DEMOLISHING FARM IMPROVEMENTS

— by Neil E. Harl*

Farm consolidation and shifts in livestock production patterns have generated intense interest in the demolition of buildings on farms and ranches. The income tax treatment of — (1) any remaining basis in the property and (2) the costs of demolition, influence the timing of the decision to demolish and whether unused buildings and other improvements should be left standing.

Demolition before 1984

Prior to enactment of the Deficit Reduction Act of 1984, if a building or other improvement was acquired with an intent to demolish, it was not possible to deduct a depreciation allowance for any income tax basis in the property. If the intent to demolish was formed after acquisition and allocation of a basis amount to assets, a deduction could be claimed for the remaining basis at the time of demolition. The litigated cases tended to focus on when the intent to demolish a structure was formulated.

Demolition after 1983

After December 31, 1983, no deduction has been allowed for losses "on account of" demolition with respect to a structure or for any expenses incurred in the demolition. Those amounts are to be capitalized and added to the income tax basis of the land on which the structure was located.

Repeal of the land clearing expense deduction in 1986 effective at the end of 1985 removed also the possibility of a deduction for removal of trees, stumps and brush and for other expenses associated with the clearing of land to make it suitable for use in farming.

In 1990, IRS pointed out that the 1984 enactment prohibiting a deduction on demolition did not apply to "amounts expended for the demolition of a structure damaged or destroyed by casualty, and to any loss sustained on account of such a demolition." The IRS noted that if a casualty damages or destroys a structure, and the structure is then demolished, the income tax basis of the structure must be reduced by the deductible casualty loss before the "loss sustained on account of" the demolition is determined.

Thus, if a building were to be destroyed by an earthquake, the basis in the building would be deductible as a casualty loss but the cost of cleaning up the rubble would have to be added to the basis of the land.

DeCou v. Commissioner

A 1994 Tax Court case, DeCou v. Commissioner, allowed an "abnormal retirement loss" where a building had suffered a reduction in value before demolition took place. In that case, a government inspector had noted deterioration of the building in question, defects in the floor, water leaks in the roof and shorts in the electrical system. Later, the building was demolished.

The owner of the building claimed the remaining basis in the building ($85,987) as "an ordinary abandonment or retirement loss deduction" but added the cost of demolition ($17,655) to the basis in the land. IRS disagreed, arguing that the taxpayer was not entitled to a loss deduction because it was not the result of a casualty or extraordinary obsolescence. The Service position was that the remaining basis in the building should be considered as a nondeductible cost of demolishing the building.

The Tax Court agreed with the taxpayer and allowed a deduction for an "abnormal retirement loss." The court noted that IRS had implied, in Notice 90-21, that a loss sustained before a building's demolition would not be treated as sustained "on account of" the demolition. Therefore, such losses would not be disallowed by I.R.C. § 280B. As the court explained, "the withdrawal of the...building constituted an abnormal retirement that was caused by the unexpected and extraordinary obsolescence of the building." The court found that the building’s fair market value and salvage value were both zero on the date of demolition; therefore, the entire remaining basis was an allowable deduction.

In conclusion

Although the amounts actually expended for demolition are usually non-deductible and must be added to the basis of the land, two possibilities exist for claiming a partial or total deduction for any remaining basis in the property demolished. First, a casualty loss may be claimable if, in fact, a casualty has damaged or destroyed the property. Second, an abnormal retirement loss deduction may be available if the improvement had suffered a reduction in value prior to the demolition.
FOOTNOTES
1 See generally 4 Harl, Agricultural Law § 29.06 (1995).
3 4 Harl, supra n. 1.
4 Id.
7 I.R.C. § 280B(a).
8 I.R.C. § 280B(a)(2).
10 See 4 Harl, supra n. 1, § 28.04[3].
12 I.R.C. § 165.
14 Id. at 333-334.
15 103 T.C. 80 (1994).
16 Id. at 82.
17 103 T.C. 80, 85.
18 103 T.C. 80, 87.
19 103 T.C. 80, 89.
20 1990-1 C.B. 332.
21 103 T.C. 80, 88.
22 I.R.C. § 165.
23 DeCou v. Comm'r, 103 T.C. 80 (1994).

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

BANKRUPTCY

GENERAL-ALM § 13.03.*

DISCHARGE. The debtor's corporation had purchased real property from the creditor and had given a note personally guaranteed by the debtor for a portion of the purchase price. The note required written consent from the creditor before the property could be sold. The debtor's corporation sold the property to a partnership when the debtor sought modification of the note terms. The creditor argued that, under Section 523(a)(2)(A), instead of reasonable reliance as required by justifiable reliance by the creditor applied to Section 523(a)(2)(A) because the debtor had committed fraud in failing to reveal the conveyance or seek prior consent for the transfer. The court ruled that the standard of justifiable reliance by the creditor applied to Section 523(a)(2)(A), instead of reasonable reliance as required by Section 523(A)(2)(B). Field v. Mans, __ S. Ct. __ (1995), rev'g, 36 F.3d 1089 (1st Cir. 1994).

LIMITED LIABILITY COMPANIES. The debtor was a member of several limited liability companies (LLC), all of which had incorporated the Nebraska limited liability company law into their Articles of Organization such that the bankruptcy of a member dissolved the company unless two-thirds of the other members vote to continue the LLC. After the debtor's Chapter 11 filing, the members of the LLCs voted to continue the LLCs but without the debtor. The court held that the state law dissolution provision was unenforceable against a member in bankruptcy and that the actions of the other members in continuing to operate the LLCs without the debtor violated the automatic stay. The court held that the LLC Articles of Organization and Operating Agreements were executory contracts which the debtor could assume or reject in bankruptcy. The court also refused to order sanctions for the violations of the automatic stay because the other members were acting in good faith under the state law. Matter of Daughtery Const., Inc., 188 B.R. 607 (Bankr. D. Neb. 1995).

PRIORITY. The debtor was a walnut handler subject to assessments by the California Walnut Commission for promotional and marketing programs. The Commission filed a claim for unpaid assessments and sought priority status for the claim as a tax claim. The assessments were used to promote and advertise the sale of walnuts, to conduct marketing research and to publish information for walnut producers and handlers. The court held that the claim was not entitled to priority status as a tax because the assessments primarily benefited private walnut producers and not the general public. In re S.N.A. Nut Co., 188 B.R. 392 (Bankr. N.D. Ill. 1995).

CHAPTER 13-ALM § 13.03.*

PLAN. Prior to filing for bankruptcy, the debtors had granted to a creditor a security interest in the debtors' rural residence and farm equipment. The security interests were subordinated by agreement of the creditor to a security interest held by another creditor. On the petition date, the value of the farm equipment was less than the secured claim of the first security interest holder and the value of the real property was insufficient to fully secure the claim of the creditor with the second security interest. That creditor argued that, under Section 1322(b)(2), its secured claim could not be modified by the plan because it was secured only by the debtors' residence at the time of the petition. The court held that, in determining whether Section 1322(b)(2) applied, the rights of the creditor under state law determined whether the creditor's claim was secured solely by the debtors' residence. The court held that, because the security interest covered the residence and farm equipment, the creditor's claim was not secured solely by the residence and could be modified by the Chapter 13 plan. In re Barrett, 188 B.R. 285 (Bankr. D. Or. 1995).

TRUSTEE'S FEES. The debtors were farmers with nonfarm income. The debtors' Chapter 13 plan provided for direct payments to the IRS and payment of all unaired claims. The plan also provided payment on an impaired claim filed by the FmHA. The debtors' plan projected income of $34,854 and annual expenses of $16,613.67. The direct payments left only $569.00 for payments to unsecured creditors and trustee's fees. Therefore, if the trustee's fee had to be paid on any of the direct payments, the plan could not be confirmed because there was insufficient income. The court held that, as in Chapter 12...
cases, payment could be made directly to creditors with unimpaired claims and to sophisticated creditors with impaired claims. The court held that the debtor's plan was confirmable because the FmHA was a sophisticated lender which had the ability to foreclose on its claim if the debtors defaulted on their plan payments. In re Slaughter, 188 B.R. 29 (Bankr. D. N.D. 1995).

**FEDERAL TAXATION-ALM § 13.03[7].**

**ABANDONMENT.** On the date of the petition, the debtor owned interests in a partnership which owned two pieces of real estate. The Chapter 7 trustee sold the two properties and received the proceeds of the sales, totaling over $47,000. However, after the sales were complete, the debtor's records for the two previous tax years were cleared up and the trustee discovered that the sales of the two properties would result in recognition of over $600,000 in taxable gain to the bankruptcy estate. The trustee sought permission to retroactively abandon the debtor's interests in the sold properties but the court held that no provision existed for retroactive abandonment and that the equitable powers of the court, under Section 105, could not be used just to protect the unsecured creditors who would suffer from the tax liability of the estate. In re Perlman, 188 B.R. 704 (Bankr. S.D. Fla. 1995).

**AVOIDABLE LIENS.** The debtor filed for Chapter 7 bankruptcy and received a discharge. The IRS had filed tax liens against the debtor's property, including property claimed by the debtor as exempt in the bankruptcy case. After the discharge, the IRS began collection efforts on the liens and the debtor sought a ruling allowing the avoidance of the liens to the extent the liens secured tax penalties. The court held that the tax liens survived the bankruptcy case, including liens that secured tax penalties. In re DeMarsh, 188 B.R. 426 (E.D. Cal. 1993), rev'd, 62 F.3d 1248 (9th Cir. 1995).

The IRS had perfected a tax lien against the debtor's personal property, which included a promissory note owned by the debtor. The Chapter 7 trustee sought to avoid the tax lien under Section 545(2) as a bona fide purchaser of the note and under I.R.C. § 6323(b) which excepted bona fide purchasers from the tax lien. The court held that the bankruptcy provision was not applicable to the I.R.C. provision and the trustee could not avoid the tax lien. In re Berg, 188 B.R. 615 (Bankr. 9th Cir. 1995).

**CLAIMS.** The debtor's estate included a residence which was subject to priority liens ahead of an IRS tax lien. The debtors' plan provided for payment of all secured claims and the debtors' retention of the residence. The issue in the case was the value of the residence for purposes of determining the secured portion of the IRS lien where the debtors retained possession of the residence. Although the court acknowledged its own precedent that the value could be determined by the amount a creditor would receive from a sale of the collateral, the court deferred to precedent from other circuits to hold that the fair market value of the residence without reductions for the costs of a hypothetical sale was the value to be used for determining the secured portion of the IRS lien where the debtors retained possession of the residence. In re Taffi, 68 F.3d 306 (9th Cir. 1995), rev'g unrep. D. Ct. dec. aff'd, 144 B.R. 105 (Bankr. C.D. Cal. 1992).

