To Repeal Or Not Repeal the Rule Against Perpetuities
— by Neil E. Harl*

The new century is rapidly coming to be dominated by two developments—terrorism and the realization that the universal dismantling of important institutional structures can have devastating long-term consequences. The latter point has been dramatically made by the Enron debacle, the Andersen accounting fiasco, the Global Crossing bankruptcy, the Tyco problems and the general distrust at all levels of aggressive business strategies and tax shelter schemes. The message in all of this is critical: we should be very, very careful in dismantling important institutional constructs in the euphoria of the moment.

That is what makes the argument that states should repeal the Rule Against Perpetuities appear out of touch with reality. Those urging repeal have dusted off the thread-bare and largely discredited arguments that the venerable Rule Against Perpetuities is no longer needed and should be jettisoned.

What the argument's all about

The basic issue is how long property can be tied up in trust. The Rule has come to stand for the proposition that interests in trust must vest, if at all, not later than 21 years after the last to die of a class of lives in being at the creation of the interest in trust.

As a practical matter, that has tended to impose a maximum term of 100 to 125 years for property to be held in trust.

Complete repeal of the Rule removes the limits on how long property can be held in trust.

With repeal, assets could be tied up 500 years, 1,000 years, indeed forever. Professor Lewis Simes, a well-known legal scholar of his era articulated two reasons for the Rule in contemporary society—

“First, the Rule Against Perpetuities strikes a fair balance between the desires of members of the present generation, and similar desires of succeeding generations, to do what they wish with the property which they enjoy”. In a sense this is a policy of alienability, but it is not alienability for productivity. It is alienability to enable people to do what they please at death with the property which they enjoy in life. As Kohler says in his treatise on the Philosophy of Law—

“The far-reaching hand of a testator who would force his will in distant future generations destroys the liberty of other individuals, and presumes to make rules for distant times.”

“But in my opinion, a second and even more important reason for the Rule is this. It is socially desirable that the wealth of the world be controlled by its living members and not by the dead. I know of no better statement of that doctrine than the language of Thomas Jefferson, contained in a letter to James Madison, when he said: ‘The earth belongs always to the living generation. They may manage it then, and what proceeds from it, as they please during their usufruct.’”

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To the above two reasons, a third can be added. It is an article of faith that economic growth is maximized if resources are subject to the forces and pressures of the market. Prices emanating from free, open and competitive markets are the best way to allocate resources and to distribute income if economic growth is to be maximized. Without question, repeal of the Rule would tend to insulate assets from the market. Over time, this could be a highly significant factor and would almost certainly slow economic growth. With the trust assets shielded from market forces, widespread ownership of assets in such dynasty trusts would almost certainly reduce the rate of economic growth. That could easily amount to 0.2 to 0.3 percent per year—with the damping effect possibly increasing over time.

For example, assume a couple with two children place $1,000,000 of property in trust in 2003. Further, assume the state in question is one of the dozen or so states that have repealed the Rule.\(^6\) What could be the consequences of setting up the trust to last forever?

- Fast forwarding to 2503, 500 years from now, our two beneficiaries would have increased to 3.4 million (based on projections by the Joint Editorial Board for the Uniform Probate Code) assuming current fertility levels.

As the Joint Editorial Board for the Uniform Probate Code has stated—

“Over time, the administration of such trusts is likely to become unwieldy and very costly.

“Government statistics indicate that the average married couple has 2.1 children. Under this assumption, the average settlor will have more than 100 descendants (who are beneficiaries of the trust) 150 years after the trust is created, around 2500 beneficiaries 250 years after the trust is created and 45,000 beneficiaries 350 years after the trust is created. Five hundred years after the trust is created, the number of living beneficiaries could rise to an astounding 3.4 million.”

And that’s only 500 years. In 1,000 years, it would clearly be unmanageable.

As the period of trust life lengthens, with millions of trust beneficiaries, a situation would be created where trust-owned property would be perceived in a manner similar to government-owned property. It would resemble the way beneficiaries view the social security trust fund, for example.

