the conditions that must be satisfied to accept an offer to compromise liabilities arising under the internal revenue laws, they do not prescribe the terms or conditions that should be contained in such offers. Thus, the amount to be paid and future compliance or other conditions precedent to satisfaction of a liability for less than the full amount due are matters left to the discretion of the Secretary. The regulations also add provisions relating to the promulgation of requirements for providing for basic living expenses, evaluating offers from low income taxpayers, and reviewing rejected offers, as required by RRA 1998. The regulations provide for the development and publication of national and local living allowances that permit taxpayers entering into offers in compromise to have an adequate means to provide for their basic living expenses. In accordance with I.R.C. § 7122(c)(3)(A), the regulations also require the development of supplemental guidelines for the evaluation of offers from “low income” taxpayers. 67 Fed. Reg. 48025 (July 23, 2002).

RETURNS. The IRS posted over 400 phone numbers for local taxpayer assistance centers (TACs) on its website on July 24. The posting represents an expansion of the IRS’s customer service for taxpayers. The program, “Everyday Tax Solutions,” allows taxpayers or their representatives to call a local number to set up a personal appointment on any business day. The local phone numbers are dedicated to setting up face-to-face appointments to help solve taxpayer problems. According to the web posting, the service addresses taxpayer problems such as account and notice issues, installment agreements, release of federal tax liens and levies, and innocent spouse claims. The regular IRS help number, 1-800-829-1040, should be used for telephone inquiries. The IRS also allows taxpayers and tax professionals to submit general tax questions through a form on its website. As recently as May 2002, the Treasury Inspector General for Tax Administration (TIGTA) issued a report indicating that a majority of these phone numbers had not been published in local telephone books TIGTA faulted the IRS for not having a system to monitor the publishing progress. See http://www.irs.gov. CCH Taxday Aug. 1, 2002.

S CORPORATIONS-ALM § 7.02[3][c].*

ACCOUNTING METHOD. The taxpayer was the sole shareholder of a cash basis S corporation which provided music entertainment services for parties. The corporation often entered into service contracts for events which would occur in later tax years but received deposits on these contracts immediately. The contracts had provisions for full and partial refunds of the deposits but the corporation’s practice was to provide full refunds to maintain good will. The taxpayer initially would include the deposits in current income but, on the advice of an accountant, started including the deposits in income for the year the services were provided. The court held that change in the timing of the reporting of the deposits in come was a change of accounting method which required prior consent from the Commissioner; therefore, the taxpayer was required to continue reporting the deposits in current income. Morganstein v. Comm’r, T.C. Summary Op. 2002-96.

SHAREHOLDER LOANS. The taxpayers owned several S corporations which were part of their trucking business. The corporations made a series of loans to the shareholders and the other corporations and the taxpayers, in turn, loaned the money to the S corporations. The court found that the loans were without economic substance but were merely offsetting bookkeeping entries since the loans were not repaid until the IRS started to investigate the legitimacy of the loans and the taxpayers’ increase of basis in their interests in the corporations. The court held that the taxpayers’ loans to the corporations did not increase their basis in the corporations because the loans lacked economic substance. The taxpayers had also guaranteed some of the corporations’ loans but the court also held that the guarantees did not affect the basis for the same reason. Oren v. Comm’r, T.C. Memo. 2002-172.

TAX-EXEMPT BONDS. The IRS has issued a listing of the proper population figures to be used when calculating the 2002 calendar-year limitation under I.R.C. § 142(k)(5) on the aggregate face amount of the tax-exempt bonds by states and other issuers of qualified public educational facility bonds described in I.R.C. § 142(a)(13). The proper population figures for calculating the volume limitation for calendar year 2002 are the estimates of the resident population of the 50 states and the District of Columbia released by the Bureau of the Census on December 28, 2001. Notice 2002-56, I.R.B. 2002-31.
ATTACHMENT. The plaintiff was a bank which loaned money to the defendant. The defendant granted a security interest in all cattle owned by the defendant at the time and all after-acquired cattle. After the security was perfected, the defendant’s father purchased cattle but had the cattle branded with the defendant’s brand and kept the cattle under the defendant’s care at the defendant’s ranch. The father also kept other cattle at the defendant’s ranch but those cattle had the father’s brand. The plaintiff sought to include those cattle as part of the collateral for the loan. The father claimed that the cattle were his and were not subject to the security interest. The defendant and father were part of an Indian tribe and the tribal court had ruled that the disputed cattle belonged to the father. The father argued that the court should accept the tribal court ruling under the doctrine of comity. The court held that the tribal court ruling was not entitled to comity because the plaintiff was not part of that proceeding and the proceeding did not adjudicate the security interest issue. The court held that the cattle were subject to the security interest because the defendant had sufficient indicia of ownership in the cattle for the security interest to attach. The court noted that the cattle had the defendant’s brand, the defendant had possession and control over the cattle, and the defendant made all decisions as to culling, sale and care of the cattle. First Nat’l Bank of Philip v. Temple, 642 N.W.2d 197 (S.D. 2002).

FARM PROGRAM PAYMENTS. During the bankruptcy case, the Chapter 12 debtor had granted a security interest in crops and government agricultural program payments and proceeds to secure an operating loan. The creditor had perfected the security interest in May 1999. The plaintiff loaned operating funds to the debtor in May 2000 and was also granted a security interest in crops and government agricultural program payments and proceeds to secure the operating loan. The plaintiff perfected that security interest in June 2000. In October 2000, the debtor received disaster relief assistance payments and the plaintiff sought to have the other creditor’s security interest declared secondary. Initially, the debtor argued that the disaster payments were not bankruptcy estate property because the right to the payments arose post-petition. The court followed In re Lemos, 243 B.R. 96 (Bankr. D. Idaho 1999) and held that the disaster payments were the proceeds of crops and were estate property subject to the security interests of both creditors. The plaintiff sought priority for its security interest under the new value provision of N.D. Cent. Code § 41-09-33(4). However, the court held that provision did not apply because the collateral here was not crops but the disaster payments and because the other creditor’s note was due within six months of the planting of crops secured by the plaintiff’s security interest. The plaintiff also sought to use N.D. Cent. Code § 35-05-01.1 to unperfect the creditor’s security interest in any crops other than the crop next maturing after the security interest was perfected. Again, the court held that the provision did not apply because the collateral was disaster payments and not crops. Farmpro Services, Inc. v. Brown, 276 B.R. 620 (D. N.D. 2002).

PERFECTION. The debtor owned a farming business, a farm equipment dealership and an accounting business. The accounting business and equipment dealership were operated at the same address. The debtors had granted security interests in their farm personal property to two banks. The first bank perfected its security interest first and the financing statement described the collateral as “all inventory, chattel paper, accounts, equipment and general intangibles.” However, the financing statement listed the debtors’ address as the farm equipment/accounting business address and not the address of the farm. The second bank also perfected a security interest in farm equipment and listed several specific pieces. The second bank’s financing statement listed the debtors’ farm address. The second bank argued that the first bank’s financing statement was insufficient to perfect the security interest because the address was wrong and the description of the collateral was too vague. The court noted that the Revised Article 9 statute was controlling in the case and held that the Revised Article 9 required only that the financing statement describe the collateral sufficiently to put another creditor on notice that property may be subject to a lien and that the other creditor should inquire further as to the specific property covered. Since the collateral description was so inclusive, the second bank was put on notice that the debtors’ farm equipment could be covered by the first bank’s security interest. The court also held that the use of the business address was not fatal to the security interest because the financing statement did not describe the collateral in terms of its location, putting another creditor on notice that the financing statement governed all such collateral wherever located. In addition, the financing statement listed the debtors personally and not their businesses, also indicating that the collateral could include their farm equipment. This case clearly demonstrates that the burden is on creditors to thoroughly research beyond financing statements to precisely determine which collateral is subject to a security interest. In re Grabowski, 277 B.R. 388 (Bankr. S.D. Ill. 2002).

CITATION UPDATES

Walshire v. United States, 288 F.3d 342 (8th Cir. 2002) (disclaimers) see p. 89 supra.

IN THE NEWS

ANIMALS. The Nebraska Court of Appeals has ruled in a livestock trespass case that Roberts v. Weber and Sons and the use of the res ipsa doctrine does not apply in a case involving a standard barbed wire fence. The court noted that cows can escape such enclosures without the negligence of the owner, that the fence was a legal fence in Nebraska, and that the fence was different than the one at issue in Roberts.
AGRICULTURAL TAX AND LAW SEMINARS

by Neil E. Harl and Roger A. McEowen

September 24-27, 2002   Interstate Holiday Inn, Grand Island, NE

Come join us for expert and practical seminars on the essential aspects of agricultural tax and law. Gain insight and understanding from two of the nation’s top agricultural tax and law instructors.

The seminar are held on Tuesday, Wednesday, Thursday, and Friday. Registrants may attend one, two, three or all four days, with separate pricing for each combination. On Tuesday, Dr. Harl will speak about farm and ranch income tax. On Wednesday, Dr. Harl will cover farm and ranch estate planning. On Thursday, Roger McEowen will cover farm and ranch business planning. NEW THIS YEAR: On Friday, Roger McEowen will cover agricultural contracts. Your registration fee includes comprehensive annotated seminar materials for the days attended which will be updated just prior to the seminar. The seminar materials will also be available on CD-ROM for a small additional charge.

The seminar registration fees for current subscribers to the Agricultural Law Digest, the Agricultural Law Manual, or Principles of Agricultural Law (and for multiple registrations from one firm) are $185 (one day), $360 (two days), $525 (three days), and $670 (four days). The registration fees for nonsubscribers are $200, $390, $570 and $720, respectively.

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“Farm & Ranch Income Tax” and “Farm & Ranch Estate and Business Planning.”

The seminars are held on Thursday, and Friday. Registrants may attend one or both days, with separate pricing for each combination. On Thursday, Dr. Harl will speak about farm and ranch income tax. On Friday, Roger McEowen will cover farm and ranch estate and business planning. The registration fee includes comprehensive annotated seminar materials for the days attended which will be updated just prior to the seminar.

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SUBSCRIPTION RATE INCREASE

The recent increase in postage rates and increased printing costs over the years have finally forced us to increase the annual subscription rate for the print version of the Agricultural Law Digest to $110 per year. This is the first price increase for the Digest since it began in 1989. The new rates will take effect with the next billing date after July 1, 2002 for each subscriber. Each billing offers subscribers the option to subscribe to our e-mail version of the Digest which remains at $90 per year and which is e-mailed on the Monday before the print version is published. You can beat the rush and change your subscription now to the e-mail version and we will credit your account with an additional issue for each three print issues remaining on your subscription. Send an e-mail to robert@agrilawpress.com for a free sample or to order the change in subscription.
The Latest on Mizell
— by Neil E. Harl

The progeny of the 1995 decision in *Mizell v. Commissioner* continues to ricochet through the courts with little hope that the end of the litigation is near. The latest decision of the Tax Court agreeing with the Eighth Circuit Court of Appeals is unlikely to be the last word in the controversy.

History of Mizell

The decision in *Mizell v. Commissioner* involved an Arkansas farmer who rented 731 acres of farmland to a family partnership owned equally by Mizell and his three sons (each with a 25 percent interest). The lease of the 731 acres was on a 25 percent crop-share basis with the partnership paying all of the crop expense. The elder Mizell treated the arrangement as a non material participation lease and did not report the rental amounts as self-employment income.

The Tax Court focused on the language in the statute providing an exception to the general rule that rentals from real estate are excluded from net earnings from self-employment, if there is an “arrangement” with material participation by the owner in the “production or the management of the production” of agricultural commodities. The court noted that the elder Mizell was materially participating in the partnership operations and the statutory language referring to an “arrangement” necessarily embraced the taxpayer’s involvement in the partnership as partner as well as under the lease. Therefore, the rental income under the lease was subject to self-employment tax.