The IRS had filed a timely claim for 1989 taxes owed by the debtor. The IRS had also initiated an audit of the debtor's 1991 taxes but failed to file a claim for those taxes until after the claims bar date and six months after confirmation of the debtor's Chapter 13 plan. The 1991 tax claim was seven times the amount of the 1989 tax claim. The Bankruptcy Court held that the untimely claim was not allowed because it was for a different tax year and was a multiple of the original claim. The District Court held that the Bankruptcy Court did not abuse its discretion in denying the claim in that the court relied on case precedent in the district. United States v. Robinson, 188 B.R. 364 (D. Md. 1995).

The debtors filed for Chapter 13 in October 1990 and did not list any claim by the IRS for taxes. The IRS claimed not to have received any notice of the claims bar date or the plan confirmation hearing. In September 1992, the debtors sought a modification of the plan to include tax claims, including an IRS claim for 1989 taxes, and the IRS filed a claim for the taxes. The court held that the IRS's untimely filed claim was not allowed in the case but the claim was not discharged in the case and remained viable after the plan was completed in April 1996, because the IRS did not receive timely notice of the case. Thus, the IRS's only penalty for the untimely filing was a delay in the collection of the claim for the remaining eight months of the plan. In re Herndon, 188 B.R. 562 (Bankr. E.D. Ky. 1995).

**DISCHARGE.** In 1985 and 1986, the debtor filed erroneous W-4 forms with the debtor's employer. The forms claimed a highly exaggerated number of allowances such that the amount of withheld taxes was zero. The debtor also failed to file income tax returns or pay taxes on the debtor's wages. The IRS sought to have the taxes for those years ruled nondischargeable under Section 523(a)(1)(C) for willful evasion of taxes. The debtor claimed that the debtor had an honest belief that no taxes were due or that returns needed to be filed after the debtor attended several tax protestor seminars. However, the court noted that the debtor had filed returns and paid taxes for 18 years prior to the years involved and in 1987 and thereafter, also filed returns and paid taxes when due. Therefore, the court held that the taxes were nondischargeable for willful attempt to evade the payment of the taxes. In re Semo, 188 B.R. 359 (Bankr. W.D. Pa. 1995).

**SETOFF.** The debtors filed for bankruptcy in February 1995 and the IRS filed a secured claim for 1990 taxes. The debtors' Chapter 13 plan provided for full payment of the tax claim. The IRS filed for relief from the automatic stay and for setoff of the debtors' 1994 refund against the claim for the 1990 taxes. The debtors argued that setoff was not permitted after a plan was submitted which provided for full payment of the claim. The court held that the setoff was not prohibited by the plan provision and that the setoff was allowed because all requirements under Section 553 were met and the debtors and secured and unsecured creditors could benefit from the setoff. In re Womack, 188 B.R. 259 (Bankr. E.D. Ark. 1995).
FEDERAL AGRICULTURAL PROGRAMS

ADMINISTRATION. The Consolidated Farm Service Agency (CSFA) has been renamed the Farm Service Agency (FSA). 60 Fed. Reg. 64297 (Dec. 15, 1995).

GRAIN INSPECTION. The Grain Inspection, Packers and Stockyards Administration (GIPSA) has issued proposed regulations amending the standards for corn to report test weight to the nearest tenth of a pound, eliminate the count limit on stones, and reduce the sample grade aggregate weight tolerance to more than 0.1 percent. 60 Fed. Reg. 61100 (Nov. 28, 1995).

NATIONAL FORESTS. The defendant rented horses to individuals who traveled on the horses on national forest land. The defendant did not have a permit to perform any services in the forest. The defendant transported the horses to camp sites on national forest land and was cited with violation of 36 C.F.R. § 261.10(c) which prohibited any "work activity or service" in national forest land without a permit. The defendant argued that because the defendant did not charge for the transportation of the horses and the horses were rented at a location off national forest land, the regulation did not apply. The court held that the regulation language was broad enough to cover any work or activity, not just work or activity for a fee. United States v. Peterson, 897 F. Supp. 499 (D. Colo. 1995).

PEANUTS. The CCC has adopted as final regulations to add the requirement that peanut producers comply with the crop insurance regulations of 7 C.F.R. Part 400 in order to qualify for the price support program. 60 Fed. Reg. 61198 (Nov. 29, 1995).

TUBERCULOSIS. The APHIS has issued interim regulations changing Wisconsin from an accredited-free state to an accredited-free (suspended) state. 60 Fed. Reg. 62988 (Dec. 8, 1995).

WETLANDS. The Natural Resources Conservation Service and other agencies have issued final policy guidance concerning the establishment, use and operation of mitigation banks for compensating for adverse impacts to wetlands under Section 404 of the Clean Water Act and the "swampbuster" provisions of the Food Security Act of 1990. 60 Fed. Reg. 58605 (Nov. 28, 1995).

FEDERAL ESTATE AND GIFT TAX

ANNUITIES-ALM § 6.04. Under Treas. Reg. §§ 1.7520-3(b)(3), 20.7520-3(b)(3), 25.7520-3(b)(3), interests in annuities, term of years interests, and remainder interests are not to be valued using the valuation tables if the individual who is the measuring life is terminally ill at the time of the creation of the interests. The IRS has announced that Revenue Rulings 80-80 and 66-307 have been obsoleted by the regulations. Rev. Rul. 96-3, I.R.B. 1996-1.

DEDUCTIONS-ALM § 5.04. The trustees of a trust claimed a deduction for the full cost of investment advice, arguing that the investment advice was required in order for the trustees to fulfill their fiduciary duty to make prudent investments of trust property. The Tax Court, however, held that I.R.C. § 67 allowed a full deduction (i.e. not limited to the excess of 2 percent of AGI) only for expenses unique to trust administration. Because the investment advice was normal for any investment, the advice was not unique to trusts and was subject to the 2 percent limitation. The Tax Court also held that the trustees failed to prove that the investment advice was required by state law. The appellate court reversed, holding that the trustees' lack of investment experience made the investment advice necessary. O'Neill v. Comm'r, 93-1 U.S. Tax Cas. (CCH) ¶ 50,332 (6th Cir. 1993), rev'g. 98 T.C. 227 (1992). The Chief Counsel of the IRS has recommended that the IRS nonacquiesce on this case. CC-1994-06, IRPO ¶ 51,006.

GENERATION SKIPPING TRANSFERS-ALM § 5.04[6].* The IRS has announced that it will not issue advance rulings as to whether a pre-September 25, 1995 irrevocable trust will lose its GSTT exempt status from a change of situs of the trust to outside the United States. Rev. Proc. 95-50, I.R.B. 1995-50.

The IRS has adopted as final regulations implementing several aspects of GSTT. The regulations provide that no automatic allocation of the $1 million GSTT exemption will be made to trusts which will have a new transferor before any GST will occur, e.g. a reverse QTIP election. Allocation of the exemption, either by the executor or automatically, to a trust must be made to the entire trust principal and not to any specific trust asset. Treas. Reg. § 26.2632-1.

The regulations provide that when a GSTT exemption is allocated to a lifetime transfer on a late filed Form 709, the transferor may elect to value the property at the fair market value as of the first day of the month of the late allocation. However, the date of death value must be used if the transfer occurs within 15 months of the decedent's death or the fiduciary is required to fund the payment with property fairly representative of the net appreciation or depreciation occurring between the date of death and the payment date. Special use valuation must be used for property for which the special use valuation election was made. Treas. Reg. § 26.2642-2.

The regulations provide the method for recomputing the inclusion ratio for a trust for which an additional transfer is made, for trusts consolidated with other trusts, and for charitable lead annuity trusts. Treas. Reg. § 26.2642-1.

Under the rules, a pecuniary amount payable from a trust which is included in the transferor's gross estate may be treated as a separate trust if the pecuniary amount is promptly funded. The regulations also allow division of a trust into separate trusts if the separation occurs prior to the filing of the estate tax return and the division is allowed under the governing instrument or local law. Treas. Reg. § 26.2654-1.

For reverse QTIP elections made for a trust prior to December 24, 1992, the executor may elect to treat the trust as two trusts, one with a zero inclusion ratio. Treas. Reg. § 26.2652-1.

A beneficiary of a trust which allows the beneficiary a right of withdrawal is treated as the transferor of the trust property when the right of withdrawal expires, to the extent the beneficiary is treated as making a transfer subject to gift tax. Treas. Reg. § 26.2652-1.

If a member of an intervening generation dies within 90 days after a transfer to that person, the deceased person is treated as having predeceased the transferor, if provided by

* Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.
the governing instrument or state law. Treas. Reg. § 26.2612-1(a)(2).


INCOME IN RESPECT OF DECEDENT. The decedent had entered into a number of agreements with third parties to publish works by the decedent for the term of the copyright for each work. The IRS ruled that the agreements were licenses to exploit the copyrights and that the income from the agreements accrued and received after the death of the decedent was not income in respect of decedent. Ltr. Rul. 9549023, Sept. 8, 1995.

MARITAL DEDUCTION-ALM § 5.04[3]. The estate obtained an extension to file the federal estate tax return. The estate timely filed a Form 706 but failed to make a complete reverse QTIP election on Schedule R. The estate filed a second return before the extended filing date with a properly filed reverse QTIP election on Schedule R. The IRS ruled that the reverse QTIP election on the second return was timely filed. Ltr. Rul. 9552005, Sept. 21, 1995.

VALUATION. The taxpayer established irrevocable annuity trusts for the taxpayer's children. The trusts provided for annuities of 13.34 percent of the value of the trusts assets for 11 years. If the taxpayer died before the trusts terminated, the trusts' assets passed to the taxpayer's estate. The trusts provided for payment of the annuities from trust income and then from trust principal with any excess income to be added to principal. The taxpayer had the power to exchange other property for trust property. The IRS ruled that the taxpayer was to be treated as the owner of the trusts because the annuity interest exceeded 5 percent of the value of the trusts' assets. The IRS also ruled that no gain or loss was recognized from the transfer of assets to the trusts or from any exchange of assets. The IRS also ruled that the value of the gifts to the remainder holders was the fair market value of the trusts' assets transferred less the value of the taxpayer's retained interests in the trusts. Ltr. Rul. 9551018, Sept. 21, 1995.

FEDERAL INCOME TAXATION

BAD DEBTS-ALM § 4.03[7]. The taxpayers had loaned money to their solely-owned corporation which attempted to develop a metal plating process for the U.S. Army under a government contract. The contract was terminated by the government and the corporation was dissolved. The taxpayers pursued a breach of contract action against the government but claimed a business bad debt deduction in the tax year of the dissolution of the corporation. The taxpayers argued that, after the dissolution, the corporation had no assets to repay the loan. The court held that the taxpayers' vigorous pursuit of the breach of contract action and subsequent appeals indicated that the taxpayer believed that the action had worth; therefore, the loan was not totally worthless in the year of the dissolution and could not be claimed as a bad debt deduction. Couch v. Comm'r, T.C. Memo. 1995-583.