- The trust, perhaps in 2003, would be administered in some place like Sioux Falls, South Dakota. But with the dramatic consolidation in banking and among trust companies, the trust might eventually be managed in Beijing or Jakarta or Hong Kong. Not everyone is comfortable with that.

- As the centuries pass, it would lead to enormous economic power in the hands of banks and trust companies. That is obvious, with beneficiaries limited in terms of their right to participate in management decisions. Remember, trusts are not like corporations with perpetual life where shareholders have and can (and do) exercise their rights.

Some argue that much of the family wealth is in 401(k) plans and IRAs and those are already managed by financial institutions. That is correct—but all qualified plans require a minimum distribution beginning after a beneficiary attains age 70 1/2.\(^7\)

Therefore, pension and profit sharing accounts \textit{cannot} be held in economic hostage forever.

This country was not based on dynasties. Indeed, this country was founded, in part, on the notion of open access to assets, not on the idea that property owners could tie up property forever.

Part of the drive to repeal the Rule was based on the belief that the generation-skipping transfer tax is less advantageous when the Rule limits the period in which property can be placed in trust to lives in being plus 21 years.\(^8\) Congress in 2001 repealed that tax, effective for deaths after 2009.\(^9\) The combination of repeal of the generation-skipping transfer tax, repeal of the federal estate tax and repeal of the Rule Against Perpetuities would lead not only to dynasty trusts; it would lead to a separation of the legal ownership from equitable ownership of property to a degree we’ve never seen in this country.

\textbf{In conclusion}

The Rule Against Perpetuities was developed for good reason; those underpinnings to the Rule haven’t changed in the centuries since the Rule was first articulated.

Many opponents of repeal are supportive of efforts to permit the reasonable accomplishment of educational and other objectives of property owners. Indeed, many are willing to lend support to proposals that would assure a trust duration of 150 years.\(^10\) That should be long enough to permit rational planning even with regular increases in life expectancy for at least the next few years.

\textbf{FOOTNOTES}

\(^1\) Duke of Norfolk’s Case, 3 Ch. Cas. 1, 22 Eng. Rep. 931 (1682).
\(^2\) See e.g., Iowa Code § 558.68(1) (2003).
\(^4\) 12 Modern Philosophy 205 (1914).
\(^8\) See Bloom, “The GST Tax Tail is Killing the Rule Against Perpetuities.” 87 Tax Notes 569 (2000).
\(^9\) EGTRRA of 2001, Sec. 501(a), (b), repealing I.R.C. §§ 2210, 2664. The provisions of EGTRRA of 2001 are subject to a “sunset” provision for decedents dying, gifts made and generation skipping transfers after December 31, 2010. EGTRRA of 2001, Sec. 901.
The debtor participated in a partnership which operated a hog raising operation. Some of the partners sold grain to the partnership but were not paid. The partnership lost its lease and was terminated. The hogs became infected with Porcine Reproductive and Respiratory Syndrome and all eventually died. The debtor had moved the hogs to other property after the partnership terminated. The creditor/partners sought to have the debt from the unpaid grain declared nondischargeable under Section 523(1) for fraud or defalcation while acting in a fiduciary capacity; (2) for willful and malicious injury by the debtor to the creditors’ property. The creditors alleged that the debtor sold partnership property without paying the partnership but the evidence demonstrated that the proceeds were paid for partnership expenses. The creditors also alleged that the debtor failed to keep records of the hogs sold but the debtor produced evidence of the ear notches and the sales records. The creditor/partners also alleged that the debtor’s poor management of the hog operation caused the losses. The court noted that the creditor/partners failed to take any actions during the existence of the partnership to oversee the operation and held that they failed to prove any fraud or defalcation by the debtor. The court also noted that the losses resulted primarily from the infection disease and not by operation of the debtor. The court held that the partners’ claims were dischargeable. *In re DeOrnellas*, 293 B.R. 450 (Bankr. C.D. Ill. 2003).