A 1996 private letter ruling reached the same conclusion with a cash rent lease to a corporation. Three Field Service Advice rulings in 1998 were in accord. Three Tax Court cases, all decided in 1999, agreed with *Mizell v. Commissioner* and the IRS rulings. The cases, *Bot v. Commissioner*, *Hennen v. Commissioner*, and *McNamara v. Commissioner* were appealed to the Eighth Circuit Court of Appeals. Ironically, the Eighth Circuit would have been the appellate court for the case of *Mizell v. Commissioner* had *Mizell* been appealed. The Eighth Circuit was not impressed by the taxpayer’s arguments that Section 1402(a)(1) only applies to “rental

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Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
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 I.R.C. § 1402(a)(1).

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. Thus, the Eighth Circuit went beyond the focus up to that time, on the words “under an arrangement” in Section 1402(a)(1), and looked at the phrase “derived under an arrangement” in the statute.

The court remanded the cases to the Tax Court to provide an opportunity for IRS to show a connection between the rents and the “arrangement.”

In mid-July, 2002, the Tax Court in a brief opinion, conceded that the rentals in the three cases were fair market rentals.

Other cases
Another case appealable to the Eighth Circuit, Milton v. Commissioner, involves the leasing of land by a family partnership to a corporation controlled by the same individuals. IRS argued that the partnership rental income was subject to self-employment tax.

A case in New York State, appealable to the Second Circuit Court of Appeals, has been docketed in the Tax Court. That case, Fowler v. Commissioner, involved the rental of land containing apple trees to a family-owned corporation. That case indicates that the Internal Revenue Service is positioned to challenge in another circuit the Eighth Circuit Court’s analysis in situations involving the rental of land to a family-owned entity as tenant.

In conclusion
While the advice to taxpayers potentially subject to challenge to be careful to set rental rates in keeping with rental rates in the area for comparable land is still good counsel, indications that IRS is litigating another case in the Second Circuit Court of Appeals area suggests that the more general solutions to the problem continue to be relevant. Those solutions include—(1) shifting ownership of rental land to the name of a spouse (who is not involved in the business); (2) conveying the land to another entity (such as an LLC or LP); (3) retiring from the business; or (4) seeking a broader solution through legislative amendment.

FOOTNOTES
2 Hennen v. Comm’r, T.C. Docket No. 7535-98 (July 10, 2002). The Tax Court opinion has not, as of August 20, 2002, been posted on the Tax Court web site (www.ustaxcourt.gov) or released by the major tax services.
3 T.C. Memo. 1995-571.
4 Id.
5 I.R.C. § 1402(a)(1).
6 Id.
7 Id.
8 Ltr. Rul. 9637004, May 1, 1996.
10 T.C. Memo. 1995-571.
11 T.C. Memo. 1999-256.
12 T.C. Memo. 1999-306.
13 T.C. Memo. 1999-333.
14 236 F.3d 410 (8th Cir. 2000).
15 Id.
16 Id.
17 See n. 2 supra.
18 T.C. Docket No. 13594-01.
20 5 Harl, Agricultural Law § 37.03[3][a] (2002).

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

BANKRUPTCY

GENERAL-ALM § 13.03.*

ESTATE PROPERTY. The Chapter 7 debtors operated a business which purchased agricultural commodities and was subject to PACA. Several creditors had claims against the PACA trust and filed claims in the bankruptcy case. The bankruptcy trustee filed proceedings to recover preferential transfers made by the debtors for goods and services provided by third parties. The trustee negotiated a settlement for an amount which was paid to the bankruptcy estate. The PACA trust creditors sought to recover the preferential transfer amount as part of the PACA trust. The bankruptcy trustee agreed that the recovered amount was subject to the PACA trust but argued that the amount should be reduced by the costs of the recovery. The bankruptcy trustee proposed paying 83 percent of the recovery amount to the PACA trust.
However, the PACA creditors were not satisfied with the “bird in the hand” and argued that the entire recovery was PACA trust property. The dispute resulted in the PACA trust creditors losing all “the birds in the bush.” The court noted that the dispute did not arise if the recovered funds were not PAC trust property; therefore, the court first examined that issue. The court held that a preferential recovery, in itself, was not subject to the PACA trust because it was not an agricultural commodity, was not an inventory of food or other product derived from an agricultural commodity, and was not a receivable or proceeds from the sale of a commodity. Assuming that the preferential transfers were initially funded from the sale of an agricultural commodity, the court held that the recovered funds could not be traced to the sale proceeds because the recovery occurred more than two years after any agricultural commodity sales by the debtors. The court noted that the PACA trust did not extend to the general assets of the preferential creditors unless traceable to the sales of commodities. The court next examined the authority under the bankruptcy law for excluding PACA trust assets from the bankruptcy estate and held that Section 541(d) does not exclude PACA trust assets which become part of the estate through the preferential transfer rules because, at the commencement of the case, the debtors did not have an interest in the preferential transfer property. The preferential transfer property can be recovered only by the bankruptcy trustee and did not arise as estate property until more than one year after the bankruptcy petition. The court held that the recovered preferential transfer property was not subject to the PACA trust and the bankruptcy trustee’s proposal was improper. *In re Churchfield, 277 B.R. 769 (Bankr. E.D. Cal. 2002).*

**EXEMPTIONS**

**TOOLS OF THE TRADE.** The debtors, husband and wife, had farmed for almost 20 years before experiencing financial difficulties. The wife and then the husband took off-farm jobs while continuing to farm. The bank first refused to make any additional operating loans and then threatened foreclosure of the farm mortgage. The debtors were able to continue farming by obtaining credit for seed and supplies directly from their suppliers but filed for Chapter 7 during the crop year. The crop was harvested post-petition. The debtors both claimed exemptions for farm machinery as tools of the trade of farming. The creditors objected to the wife’s exemption, arguing that the wife did not have an ownership interest in the equipment and neither debtor was a farmer because the farm was being foreclosed upon by the bank and the debtors had more income from nonfarm employment. The court held that the debtors were farmers on the date of the petition because the debtors had planted crops and harvested them post-petition. Although the debtors were likely to lose their land, the debtors had arranged for renting farm land from relatives and third parties. The court also noted that the proceeds of those crops exceeded their wages from off-farm employment. The court also noted that the off-farm income was used to support the farm and was used to pay farm expenses in excess of revenues. The court held that the wife had an ownership interest in the farm equipment because (1) the equipment was purchased with general farm income which she helped to produce; (2) the wife co-signed all loans used to purchase the equipment; and (3) the debtors shared all property as family property. The court noted that the exemption statute, Kan. Stat. § 60-2304(e), did not set a minimum ownership requirement. The creditors also argued that, if the debtors co-owned the farm equipment, they formed a partnership and the equipment was not eligible for the exemption as partnership property. The court held that co-ownership of property by a husband and wife did not form a partnership without other indicia of intent to form a partnership, which were not present here. *In re Lampe, 278 B.R. Bankr. 10th Cir. 2002.*

**FEDERAL TAXATION-ALM § 13.03[7].**

**DISCHARGE.** The debtors had income for 1996 and claimed that they filed an income tax return for that year but had no proof of the filing. The IRS prepared a substitute return for 1996 and made an assessment of taxes based on that return in 1998. The debtors filed for Chapter 7 in 2001 and sought to have the taxes for 1996 declared dischargeable. The court held that, because the debtors had no proof of filing other than their testimony, the taxes were nondischargeable. *In re Crump, 2002-2 U.S. Tax Cas. (CCH) ¶ 50,562 (Bankr. N.D. Ohio 2002).*

**NET OPERATING LOSSES.** The debtor was a corporation which filed two bankruptcy cases, a Chapter 11 case and a Chapter 7 case three years later. In the Chapter 11 case, the Bankruptcy Court approved estate expenses for professional fees. The debtor claimed these expenses as net operating losses, carried back three years and as capitalized expenses. After filing the second Chapter 7 case, the debtor filed an amended return and carried the capitalized costs as net operating losses back 10 years under I.R.C. § 172(f) as a “specified liability loss” resulting from the first bankruptcy case. The debtor argued that the fees were eligible for the special 10 year carryback because the fees arose under the bankruptcy law. The court held that the connection between the bankruptcy law and the fee expenses was too attenuated to qualify as required by law. The court noted that while the fees were authorized by the bankruptcy law, there was no requirement that fees be paid and the amount of the fees was contingent until the bankruptcy court approved them. *Standard Brands Liquidating Creditor Trust v. United States, 2002-2 U.S. Tax Cas. (CCH) ¶ 50,565 (Fed. Cts. 2002).*

**FEDERAL AGRICULTURAL PROGRAMS**

**ADMINISTRATIVE OFFSET.** The plaintiffs were a corporation, family trust and partnership which operated farms. In each case, a government farm program payment to the entity was reduced by an offset of money owed personally by a shareholder, member or partner to the CCC or USDA. Under its interpretation of the regulations, the USDA gave notice of the offset to the individuals but not to the plaintiffs. The plaintiffs argued that the no-notice to non-debtors policy...
violated their due process rights. The District Court dismissed the case for lack of subject matter jurisdiction because the plaintiffs had not exhausted their administrative appeals, as required by 7 U.S.C. § 6912(e). The court held that the statute did not prohibit judicial review of the USDA action because the exhaustion statute merely reiterated the exhaustion requirement and did not specifically prohibit judicial review until administrative appeals were exhausted. The court also noted that the exhaustion doctrine was not required to be followed where there was a constitutional claim which was “(1) collateral to a substantive claim of entitlement, (2) colorable, and (3) one whose resolution would not serve the purposes of exhaustion.” The court held that all three conditions were met: (1) the USDA had no administrative appeal process for facial constitutional claims against a regulatory policy, (2) lack of notice was a colorable due process claim, and (3) exhaustion of the administrative appeal process would be futile because the National Appeals Division had no authority over this kind of claim. The USDA also claimed that the case was moot because it had changed its policy to provide notice to non-debtors, but the court refused to dismiss the case because of some evidence that local USDA offices were not providing notice to non-debtors.

*CROP INSURANCE.* The plaintiffs were sugar beet growers who had purchased multi-peril crop insurance from the defendants, various crop insurance companies. The plaintiffs experienced crop losses from a hard frost and filed claims with the defendants but the defendants refused to pay the claims. The plaintiffs sued the defendants in state court for contract damages and for violation of the Minnesota Prevention of Consumer Fraud Act (MPCF Act). The defendants moved the case to federal court and the plaintiffs filed a motion to remand the cases back to state court, arguing that the federal court lacked subject matter jurisdiction. The defendants argued that the federal court had diversity jurisdiction because all of the parties are from different states and the amount in controversy exceeded $75,000. The petitions claimed damages of only $50,000 per plaintiff but the defendants argued that the total damages, when divided equally among the plaintiffs, amounted to more than $75,000 per plaintiff. The court rejected this method of determining the amount in controversy for individual plaintiffs, noting that several plaintiffs had much less than $75,000 in damages. The court also refused to separate the plaintiffs with less than $75,000 in damages. As to the two remaining plaintiffs, the defendants argued that a federal question was involved in that the crop insurance system was highly regulated and that these regulations would be involved in the case. The court also rejected this argument and remanded the cases of these two plaintiffs back to state court. The court noted that the actions did not attack the federal crop insurance system or regulations but sought damages for the actions of private companies.


**WAREHOUSES.** The FSA has adopted as final regulations revising the regulations administering the United States Warehouse Act (USWA) to implement the provisions of the Grain Standards and Warehouse Improvement Act of 2000 (the 2000 Act). The regulations update federal warehouse licensing operations, authorize 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. 67 Fed. Reg. 50777 (Aug. 5, 2002).