CONSTRUCTIVE INCOME. A corporation purchased homes from relocating employees based on a market analysis of the fair market value of the homes. Because the sale to the corporation was direct, no broker's commission was incurred or paid by either party. The IRS ruled that the employees did not receive constructive income from the nonpayment of a real estate broker's commission. Ltr. Rul. 9552040, Sept. 29, 1995.

COURT AWARDS AND SETTLEMENTS-ALM § 4.02[12]. The taxpayer received a jury award of punitive damages in an action for tortious interference with future employment. The taxpayer also reached a settlement which included additional damages and interest on the judgment. The court held that the punitive damages and the interest on the judgment were not excludable from income. Bagley v. Comm'r, 105 T.C. No. 27 (1995).

The taxpayers sued a creditor for failure to release a lien and won a jury verdict for lost profits, actual damages, attorney's fees and punitive damages. However, the taxpayers negotiated with the lender and in exchange for the lender's waiver of an appeal, the taxpayers settled for a reduced amount. The taxpayers requested that the settlement allocate the amount 95 percent to mental anguish and 5 percent for lost profits. The lender testified that it had no interest in the allocation and went along with the taxpayers' request. The Tax Court held that the allocation of the agreement would not be followed because it was made only to minimize the taxpayers' tax liability. The Tax Court used the original jury verdict allocations to reallocate the settlement amount and allowed the exclusion of the punitive damages because the punitive damages were part of the compensation for personal injuries. The appellate court reversed on the punitive damage issue, holding that punitive damages are included in income because punitive damages are not compensatory. Robinson v. Comm'r, 70 F.3d 34 (5th Cir. 1995), rev'g in part, 102 T.C. 116 (1994).

DEPRECIATION-ALM § 4.03[4]. During a tax year in which the taxpayer started a real estate sales business, the taxpayer purchased a computer and software for use in the business and paid rent for office space and services from another real estate company. The taxpayer claimed a depreciation deduction for the computer and rental expense for the office services. The court denied the deductions because the taxpayer failed to provide any written records to support the expenses. Munshi v. Comm'r, T.C. Memo. 1995-578.

A taxpayer was not allowed depreciation deductions in excess of the cash paid for a horse because the taxpayer failed to substantiate that the promissory notes also given for the purchase of the horse were bona fide debt. The case is designated as not for publication. Mulderig v. Comm'r, 95-2 U.S. Tax Cas. (CCH) ¶ 50,638 (2d Cir. 1995).

EMPLOYEE EXPENSES. The IRS has announced that there is a delay in the annual publication of revised procedures for deemed substantiation of employee expenses for lodging, meals and other traveling expenses where the employer provides a per diem allowance for expenses. The revised procedures also provide an optional method for employers and self-employed individuals to compute the deductible costs of business meals and other travel expenses. The IRS stated that until the revised revenue procedure is published, taxpayers may rely on Rev. Proc. 94-77, 1994-2 C.B. 825. Notice 95-67, I.R.B. 1995—.

EXEMPT ORGANIZATIONS. The IRS has issued proposed regulations which deny tax-exempt status, under
I.R.C. § 501(c)(5), to labor, agricultural or horticultural organizations whose principal activity is the management of or retirement plans for workers. 60 Fed. Reg. 66228 (Dec. 21, 1995).

INVESTMENT INCOME. In 1992 and 1993, the taxpayers had long-term capital gains from the sale of stock. In 1992, the capital gains were offset by long-term capital losses carried over from previous tax years. In 1993, the capital gains were partially setoff by the carried over losses. The IRS ruled that the capital gains in 1992 and 1993 which were not taxable because of the offsets were not included in investment income for purposes of the I.R.C. 163(d)(1) limitation on investment interest deduction. Ltr. Rul. 9549002, Aug. 25, 1995.

JOINT TENANCY. The taxpayer purchased a residence as joint tenants when they were married. Under a divorce decree, the spouse was entitled to possession of the residence until she either remarried or moved out. Upon the sale of the residence, the spouse was entitled to 50 percent of the proceeds. The court held that the divorce decree severed the joint tenancy, creating a life estate in the residing spouse and a 50 percent remainder interest. Gibbons v. United States, 96-1 U.S. Tax. Cas. (CCH) ¶ 50,008 (10th Cir. 1995).

LIKE-KIND EXCHANGES. The taxpayers were the heirs of a decedent's estate who challenged the decedent's testamentary capacity and the validity of the decedent's exercise of a power of appointment. The taxpayers reached a settlement agreement with the estate to exchange interests in real property held for investment such that the taxpayers would own complete interests in various pieces of real estate. The interests exchanged were equal in value. The IRS ruled that the exchanges were eligible for like-kind exchange nonrecognition of gain treatment. Ltr. Rul. 9550020, Sept. 15, 1995; Ltr. Rul. 9550021, Sept. 15, 1995; Ltr. Rul. 9550022, Sept. 15, 1995.

MILEAGE DEDUCTION. The standard mileage rate for 1996 is 31 cents per mile for business use, 12 cents per mile for charitable use and 10 cents per mile for medical and moving expense purposes. Rev. Proc. 95-54, I.R.B. 1995-__.

PARTNERSHIPS-ALM § 7.03.

CONTRIBUTED PROPERTY. Under I.R.C. § 704(c)(1), (2), a partner who contributes appreciated property to a partnership recognizes gain if the property is distributed to another partner within five years after the property is contributed to the partnership. Under I.R.C. § 737, a partner who contributed appreciated property to a partnership recognizes gain upon the distribution to that partner of partnership property, other than money, to the extent of the lesser of (1) the net precontribution gain on the property contributed to the partnership by the partner or (2) the excess of the value of the distributed property over the adjusted basis of the partner’s interest in the partnership. The IRS has adopted as final regulations implementing these rules. 60 Fed. Reg. 66727 (Dec. 27, 1995).

LIMITED LIABILITY COMPANIES. The taxpayers formed a limited liability company under a limited liability act which provided that an LLC is dissolved upon the death, expulsion, withdrawal, bankruptcy or dissolution of a member or other terminating event, unless there is at least one remaining member and a number of the remaining members, as established by the LLC agreement, vote to continue the LLC. The Act also prohibited the assignment or transfer of an LLC interest unless allowed by the LLC agreement. The IRS ruled that the LLC would be a partnership under the I.R.C. Ltr. Rul. 9552015, Sept. 26, 1995.

PASSIVE ACTIVITY LOSSES-ALM § 4.05[3]. Effective for taxable years beginning after December 31, 1993, rental real estate activities in which the taxpayer materially participates are not subject to limitation under the passive loss rules if the taxpayer meets eligibility requirements relating to real property trades or businesses in which the taxpayer performs services. See I.R.C. § 469(c)(7). An individual meets the requirements if (a) more than one-half of the personal services the taxpayer performs in trades or businesses during the taxable year are performed in real property trades or businesses in which the taxpayer materially participates and (b) the taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates. See I.R.C. § 469(c)(7)(B). A "real property trade or business" includes any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. See I.R.C. § 469(c)(7)(C). The IRS has adopted final regulations implementing these rules. 60 Fed. Reg. 66496, Dec. 22, 1995.

The taxpayer was a corporation involved in the development and management of real estate. The IRS ruled that the taxpayer could treat all of its interests in rental real estate as one activity, for purposes of the passive activity rules, because the corporation had one full time employee involved in the active management of the real estate and deductions in excess of 15 percent of the gross income from the properties. The taxpayer also disposed of just under 50 percent of its rental real estate and the IRS ruled that the taxpayer could treat the disposed of properties as a separate activity. Ltr. Rul. 9551030, Sept. 26, 1995.

PENALTIES. The IRS has issued a revised revenue procedure for identifying circumstances under which the disclosure on a taxpayer’s return of a position on an item is adequate for the purpose of reducing the understatement of income tax penalty of I.R.C. § 6662(d) and for the purpose of avoiding the preparer penalty of I.R.C. § 6694(a). Rev. Proc. 95-55, I.R.B. 1995-__, revising Rev. Proc. 94-74, 1994-2 C.B. 823.

QUALIFIED DEBT INSTRUMENTS. The IRS has announced the 1996 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>1996</td>
<td>$3,622,500</td>
<td>$2,587,500</td>
</tr>
</tbody>
</table>

The $3,622,500 figure is the dividing line for 1995 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 $3,622,500 figure, the imputed rate is 100 percent of the
Agricultural Law Digest

AFR except in cases of sale-leaseback transactions, where the imputed rate is 110 percent of AFR. If the amount of seller financing is $2,587,500 or less (for 1996), both parties may elect to account for the interest under the cash method of accounting. Rev. Rul. 96-4, I.R.B. 1996-.--

RENTAL EXPENSE. The taxpayer purchased rental properties which were used by the taxpayer’s relatives as residences in exchange for management of the properties. The taxpayer and each relative took title to the properties as tenants in common, although the taxpayer paid the entire purchase price and paid all of the expenses for the properties. The taxpayer also received all rental income from the properties. The taxpayer claimed all of the income as taxable and claimed all of the expenses as business deductions. James v. Comm’r, T.C. Memo. 1995-562.

RETURNS. The IRS has indicated a delay in issuing proposed regulations governing the so-called "check-the-box" election of entity status for foreign business entities.

S CORPORATIONS-ALM § 7.02[3][c].

LOSSES. The taxpayer and the taxpayer’s former spouse owned stock in an S corporation. In one tax year, losses attributable to the spouse’s shares were not deductible because the spouse did not have sufficient basis to claim the losses. In a divorce decree, the spouse’s stock was transferred to the taxpayer. Under I.R.C. § 1041, no recognition of gain or loss occurred from that transfer. The IRS ruled that the taxpayer could not claim the disallowed losses from the period when the spouse owned the stock. Ltr. Rul. 9552001, Aug. 31, 1995.

SALE OF ASSETS. The IRS has issued proposed regulations requiring the recognition of ordinary income treatment at the shareholder level for dispositions of I.R.C. § 1254 property by the corporation. The regulations also provide that ordinary income treatment is required for the sale of S corporation stock to the extent of the shareholder’s I.R.C. § 1254 costs attributable to the shares transferred.