**EXEMPTIONS.**

HOMESTEAD. The debtor claimed a homestead exemption for four contiguous lots under Mass. Gen. Laws ch. 188, § 1. Most of the property, except immediately around the residence was wooded and wetland. One parcel contained the residence, one parcel contained the out buildings, the driveway crossed the third parcel and the fourth was all wooded. None of the property was used for agriculture or any business. The trustee objected to including the wooded parcel in the homestead exemption and the Bankruptcy Court disallowed the exemption as to the wooded parcel. The appellate court reversed, holding that the issue was whether the four parcels were used and occupied as part of the principal residence. The case was remanded for findings by the Bankruptcy Court as to whether the wooded parcel was used as part of the residence. *In re Fify*, 293 B.R. 550 (Bankr. 1st Cir. 2003).

**CHAPTER 12.**

LEGISLATION. On August 15, 2003, the President signed into law an extension of Chapter 12 from July 1, 2003 to December 31, 2003.

**FEDERAL TAX.**

DISCHARGE. The debtors, husband and wife, invested in a horse racing and breeding venture and were assessed taxes resulting from disallowance of deductions based on the horse venture investment. The debtors challenged the assessment in Tax Court but the Tax Court held that the venture was an economic
and the FTC ruling was improper for failing to provide reasoning to support its ruling. The court also held that even if the Act did apply to attorneys, the FTC ruling was arbitrary and capricious for failing to consider an exemption for attorneys. New York State Bar Ass’n v. Federal Trade Commission, 2003 U.S. Dist. LEXIS 13939 (D. D.C. 2003).

**FEDERAL AGRICULTURAL PROGRAMS**

**EXOTIC NEWCASTLE DISEASE.** The APHIS has issued interim regulations amending the Exotic Newcastle disease regulations by removing portions of Arizona, California, Nevada, and Texas from the list of quarantined areas prohibiting or restricting the movement of birds, poultry, products, and materials that could spread Exotic Newcastle disease from the quarantined area. With this action, there are no longer any areas in Arizona, Nevada, and Texas that are quarantined because of exotic Newcastle disease. 68 Fed. Reg. 45741 (Aug. 4, 2003).

**LIVESTOCK REPORTING.** The GIPSA has issued final regulations establishing a swine contract library as required by the Swine Packer Marketing Contracts subtitle of the Livestock Mandatory Reporting Act of 1999. The regulations establish a library or catalog of contract types that packers use to purchase swine for slaughter and make information about the contract terms available to the public. The regulations also provide for monthly reports on the estimated number of swine committed for delivery to packers under existing contracts. 68 Fed. Reg. 47801 (Aug. 11, 2003).

**PERISHABLE AGRICULTURAL COMMODITIES ACT.** The plaintiff and defendants were agricultural produce sellers who sold produce to a PACA produce handler who did not pay for the produce. The defendants had previously filed suit against the produce handler for repayment from the PACA trust when the defendants knew the produce handler was insolvent. The plaintiff argued that under general trust principles, a co-beneficiary of the PACA trust has a fiduciary duty to the other beneficiaries not to deplete the trust principal to the detriment of the other beneficiaries. The court agreed and held that, once a PACA trust beneficiary learns the produce handler was insolvent, the PACA trust funds are to be escrowed for pro rata distribution among all PACA trust beneficiaries. Thus, the defendants were required to return all PACA trust funds received after their learning about the produce handler’s insolvency. The plaintiff sought an amendment to the original judgment to provide for prejudgment interest on the amount required to be returned. The court granted the amendment and awarded interest from the date the defendant received the payments up to the date of the judgment ordering disgorgement, to be paid at the statutory rate. Fresh Kist Produce, LLC v. Choi Corp., Inc., 251 F. Supp.2d 138 (D. D.C. 2003), amending, 223 F. Supp.2d 1 (D. D.C. 2002).
TREE ASSISTANCE PROGRAM. The FSA has issued proposed regulations implementing, subject to the availability of funds, the Tree Assistance Program (TAP) authorized by the Farm Security and Rural Investment Act of 2002. The TAP program provides assistance to tree, bush and vine owners who have trees, bushes or vines lost by a natural disaster. No funds have been appropriated for the program at this time. 68 Fed. Reg. 47499 (Aug. 11, 2003).