**FEDERAL ESTATE AND GIFT TAX**

**DISCLAIMER.** The decedent’s will provided for the residue of the estate to pass in trust to the surviving spouse, with the principal and net income to be distributed for the spouse’s support, care and welfare. The remainder of the trust passed to a charitable organization. Within nine months after the decedent’s death, the spouse disclaimed in writing all of the interest in the trust as a discretionary distributee of trust principal. The trust was then reformed by a local court to provide for a unitrust amount to the spouse of 6.525 percent of net fair market value of the trust assets valued annually. The remainder still passed to the charitable organization. The IRS ruled that the disclaimer of the interest in the principal was qualified, the value of the spouse’s unitrust interest was eligible for the marital deduction, and the reformation of the trust did not prevent a charitable deduction for the value of the charity’s remainder interest.

*Ltr. Rul. 200232015, May 1, 2002.*

**ESTATE PROPERTY.** The beneficiaries of the decedent’s estate discovered that the decedent’s caretakers had misappropriated funds from the decedent while the decedent was alive but incapacitated. The beneficiaries sued the law firm, among others, which handled the decedent’s affairs and obtained a settlement for return of the legal fees paid to the firm and for damages resulting from the firm’s malpractice. The issue was whether and to what extent the recovery from the law firm was to be included in the decedent’s estate as representing the value of the claim at the death of the decedent. The court held that the return of the legal fees was not included in the value of the decedent’s estate because the legal services were performed after the decedent’s death for the estate. As to the main settlement, the court held that the entire settlement represented the value of the claim but allowed a deduction for the value of the legal fees expended.
to bring the action and reach the settlement and a deduction for the costs expended by the beneficiaries in discovering the lawyers’ malpractice and malfeasance of the caregivers. The court held that no deduction was allowed for a portion of the settlement paid directly to the beneficiaries because that amount would have otherwise passed to the beneficiaries from the estate. \textit{Estate of Glover v. Comm’r}, T.C. Memo. 2002-186.

**VALUATION OF STOCK.** The decedent owned 62.96 percent of the stock in a family corporation which operated a heavy equipment rental company. The value of the decedent’s stock as determined by the Tax Court was based on a combination of the value the company assets (65 percent weight) and the earnings of the company (35 percent weight) because the company was in no danger of liquidation. The appellate court held that the correct ratio was 85 percent based on asset value and 15 percent based on earnings value. The appellate court also allowed a discount of 34 percent of any built-in gain in the assets’ values. The Tax Court and appellate court allowed a 15 percent discount for lack of marketability and 7.5 percent discount for lack of super-majority control. A super-majority vote was required by the corporate charter to force the liquidation of the company. \textit{Estate of Dunn v. Comm’r}, 2002-2 U.S. Tax Cas. (CCH) ¶ 60,446 (5th Cir. 2002), rev’g and rem’g. T.C. Memo. 2000-12.

**FEDERAL INCOME TAXATION**

**ALTERNATIVE MINIMUM TAX.** The taxpayer had income from wages and claimed deductions for unreimbursed employee expenses, charitable contributions and state and local taxes. The taxpayer also claimed the personal exemption. The taxpayer did not compute alternative minimum taxable income and paid tax based on the regular income only. The court held that I.R.C. § 55(b)(2) required computation of AMTI which did not allow deductions for unreimbursed employee expenses (under I.R.C. § 67(b)), the personal exemption, and the deduction for state and local taxes. Because the taxpayer’s AMTI exceeded the exemption amount, the taxpayer was liable for AMT on the amount that the AMTI exceed the exemption amount. Because the AMT exceeded the regular tax, the taxpayer was liable for the AMT. \textit{Moore v. Comm’r}, T.C. Memo. 2002-196.

**AUTOMOBILE EXPENSES.** The taxpayer operated a music entertainment business which involved a band which performed for a fee. The taxpayer claimed a deduction for expense method depreciation and travel expenses for the van. The deductions were disallowed because the taxpayer failed to provide substantiation of the business use of the van and the business purpose for the expenses and because the van was placed in service in a personal activity in a prior taxable year. \textit{Kay v. Comm’r}, T.C. Memo. 2002-197.

The taxpayer was employed as a nurse. Initially the taxpayer worked at a medical facility in the taxpayer’s city of residence. However, the employer assigned the taxpayer to temporary employment at the employer’s facilities in other cities, with the promise that the taxpayer would eventually be permanently assigned to the facility in the taxpayer’s city of residence. When this promise was not fulfilled, the taxpayer changed to permanent employment in another city. The taxpayer claimed travel expenses for automobile and other travel costs for travel to the temporary work sites and maintained travel logs and other written records of the expenses. The court upheld the taxpayer’s deductions for the travel expenses for commuting to the temporary work sites because the taxpayer demonstrated a business purpose, the promise of permanent employment, for the location of the residence and substantiated the expenses with written records. \textit{Diaz v. Comm’r}, T.C. Memo. 2002-197.

**BUSINESS EXPENSES.** The taxpayer operated a music entertainment business which involved a band which performed for a fee. The taxpayer claimed deduction for management fees and for professional convention expenses. The court disallowed the deduction because the taxpayer failed to provide substantiation of the business purpose of the expenses. \textit{Kay v. Comm’r}, T.C. Memo. 2002-197.

The taxpayer operated a real estate sales business as a sole proprietorship and formed a wholly-owned corporation which operated two retail businesses and a real estate development business. The taxpayer’s business entered into a management contract with the corporation in exchange for a fee of the greater of $48,000 or 70 percent of the net profit of the real estate sales business. The fee was increased over several years by amending the management contract. The taxpayer performed all the management services provided by the corporation but did not receive any salary or other compensation. The taxpayer reported the fees as deductions on Schedule C on the taxpayer’s individual tax returns and included the fees in income on the corporation’s tax returns. The court held that the existence of the corporation could be ignored because the taxpayer performed all the services and controlled the arrangements that established the management contract and fee. The evidence demonstrated that the taxpayer did not perform the services as an employee of the corporation; therefore, the management contract was ignored and the payment of the management fee was not deductible as an ordinary and necessary business expense. \textit{Stewart v. Comm’r}, T.C. Memo. 2002-199.

**CAPITAL GAINS.** The IRS has announced that the election under § 311(e) of the Taxpayer Relief Act of 1997 (TRA 97), (as amended by § 314(c) of Pub. L. 106-554 and § 414 of Pub. L. 107-147), to treat certain assets held on January 1, 2001, as having been sold and then reacquired on that date is properly made by following the instructions for Form 4797, Sales of Business Property, or Schedule D, Capital Gains and Losses, for Form 1040, 1120, 1120S, 1065, or 1041. Under appropriate circumstances, the IRS will grant requests to make a late election under § 311(e) of TRA 97 and this notice under Treas. Reg. §§ 301.9100-1 through 301.9100-3. See Harl, “‘Deemed Sales’ of Capital and Section 1231(B) Assets,” 13 Agric. L. Dig. 113 (2002). \textit{Notice 2002-58, I.R.B. 2002-__}.
CASUALTY LOSS. The taxpayer’s residence was damaged by a rain and wind storm. The taxpayer received insurance proceeds and hired a contractor to replace rotten decking and to install a new roof. The taxpayer claimed a casualty loss deduction based on the loss of fair market value of the residence after the storm. However, the taxpayer failed to present evidence of the fair market value of the residence before and after the storm; therefore, the court denied the casualty loss deduction. The taxpayer also sought to justify the loss on the basis of the cost of repair but also failed to substantiate sufficient costs above the 10 percent of gross income limitation. Kay v. Comm’r, T.C. Memo. 2002-197.

DEPENDENTS. The taxpayer was divorced from the mother of the taxpayer’s children, with the mother receiving custodial rights and entitled to child support payments. The children lived with the mother for more than one-half of the tax year. The mother did not sign a statement, either written or on Form 8332, that she did claim the children as dependents for federal income tax purposes. The court held that the taxpayer could not claim the dependency exemption for the children and the earned income tax credit. In addition, the court held that the taxpayer could not use the head of household filing status. Anderson v. Comm’r, T.C. Summary Op. 2002-103.

DISASTER PAYMENTS. On July 11, 2002, the President determined that certain areas in the Federated States of Micronesia are eligible for assistance from the federal government under the Disaster Relief and Emergency Assistance Act (42 U.S.C. § 5121) as a result of Tropical Storm Chata'an, which included flooding, mudslides and landslides, that began on July 2, 2002. FEMA-1427-DR. Accordingly, taxpayers who sustained losses attributable to the disaster may deduct them on their 2001 federal income tax returns.

DISCHARGE OF INDEBTEDNESS. The taxpayer had a credit card account and had written to the credit card company to verify the balance on the account. The taxpayer then made a cash withdrawal on that account and made several minimal payments on the account. The taxpayer and credit card company disputed several late charges and the interest rate over several months. The credit card company eventually offered a substantially reduced amount to settle the account, which the taxpayer paid. The credit card company issued a From 1099-C and listed the reduction amount, over $19,000, as discharge of indebtedness income to the taxpayer. The credit card company based the amount on the balance shown on their records as of the settlement date less the settlement amount paid by the taxpayer. The taxpayer argued that the account reduction was not discharge of indebtedness but a determination of the true balance of the account reached by negotiation of a disputed claim. The court held that the taxpayer had discharge of indebtedness income in the amount of the verified balance plus the cash withdrawal less the amount of monthly payments made and the final settlement amount. Earnshaw v. Comm’r, T.C. Memo. 2002-191.

HOBBY LOSSES. The taxpayer was a physician who also operated a horse breeding operation in conjunction with an S corporation, owned in part by the taxpayer, which owned a farm on which the horses were boarded and trained. The taxpayer developed a business plan for the breeding operation which identified advisors, projected income and expenses, and included a list of assets with expected appreciation and an economic analysis of the horse breeding industry produced by a university. The plan was later amended to change the focus from breeding to racing. The taxpayer was a licensed horse trainer and a certified horse appraiser. The taxpayer published articles on various aspects of horse breeding and racing. The operation, however, produced only losses for its 18 year existence. The court held that the horse breeding/racing operation was not operated for profit because (1) the taxpayer failed to demonstrate that separate and accurate records were maintained which were sufficient to analyze the efficiency and profitability of the operation; (2) the operation produced only losses; (3) the taxpayer had substantial personal income which was offset by the losses; (4) the taxpayer failed to provide evidence that any of the business assets would appreciate in value to offset the losses; and (5) although the taxpayer was either knowledgeable about horse breeding or sought expert advice, the taxpayer failed to provide evidence that the taxpayer had any expertise or sought advice as to how to make the operation profitable. In its discussion of these factors, a major concern of the court was the taxpayer’s failure to provide evidence other than the taxpayer’s own assertions as to the intent to operate the horse breeding as a profitable business. The case demonstrates a growing emphasis on the need of other-income taxpayers with several years of farm losses to demonstrate that they have made substantial efforts to restructure the farm business to make it profitable within a reasonable period of time. The court here made an observation that if the taxpayer did not have substantial income from a medical career, the taxpayer would not, or even could not, have allowed the losses to continue. Kuberski v. Comm’r, T.C. Memo. 2002-200.

LOSSES. The taxpayers, husband and wife, initially operated their construction business as a sole proprietorship and then incorporated the business as a C corporation. The corporation terminated in 1991 and the business was terminated. The corporation did not file income tax returns because the corporation never had a profit. The taxpayers claimed a Schedule C loss on their individual Form 1040 tax return for 1995 but did not file a Schedule C. the taxpayers claimed that the loss resulted from an uncollectible judgment awarded to the corporation in 1991. However, the taxpayers presented no explanation as to why the corporation’s loss could be passed on to them. The taxpayers merely argued that they had contributed capital to the corporation and should be entitled to the loss. The primary evidence was a check register which did not list the bank or bank account involved and which listed the checks out of numerical order. The court held that the taxpayers were not entitled to a loss deduction because the taxpayers failed to provide any evidence that they suffered a loss. Portaluppi v. Comm’r, T.C. Summary Op. 2002-106.