SALE OF RESIDENCE. The taxpayers purchased a new residence in July 1989 while still owning another residence. The taxpayers entered into a lease with potential buyers of the old residence and eventually executed an option agreement under which the buyer took possession of the old residence and made the mortgage, tax and insurance payments owed by the taxpayers on the old residence. Title to the old residence was held in escrow until the option was exercised; however, the title did not pass until August 1991, more than two years after the taxpayer purchased the new residence. The court held that the taxpayers were not eligible for nonrecognition of gain from the sale of the old residence because neither the title nor the rights and burdens of ownership passed to the buyers until more than two years after the purchase of the second residence. Ryan v. Comm’r, T.C. Memo. 1995-579.

SELF-EMPLOYMENT. The taxpayer owned farm land which the taxpayer cropshare leased to a partnership composed of the taxpayer and the taxpayer’s two sons. Under the partnership agreement, the taxpayer was required to materially participate in the farm operation of the partnership. The taxpayer argued that because the cropshare lease agreement with the partnership did not require the material participation of the taxpayer, the rental income from the farm land was not self-employment income under I.R.C. § 1402(a)(1). The court looked at the entire arrangement between the parties and included the partnership agreement in the total arrangement of the land rental to the partnership. Because the partnership agreement required the taxpayer’s material participation and the taxpayer actually materially participated in the farm operation, the rental income from the cropshare lease was self-employment income to the taxpayer. Note: this case will be the subject of an article by Neil Harl in a future issue of the Digest. Mizell v. Comm’r, T.C. Memo. 1995-571.

The taxpayer was a publishing company which employed individuals to deliver newspapers published by the taxpayer. The workers provided their own vehicles and were reimbursed for their mileage. The workers delivered to existing subscribers and helped obtain new subscribers. The workers purchased plastic bags and rubber bands from the taxpayer. The workers did not hold themselves out as in the newspaper delivery service nor did they provide delivery services for other persons or entities. The IRS ruled that the workers were employees and not independent contractors. Ltr. Rul. 9549022, Sept. 8, 1995.

TAX RATES. The standard deductions for 1996 are $6,700 for joint filers, $5,900 for heads of households, $4,000 for single filers and $3,350 for married individuals who file separately. The personal exemption is $2,550. IR-95-72.

TRUSTS. The IRS has adopted as final regulations governing the Form 1041 reporting requirements of grantor trusts. If the trust is treated as owned by one grantor or other person, instead of filing a Form 1041, the trustee may choose between two methods of reporting: the trustee must furnish to all payors of income and proceeds either (1) the name and taxpayer identification number (TIN) of the grantor or other person and the address of the trust, or (2) the name, TIN and address of the trust. If the trust is treated as owned by more than one grantor or other person and the trustee furnishes the name, TIN and address of the trust to all payors, the trustee need only file appropriate Forms 1099. Except where the trustee is also the only grantor or other owner, the trustee is required to furnish each grantor or other owner with (1) a statement of all trust income, deductions and credits; (2) information which is necessary for the grantor or other owner to compute their taxable income; and (3) a statement that all items of income or gross proceeds are to be reported by the grantor or other owner. T.D. 8633, 60 Fed. Reg. 66085 (Dec. 21, 1995), amending Treas. Reg. § 1.671-4.

WITHHOLDING. The taxpayer was a corporation which failed to include taxpayer information numbers (TIN) on filed Forms 1099. Although a portion of the backup withholding tax liability was abated, the corporation was liable for interest on the liability because a notice and demand for payment had been issued prior to the corporation’s filing of a supplemental return. Ltr. Rul. 9552003, Sept. 26, 1995.
SECURED TRANSACTIONS

LIVESTOCK LIENS. The Iowa legislature has adopted a new law providing for a statutory lien for a custom cattle feedlot operator on livestock and identifiable cash proceeds of livestock cared for by the operator. The lien is created at the time the cattle arrive at the feedlot and continues for one year after the cattle leave the feedlot. The lien covers the amount of the contract price for the feed and care of the livestock. The feedlot operator is required to file a lien statement with the Secretary of State within 20 days after the cattle arrive in order to preserve the lien. The signed statement is to include an estimate of the amount of feed and care to be provided under the contract, the duration of the care, the names of the parties to the contract, and the description of the location of the feedlot. Iowa Code Ch. 579A.

PRODUCER’S LIEN. The debtor was a cannery which purchased tomatoes from a farmer. One of the officers of the debtor was an acquaintance of the farmer and approached the farmer with the contract to purchase the tomatoes. In the first year, the farmer signed an agreement to subordinate the farmer’s producer lien to the debtor’s secured creditor. That contract was successfully completed by both parties. In the second year, the farmer also signed the subordination agreement but the debtor filed for bankruptcy before the farmer was fully paid and the creditor claimed a priority security interest in the debtor’s remaining assets. The farmer had many years of experience in growing and selling tomatoes but could not read words and relied on others to explain the contents of contracts. Although the farmer understood the nature of the subordination agreement, the farmer relied on the oral statements of the debtor’s officers that the company was in good financial health and that the subordination agreement was needed only to obtain the funds for payment of the tomatoes. The farmer argued that the subordination agreement was not an effective waiver of the producer’s lien because the farmer did not have complete information about the rights which were given up. The court held that the subordination agreement was not effective because of the misrepresentations of the debtor’s officers which either misled the farmer or failed to provide the farmer with sufficient information for a knowledgeable waiver. In re GVF Cannery, Inc., 188 B.R. 651 (Bankr. N.D. Cal. 1995).

CITATION UPDATES

Cox v. Comm’r, 68 F.3d 128 (5th Cir. 1995), aff’g, T.C. Memo. 1994-189 (bad debt deduction) see Vol. 6, p. 189.

Est. of Hoover v. Comm’r, 69 F.3d 1044 (10th Cir. 1995), rev’g, 102 T.C. 777 (1994) (special use valuation) see Vol. 6 p. 189.

Hughes & Luce, L.L.P. v. Comm’r, 70 F.3d 16 (5th Cir. 1995), aff’g, T.C. Memo. 1995-559 (partnership gross income) see Vol. 6 p. 189.


ISSUE INDEX

Bankruptcy
General
Discharge 2
Limited Liabilities Companies 2
Priority 2
Chapter 13
Plan 2
Trustee fee 2
Federal taxation
Abandonment 3
Avoidable liens 3
Claims 3
Discharge 3
Setoff 3
Federal Agricultural Programs
Administration 3
Grain certification 4
National Forests 4
Peanuts 4
Tuberculosis 4
Wetlands 4
Federal Estate and Gift Tax
Annuities 4
Deductions 4
Generation skipping transfers 4
Income in respect of decedent 4
Marital deduction 5
Valuation 5
Federal Income Taxation
Bad debts 5
Constructive income 5
Court awards and settlements 5
Depreciation 5
Exempt organizations 5
Investment income 5
Joint tenancy 6
Like-kind exchanges 6
Mileage deduction 6
Partnerships
Contributed property 6
Limited liability companies 6
Passive activity losses 6
Penalties 6
Qualified debt instruments 6
Rental expense 6
Returns 7
S corporations
Losses 7
Sale of assets 7
Sale of residence 7
Self-employment 7
Tax rates 7
Trusts 7
Withholding 7
Secured Transactions
Livestock lien 8
Producer’s lien 8
Farm and ranch businesses for many years have been eligible for discounts for minority interest and for non-marketability. Since 1976, farmland used in a business has been eligible for special use valuation at death for federal estate tax purposes. The question has been whether the two types of discounts could both be claimed with respect to the same property.

Nature of the discounts

A discount for minority interest and for non-marketability, often between 20 and 30 percent, has been allowed for stock interests in many closely held corporations including farm and ranch corporations. Undivided interests held as community property or in co-ownership such as tenancy in common have also been subject to a substantial discount, often in the range of 15 to 20 percent.

The discount for special use valuation has been limited to a maximum reduction (of the gross estate) of $750,000. The actual reduction in value depends upon the outcome of the cash rent capitalization formula or the five-factor formula for valuation. A 30 to 60 percent discount has been possible in recent years with even greater discounts in the 1970s.

Can both sets of discounts be used?

Until 1989, no formal determination had been made as to whether a discount could be obtained for a minority interest and for non-marketability in addition to the reduction in value based on special use valuation. It had been generally believed that such "stacking" of discounts was not permissible and in that year the Tax Court decided a case confirming that outcome. In that case, Estate of Maddox, the tax court held that for stock valued at a discount by virtue of special use valuation, a minority discount was not also available.

In the 1994 case of Estate of Hoover, the Tax Court again confirmed that position in denying an attempted 30 percent minority discount for a 26 percent interest in a limited partnership engaged in cattle ranching followed by special use valuation of the land. However, that decision has been reversed on appeal with the Tenth Circuit Court of Appeals holding that both sets of discounts may be available if the special use valuation limit of $750,000 has been reached. In Hoover, the estate had first subtracted the $750,000 maximum reduction of gross estate and then applied the minority interest discount.

The court in Hoover noted that the earlier Maddox case had not involved the $750,000 limit on special use valuation. The appellate court distinguished Hoover from Maddox and held that "a proper determination of fair market value necessarily must consider the decedent's minority interest and discount for it." Thus, the discount for minority interest and non-marketability should first be applied to determine fair market value and the special use valuation reduction in gross estate (up to $750,000) could be claimed.

With that reasoning, an estate electing special use valuation could first reduce fair market value by the amount of the discount for minority interest and for non-marketability and then take the lesser of special use value or the value produced by the discount for minority interest and non-marketability. In the event special use value was more than $750,000 below the "fair market value" set by the discount for minority interest and non-marketability, the special use value reduction would be limited to the $750,000 figure. In that situation, the estate would receive the benefit of both discounts. Otherwise, if the $750,000 minimum reduction of the gross estate was not at issue, the estate could claim the lesser of the special use value or the value after claiming the discount for minority interest and non-marketability.

Another factor to consider

In analyzing the availability of the two separate sets of discounts, it is important to note that special use value applies only to land and not to value represented by machinery, equipment or livestock. The discount for minority interest and non-marketability applies to ownership interests regardless of the nature of the underlying property. Therefore, the portion of value attributable to non-real estate should arguably be eligible for a minority interest and non-marketability discount even though the land is valued under special use valuation.

To date, neither IRS nor the courts have recognized that distinction.