FEDERAL INCOME TAXATION

BUSINESS EXPENSES. 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 appellate court affirmed in a decision designated as not for publication. Wilson v. Comm’r, 2003-2 U.S. Tax Cas. (CCH) ¶ 50,614 (9th Cir. 2003), aff’g, T.C. Memo. 2002-61.

C CORPORATION

EMPLOYEE. The taxpayer and spouse were the sole shareholders and officers of a corporation which provided an office supply business with sales primarily to governmental agencies. The taxpayer provided all of the labor for the taking, billing and shipping of orders. The taxpayer entered into an employment agreement with the corporation which provided for payment for rent and royalties instead of wages. The appellate court affirmed in a decision designated as not for publication. Wilson v. Comm’r, 2003-2 U.S. Tax Cas. (CCH) ¶ 50,614 (9th Cir. 2003), aff’g, T.C. Memo. 2002-61.

COOPERATIVES. The taxpayer was a farmers’ marketing cooperative which initially used current market values to determine the patronage payments for delivery of produce from member growers. The cooperative members agreed to institute a “committee method” of valuing a crop year’s produce by using a committee to propose a current valuation which was accepted by a vote of the members or by arbitration. The IRS ruled that this approach was acceptable under I.R.C. § 521(b)(1) for operating on a cooperative basis. Ltr. Rul. 200332001, May 2, 2003.

COURT AWARDS AND SETTLEMENTS. The taxpayer filed a malicious prosecution lawsuit against a former business associate and received a money judgment, including prejudgment interest, which was paid by the defendant. The taxpayer received half of this money after payment of legal expenses and attorney’s fees. Although the actions giving rise to the malicious prosecution lawsuit arose prior to amendment of I.R.C. § 104 by the Small Business Job Protection Act of 1996, the judgment was paid after the amendment was enacted. The taxpayer argued that application of the amended Section 104 was an unconstitutional retroactive application. The court held alternatively that (1) the amendment applied because the judgment was received after the amendment was enacted and (2) because the amendment only increased a tax, the retroactive application was constitutional. Because the judgment was not received as compensation for physical injuries to the taxpayer, the portion received by the taxpayer was included in taxable income. Venable v. Comm’r, T.C. Memo. 2003-240.

The taxpayer was employed as an accountant/bookkeeper with a construction company. The taxpayer’s employment was terminated after a dispute over profit-sharing and the parties reached a settlement for a lump-sum payment. At no time did the taxpayer allege any physical injuries, but the taxpayer excluded the settlement from taxable income. The taxpayer argued that the amendment of I.R.C. § 104 by the Small Business Job Protection Act of 1996 to exclude from taxable income only money received for physical injuries was unconstitutional. The court held that the distinction between money received for physical and nonphysical injuries had a rational basis and was constitutional; therefore, the taxpayer’s employment termination settlement was taxable income. Lockmiller v. Comm’r, T.C. Summary Op. 2003-108.

DISASTER LOSSES. On July 17, 2003, the President determined that certain areas in Texas were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of Hurricane Claudette that began on
EARNED INCOME CREDIT. The IRS has announced that it will launch the Earned Income Tax Credit (EITC) Certification Pilot Program in early 2004. The EITC program is aimed at rewarding work and helping families out of poverty. The pilot program will use an integrated approach addressing potential erroneous claims by identifying cases that have the highest likelihood of error before they are accepted for processing and before any EITC benefits are paid. IR-2003-97.