PENSION PLANS. For plans beginning in August 2002, the weighted average is 5.65 percent with the permissible range of 5.09 to 6.22 percent (90 to 120 percent permissible range) and 5.09 to 6.78 percent (90 to 110 percent permissible range) and 5.09 to 6.78 percent (90 to 110 percent permissible range) and 5.09 to 6.78 percent (90 to 110 percent permissible range) and 5.09 to 6.78 percent (90 to 110 percent permissible range).
PRODUCT LIABILITY

ANIMAL FEED. The plaintiff owned a horse breeding operation and purchased feed from the defendant. The plaintiff’s horses became sick and an autopsy on one horse indicated that the ingestion of rat poison was the cause of death. The plaintiff claimed that the feed sold by the defendant was contaminated with rat poison and sued for negligence, breach of implied warranty, strict liability, and violation of the Virginia Commercial Feed Law and Pesticide Control Act. The defendant argued that neither law provided for a right of private action to enforce those laws and that the other claims were preempted by FIFRA. The court held that the state laws did not provide for a right of private action and dismissed those claims. The court also held that the negligence, breach of implied warranty and strict liability claims were not preempted by FIFRA because they were not based on any defect of the label. *Southern States Coop., Inc. v. I.S.P. Co.*, 198 F. Supp.2d 807 (N.D. W.Va. 2002).

ZONING

HOG CONFINEMENT FACILITY. The plaintiff applied for a conditional use permit to construct two hog confinement facilities for over 6,000 pigs. The county board of commissioners denied the permit because (1) the facilities would impact the local roads, create pollution and create undue risk of offensive odors; (2) the manure spreading range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). *Notice 2002-57, I.R.B. 2002-33.*

RETURNS. The IRS has posted the following publications on its web site at www.irs.gov, in the "Forms & Pubs" section: Publication 3402 (Rev. 7-2002), Tax Issues for Limited Liability Companies; Form W-2 (Rev. February 2002), Wage and Tax Statement; and Publication 505 (Rev. December 2001), Tax Withholding and Estimated Tax. These documents are also available at no charge and can be obtained (1) by calling the IRS’s toll-free telephone number, 1-800-TAX-FORM (1-800-829-3676); (2) through FedWorld on the Internet; or (3) by directly accessing the Internal Revenue Information Services bulletin board at (703) 321-8020.

The IRS has announced changes in the filing locations for some taxpayers for 2002 paper returns. The IRS has issued an advance list for tax return preparers; the new addresses will be included with the tax return packets sent to taxpayers. IR-2002-92.

The IRS has adopted as final regulations that allow income tax return preparers to elect an identifying number as an alternative to their social security number for purposes of identifying themselves on returns they prepare. The regulations do not specify any standards as to the alternative number but do require individuals who employ other tax return preparers to use the individual’s employer identification number. 67 Fed. Reg. 52862 (Aug. 14, 2002).

CITATION UPDATES

Walshire v. United States, 288 F.3d 342 (8th Cir. 2002) (disclaimers) see p. 89 *supra.*

IN THE NEWS

AGRICULTURAL TAX AND LAW SEMINARS

by Neil E. Harl and Roger A. McEowen

September 24-27, 2002  Interstate Holiday Inn, Grand Island, NE

Come join us for expert and practical seminars on the essential aspects of agricultural tax and law. Gain insight and understanding from two of the nation’s top agricultural tax and law instructors.

The seminar are held on Tuesday, Wednesday, Thursday, and Friday. Registrants may attend one, two, three or all four days, with separate pricing for each combination. On Tuesday, Dr. Harl will speak about farm and ranch income tax. On Wednesday, Dr. Harl will cover farm and ranch estate planning. On Thursday, Roger McEowen will cover farm and ranch business planning. NEW THIS YEAR: On Friday, Roger McEowen will cover agricultural contracts. Your registration fee includes comprehensive annotated seminar materials for the days attended which will be updated just prior to the seminar. The seminar materials will also be available on CD-ROM for a small additional charge.

The seminar registration fees for current subscribers to the Agricultural Law Digest, the Agricultural Law Manual, or Principles of Agricultural Law (and for multiple registrations from one firm) are $185 (one day), $360 (two days), $525 (three days), and $670 (four days). The registration fees for nonsubscribers are $200, $390, $570 and $720, respectively.

Registration brochures were mailed in June and July. However, complete information and a registration form are available now on our web site at http://www.agrilawpress.com. For more information, call Robert Achenbach at 1-541-302-1958, or e-mail to robert@agrilawpress.com

October 17-18, 2002  Spa Resort, Palm Springs, CA

“Farm & Ranch Income Tax” and “Farm & Ranch Estate and Business Planning.”

The seminars are held on Thursday, and Friday. Registrants may attend one or both days, with separate pricing for each combination. On Thursday, Dr. Harl will speak about farm and ranch income tax. On Friday, Roger McEowen will cover farm and ranch estate and business planning. The registration fee includes comprehensive annotated seminar materials for the days attended which will be updated just prior to the seminar.

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SUBSCRIPTION RATE INCREASE

The recent increase in postage rates and increased printing costs over the years have finally forced us to increase the annual subscription rate for the print version of the Agricultural Law Digest to $110 per year. This is the first price increase for the Digest since it began in 1989. The new rates will take effect with the next billing date after July 1, 2002 for each subscriber. Each billing offers subscribers the option to subscribe to our e-mail version of the Digest which remains at $90 per year and which is e-mailed on the Monday before the print version is published. You can beat the rush and change your subscription now to the e-mail version and we will credit your account with an additional issue for each three print issues remaining on your subscription. Send an e-mail to robert@agrilawpress.com for a free sample or to order the change in subscription.

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PARTITION AND THE RELATED PARTY RULE
— by Neil E. Harl

The settlement of an estate and distribution of property to the heirs or devisees after the deaths of the parents often involve an exchange of interests between or among the individuals involved unless the parties sell or exchange the entire property interest, agree to maintain their undivided interests for some time or shift the asset or assets involved to a separate entity. One concern is whether the exchange invokes the related party rules under the like-kind exchange provision.

Related party rules

Under the related party rule applicable to like-kind exchanges, if, within two years of a like-kind exchange with a related person, the related person disposes of the property, or the taxpayer disposes of the property, the gain is recognized.  A primary objective in enactment of the related party rules was to deny non-recognition treatment for transactions in which related parties exchange high basis property for low basis property in anticipation of sale of the low basis property. Thus, if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, “cashed out” of the investment and the original exchange is not accorded nonrecognition treatment. The related parties, in such transactions, are treated as a single taxpayer and the subsequent disposition of exchange property by the related party is treated as a “cashing out” by the other related property.

For this purpose, “related person” is defined in I.R.C. §§ 267(b) and 707(b)(1) of the Internal Revenue Code. That means the term includes members of the family (brothers and sisters, spouse, ancestors and lineal descendants), an individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual, two corporations which are members of the same controlled group, a grantor and a fiduciary of a trust, a fiduciary of a trust and the fiduciary of another trust if the same person is a grantor of both trusts, a fiduciary of a trust and the beneficiary of the same trust, a fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person.
who is a grantor of the trust, a person and a tax-exempt organization which is controlled, directly or indirectly, by the person or by members of the person’s family, a corporation and a partnership if the same persons own more than 50 percent in value of the outstanding stock of the corporation and more than 50 percent of the capital or profits interest in the partnership, an S corporation and another S corporation if the same person or persons own more than 50 percent in value of the outstanding stock of each corporation, an S corporation and a C corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation or an executor of an estate and a beneficiary of the same estate (except for a sale or exchange in satisfaction of a pecuniary bequest). In addition, the term “related person” includes a partnership and a person owning, directly or indirectly, more than 50 percent of the capital or profits interest in the partnership or two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital or profits interests.

IRS has ruled that routing the exchange through an unrelated party to avoid the related party rules does not avoid the denial of like-kind exchange treatment. In that type of exchange, the mere interposition of a qualified intermediary between the parties does not correct a transaction otherwise flawed under the related party rule. The same outcome occurs for a multi-party transaction involving related parties where there is “basis shifting” of the taxpayer’s low basis in its relinquished property to the replacement property which had been owned by the related party prior to the transactions that included the exchanges.

Exceptions to the related party rule

The like-kind exchange related party rule does not apply to—(1) dispositions involving the death of the taxpayer or a related person, (2) compulsory or involuntary conversions if the exchange occurred before the threat or imminence of conversion or (3) if IRS is convinced that neither the exchange nor the disposition had as one of its principal purposes the avoidance of federal income tax. The Senate Finance Committee report states that the third exception includes—(1) transactions involving an exchange of undivided interests in different properties that result in each taxpayer holding either the entire interest in a single property or a larger undivided interest in any of the properties; (2) dispositions of property in non-recognition transactions; and (3) transactions that do not involve the shifting of basis between properties.

IRS has ruled that the exchange of an undivided interest for a whole interest is not a “disposition” of property subject to the waiting period for related party transactions. In the facts of that ruling, a like-kind exchange of timberland between spouses after a divorce of what had been tenancy in common property did not preclude cutting of the timber during the two year period; the transaction came within the exception where IRS did not believe it was a matter of tax avoidance.

In conclusion

An exchange of interests in the nature of a partition of property, where related taxpayers with undivided interests end up with whole interests in assets, does not come within the two-year redisposition rules.

FARM PROGRAMS. The USDA has announced the types of documentation that producers may use to update farm yields if they elect to do so under the direct and counter-cyclical payment programs under the 2002 Farm Bill. Under the new farm law, eligible producers have the option to update their farm base acres and yields. Landowners who elect to update their base acres also may update their yields for counter-cyclical payments. Oilseed producers also may establish a yield for direct and counter-cyclical payments. In general, producers who wish to establish or update yields must have actual verifiable production evidence such as weight tickets, loan deficiency payments (LDPs), crop insurance appraisals or sales records. This approach to verification will be used by the vast majority of producers. Some crops, however, are harvested or utilized in a manner that does not result in tangible records of measurable production. This includes crops that were grazed, harvested as silage or hay or fed on the farm. In these situations, previous LDPs on record at the county office may be used to establish farm yields. When LDPs are not available, but crop insurance records or other FSA records indicate the crop was grazed, harvested as silage or hay or fed on the farm, then FSA may assign a yield based on the actual grain yield for three similar farms. In the case when producers cannot meet any of these requirements, or they have experienced abnormally low yields, then 75 percent of the county average yield will be used as specified in the new law. Producers selecting the yield update option will need form FSA-658P (Producer’s Record of Production) to list the sources of the production evidence. The actual documentation does not have to be produced at the time the option is selected. However, the production evidence will have to be provided at a subsequent time if required under spot-check procedures. Farm Service Agency Service Centers will begin accepting yield updates in mid-September. On October 1, producers can apply for the direct and counter-cyclical payment program. All applications for updates must be received before April 1, 2003. Producers who reported yields for crop insurance purposes must report the same yields for the direct and counter-cyclical program. They do not have to provide the FSA Service Center with production evidence at time of sign-up but would subsequently if subject to a spot-check. Information pertaining to the 2002 Farm Bill implementation

GRAIN INSPECTION. The GIPSA has issued proposed regulations revising the regulations under the United States Grain Standards Act to allow interested persons to specify the quality factor(s) that would be reetermined during a reinspection or appeal inspection for grade. Currently, reinspections and appeal inspections for grade must include a redetermination (i.e., a complete review or examination) of all official factors that may determine the grade, are reported on the original certificate, or are required to be shown. 67 Fed. Reg. 54133 (Aug. 21, 2002).