---

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
FOOTNOTES
3 See Est. of Ford v. Comm'r, T.C. Memo. 1993-580, aff'd, 53 F.3d 924 (8th Cir. 1995) (20 percent discount for non-marketability; 10 percent discount allowed for different corporations for non-marketability; 20 percent discount allowed for one-third minority interest in one corporation in addition to 15 percent lack of marketability discount); Est. of Frank v. Comm'r, T.C. Memo. 1995-132 (discounts allowed for minority ownership and lack of marketability in closely-held family corporation). See also Est. of Berg v. Comm'r, T.C. Memo. 1991-279, aff'd on these issues, 976 F.2d 1163 (8th Cir. 1992) (estate entitled to 20 percent minority discount and 10 percent for lack of marketability for 26.9 percent interest in closely-held real estate holding company).
4 Propstra v. U.S., 680 F.2d 1248 (9th Cir. 1982).
5 See, e.g., Est. of Youle v. Comm'r, T.C. Memo. 1989-138 (discount of 12-1/2 percent allowed for tenancy in common ownership); Est. of Cervin v. Comm'r, T.C. Memo. 1994-550, appeal docketed, 5th Cir. August 31, 1995 (20 percent discount allowed for 50 percent interest in farm and homestead). But see Ltr. Rul. 9336002, May 28, 1993 (discount should be limited to cost of partitioning property).
6 See, e.g., Est. of Pittsburg v. Comm'r, T.C. Memo. 1992-425 (15 percent discount allowed for undivided 77 percent and 50 percent interests in real estate).
7 I.R.C. § 2032A(a)(2).
8 I.R.C. § 2032A(e)(7). See 5 Harl, supra n. 2, § 43.03[2][b].
9 I.R.C. § 2032A(e)(8). See 5 Harl, supra n. 2, § 43.03[2][c].
11 Est. of Maddox v. Comm'r, 93 T.C. 228 (1989).
12 Id.
14 102 T.C. 777 (1994).
15 Id.
16 Hoover v. Comm'r, 68 F.3d 1044 (10th Cir. 1995).
17 Supra n. 11.
18 Supra n. 16.

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

BANKRUPTCY
GENERAL-ALM § 13.03.*

AUTOMATIC STAY. The debtors farmed land leased from a related person on a 60/40 crop share basis. The land owner had a mortgage against the farm under a note co-signed by the debtors and the debtors had made all the payments on the note. The debtors' Chapter 12 plan provided for payment of the note in full. The lender initiated a foreclosure action against the land owner without first seeking relief from the automatic stay. The court held that, although it would have been prudent for the lender to first seek relief from the automatic stay, the foreclosure suit did not violate the stay because the suit was against a nondebtor seeking relief from the automatic stay. The court held that, Rule 3003 could not be used to allow the late filing, that Rule 3003 could not be used to allow the late filing, and would not affect the debtors' rights under the lease. In re Smith, 189 B.R. 11 (Bankr. C.D. Ill. 1995).

CLAIMS. A secured creditor had obtained a pre-petition judgment of foreclosure against the debtor but the foreclosure sale was stayed by the debtor's bankruptcy petition. The Bankruptcy Court set a bar date for creditors' claims and the order required all disputed claims to be filed by the bar date and made all creditors responsible for verifying the accuracy of claims filed by the debtor. The creditor obtained relief from the automatic stay and proceeded with the foreclosure sale. Once the sale was completed and the deficiency amount determined, the creditor finally filed a claim, more than one month after the claims bar date. The creditor sought approval for the late filing under Bankr. Rules 9006(b)(1) for excusable neglect or 3003(c)(3) for good cause. The Bankruptcy Court held that the late filing was allowed under Rule 3003 because the delay in filing was caused by the creditor's waiting for the foreclosure sale to be completed in order to determine the amount of the claim. The District Court reversed, holding that Rule 3003 could not be used to allow the late filing, under Pioneer Inv. Services v. Brunswick, 507 U.S. 380 (1993). In addition, the District Court held that the creditor did not comply with the Rule 9006 excusable neglect standard because the creditor intentionally delayed the claim filing until after the foreclosure sale. Agribank v. Green, 188 B.R. 982 (C.D. Ill. 1995).

ENVIRONMENTAL CLEANUP COSTS. The debtor had operated a trucking business at a facility leased from a creditor. The lease provided that the debtor was responsible for any costs of cleaning up environmental damage caused by the debtor during the lease. After the debtor filed for bankruptcy, the lease was rejected by the debtor and the landlord had the property inspected for environmental damage. The state (New Jersey) environmental quality agency required a number of cleanup actions and the landlord sought recovery of those costs as administrative expenses. The court held that the cleanup costs were not entitled to administrative priority because the costs were incurred post-petition and the environmental hazards were not an imminent hazard to public health and safety. In re McCrory Corp., 188 B.R. 763 (Bankr. S.D. N.Y. 1995).

EXEMPTIONS
IRA. The debtor claimed a federal exemption for the debtor's interest in an IRA. The trustee objected to the exemption on the basis that the debtor was not entitled to

*Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.
current distributions from the IRA. The court held that a right to current distributions was not a requirement for claiming an exemption for an IRA. In re Marsella, 188 B.R. 731 (Bankr. D. R.I. 1995).

FEDERAL TAXATION-ALM § 13.03[7]." CLAIMS. Although the IRS received notice of the claims bar date of April 1993, the IRS did not file its priority tax claim until October 1994, but still prior to final distribution of the estate property. The Bankruptcy Court allowed the claim but subordinated the claim to the level of a general unsecured claim. The District Court reversed, holding that an untimely priority tax claim was not automatically barred from priority status. However, the court indicated that the Bankruptcy Court would have, on remand, the equitable authority to subordinate the claim based on its tardiness. The court also noted that a 1994 amendment to Section 726(a) provides for allowance of untimely filed priority tax claims if the claim is filed prior to distribution of the estate. Pub. L. 103-394, Sec. 213, 108 Stat. 4126 (1994). In re Lee, Inc., 189 B.R. 1 (D. R.I. 1995).

PRIORITY. The debtors were assessed additional taxes for investment in tax shelters and were assessed interest under I.R.C. § 6621(d) for substantial underpayment of taxes attributable to tax motivated transactions. The IRS included the interest in its priority claim and the debtors objected that the interest assessed was actually a penalty and not entitled to priority status. The court held that the Section 6621 assessment was interest because the purpose of the assessment was to increase taxation of taxpayers who use tax motivated abusive tax shelters. In re Hall, 96-1 U.S. Tax Cas. (CCH) ¶ 50,031 (Bankr. D. Alas. 1995).

CONTRACTS

TERMINATION. The plaintiff operated a farm equipment dealership under a written agreement with the defendant, a manufacturer of the equipment sold by the plaintiff. The plaintiff alleged that the defendant's agent orally promised that the relationship would continue as long as the plaintiff met the sales targets set by the defendant. However, the written agreement between the parties stated that the agreement could be terminated by either party with six months' notice and for any reason. Although the agreement was extended to one at will, the defendant eventually notified the plaintiff that the agreement would be terminated and another dealer in the area would carry the defendant's products. The plaintiff claimed the defendant breached the oral agreement and failed to compensate adequately the plaintiff for expenses incurred in reliance on the expected continuing relationship. The court held that the plaintiff's involvement with the second shipment of cattle involved transporting the buyer, the buyer's broker and a veterinarian to the seller's ranch for an inspection. Some of the cattle in the second load had not been tested for brucellosis within 30 days prior to shipment, in violation of 9 C.F.R. § 78.9(b)(3)(ii). The plaintiff was cited for "moving" cattle interstate in violation of the regulations cited above. Although the Administrative Law Judge (ALJ) dismissed the case against the plaintiff, the Judicial Officer (JO) reversed, holding that the term "moved" included "indirectly aiding, inducing or otherwise causing movement" sufficient to include the plaintiff's actions involving the two shipments. The court reversed, holding that the plaintiff's involvement with the shipments was too attenuated to support liability for the violations. Culbertson v. USDA, 69 F.3d 463 (10th Cir. 1995).

BRUCELLOSIS. The defendant was a corporation which operated a cheese processing and distribution activity. The defendant's facility was inspected by FDA inspectors who found unsanitary conditions resulting from insects, lack of washing facilities, unsanitary employee habits, and numerous unsanitary work procedures. The inspectors found cheese contaminated with Listeria monocytogenes (L. mono.). A return inspection found L. mono. in the insects, on the floors and on equipment in the facility. Although informed about the problem, the defendant failed to take any remedial action and the FDA cited the defendant for violation of 21 U.S.C. § 331 for introduction of adulterated food into interstate commerce. The defendant argued that it did not adulterate the cheese because the L. mono. was not intentionally added and that the cheese curing process was supposed to kill the L. mono. bacteria. The court held that the adulteration for purposes of the statute could occur by the failure to maintain sanitary conditions and that the defendant's failure to apply even minimal remedies to the known unsanitary conditions and procedures causing the contamination was a clear violation of the statute. The case is remarkable for the number and extent of the unsanitary conditions and extent of the contamination. It should not be read after eating cheese. United States v. Union Cheese Co., 902 F. Supp. 778 (N.D. Ohio 1995).
DISASTER ASSISTANCE. The plaintiff operated a fruit farm and suffered loss of apple trees from fire blight in 1991. The plaintiff applied for disaster relief under the Tree Assistance Program, Section 2255 of the FACT Act 1990, Pub. L. No. 101-624, 104 Stat. 3974 (1990). The ASCS (now FSA) denied the application because fire blight was not included in the tree losses covered by the Act. Section 2255 states that reimbursement of the cost of replacing trees is available for trees lost due to "freeze, earthquake, or related condition." The plaintiff argued that the definition of "related condition" found in Section 2251 also applied to Section 2255, because the Section 2251 provision states that it applied to the whole chapter of the Act. Section 2255 is in subchapter B and Section 2251 is in subchapter A, both of which are in Chapter 3 of the Act. The court noted that the references to chapter and subchapter were not consistent throughout the Act; therefore, reliance on the use of the word "chapter" in section 2251 was insufficient to demonstrate that the definition of "related condition" in Section 2251 also applied in Section 2155. Thus, the court held that the ASCS properly denied reimbursement assistance to the plaintiff for the losses from fire blight.


INSPECTOR GENERAL. The plaintiffs were sheep and goat ranchers who had participated in the wool and mohair price support programs for several years. The Inspector General's Office (IGO) of the USDA initiated an audit of the plaintiffs' business to determine whether the plaintiffs had complied with the program requirements, including the payment limitation provisions. The plaintiffs complied with all document requests from the IGO until the FSA also started an audit of the plaintiffs' compliance with the wool and mohair programs. The IGO issued administrative subpoenas to enforce its document requests and the plaintiffs sought a declaratory judgment that the IGO did not have the authority to conduct the audit. Although the subpoenas contained boilerplate language that the subpoenas were necessary for the performance of the IGO's responsibilities for detecting fraud in the programs and administration of the USDA operations, the court held that the IGO did not have the authority to conduct what in actuality was a compliance review of the plaintiffs, which was strictly within the authority of the FSA. Winters Ranch Partnership v. Viadero, 901 F. Supp. 237 (W.D. Tex. 1995).