HOBBY LOSSES. The taxpayer was employed full-time as a business manager. The taxpayer also bred, trained, sold, and showed “reining” horses. The horse activity was operated under an assumed business name but did not obtain a business license. The taxpayer had signed a declaration with the Reining Association stating that he had not trained or assisted in training for remuneration for the prior five years. Most of the records produced to support the validity of the activity were produced from computer files in preparation for the case and were dismissed by the court as unreliable. The court held that the activity was not engaged in for profit because (1) the taxpayer did not maintain complete and accurate records sufficient to support the deductions claimed or to provide sufficient information to determine the future profitability of the activity; (2) the activity had substantial and continual losses and the taxpayer provided no plan that would make the activity profitable; and (3) all of the horses were used by the taxpayer and family for recreation. Bunney v. Comm’r, T.C. Memo. 2003-233.

MORTGAGE INTEREST. The taxpayer borrowed money using a mortgage loan on the taxpayer’s parent’s house. The loan was made in the parent’s name, although the taxpayer made all the loan payments. The money was used in the taxpayer’s business and the taxpayer and parent had agreed that, if any of the loan was unpaid at the parent’s death, the remainder would be excluded from the taxpayer’s share of the parent’s estate. The taxpayer did not live in the house. The court held that the taxpayer was not eligible to deduct the interest expense of the loan because the taxpayer was not directly liable for the loan. Montoya v. Comm’r, T.C. Summary Op. 2003-109.

NET OPERATING LOSSES. The taxpayers claimed a net operating loss for 1981 and 1982 resulting from a failed retail store operated as an S corporation. However, the taxpayers did not provide any evidence to support their income tax basis in the corporation nor their income during 1983 through 1988. The taxpayers claimed carryover losses in the following years, including 1998 and 1999, although the taxpayers did not provide any substantiation of the nature and source of the net operating losses. The IRS denied the NOL carryover deductions for 1998 and 1999 as occurring more than 15 years after the initial net operating loss. The court held that, because the taxpayers provided no substantiation of the NOLs carried over after 1981 and 1982, the NOLs were considered as occurring in 1981 and 1982 and the time for allowing further carryover had expired by 1998 and 1999 and the NOLs could not be deducted in those years. Green v. Comm’r, T.C. Memo. 2003-244.

OFFERS IN COMPROMISE. The IRS has adopted as final regulations providing for a $150 user fee for processing certain offers in compromise. The user fee will not apply to offers based solely on doubt as to liability and offers made by low income taxpayers whose incomes are at or below the poverty guidelines set by the Department of Health and Human Services. While the fee will not be refunded if an offer is withdrawn, rejected, or returned as nonprocessable after acceptance for processing, no additional fee will be charged if a taxpayer resubmits an offer the IRS determines to have been rejected or returned in error. 68 Fed. Reg. 48785 (Aug. 15, 2003).

PARTNERSHIPS

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. 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, 2003 U.S. App. LEXIS 16138 (8th Cir. 2003), aff’g, T.C. Memo. 2002-160.

PENSION PLANS. For plans beginning in August 2003, the weighted average is 5.31 percent with the permissible range of 4.78 to 5.85 percent (90 to 120 percent permissible range) and 4.78 to 6.38 percent (90 to 110 percent permissible range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). Notice 2003-58, I.R.B. 2003-35.

TAX RETURN EXPENSES. The taxpayer claimed a miscellaneous itemized deduction at the standard mileage rate for mile driven for (1) copying and filing of personal federal and state income tax returns, (2) for meetings with IRS personnel related to the examination of personal income tax returns, (3) for
a trip to a law library, and (4) for copying of a document entitled “Response to AG of IRS Investigation.” The court held that, under Treas. Reg. § 1.212-1(1), the mileage costs were deductible as an ordinary and necessary expense in connection with a determination of federal and state income taxes. Stussy v. Comm’n, T.C. Memo. 2003-232.