SUGAR. The CCC has issued final regulations which implement the provisions of Title I of the Farm Security and Rural Investment Act of 2002 relating to the various activities affecting sugar beet and sugar cane producers and processors and the marketing of sugar. Generally, these regulations are applicable through Fiscal Year 2007. Major provisions of the 2002 Act terminate marketing assessments; make in-process sugar eligible for loans; authorize the establishment of a payment-in-kind program; cap the minimum payment requirement for sugar beet growers; eliminate a loan forfeiture penalty; provide for storage facility loans; and establish flexible marketing allotments. 67 Fed. Reg. 54925 (Aug. 26, 2002).

**FEDERAL ESTATE AND GIFT TAX**

ALTERNATE VALUATION DATE. Due to a misunderstanding between the executor and the estate accountant, the estate failed to make the election to value estate property on the alternate valuation date. The estate assets were valued as of the decedent’s date of death and reported on a timely filed Form 706. The decedent’s estate contained real estate, bonds and marketable securities, among other assets. The failure to make the election was discovered within one year after the Form 706 filing and the estate immediately requested an extension of time to make the election. The IRS granted the extension. Ltr. Rul. 200234037, May 16, 2002.

FAMILY-OWNED BUSINESS DEDUCTION. Under I.R.C. § 2057(h), each person who has an interest (whether or not in possession) in FOBD property must sign an agreement consenting to the recapture provisions described in I.R.C. § 2057(f) with respect to such property. The decedent’s estate claimed the FOBD and the executor filed Schedule T with the Form 706, but the executor failed to sign the Section 2057(b) agreement. In a Chief Counsel Advice letter, the IRS ruled that the provisions for correction of minor errors used for special use valuation elections (see I.R.C. § 2032A(d)(3)) would also apply to FOBD elections. Therefore, the executor was allowed a reasonable period of time, not to exceed 90 days, after being notified of the error or omission to supply the missing information or signature. CCA Ltr. Rul. 200234055, May 22, 2002.

Although the estate qualified for the FOBD and retained professional assistance in preparing the estate tax return, no election was made. The error was discovered upon review by another professional and the estate sought an extension of time to file the FOBD election. The IRS granted the extension. Ltr. Rul. 200234004, Jan. 18, 2002.

GENERATION-SKIPPING TRANSFERS. Prior to September 1985, the taxpayer established several trusts for the benefit of descendants of the taxpayer. The trusts were funded with 53 percent of the stock of a corporation which later elected S corporation status. The S corporation contributed property and cash to a newly created limited liability company in an amount not more than its accumulated adjustments account. The IRS ruled that the creation of the LLC did not constitute an addition to the trusts that would subject the trusts or distributions from them to the generation-skipping transfer tax. Ltr. Rul. 200234062, May 22, 2002.

JOINT TENANCY PROPERTY. The decedent had acquired a residence as joint tenant with the decedent’s mother and sister. The mother and sister predeceased the decedent and the decedent acquired full ownership of the residence. The decedent, however, did not want to continue living in the residence and agreed to transfer the property to herself and a niece as joint tenants in exchange for allowing the decedent to keep her dogs at the residence and for the decedent’s right to reside at the niece’s residence. The niece’s husband also agreed to manage the decedent’s rental property. The fair rental value of the decedent’s right to reside with the niece exceeded one-half of the value of the decedent’s residence. The IRS argued that the entire value of the residence was included in the decedent’s gross estate because the niece did not contribute to the purchase of the property and did not give consideration for her joint tenancy interest. The court held that the value of the right to reside with the niece was adequate consideration for the joint tenancy interest; therefore, only one-half of the value of the residence was included in the decedent’s estate. Estate of Concordia v. Comm’r, T.C. Memo. 2002-216.

LIFE INSURANCE. The IRS has issued an explanation of the standards it will use in valuing current life insurance protection under a split-dollar life insurance arrangement. This notice is in response to abusive split-dollar life insurance arrangements to avoid taxes by parties paying inappropriately high current term insurance rates or using other techniques in order to understate the value of the taxable policy benefits. Pursuant to the notice, a party participating in a split-dollar arrangement may use the premium rates in Table 2001 (Notice 2002-8, I.R.B. 2002-4, 398) or the insurer’s lower published premium rates only for the purpose of valuing current life insurance protection, and when such protection confers an economic benefit from one party to another party. Therefore, if one party has any right to current life insurance protection, neither the premium rates in Table 2001 nor the insurer’s lower published premium rates may be relied upon to value that party's
current life insurance protection for the purpose of valuing any policy benefits to which another party may be entitled. Notice 2002-59, I.R.B. 2002-35.

**MARITAL DEDUCTION.** The decedent’s will bequeathed property in trust to the surviving spouse. The bequest granted the spouse the lifetime power to appoint trust income and principal to the decedent’s heirs. The decedent’s will stated that the spouse’s trust was intended to qualify for the marital deduction and prohibited the executor from doing anything to disqualify the trust for the deduction. The will also created a family trust which received the remainder of the decedent’s estate and would receive any property which would not qualify for the marital trust. The spouse filed the estate tax return as executor and claimed the trust as a marital deduction as QTIP. More than nine months after the decedent’s death, the surviving spouse filed a disclaimer of any interest in the trust which would disqualify it for the marital deduction. The IRS ruled that the spouse’s power to appoint trust income and principal disqualified the trust for the QTIP marital deduction. The IRS also ruled that the disclaimer was not qualified because it was made more than nine months after the decedent’s death. The spouse argued that (1) the filing of the estate tax return was a disclaimer of the power of appointment because the QTIP election was made for the trust and the decedent’s will prohibited the spouse from doing anything which would disqualify the trust for the marital deduction, and (2) if the marital trust property did not qualify for the marital deduction, it passed to the family trust and was also eligible for the marital deduction because the spouse received the income from that trust. The IRS ruled that an estate tax return could not function as a disclaimer because the return did not contain any statement of disclaimer. The IRS also ruled that the savings clause in the trust could not be used to negate the unambiguous grant of the power of appointment. The IRS ruled that the provision for passing of marital trust property to the family trust was effective only for property which was not of a character to which the marital deduction would apply and did not affect powers held by the surviving spouse. Ltr. Rul. 200234017, May 13, 2002.

**FEDERAL INCOME TAXATION**

**COOPERATIVES.** The taxpayer was a tax-exempt telephone cooperative. The taxpayer received 90 percent of its income from member patrons, 5 percent of its income from dividends from a C corporation owned by the taxpayer, and 5 percent from interest income. The taxpayer did not provide any services to the corporation which was not a member of the taxpayer. The IRS stated that, under Moline Properties, Inc. v. Comm’r, 319 U.S. 436 (1943), a corporation was a separate taxable entity from its shareholders for federal income tax purposes if the corporation is formed for valid business purposes and is not a sham, an agency or instrumentality of the shareholders. The IRS ruled that, if the corporation was a separate entity under Moline Properties, the taxpayer had more than 85 percent of its income from member business and was eligible for tax-exempt cooperative status. Rev. Rul. 2002-55, I.R.B. 2002-__.

**COURT AWARDS AND SETTLEMENTS.** The taxpayer was terminated from employment and filed a claim against the employer with the Utah Industrial Commission in which the taxpayer alleged employment discrimination, sexual harassment, and retaliation. The taxpayer later filed a law suit against the employer for sexual harassment and wrongful termination. The petition asked for damages for back pay and reimbursement for lost sick leave, health and disability insurance benefits, pension benefits, and social security benefits. The petition also asked for damages for personal humiliation and for punitive damages. The taxpayer reached a settlement with the employer and received payment for back pay, less payroll deductions, and for pain and suffering from sexual discrimination. The taxpayer excluded the settlement payments from income, arguing that the taxpayer suffered physical injury from the sexual harassment incidents. The court concluded that the taxpayer’s testimony about physical injuries was not credible because it was not supported by other evidence and was not alleged in the lawsuit against the employer. The court held that the settlement was included in income because the law suit did not involve claims for physical injury. Nield v. Comm’r, T.C. Summary Op. 2002-110.

**DISCHARGE OF INDEBTEDNESS.** The taxpayer defaulted on a consumer credit debt and the creditor issued a Form 1099-C for discharge of indebtedness income for the unpaid debt. The taxpayer included the discharge of indebtedness in income. In a later tax year, the taxpayer repaid the debt, either voluntarily or under enforced collection. In a Significant Service Center Advice letter, the IRS ruled that the taxpayer’s repayment of the debt indicated that the original debt was not discharged; therefore, the taxpayer was entitled to file for a refund of the tax paid on the amount included as discharge of indebtedness income. SSA Ltr. Rul. 200235030, June 3, 2002.

**EMPLOYEE.** The taxpayer was a medical doctor who worked for a municipal water and power company. The company reported income of all its physicians on Forms W-2, Wage and Tax Statement, and withheld taxes and contributions. The taxpayer had objected to the company’s method of reporting and withholding. The taxpayer claimed the income from the employment on Schedule C as an independent contractor. The court held that the taxpayer was an employee of the company because the company controlled the work time, supervised the taxpayer’s work, and provided all equipment and facilities. In addition, the court noted that the taxpayer did not bill the patients, did not make the services available to the general public, and did not have a business license to practice as a sole proprietor. Naughton v. Comm’r, T.C. Memo. 2002-222.

**INTEREST.** The taxpayer was a lawyer whose law practice was operated as a sole proprietorship. The taxpayer’s tax returns were audited and the amount of income from the practice was adjusted, resulting in assessment of interest on underpayment of taxes on the
taxpayer’s personal income tax return. The taxpayer claimed the interest as a deduction on Schedule C as related to the business. Under Temp. Reg. §§ 1.163-8T, 1.163-9T(b)(2)(i)(A), the interest was nondeductible personal interest. The Tax Court had held the regulations to be invalid in several previous cases, but the regulations were held valid by five Circuit Courts of Appeal. The court gave a lengthy review of the statutes and regulations and held that the regulations were a valid interpretation of the statute, effectively overruling its prior decisions. Robinson v. Comm’r, 119 T.C. No. 4 (2002).

INTEREST RATE. The IRS has announced that, for the period October 1, 2002 through December 31, 2002, the interest rate paid on tax overpayments remains at 6 percent (5 percent in the case of a corporation) and for underpayments at 6 percent. The interest rate for underpayments by large corporations remains at 8 percent.

The overpayment rate for the portion of a corporate overpayment exceeding $10,000 remains at 3.5 percent. Rev. Rul. 2002-59, I.R.B. 2002-__

PASSIVE ACTIVITY LOSSES. The IRS has adopted as final regulations governing the treatment of self-charged items of income and expense for purposes of the limitation on passive activity losses and credits. The regulations cover loans to or from a pass-through entity, a partnership or S corporation, and to an owner of 10 percent or more of the entity. If an owner’s allocable share of all self-charged interest deductions from owner loans to an entity exceed interest income from the loans, a portion of the interest income is recharacterized as passive interest income based on the ratio of passive interest deductions to total interest deductions. The recharacterized passive income is allocated among the owner’s passive activities based upon the proportion of the passive interest deductions of those activities. In addition, if income is recharacterized as passive under these rules, interest expenses attributable to that income are also recharacterized as passive. 67 Fed. Reg. 54087 (Aug. 27, 2002), adding Treas. Reg. § 1.469-7.