MILK. Vermont passed a labeling law which required milk and milk product retailers to identify through signs and stickers (i.e., no product label changes were required) the milk and milk products which were produced from cows which had been injected with recombinant bovine growth hormone (rBST). The plaintiffs were various trade associations representing retailers and milk producers. The plaintiffs alleged that the labeling law violated the First Amendment and the Commerce Clause of the U.S. Constitution and sought a preliminary injunction. The defendant, Vermont, stated that the purpose of the labeling law was to inform consumers so that the consumers could make purchases based on their concerns about rBST treatment of cows and the economic and health concerns from such treatment. The court denied the injunction because the plaintiffs failed to show irreparable harm or likelihood of success on the merits. The court found that the costs of such labeling were minimal and easily recouped from a minimal increase in the cost of milk products. The court noted that the increase of production from rBST-treated cows could decrease the cost of such milk products, thus increasing the sales and profits of retailers. The plaintiffs also alleged that even the minimal loss of First Amendment freedoms was sufficient harm to support an injunction. The court held that the labeling law does not curtail any speech but only requires truthful statements about the milk products. The court also held that the plaintiffs were not likely to succeed on the merits because the labeling law did not discriminate against out-of-state producers by favoring in-state producers, since all producers are subject to the same labeling requirements and both in-state and out-of-state producers produce both kinds of milk products. The court also noted that the state had a legitimate interest in providing its consumers with full information about retail products and that the labeling law was passed in response to a variety of public concerns over milk products from rBST treated cows. The court held that the labeling law did not violate the First Amendment because the speech involved here was commercial speech which could be restricted by a substantial governmental interest, such as truthfully informing consumers. International Dairy Foods Ass'n v. Amestoy, 898 F. Supp. 246 (D. Vt. 1995).

PERISHABLE AGRICULTURAL COMMODITIES ACT—ALM § 10.05[2]. The plaintiff was a licensed PACA produce dealer. A friend of the plaintiff was an officer and more than 10 percent owner in a PACA licensee which had filed to make payments in several repayments cases and which then ceased operations. The friend sought employment with the plaintiff who hired the friend to perform various tasks. The USDA informed the plaintiff that the friend was determined to be a person responsibly connected to the licensee and employment of the friend was prohibited without permission from the USDA. The USDA allowed the employment of the friend if the plaintiff first obtained a $100,000 bond. The plaintiff made several attempts to obtain a bond over several months but eventually found a bond too expensive and terminated the friend's employment instead. During the several months of bond seeking, the plaintiff continued to employ the friend even after repeated warnings from the USDA that employment of the friend without a bond violated PACA. The ALJ had imposed a 30 day suspension for the plaintiff's failure to obtain a bond within 30 days after receiving notice that employment of the friend without a bond would violate PACA. The plaintiff argued that the circumstances warranted allowing the plaintiff more time to obtain the bond. The ALJ and JO ruled that the 30 day requirement was statutory and the statute did not provide any authority for extending the period. However, the JO increased the suspension to 90 days because the employment of the friend threatened to undermine PACA's purposes. The appellate court affirmed on the ruling that the plaintiff violated PACA but reduced the suspension to the original 30 days because the plaintiff made a good faith effort to obtain a bond, the employment of the friend did not threaten the produce industry because the friend did not have sufficient authority in the plaintiff's business, the plaintiff had an exemplary business record under PACA, and the 90 day suspension

**FEDERAL ESTATE AND GIFT TAX**

GIFT-ALM § 6.01.* The taxpayer's father entered into a earnest money contract to purchase land under a joint venture. The father arranged for an agent to represent the taxpayer and another child and to hold interests in the joint venture for the children. The agent sent a letter to the mother, explaining the agency arrangement. The interests were eventually sold with the taxpayer and the other sibling receiving promissory notes for their interests in the property. The notes were eventually paid and the taxpayer endorsed the check as satisfying the note obligation. The issue was who was taxable on the note proceeds. The court held that the father had made a gift of the interests to the children when the earnest money contract was executed and the agency created. Streber v. Comm'r, T.C. Memo. 1995-601.

INSTALLMENT PAYMENT OF ESTATE TAX. The decedent owned all of the stock in five corporations which owned commercial and residential rental properties. The decedent also owned a 50 percent interest in a partnership which also owned similar property. Until four years before death, when an illness incapacitated the decedent, the decedent actively participated in the management of the properties, either through personal activities or through employees. After the illness, the decedent's management duties were performed by the decedent's spouse and son. The IRS ruled that the decedent's interests in the corporations and partnership were interests in closely-held business for purposes of installment payment of estate tax. The IRS ruled that the activities of the employees, spouse and son, were attributed to the corporations and partnership. Ltr. Rul. 9602017, Oct. 11, 1995.

POWER OF ATTORNEY. The decedent had established a revocable trust for the benefit of the decedent with the decedent as trustee. The trust provided that the trust property property at any time. The trust also provided that the power to "fund a previously created living trust or establish irrevocable trusts and the funds were included in the decedent's gross estate. Ltr. Rul. 9601002, Sept. 22, 1995.

**FEDERAL INCOME TAXATION**

IRS ON THE INTERNET. The IRS is now available on the Internet through the World Wide Web (http://www.irs.ustreas.gov) with its own home page. The IRS may also be accessed by direct dial up (no parity, 8 data bits, 1 stop bit) at 1-703-321-8020 and entering "guest" at the prompt. The main internet address by Telnet is ins.irs.ustreas.gov. Through these access points, online users can order forms, obtain plain English descriptions of treasury regulations, and find answers on over 140 topics.

ASSIGNMENT OF INCOME. The taxpayer was a lawyer employed by the State of New York. The taxpayer agreed to represent the taxpayer's sister in a malpractice suit against a hospital for personal injuries. The taxpayer also engaged an independent law firm to represent the sister and agreed to split the contingency fee with the law firm. The suit was eventually settled and the settlement included a waiver of the taxpayer's portion of the fees to the sister. The court order incorporating the settlement also referred to the waiver of the fees. The taxpayer did not include the fees in gross income and the sister also excluded from income the waived fees as a part of the recovery for personal injuries. The court held that the waiver was an assignment of income and included the fees in the gross income of the taxpayer because the fees were earned by the taxpayer for the work in the case. Sutherland v. Comm'r, T.C. Memo. 1996-1.

C CORPORATIONS-ALM § 7.02.*

REORGANIZATIONS. The taxpayer was a farm corporation owned by six shareholders. Disagreements by three shareholders over management, operation and general business philosophy caused the shareholders to split the corporation into three corporations. The reorganization was accomplished by distributing assets to the new corporations in exchange for stock and then distributing that stock to the shareholders of the original corporation. After the reorganization, each of the three disagreeing shareholders owned a controlling interest in one of the resulting corporations, with the other three shareholders having an interest in all three corporations generally equal to their interests in the original corporation. After the reorganization qualified as a "Type D" reorganization under I.R.C. § 368(a)(1)(D) such that no gain or loss was recognized and the basis and holding periods of corporation property carried over to the new corporations. Ltr. Rul. 9601045, Oct. 10, 1995.

DISCHARGE OF INDEBTEDNESS-ALM § 4.02[15].* The IRS has adopted as final regulations relating to information reporting requirements of financial entities discharging $600 or more of indebtedness per year per
debtor. The regulations provide that the date of discharge for information reporting purposes occurs when an identifiable event occurs after which the debt no longer need be paid. Such events include (1) a discharge in bankruptcy, (2) a cancellation or extinguishment of an indebtedness that renders a debt unenforceable in a receivership, foreclosure, or similar proceeding; (3) a cancellation or extinguishment of an indebtedness upon the expiration of a statute of limitations for collection of an indebtedness or bringing an action or claim; (4) a cancellation or extinguishment of an indebtedness pursuant to an election of foreclosure remedies that bars the collection of the indebtedness; (5) a cancellation or extinguishment of an indebtedness that renders a debt unenforceable pursuant to a probate proceeding; (6) a discharge of an indebtedness pursuant to an agreement between an applicable financial entity and a debtor for less than full consideration; (7) a discharge of indebtedness pursuant to a decision by the creditor or the application of a defined policy of the debtor not to continue collection activity; and (8) the expiration of the nonpayment testing period. The testing period referred to in item (8) is 36-months increased by the number of calender months during all or part of which the creditor was precluded from engaging in collection activity by operation of law. If a discharge of indebtedness occurs in connection with a foreclosure or abandonment of secured property reportable under I.R.C. § 6050J, only a reporting under these regulations by Form 1099-C is required. The regulations are effective for debt discharges occurring after December 21, 1996. Until that date, the temporary regulations and Notice 94-73 remain in effect. Note: A future issue of the Digest will publish an article by Dr. Harl on this issue. Redlark v. Comm’r, 106 T.C. No. 2 (1996).

INVESTMENT TAX CREDIT-ALM § 4.03[12]. The taxpayer was a publicly owned corporation which operated child care centers. The taxpayer claimed investment tax credit for wall panels used for writing, mansard roof systems, playground fencing, exterior lighting systems, handicap restroom accessories, grease traps in the kitchen, thermal recovery systems and split door systems. The court held that the property items were not eligible for investment tax credit because the property items were integrated into the building structures so that the property was structural components. La Petite Academy v. U.S., 96-1 U.S. Tax Cas. (CCH) ¶ 50,020 (8th Cir. 1995), aff’d, 95-1 U.S. Tax Cas. (CCH) ¶ 50,193 (W.D. Mo. 1995).

LETTER RULINGS. The IRS has issued its annual list of procedures for issuing letter rulings. Rev. Proc. 96-1, I.R.B. 1996-1, 8.

The IRS has issued its annual list of procedures for furnishing technical advice to District Directors and Chiefs, Appeals Offices. Rev. Proc. 96-2, I.R.B. 1996-1, 60.

The IRS has issued its annual list of tax issues for which the IRS will not give advance rulings or determination letters. Rev. Proc. 96-3, I.R.B. 1996-1, 82.

The IRS has issued procedures for issuing determination letters on the qualified status of employee plans under Sections 401(a), 403(a), 409 and 4975(e)(7). Rev. Proc. 96-6, I.R.B. 1996-1, 151.

The IRS has issued revised fee schedules for issuing determination letters on the qualified status of employee plans under Sections 401(a), 403(a), 409 and 4975(e)(7). Rev. Proc. 96-8, I.R.B. 1996-1, 187.

LIKE-KIND EXCHANGES. The taxpayer owned land used for cattle grazing and duck hunting. The taxpayer granted to the U.S. Fish and Wildlife Service (FWS) a conservation easement over the property which prevented the taxpayer from altering the character of the land and allowed the FWS rights to water on the property in maintaining the property as a seasonable waterfowl habitat. The taxpayer retained the right to hunt and operate a hunting club on the property and the right to all subsurface minerals. State law recognized the conservation easement as a right in property. The taxpayer entered into a multi-party exchange transaction under which the FWS obtained replacement property which the taxpayer would use in a trade or business. The IRS ruled that the exchange of a conservation easement for a fee interest in trade or business property was a like-kind exchange eligible for nonrecognition of gain or loss. Ltr. Rul. 9601046, Oct. 10, 1995.