TRUSTS. The IRS has issued annotated sample declarations of trust and alternate provisions that meet the charitable remainder annuity trust (CRAT) requirements under I.R.C. § 664(d)(1) and Treas. Reg. § 1.664-2. The alternate provisions relate to: (1) the statement of the annuity amount as a specific dollar amount; (2) payment of a portion of the annuity amount to an I.R.C. § 170(c) charitable organization; (3) a I.R.C. § 664(f)(3) “qualified contingency”; (4) the last payment of the annuity amount to the recipient; (5) restriction of the charitable remainderman to a “public charity”; (6) the donor’s retained right to substitute for the designated charitable remainderman; (7) a power of appointment to designate the charitable remainderman; (8) the donor’s retained right to revoke the interest of the successor recipient; and (9) discretion of the trustee to apportion the annuity amount among members of a class. The sample declarations of trust include: (1) an inter vivos CRAT for one measuring life, superseding Rev. Proc. 89-21, 1989-1 CB 842; (2) an inter vivos CRAT for a term of years; (3) an inter vivos CRAT for two measuring lives (payable consecutively), superseding section 4 of Rev. Proc. 90-32, 1990-1 CB 546; (4) an inter vivos CRAT for two measuring lives (payable concurrently and consecutively), superseding section 5 of Rev. Proc. 90-32, 1990-1 CB 546; (5) a testamentary CRAT for one measuring life, superseding section 6 of Rev. Proc. 90-32, 1990-1 CB 546; (6) a testamentary CRAT for a term of years; (7) a testamentary CRAT for two measuring lives (payable consecutively), superseding section 7 of Rev. Proc. 90-32, 1990-1 CB 546; and (8) a testamentary CRAT for two measuring lives (payable concurrently and consecutively), superseding section 8 of Rev. Proc. 90-32, 1990-1 CB 546. Rev. Proc. 2003-53 through 2003-60, I.R.B. 2003-31.

AGRICULTURAL USE. The plaintiff purchased 4.9 acres of property which was zoned as suburban agricultural which was defined as a “district to protect and preserve agricultural lands for the performance of limited agricultural functions and to provide a buffer between urban and unlimited agricultural uses, encouraging concentration of such uses in areas where potential friction of uses will be minimized.” The previous owner had used the property as a dairy farm and for the repair of farm machinery owned by others. The plaintiff did not operate a dairy on the property but used the property for the repair, maintenance and storage of heavy equipment, primarily for logging and construction. The plaintiff did not use the property for farming. The evidence showed that the previous owner’s repair business was small and inside the buildings but the plaintiff’s repair business was open and involved large amount of machinery. The county determined that the plaintiff’s use of the property was a nonconforming use. The court upheld the nonconforming use ruling because the plaintiff’s use varied significantly from the previous owner’s use of the property. Russell v. Flathead County, 67 P.3d 182 (Mont. 2003).

BIOSAFETY. The Cartagena Protocol on Biosafety, the first legally binding international agreement governing the movement of living modified organisms (LMOs) across national borders, will take effect on September 11, 2003. This was made possible after the Republic of Palau became the 50th country to ratify it in June 2003. The Protocol, adopted on January 11, 2000 after more than five years of negotiation under the Convention on Biological Diversity, seeks to provide an adequate level of safety for the safe transfer, handling and use of LMOs resulting from modern biotechnology that may have adverse effects on the conservation and sustainable use of biological diversity. For more information on the protocol requirements, see http://rd.bcentral.com/?ID=1031240&s=48119610.

FARM LABOR. The National Agricultural Statistics Service (NASS) has issued the latest agricultural labor statistics which show the number of hired farm workers up 1 percent and wages up 4 percent from July 2002. All NASS reports are available by subscription free of charge direct to an e-mail address. Starting with the NASS home page at http://www.usda.gov/nass/, click on Publications, then click on the Subscribe by E-mail button which takes you to the page describing e-mail delivery of reports. August 15, 2003, by the National Agricultural Statistics Service, Agricultural Statistics Board, U.S. Department of Agriculture.

WEATHER-RELATED SALES OF LIVESTOCK. The state of Colorado allows a credit against state corporate and personal income tax for taxpayers eligible to defer income for federal income tax purposes under IRC § 451(e), concerning the sale of livestock due to weather-related conditions. Reg. 39-22-128, Colorado Department of Revenue, effective March 2, 2003.
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