PENSION PLANS. For plans beginning in September 2002, the weighted average is 5.63 percent with the permissible range of 5.07 to 6.20 percent (90 to 120 percent permissible range) and 5.07 to 6.76 percent (90 to 110 percent permissible range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). Notice 2002-61, I.R.B. 2002-__

RETURNS. The IRS has announced the publication of revised Form 706 (Rev. August 2002), United States Estate (and Generation-Skipping Transfer) Tax Return, and its instructions. The IRS has announced that a supplement to Publication 590, Individual Retirement Arrangements (IRAs), is available. The supplement contains new life expectancy and uniform lifetime tables, which are used in figuring required minimum distributions. These publications can be obtained by calling 1-800-TAX-FORM (1-800-829-3676); they are also available on the IRS’s website at www.irs.gov.

The IRS has announced that it has added FedEx International Priority and FedEx International First to the list of designated private delivery services effective September 5, 2002. Notice 2002-62, I.R.B. 2002-__

SALE OF RESIDENCE. Under I.R.C. § 121(c), taxpayers who sell their residence within two years after purchase may be eligible for a reduced exclusion of gain from the sale if the sale was caused by unforeseen circumstances. The IRS has issued proposed regulations and sought comments on what would qualify for the unforeseen circumstances exception. 65 Fed. Reg. 60136 (Oct. 10, 2000). The IRS stated that it intends to include the death of the taxpayer's spouse, man-made disasters, and acts of war as unforeseen circumstances in the final regulations. The IRS has also announced that a taxpayer may claim a reduced maximum exclusion of gain on a sale or exchange of the taxpayer's principal residence by reason of unforeseen circumstances if the taxpayer sells or exchanges the residence as a result of being affected by the terrorist attacks on the world trade center in one or more of the following ways: (1) a qualified individual was killed, (2) the taxpayer's principal residence was damaged (without regard to whether, under the taxpayer's circumstances, the taxpayer is entitled to a casualty loss deduction under §165(h)), (3) a qualified individual lost employment and became eligible for unemployment compensation, or (4) a qualified individual experienced a change in employment or self-employment that resulted in the taxpayer's inability to pay reasonable basic living expenses for the taxpayer's household. The term "qualified individual" means, as of September 11, 2001, (1) the taxpayer, (2) the taxpayer's spouse, (3) a co-owner of the residence, or (4) a person whose principal place of abode is in the same household as the taxpayer. Notice 2002-60, I.R.B. 2002-36.

SAFE HARBOR INTEREST RATES

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LIMITED LIABILITY COMPANIES

PIERCING THE VEIL. In a certified question from a district court, the Wyoming Supreme Court was asked to rule whether, in the absence of fraud, a limited liability

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*American Law Manual (ALM).*
company may be disregarded so as to hold one of its members liable for an act of the company. The plaintiff had leased land to a limited liability company owned by the defendant for the purpose of extracting oil and gas from the property. The plaintiff claimed that the company contaminated the property and sought to hold the defendant liable for the contamination damage. The court acknowledged that the limited liability company statute, Wyo. §§ 17-15-101 et seq., was silent on the issue; however, the court held that there was no impediment in the statute or case law to prevent piercing the limited liability company to hold the members personally liable if the factors existed which are used to pierce the corporate veil or corporations. The court acknowledged that other states’ limited liability company statutes provide for personal liability of members but noted that Wyoming passed one of the first limited liability company statutes and did not have the benefit of experience to include a provision for personal liability of members. The court also commented on the “in the absence of fraud” portion of the certified question. The court noted that fraud by the limited liability company or members was not in itself sufficient to make a member personally liable for company acts, nor did the absence of fraud relieve a member from personal liability for company acts. Kaycee Land & Livestock v. Flahive, 46 P.3d 323 (Wyo. 2002).

STATE TAXATION

AGRICULTURAL USE. The Wisconsin legislature in 1996 enacted a agricultural land valuation law which provided for a phase-in of valuing agricultural land by its use value instead of its fair market value. The phase-in provided for a one year freeze of valuations, a ten-year period where the valuations were a combination of market and use value, and full implementation of the use value system after 2009. The statute provided for full implementation if a farmland advisory council and because the legislature had an authority of the statute, because the rules shortened the phase-in period if recommended by the farmland advisory council and because the legislature had an opportunity to object during the legislative review but did not. Mallo v. Wisconsin. Dept. of Revenue, 645 N.W.2d 853 (Wis. 2002).

ZONING

CONDITIONAL USE PERMIT. A farmer sought a conditional use permit to develop a portion of a farm into five residential parcels. The land in question was rocky with poor soil not suitable for farming. The conditional use permit was granted with some restrictions and requirements, most notably a requirement that notice be given to buyers of the Right-To-Farm Act. The residential parcels were surrounded by other farms, dairies, and livestock confinement operations. The plaintiffs were owners of neighboring land who challenged the granting of the permit on the grounds that the land use board’s decision was not supported by substantial evidence, the permit violated the county regulations, and the plaintiffs were harmed by the granting of the permit. The plaintiffs essentially argued that the five residential lots would change the character of the area and harm the plaintiffs. The court held that the board’s decision was based upon several factors which supported the permit: the unsuitability of the land for farming, the existence of several similar residential properties in the area, the small impact on the county infrastructure and the lessening of pressure to use other good farming land for residences. The plaintiffs argued that they would be harmed because the new residents were likely to complain about the noise, dust and odors from the neighboring farms. The court held that the restrictions in the permit were sufficient to prevent these problems. The court upheld the granting of the conditional use permit. Whitted v. Canyon County Bd. Of Comm’rs, 44 P.3d 1173 (Idaho 2002).

CITATION UPDATES


IN THE NEWS

PARSONAGE EXCLUSION. The Ninth Circuit Court of Appeals has dismissed the appeal of Warren v. Comm’r, 114 T.C. 343 (2000) upon motion of both parties, with the IRS agreeing to allow Warren to deduct the full amount of the cash allowance he had received for the years in question. In May 2002, the Congress passed and the President signed the Clergy Housing Allowance Clarification Act of 2002, Pub. L. No. 107-181, which provides that ministers may deduct the fair market value of their homes from their church income, including costs incurred for furniture and utilities. See McEowen, “The Parsonage Exclusion – First Amendment Concerns?,” 13 Agric. L. Dig. 75 (2002).
AGRICULTURAL TAX AND LAW SEMINARS
by Neil E. Harl and Roger A. McEowen

September 24-27, 2002  Interstate Holiday Inn, Grand Island, NE

Come join us for expert and practical seminars on the essential aspects of agricultural tax and law. Gain insight and understanding from two of the nation’s top agricultural tax and law instructors.

The seminar are held on Tuesday, Wednesday, Thursday, and Friday. Registrants may attend one, two, three or all four days, with separate pricing for each combination. On Tuesday, Dr. Harl will speak about farm and ranch income tax. On Wednesday, Dr. Harl will cover farm and ranch estate planning. On Thursday, Roger McEowen will cover farm and ranch business planning. NEW THIS YEAR: On Friday, Roger McEowen will cover agricultural contracts. Your registration fee includes comprehensive annotated seminar materials for the days attended which will be updated just prior to the seminar. The seminar materials will also be available on CD-ROM for a small additional charge.

The seminar registration fees for current subscribers to the Agricultural Law Digest, the Agricultural Law Manual, or Principles of Agricultural Law (and for multiple registrations from one firm) are $185 (one day), $360 (two days), $525 (three days), and $670 (four days). The registration fees for nonsubscribers are $200, $390, $570 and $720, respectively.

There is still plenty of room, but we request registrants to call first after September 13, 2002. Registrations may also be faxed (with checks to follow in the mail) to 541-302-1958.

For more information, call Robert Achenbach at 1-541-302-1958, or e-mail to robert@agrilawpress.com

October 17-18, 2002  Spa Resort, Palm Springs, CA

“Farm & Ranch Income Tax” and “Farm & Ranch Estate and Business Planning.”

The seminars are held on Thursday, and Friday. Registrants may attend one or both days, with separate pricing for each combination. On Thursday, Dr. Harl will speak about farm and ranch income tax. On Friday, Roger McEowen will cover farm and ranch estate and business planning. The registration fee includes comprehensive annotated seminar materials for the days attended which will be updated just prior to the seminar.

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Registration brochures were mailed in August. Complete information and a registration form are also available now on our web site at http://www.agrilawpress.com. For more information, call Robert Achenbach at 1-541-302-1958, or e-mail to robert@agrilawpress.com

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SUBSCRIPTION RATE INCREASE

The recent increase in postage rates and increased printing costs over the years have finally forced us to increase the annual subscription rate for the print version of the Agricultural Law Digest to $110 per year. This is the first price increase for the Digest since it began in 1989. The new rates will take effect with the next billing date after July 1, 2002 for each subscriber. Each billing offers subscribers the option to subscribe to our e-mail version of the Digest which remains at $90 per year and which is e-mailed on the Monday before the print version is published. You can beat the rush and change your subscription now to the e-mail version and we will credit your account with an additional issue for each three print issues remaining on your subscription. Send an e-mail to robert@agrilawpress.com for a free sample or to order the change in subscription.
WHEN A CONTRACT OBLIGOR BECOMES AN OWNER OF THE CONTRACT
— by Neil E. Harl

A contract for deed or installment contract for the sale of real estate (or other assets) between parent and child is not unusual; a frequent outcome of such transactions is that the obligor under the contract becomes the owner or a co-owner of the contract after death of the contract seller which results in often unanticipated income tax consequences.

Effect of death of contract seller

For installment obligations held until death, the fair market value of the obligation is included in the decedent’s gross estate for federal estate tax purposes. The value of the installment obligation may not be reduced by the estimated amount of income tax payable on installments remaining to be paid although courts have permitted a discount in valuing corporate stock for potential income tax liability on liquidation even though liquidation is not contemplated. A deduction is permitted to each recipient of income in respect of decedent equal to the federal estate tax attributable to the obligation.

For a beneficiary who is not the obligor, the decedent’s estate is not charged with inclusion of the potential income from an installment sale obligation as a result of distribution of the obligation which was entered into before the death of the decedent as seller. The income tax basis of the obligation in the hands of the beneficiary is the decedent’s basis, adjusted for installments received by the estate (and the decedent) before distribution to the beneficiary. The beneficiary continues to report payments in the same manner as the decedent would have done had the decedent survived.

Disposition of contract to obligor

For deaths before October 20, 1980, different theories had been utilized to determine the income tax treatment of installment obligations passing to the obligor at the death of the contract seller. However, Congress in the Installment Sales Act of 1980 addressed the issue and provided that disposition of an installment obligation to the obligor after October 19, 1980, results in recognition of any unreported gain to the deceased seller’s estate. The same treatment applies to installment obligations cancelled at death. In a 1990 private letter ruling, an installment note (the gain from which the decedent had been reporting in installments) from an heir to the decedent was cancelled; IRS ruled that the remainder of the gain on the installment sale was included in income to the decedent’s estate. That is the outcome whether

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
the disposition of the installment obligation is by bequest, devise or inheritance by the obligor or by cancellation by the estate representative. Unless there is some act of cancellation of the obligation, the disposition is considered to have occurred no later than the conclusion of administration of the estate. For obligations held by a person other than the decedent, such as a trust, the cancellation is treated as a transfer immediately after the decedent’s death by that person.

Presumably, disposition of an installment obligation to two or more persons, one of whom is the obligor, results in a taxable disposition to the extent of the obligor’s interest acquired in the installment obligation. To avoid that result, the decedent could dispose of the installment obligation to the other heirs (who are not obligors under the installment obligation) with other property passing to the obligor.