PARTNERSHIPS-ALM § 7.03.* BASIS OF PARTNER’S INTEREST. The taxpayers were equal partners in a partnership. The partnership donated partnership property to a charitable organization, with the property having a basis less than its fair market value and not subject to liabilities. The IRS ruled that the basis of each partner’s interest in the partnership is reduced by the partner’s share of the basis in the partnership property donated. Rev. Rul. 96-11, I.R.B. 1996-4.

* Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.
A partnership was comprised of a 75 percent partner and a 25 percent partner. The 75 percent partner was also a 60 percent partner of another partnership, with a 40 percent partner. The first partnership sold property to the second partnership for less than its basis in the property. The loss on the sale would be disallowed because a person owned at least 50 percent of each partnership. The IRS ruled that the disallowed loss would decrease the adjusted basis of the partners' interests in the partnership which sold the property. The loss is apportioned according to the partners' respective shares of partnership losses. The second partnership later sold the same property for more than its basis in the property but the gain did not exceed the disallowed loss on the first transaction. Under I.R.C. § 707(b)(1), 267(d), only gain on the transaction in excess of the disallowed loss from the first transaction is recognized; therefore, no gain is recognized by the partnership on the second transaction. The IRS ruled that the unrecognized gain is added to the partners' basis in their partnership interests according to the partners' interest in partnership profits. Rev. Rul. 96-10, I.R.B. 1996-2.

DISTRIBUTIONS. The IRS has issued proposed rules governing the treatment of a distribution of marketable securities by a partnership. Under I.R.C. § 731(a)(1) a partner must recognize gain on a distribution of money from the partnership to the extent the money received exceeds the partner's basis in the partner's partnership interest. Under I.R.C. § 731(c), marketable securities are to be treated as money for purposes of Section 731(a). Under I.R.C. § 731(c)(3)(B), the amount of marketable securities that is treated as money is reduced by the excess of (1) the partner's share of the net gain of the securities of the same class and issuer over (2) the partner's share of such net gain immediately after the distribution. The proposed regulations provide that all securities held by the partnership are to be treated as the same class and issuer. The proposed regulations also provide that marketable securities include an interest in a entity of which 90 percent or more of the assets are marketable securities. In addition, marketable securities include an interest in an entity if the interest in the entity is attributable to marketable securities owned by the entity which comprise 20 percent or more but less than 90 percent of the assets of the entity. The proposed regulations provide three exceptions. (1) The marketable securities rules do not apply if the distributee partner contributed the marketable securities to the partnership. (2) The marketable securities rules do not apply if the partnership acquired the marketable securities in a nonrecognition transaction in exchange for property other than marketable securities or cash and (a) the security is actively traded and (b) the security is distributed within five years after acquisition. (3) The marketable securities rules do not apply if (a) the security was not actively traded when acquired by the partnership, (b) the security was actively traded at the time of distribution, and (c) the security became actively traded more than six months after acquisition by the partnership and (d) the security was distributed within five years after the date the security became actively traded. The marketable securities rules do not apply to investment partnerships. 61 Fed. Reg. 28 (Jan. 2, 1996), adding Prop. Treas. Reg. § 1.731-2.

RETURNS. The IRS has issued temporary regulations governing the issuance of automatic four month extensions for filing and paying federal income tax. The regulations generally implement Notice 93-22, 1993-1 C.B. 305 but the regulations do not require that a taxpayer be unable to make the tax payments on the date of the extension. The IRS encouraged taxpayers to make as large a payment as possible by the due date in order to reduce interest and penalties. 61 Fed. Reg. 260 (Jan. 4, 1996).

SAFE HARBOR INTEREST RATES

<table>
<thead>
<tr>
<th>January 1996</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>Annual</td>
</tr>
<tr>
<td>Semi-annual</td>
</tr>
<tr>
<td>Quarterly</td>
</tr>
<tr>
<td>Monthly</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Short-term</th>
</tr>
</thead>
<tbody>
<tr>
<td>AFR 5.50</td>
</tr>
<tr>
<td>5.43</td>
</tr>
<tr>
<td>5.39</td>
</tr>
<tr>
<td>5.37</td>
</tr>
<tr>
<td>110% AFR 6.06</td>
</tr>
<tr>
<td>5.97</td>
</tr>
<tr>
<td>5.93</td>
</tr>
<tr>
<td>5.90</td>
</tr>
<tr>
<td>120% AFR 6.63</td>
</tr>
<tr>
<td>6.52</td>
</tr>
<tr>
<td>6.47</td>
</tr>
<tr>
<td>6.43</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Mid-term</th>
</tr>
</thead>
<tbody>
<tr>
<td>AFR 5.73</td>
</tr>
<tr>
<td>5.65</td>
</tr>
<tr>
<td>5.61</td>
</tr>
<tr>
<td>5.58</td>
</tr>
<tr>
<td>110% AFR 6.32</td>
</tr>
<tr>
<td>6.22</td>
</tr>
<tr>
<td>6.17</td>
</tr>
<tr>
<td>6.14</td>
</tr>
<tr>
<td>120% AFR 6.89</td>
</tr>
<tr>
<td>6.78</td>
</tr>
<tr>
<td>6.72</td>
</tr>
<tr>
<td>6.69</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Long-term</th>
</tr>
</thead>
<tbody>
<tr>
<td>AFR 6.19</td>
</tr>
<tr>
<td>6.10</td>
</tr>
<tr>
<td>6.05</td>
</tr>
<tr>
<td>6.02</td>
</tr>
<tr>
<td>110% AFR 6.82</td>
</tr>
<tr>
<td>6.71</td>
</tr>
<tr>
<td>6.65</td>
</tr>
<tr>
<td>6.62</td>
</tr>
<tr>
<td>120% AFR 7.45</td>
</tr>
<tr>
<td>7.32</td>
</tr>
<tr>
<td>7.25</td>
</tr>
<tr>
<td>7.21</td>
</tr>
</tbody>
</table>

S CORPORATIONS-ALM § 7.02[3][e]*

ELECTION. The taxpayer was a shareholder of a corporation which claimed to have timely filed a From 2553 Subchapter S Election for 1986. However, the IRS claimed to have not received the form. The taxpayer presented extensive testimony by the form preparer that the form was timely mailed, and the Tax Court acknowledged that this testimony was believable. However, the court held that a presumption of delivery was not available to the taxpayer and that the requirements of I.R.C. § 7502 were the only means of proving delivery of a mailing. Section 7502 requires direct evidence of a postmark on the document involved, which the court stated could only be met, in cases of lost documents, by the record of registered or certified mail. The taxpayer also presented some evidence that the IRS had later mailed forms to the taxpayer with information allegedly obtainable only from the disputed Form 2553, thus proving IRS receipt of the Form 2553. The court rejected the significance of this evidence because the taxpayer failed to demonstrate that the information was not supplied to the IRS by some other means. As the Tax Court warns at the end of the opinion, taxpayers assume the full risk of IRS's nonreceipt or loss of filings unless the filings are mailed by registered or certified mail. Carroll v. Comm'r, 96-1 U.S. Tax Cas. (CCH) ¶ 50,010 (6th Cir. 1995), aff'd, T.C. Memo. 1994-229.

INADVERTENT TERMINATION. A shareholder of an S corporation distributed shares of stock to a trust which had the shareholder's two children as co-beneficiaries, causing the corporation to no longer qualify as an S corporation. The corporation did not learn this until the corporation's income tax return was prepared. The shareholder immediately reformed the trust into two separate trusts, each with one beneficiary, and language requiring annual distribution of income to the sole beneficiary and prohibiting distribution of trust principal except to the sole beneficiary. The IRS ruled that the new trusts were QSSTs and that the termination of S corporation status was inadvertent; therefore, the corporation was allowed to continue as an S corporation so long as all parties filed income tax returns consistent with an S corporation election. Ltr. Rul. 9552031, Sept. 29, 1995.
JOURNAL ARTICLES


Bensing, Daniel, "The Promulgation and Implementation of Federal Marketing Orders Regulating Fruit and Vegetable Crops Under the Agricultural Marketing Agreement Act of 1937."

Leighton, Brian C., "The Socialization of Agricultural Advertising: What Perestroika Didn't Do the First Amendment Will."


Padberg, Daniel I. and Hall, Charles, "The Economic Rationale for Marketing Orders."

Pineles, Barry, "Marketing Orders and the Administrative Process: Fitting Round Fruit into Square Baskets."

CITATION UPDATES


Estate of Green v. United States, 68 F.3d 151 (6th Cir. 1995) (gross estate) see Vol. 6, p. 182.

AGRICULTURAL LAW MANUAL

by Neil E. Harl

This comprehensive, annotated looseleaf manual is an ideal deskbook for attorneys, tax consultants, lenders and other professionals who advise agricultural clients. The book contains over 900 pages and an index.

As a special offer to Digest subscribers, the Manual is offered to new subscribers at $115, including at no extra charge updates published within five months after purchase. Updates are published every four months to keep the Manual current with the latest developments. After the first free update, additional updates will be billed at $100 per year or $35 each.

For your copy, send a check for $115 to Agricultural Law Press, P.O. Box 50703, Eugene, OR 97405.

Satisfaction guaranteed. 30 day return privilege.

ISSUE INDEX

Bankruptcy
  General
    Automatic stay 10
    Claims 10
    Environmental cleanup costs 10
    Exemptions
    IRA 10
  Federal taxation
    Claims 11
    Priority 11
Contracts
  Termination 11
Federal Agricultural Programs
  Brucellosis 11
  Cheese 11
  Disaster assistance 11
  Inspector general 12
Milk 12
PACA 12
Federal Estate and Gift Tax
  Gift 13
  Installment payment of estate tax 13
  Power of attorney 13
Federal Income Taxation
  Assignment of income 13
  C corporations
    Reorganizations 13
  Discharge of indebtedness 13
  Hobby losses 14
  IRA 14
  Investment tax credit 14
  Interest 14
  Letter rulings 14
  Like-kind exchange 14
Partnerships
  Basis of partner's interest 14
  Distributions 15
  Returns 15
  Safe harbor interest rates
  January 1996 15
S corporations
  Election 15
  Inadvertent termination 15
INDEPENDENT CONTRACTOR OR EMPLOYEE?