**Installment sale by the estate**

For installment sale obligations entered into by the administrator or executor on behalf of the estate, distribution of the installment sale obligation from the estate constitutes a taxable disposition by the estate. A statutory provision shields from recognition of gain amounts with respect to property under special use valuation and then only to the extent the fair market value at death or the alternate valuation date exceeds the special use value and then only if the transfer is to a qualified heir. The exception in I.R.C. § 453B(c), for “transmission of installment obligations at death,” does not apply to installment obligations entered into by the estate inasmuch as the distribution of installment obligations entered into by an estate would not involve “the transmission of installment obligations at death.”

**FOOTNOTES**

2. See I.R.C. § 691(a).
3. I.R.C. § 2031(a).
8. See 6 Harl, *supra* note 1, § 48.03[8][h][i].
10. See Jack Ammann Photogrammetric Engineers, Inc. v. Comm’r, 341 F.2d 466 (5th Cir. 1965) (no income tax obligation on merger of obligor and obligee of installment obligation); Wilkinson v. Comm’r, 49 T.C. 4 (1967) (merger of obligor and obligee under installment sale obligation was taxable disposition to taxpayers).
15. *Id.*
17. *Id.* at 23.
22. See I.R.C. § 2032A(e)(1).

**CASES, REGULATIONS AND STATUTES**

by Robert P. Achenbach, Jr.

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**BANKRUPTCY**

**FEDERAL TAX-ALM § 13.03[7].**

**AUTOMATIC STAY.** The debtor was a partnership and the partners had filed a Tax Court case seeking readjustment of a final partnership administrative adjustment. The partners sought a stay of the Tax Court proceedings, based on the automatic stay in bankruptcy. The court held that the debtor was not involved in the Tax Court proceeding because the debtor was not a taxed entity and had no assets subject to the partners’ claims in bankruptcy. The court held that the partners’ Tax Court case was not stayed by the partnership’s bankruptcy case. *In re Madison Recycling Assoc., 2002-2 U.S. Tax Cas.*

FARM LOANS. The FSA has adopted as final regulations amending its agricultural loan mediation regulations to implement the requirements of the Federal Crop Insurance Reform and Department of Agriculture Reorganization Act of 1994 and the United States Grain Standards Act of 2000. The regulations establish and modify requirements and procedures for certification and funding of state mediation programs. This regulations also move the mediation provisions from Part 1446 of title 7 of the Code of Federal Regulations to Part 785. 67 Fed. Reg. 57309 (Sept. 10, 2002).

SEEDS. The AMS has issued a policy statement which makes clear that the AMS has a comprehensive compliance program in place that monitors and tests seed shipped in interstate commerce for truthful varietal labeling. The AMS stated that recently, numerous interested parties, including officials of the National Cattlemen's Beef Association and Mississippi State University, have expressed concern that with the expiration of the Plant Variety Protection Certificate issued under the Plant Variety Protection Act for the Marshall variety of annual ryegrass, inferior seed of other varieties may be marketed as Marshall annual ryegrass. The policy statement describes the procedures and enforcement actions which are used to monitor compliance with the labeling provisions of the Federal Seed Act. 67 Fed. Reg. 59769 (Sept. 24, 2002).

FEDERAL ESTATE AND GIFT TAX

ALTERNATE VALUATION DATE. The decedent’s estate filed a timely Form 706. Although the estate hired an estate tax attorney and an accountant, no alternate valuation date determination and no election were made. After the Form 706 filing, the executors learned about the availability of the alternate valuation election and filed for an extension of time to make the election. The IRS granted the extension. Ltr. Rul. 200236041, June 11, 2002.

CHARITABLE DEDUCTION. The decedent made bequests through a will and an inter vivos trust. The will provided for payment of claims and taxes from the residuary estate but provided for payment of any deficiency from the trust. The trust had charitable and noncharitable beneficiaries but did not allocate the tax burden between the beneficiaries. The court held that the charitable deduction was reduced by the charitable bequest’s liability for claims and taxes. Estate of Bradford v. Comm’r, T.C. Memo. 2002-238.

CLAIMS. 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

FEDERAL AGRICULTURAL PROGRAMS

APPLES. The CCC has adopted as final regulations which establish the Apple Market Loss Assistance Payment Program II which provides direct payments to apple producers to establish the Apple Market Loss Assistance Payment Program. In re Pilva, 2002-2 U.S. Tax Cas. (CCH) ¶ 50,635 (Bankr. S.D. Ohio 2002).

POST-PETITION INTEREST. The taxpayer filed for Chapter 11 and the IRS filed claims for pre-petition priority tax deficiencies. The Chapter 11 plan was confirmed and provided for full payment of the tax claims but did not provide for payment of interest which accrued post-petition and pre-confirmation. The court held that, under Bruming v. United States, 376 U.S. 358 (1964), the interest on nondischargeable tax claim was also nondischargeable and survived the bankruptcy case, whether filed as a claim or not, as a personal obligation of the debtor. In re Tuttle, 291 F.3d 1238 (10th Cir. 2002), aff’g, 2001 Bankr. LEXIS 293 (Bankr. 10th Cir. 2001).


DISCHARGE. The debtors had filed a consent which extended the time the IRS had for making assessments. The debtors timely filed their returns for 1995 and 1996 but the IRS, within the extension consented to, made additional assessments. The debtors filed appeals in the Tax Court of the additional assessments and the Tax Court case was still pending when the debtors filed for bankruptcy. The court held that the assessments were stayed by the Tax Court case and remained enforceable until the Tax Court case was resolved. Because the Tax Court case was pending on the bankruptcy petition date, the additional taxes were not dischargeable under Section 523(a)(1)(A)(iii). In re Pilva, 2002-2 U.S. Tax Cas. (CCH) ¶ 50,635 (Bankr. S.D. Ohio 2002).

NET OPERATING LOSSES. The debtor was a closely-held S corporation. The debtor had net operating losses in one pre-petition year and the shareholders did not make the election to carry the NOLs to later tax years and the NOLs were carried back to previous years, resulting in refunds to the shareholders. The Chapter 7 trustee sought to recover those refunds by characterizing the failure to make the carryforward election as a pre-petition preferential transfer. The court held that the refunds were not recoverable because (1) the NOLs were not corporation property but belonged to the shareholders as a passthrough item and (2) there was no transfer of the debtor’s property. In re Forman Enterprises, Inc., 2002-2 U.S. Tax Cas. (CCH) ¶ 50,655 (Bankr. W.D. Penn. 2002).

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FEDERAL INCOME TAXATION

CAPITAL EXPENSES. The taxpayers leased a store in a shopping mall. The taxpayers had to make substantial improvements in order to use the space for a bakery, including ceilings, walls and floors; ventilation systems, utility systems, safety and handicapped facilities; and general remodeling of the space. The improvements, except bakery equipment were to become the property of the landlord upon installation. The lease abated the rent for the first six months. The taxpayers claimed that the cost of the improvements was offset as rent payments. However, the six months of rent totaled only $18,000 and the remodeling expenses exceeded $127,000. The court held that the remodeling expenses were capital expenses except to the extent of the value of the six months of free rent. The taxpayers were not allowed an expense method depreciation deduction because no election was made on the original returns. McGrath v. Comm’r, T.C. Memo. 2002-231.

DEPENDENTS. The taxpayer was awarded custody of the taxpayer’s children under a divorce decree. The taxpayer provided more than one-half of the support for the children until the taxpayer became unemployed. The taxpayer’s former spouse requested the taxpayer to sign a waiver of the taxpayer right to claim a dependency deduction for the children so the spouse could claim the deduction. The taxpayer signed Form 8332 which provided for a waiver through 2013. The taxpayer became employed again and claimed the dependency deduction for 1998, although no written disclaimer of Form 8332 was filed. The court held that, because the validity of the Form 8332 was not successfully challenged, the waiver remained in effect for 1998 and the taxpayer could not claim the dependency deduction or the child tax credit for the children in 1998. Bramante v. Comm’r, T.C. Memo. 2002-228.

The taxpayer claimed a dependent deduction for a child who the taxpayer initially thought was the taxpayer’s child but who was determined by blood test to not be the taxpayer’s biological child. The child lived with the biological parent who was not married to the taxpayer. The child visited the taxpayer on weekends and the taxpayer provided some support for the child. The taxpayer also claimed head of household filing status and earned income credit based on the child as the taxpayer’s dependent. The court held that the child was not a dependent of the taxpayer and denied use of the head of household status, the

DISASTER PAYMENTS. On September 10, 2002, the President determined that certain areas in North Dakota 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 beginning on June 8, 2002. FEMA-1431-DR. On September 10, 2002, the president determined that certain areas in Wisconsin were eligible for assistance under the Act as a result of severe storms, flooding and tornadoes on September 2, 2002. FEMA-1432-DR. Accordingly, a taxpayer who sustained a loss attributable to these disasters may deduct the loss on his or her 2001 federal income tax return.

DIVIDENDS. The IRS has announced an increase, from $400 to $1500, of the threshold for filing a separate schedule for interest or dividend income for most taxpayers for 2002. IR-2002-102.

EMPLOYEE BENEFITS. A taxpayer established a self-insured medical expense reimbursement plan on December 1 of a tax year. The plan provided that it was effective as of January 1 of that year. Under the plan, a participating employee was eligible for reimbursement of medical expenses incurred by the employee, the employee’s spouse, and dependents (as defined in I.R.C. § 152) during the plan year (January 1 through December 31). An employee became a participant in the plan upon its establishment on December 1. Prior to the establishment of the plan, the employee had incurred medical expenses that qualified for reimbursement under the plan and submitted those claims for reimbursement to the employer in December. The taxpayer reimbursed the employee for the medical expenses incurred prior to the establishment of the plan in accordance with the terms of the plan. The IRS has issued a revenue ruling which rules that reimbursement payments received by the employee for the medical expenses incurred by the employee before December 1 were not excluded from income. See also Wollenberg v. U.S., 75 F. Supp. 2d 1032 (D. Neb. 1999). Rev. Rul. 2002-58, I.R.B. 2002-38.

The taxpayer was employed for 17 days when the taxpayer was injured in an automobile accident. The taxpayer received disability insurance payments from a policy carried by the employer. The taxpayer testified that the taxpayer paid $3.00 per day for this policy but did not prove that this was the sole payment of the policy premiums or that any amount paid by the employer was included in the taxpayer’s income. The court held that the disability insurance payments were included in the taxpayer’s income because at least part of the policy premium was paid by the employer which did not include the payments in the taxpayer’s income. Miley v. Comm’r, T.C. Memo. 2002-236.

GAMBLING LOSSES. The taxpayer engaged in an effort to make money from gambling, primarily on slot machines. The taxpayer used credit card advances to fund the gambling but stopped after incurring debt. The taxpayer did receive two payoffs from casinos that required Forms W2-G which reported winnings of $4,500. The taxpayer claimed the standard deduction but did not report the winnings in income. The taxpayer did not keep full and accurate records of the gambling wins and losses and did not operate the activity as a business. The court held that the gambling losses, which it assumed were greater than the winnings, were not deductible as business expenses but were only deductible as itemized expenses. The court also held that, because the taxpayer claimed the standard deduction, no additional deductions for gambling losses were allowed and the winnings were included in income. Neymeyer v. Comm’r, T.C. Summary Op. 2002-120.

IRA. The taxpayer had a self-directed IRA through an investment brokerage. The taxpayer wanted the IRA to purchase stock in a corporation but the brokerage refused because the stock was not publicly traded. The taxpayer directed the brokerage to issue a check from the IRA funds in the name of the corporation. The check was forwarded to the taxpayer who sent the check on to the corporation. The corporation sent the stock certificates to the taxpayer who forwarded them to the brokerage to be held in the IRA. The court held that the issuance of the check from the IRA funds was not a taxable distribution because the taxpayer served only as a conduit for the brokerage in its purchase of the stock. Ancira v. Comm’r, 119 T.C. No. 6 (2002).

MARKET SEGMENT SPECIALIZATION PROGRAM. The IRS has released a Market Segment Specialization Program (MSSP) Audit Technique Guide for examiners regarding the swine industry, IRPO ¶ 216,215, and the poultry industry, IRPO ¶ 216,215.

MILEAGE DEDUCTION. The IRS has issued a revenue procedure which provides that the standard mileage rate for 2003 is 36 cents per mile for business use, 14 cents per mile for charitable use and 12 cents per mile for medical and moving expense purposes. The revenue procedure also provides rules under which the amount of ordinary and necessary expenses of local travel or transportation away from home that are paid or incurred by an employee will be deemed substantiated under Treas. Reg. § 1.274-5 when a payor (the employer, its agent, or a third party) provides a mileage allowance under a reimbursement or other expense allowance arrangement to pay for such expenses. Use of a method of substantiation 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. Rev. Proc. 2002-61, I.R.B. 2002-39.

PARTNERSHIPS-ALM § 7.03.*

CLOSING AGREEMENTS. The taxpayers were partners in cattle-breeding tax shelter partnerships which were involved in Tax Court proceedings. An associate chief of appeals signed Form 906 closing agreements with the taxpayers which resolved disputes over tax treatment of partnership items. The taxpayers later filed for bankruptcy and challenged the validity of the closing agreements under Delegation Order 97 which prevented closing agreements involving issues pending in litigation. The court held that Delegation Order 209 permitted the closing agreement as to partners even though the partnership was involved in a tax case. In re Crowell, 2002-2 U.S. Tax Cas. (CCH) ¶ 50,659 (6th Cir. 2002), aff’d, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,303 (D. Tenn. 2001).
PASSIVE ACTIVITY LOSSES. The taxpayers, husband and wife, owned several rental properties, including a farm. The taxpayers incurred net losses from the activities and sought to have the losses considered as nonpassive activity losses based on the taxpayers’ status as real estate professionals because they spent more than 750 hours a year on the activities. The taxpayers used an activity calendar to estimate the number of hours spent on the rental activities. The court held that the use of the calendar was insufficient to prove the 750 hours of activity since the calendar was not adjusted to reflect the actual amount of time and the specific activity involved. Because the taxpayers were not real estate professionals, the rental activities were passive activities and subject to the passive loss rules. Fowler v. Comm’r, T.C. Memo. 2002-223.

REFUNDS. The IRS levied against the decedent’s real property and sold the property. The proceeds of the sale exceeded the tax due and the IRS notified the decedent of a right to a refund of the excess proceeds. The decedent refused to file a claim because the decedent believed the “proceeds were the work of the devil.” The decedent then tried to file a claim for refund but the IRS determined that the decedent had waited too long. However, the IRS changed its position and determined that the excess proceeds were a deposit and not a tax payment; therefore, repayment was not prohibited by the refund statute of limitations. The IRS failed to locate the decedent until after the decedent died, when the estate filed a claim for the excess proceeds. In a Chief Counsel Advice letter, the IRS ruled that the excess proceeds were a deposit. As a result, the deposit was not subject to the refund statute of limitations and was repayable, without interest, to the decedent’s estate. CCA Ltr. Rul. 200237001, June 6, 2002.

REPAIRS. The taxpayer owned a residential rental property and had the roof repaired after leaks started. The contractors replaced the roofing material covering the entire roof. The court held that the cost of the roof repair was currently deductible and was not a capital cost because the repairs were not made to prolong the life of the property, increase its value, or make it adaptable to another use. Campbell v. Comm’r, T.C. Summary Op. 2002-117.

RETURNS. The IRS has announced the publication of Form 943 (2002), Employer's Annual Tax Return for Agricultural Employees, and instructions; Form 8160-C (2002), Form 1065 Package Information; and Form SS-5 (3-2001), Social Security Administration Application for a Social Security Card. These publications can be obtained by calling 1-800-TAX-FORM (1-800-829-3676); they are also available on the IRS’s web site at www.irs.gov.

S CORPORATIONS-ALM § 7.02[3][c].* EMPLOYEE. The taxpayer was an S corporation wholly owned by one shareholder who also served as president of the taxpayer. The shareholder was an accountant and performed all the accounting services and business management for the taxpayer. The court held that the shareholder/president was an employee of the taxpayer and amounts paid to the shareholder were subject to employment taxes because the shareholder served as an officer of the taxpayer and performed substantial services for the taxpayer. Joseph M. Grey Public Accountant, P.C. v. Comm’r, 119 T.C. No 5 (2002).

STRADDLES. The IRS has announced that it plans to challenge transactions designed to use a straddle, one or more transitory shareholders, and the rules of subchapter S, to allow a shareholder to claim an immediate loss while deferring an offsetting gain in an S corporation investment. First, the IRS may disallow the loss under I.R.C. § 165(c)(2) by asserting that the loss was not incurred in a transaction undertaken for profit. Second, the IRS may disregard the transitory ownership of the shareholders other than the taxpayer and would, thus, allocate all income and losses from the activities of the S corporation to the taxpayer. Third, the IRS may disallow the taxpayer's loss deduction under I.R.C. § 269 by asserting that the taxpayer acquired control of the S corporation with the principal purpose of avoiding or evading federal income tax. In addition, the IRS may challenge the allowance of the loss deduction based on other statutory provisions, including I.R.C. § 988, and the step transaction, economic substance, business purpose, and substance over form doctrines. Transactions that use a partnership instead of an S corporation also will be challenged under the partnership anti-abuse rule of Treas. Reg. § 1.701-2. Persons who are required to satisfy the registration requirement of I.R.C. § 6111 with respect to the transaction and who fail to do so may be subject to the penalty under I.R.C. § 6707(a). Persons who are required to satisfy the list-keeping requirement of I.R.C. § 6112 with respect to the transaction and who fail to do so may be subject to the penalty under I.R.C. § 6708(a). Moreover, participants in or promoters and reporters of the transaction or substantially similar transactions may be liable for accuracy-related, return preparer, promoter, and the aiding and abetting penalties. Notice 2002-65, I.R.B. 2002-4.

SAFE HARBOR INTEREST RATES

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SALE OF RESIDENCE. The taxpayers sold a residence and reported the gain but included on Form 2119 their intent to repurchase a new residence within the replacement period. The taxpayers later filed an amended Form 2119 which identified the new residence and its purchase price. The amended form claimed a one-time exclusion of gain under I.R.C. § 121 and deferment of the rest of the gain under I.R.C. § 1034. The IRS disallowed the exclusion and deferment, ruling that the initial residence was not the taxpayers’ principal residence. The IRS ruling was within three years after the amended Form 2119 but more than three years after the initial Form 2119. The taxpayers argued that the ruling as to the principal residence ruling was

*Agricultural Law Manual (ALM).
barred by the three year statute of limitations. The court held that the taxpayers’ claim of the exclusion and deferment of gain triggered the limitations period under I.R.C. § 1034 and that the determination as to the nature of the initial residence was part of the IRS determination and was governed by the later period of limitations. Because the IRS determination was made within three years of the amended Form 2119, the determination was timely. Pilaria v. Comm’r, T.C. Memo. 2002-230.

TRAVEL EXPENSES. The IRS has released 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 July 1, 2002, through December 31, 2002. The terminal charge is $38.02, and the SIFL mileage rates are: up to 500 miles, $0.2080 per mile; 501-1,500 miles, $0.1586 per mile; and over 1,500 miles, $0.1524 per mile. Rev. Rul. 2002-56, I.R.B. 2002-37, 526.

PRODUCTS LIABILITY

SEED. The plaintiffs were farmers whose corn was allegedly contaminated with Starlink genetically-modified corn. The Starlink corn seed was approved by the EPA only for nonhuman consumption and was commingled with corn for human consumption because shippers and producers were not aware that the Starlink corn was planted nearby or was included in shipments. The plaintiffs alleged that the defendant Starlink seed producer failed to properly inform producers about the use restriction and failed to notify subsequent purchasers and users of the EPA-imposed use restrictions. The plaintiffs brought actions under theories of conversion, negligence, public and private nuisance, and violation of the Tennessee Consumer Protection Act and North Carolina Unfair Trade Practices Act. The court held that, to the extent the actions involved the warning content of the labels, the actions were preempted. However, the court otherwise allowed the claims for conversion, negligence, public and private nuisance, and violation of the Tennessee Consumer Protection Act and North Carolina Unfair Trade Practices Act to the extent that the defendant (1) violated duties imposed by the limited EPA registration; (2) made representations to growers that contradicted the EPA-approved label; and (3) failed to inform parties handling the genetically modified corn after the sale of the corn. In re Starlink Corn Products Liability Litigation, 2002 U.S. Dist. LEXIS 12791 (N.D. Ill. 2002).

TRESPASS

TIMBER. The defendant was hired by a third party to remove timber from that party’s land which was adjacent to the plaintiff’s land. The defendant removed trees from four acres of land belonging to the plaintiff and the plaintiff brought actions for trespass, nuisance and negligence. The plaintiff sought triple damages under Wis. Stat. § 26.09 which was recently amended to provide for higher damages than the previous statute. The court held that the amended statute did not apply retroactively because it made substantive changes in the damages and standards of liability and did not specifically provide for retroactive application. The trial court had awarded damages based only on the stumpage value of the trees cut as provided by the statute. The plaintiff argued that it was also entitled to restoration damages. The court held that the statute did not provide for the exclusive measure of damages and that the plaintiff could recover restoration or other damages if the other common law actions were successfully proved. Bill’s Distributing, Ltd. v. Cormican, 647 N.W.2d 908 (Wis. Ct. App. 2002).

WORKERS’ COMPENSATION

AGRICULTURAL LABORER. The plaintiff was employed as a roper with the defendant. The defendant corporation operated a farm and a cattle feedlot. The feedlot fed livestock owned by the defendant and owned by third parties under feeding contracts. The farm provided grain and other feed for the feedlot and the manure from the feedlot was spread on the farmland. The plaintiff was one of three employees and was injured while roping calves for the feedlot operation. The plaintiff filed a workers’ compensation claim and the defendant argued that the plaintiff was a ranch laborer and was excluded from coverage under Neb. Rev. Stat. § 48-106(2). The court acknowledged that the workers’ compensation statutes in many states have been interpreted so as to focus on the nature of the employee’s work in determining whether the employer was subject to the statute. However, the court held that in Nebraska the focus is on the nature of the employer’s business and an employer could have more than one type of business for workers’ compensation purposes. In this case, the court held that the defendant’s feedlot operation was a separate operation and was not a farm or ranch because the defendant offered feeding services to customers. Because the plaintiff was injured while performing duties for the commercial feedlot, the plaintiff was not a ranch laborer and was covered by workers’ compensation. Larsen v. DB Feedyards, Inc., 648 N.W.2d 306 (Neb. 2002).

CITATION UPDATES

Kerr v. Comm’r, 292 F.3d 490 (5th Cir. 2002), aff’g, 113 T.C. 450 (1999) (valuation) see p. 116 supra.

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by Neil E. Harl and Roger A. McEowen

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The recent increase in postage rates and increased printing costs over the years have finally forced us to increase the annual subscription rate for the print version of the Agricultural Law Digest to $110 per year. This is the first price increase for the Digest since it began in 1989. The new rates will take effect with the next billing date after July 1, 2002 for each subscriber. Each billing offers subscribers the option to subscribe to our e-mail version of the Digest which remains at $90 per year and which is e-mailed on the Monday before the print version is published. You can beat the rush and change your subscription now to the e-mail version and we will credit your account with an additional issue for each three print issues remaining on your subscription. Send an e-mail to robert@agrilawpress.com for a free sample or to order the change in subscription.