— by Neil E. Harl*

For several decades, the battle has raged over whether an individual is an employee or independent contractor for payroll tax purposes.1 In 1978, Congress attempted to clarify the situation by protecting most employees from a retroactive finding that an employer-employee relationship existed and by temporarily freezing the common law definition of employee.2 The 1978 legislation also prohibited the Department of the Treasury from issuing rulings and regulations on common law employment status.3 That moratorium was continued several times and made indefinite in 19824 except as to qualified real estate agents and direct sellers who were deemed to be statutorily self-employed where substantially all of the remuneration paid for their services is directly related to sales or other output and where the services are performed under written contracts providing that the individuals will not be treated as employees for federal tax purposes.5

In a 1990 ruling, a farmer employed an adult son to perform agricultural labor on the farm. The son was generally paid hourly with all of the work done under the father's control and direction. The Internal Revenue Service determined that the son was an employee.6 More than 60 letter rulings with farm facts have held similarly.7

The 20-factor test

In Rev. Rul. 87-41,8 IRS provided guidance for distinguishing between independent contractor and employee status for employment tax purposes. The 20 factors were identified to provide insight as to whether sufficient control is present to establish an employer-employee relationship.9 Since publication of the 20-factors in 1987, a long list of cases has applied the factors to determine whether an individual is properly classified as an employee or as an independent contractor.10

Handling business expenses

Recent cases have focused attention on the fact that the problem of whether someone is an employee or independent contractor is far broader than liability for payroll taxes. Several cases have raised the issue of employee versus independent contractor status in the setting of handling employee business expenses.11 As an independent contractor, an individual can file a Schedule C or F and deduct employment-related expenses.12 Employees must treat all employment-related expenses as itemized employee business expenses that are only deductible to the extent the expenses exceed two percent of the employee's adjusted gross income.13

Participation in employee benefits

A major concern in recent months has been whether a successful drive to secure independent contractor status for payroll tax purposes or business expense purposes causes problems for continuing participation in employee benefits. Several recent cases have recited that individuals considered to be independent contractors were participating in employee benefits.14

The Internal Revenue Service issued a private letter ruling in 1995 on the consequences of a successful effort to be classified as an independent contractor where the individual was participating in employee benefits.15 In the facts of that ruling, the taxpayer had mounted a successful challenge in the Tax Court to the common law employee classification by IRS. Before the Tax Court decision in the taxpayer's favor, the individual had participated in the employer's employee benefit program. IRS ruled on three questions —

• The employer should issue a corrected Form W-2 showing zero wage income and a corrected Form 1099 showing self-employment income for the years in question.
• The continued participation of the independent contractor in the employer's employee-benefit plan would no longer be consistent with the requirements for a qualified employee-benefit plan. This part of the ruling is being reconsidered by IRS, however.
• Participation by the independent contractor in the employer's employee-benefit plan prior to the Tax Court decision would not disqualify the employee retirement plans. But it would be necessary to cancel, retroactively, the independent contractor's participation in the plans, to refund the independent contractor's elective contributions and to refund the actual plan earnings. This part of the ruling is also being reconsidered by the Internal Revenue Service.

Can you have it both ways?

After the latest IRS letter ruling,16 the Sixth Circuit Court of Appeals decided the case of Ware v. United States.17 That case, decided on October 16, 1995, involved
an inside sales person in an insurance company who became an outside agent with the same company and argued, successfully, that independent contractor classification was appropriate. Accordingly, the taxpayer was allowed to deduct unreimbursed business expenses on Schedule C. The taxpayer "received extensive benefits, including paid vacation and sick days, was covered by a company-sponsored health and dental plan, and was eligible for a 401(k) and pension plan" in which the employer matched the taxpayer's contributions.

Despite the individual's participation in employee benefits, the Sixth Circuit Court of Appeals held that the taxpayer was an independent contractor. In a footnote to the decision, the court noted, "in theory, a person could be an independent contractor for [some] purposes yet remain an employee for ERISA qualification, but such instances should be rare." The court explained that how an employer chooses to compensate a worker is irrelevant to the common law tests of employee status.

**Current uncertainty**

At present, the question of independent contractor versus employee status and the consequences of the determination, are in a state of substantial uncertainty. The Commissioner of Internal Revenue has been quoted as saying that, "it does not matter to the IRS whether a worker is classified as an employee or as an independent contractor so long as the worker...is paying his or her proper amount of taxes." Several bills have been introduced in Congress to streamline the definition of who may be properly classified as an independent contractor. Unfortunately, none of the bills introduced to date takes an appropriately broad view of the problem. All focus on the payroll tax issue only. That's important, but it's not the whole story.

**FOOTNOTES**

5. I.R.C. §§ 3508(b)(1), 3508(b)(2).
7. See 4 Harl, Agricultural Law § 36.03[1], n. 18 (1996).
10. E.g., Eastern Investment Corp. v. United States, 49 F.3d 651 (10th Cir. 1995) (20-factor test applied to find sales representatives were employees, not independent contractors).
11. E.g., Weber v. Comm'r, 60 F.3d 1104 (4th Cir. 1995) (United Methodist minister deemed to be employee); Butts v. Comm'r, 49 F.3d 713 (11th Cir. 1995) (insurance agent was independent contractor permitted to report business expenses on Schedule C; taxpayer received paid vacation, pension and 401(k) plan, 75 percent of health insurance costs, coverage under employer's malpractice policy and payment of licensing and professional fees).
14. E.g., Butts v. Comm'r, 49 F.3d 713 (11th Cir. 1995) (fringe benefits provided by employer of insurance agent).
16. Id.
17. 95-2 U.S. Tax Cas. (CCH) ¶ 50,553 (6th Cir. 1995).
18. Id.
19. Id.
20. Id.
21. Id., n. 5.

**CASES, REGULATIONS AND STATUTES**

by Robert P. Achenbach, Jr.

**BANKRUPTCY**

**GENERAL-ALM § 13.03.*

**ESTATE PROPERTY.** The debtor's mother died four days before the debtor filed for Chapter 11. The mother's will was not admitted to probate until more than 180 days after the petition. During the interim, the debtor participated in settlement negotiations with the other heir. The court held that because, under state law, a beneficiary of a decedent's estate acquires an interest in the estate upon the decedent's death, the debtor acquired the interest in the mother's estate pre-petition and the interest was included in the debtor's bankruptcy estate. *In re Chappel, 189 B.R. 489 (Bankr. 9th Cir. 1995).*

**EXEMPTIONS**

**HOMESTEAD.** The debtor had used 165 acres of rural property in Texas as the home of his family, consisting of several children and a spouse. In 1987, four days after the death of the spouse, the debtor signed a homestead disclaimer as to the property in order to obtain financing secured by the property. At the time of the petition, the children had moved away and the debtor lived alone on the property. Under Texas law, a disclaimer of a homestead was not effective if the debtor used the property as a homestead and owned no other property usable as a homestead. The court held that the disclaimer was not effective because the debtor did not own any other property at the time of the disclaimer and used the property as a homestead. The debtor claimed the entire 165 acres as exempt family rural homestead property. A creditor objected, arguing that the debtor was single and lived alone; therefore, the debtor was entitled only to the 100 acre rural homestead exemption. The court held that, under Texas law, the property became a
family homestead when the debtor lived there with the children and spouse and that the debtor was entitled to treat the property as a family homestead so long as the debtor continued to live there. Matter of McDaniel, 70 F.3d 841 (5th Cir. 1995).

PRE-PETITION CONVERSIONS. Within two weeks before filing for Chapter 7, the debtors purchased life insurance policies with all of their cash. The life insurance policies were claimed as exempt property. A creditor sought denial of discharge of the debtors, arguing that the pre-petition conversion was made with intent to defraud creditors. The debtors admitted that the purchase of the insurance policies was made in order to decrease the amount of nonexempt assets available for the bankruptcy estate. The court held that the mere conversion of nonexempt assets to exempt assets just prior to filing for bankruptcy was insufficient to deny a discharge without additional evidence that the debtors engaged in sharp dealings, concealment of assets, or misrepresentations. In re Carletta, 189 B.R. 258 (Bankr. N.D. N.Y. 1995).

REVOCATION OF DISCHARGE. The Chapter 7 debtors had failed to include in their list of assets an interest in a land sales contract to purchase land. The trustee failed to discover the fraud and bring an action for revocation of discharge until more than one year after the granting of a discharge in the case. The debtors argued that the action was barred by the one year limit of Section 727(d)(1). The trustee sought to extend the limitation period by "equitable tolling" under which the limitation period did not run until the fraud was discovered. The court held that the statute did not allow for any equitable tolling of the limitation period. In re Reynolds, 189 B.R. 199 (Bankr. D. Or. 1995).

FEDERAL TAXATION-ALM § 13.03[7]. The debtor had failed to file income tax returns for 1984-1988, although the debtor had provided for withholding of taxes equal to an amount which the debtor believed was sufficient to cover any tax liability. The debtor did file the missing returns after being contacted by the IRS and only then discovered a substantial tax liability. The IRS sought denial of the debtor's discharge under Section 523(a)(1)(C) for willful attempt to evade taxes. The court noted that the IRS could seek amendment of the plan two years after confirmation. The court noted that the debtor's mischaracterization of the IRS claim in the plan was a good faith error and that, if the bad faith was found on the debtor's part, the amendment would have been allowed. In re Brenner, 189 B.R. 121 (Bankr. N.D. Ohio 1995).

DISCHARGE. The IRS sought to have the debtor's pre-petition taxes declared nondischargeable under Section 523(a)(1)(C) because the debtor filed fraudulent returns for the taxes or wilfully attempted to evade taxes by hiding assets. The debtor's nondebtor spouse had made two loans to the debtor and had received loans from a corporation which was owned by the debtor's sons and which employed the debtor. The debtor and nondebtor spouse kept their assets separate and filed separate tax returns. The debtor did not own any interest in the sons' corporation. The loan proceeds received by the nondebtor spouse were invested in the nondebtor spouse's separate property. The court held that the debtor did not receive any income from the nondebtor spouse's loans to the debtor or from the corporation; therefore, the debtor did not hide any assets or income from these transactions and the pre-petition taxes were dischargeable. In re Cox, 156 B.R. 323 (Bankr. M.D. Fla. 1993), aff'd on point, 189 B.R. 214 (M.D. Fla. 1995).

The debtor had failed to file income tax returns for 1984-1988, although the debtor had provided for withholding of taxes equal to an amount which the debtor believed was sufficient to cover any tax liability. The debtor did file the missing returns after being contacted by the IRS and only then discovered a substantial tax liability. The IRS sought denial of the debtor's discharge under Section 523(a)(1)(C) for willful attempt to evade taxes. The court noted that the debtor had not mistated any returns or concealed any assets or income. The debtor's "tax protestor" activities were limited to sending letters to the IRS complaining about the collection procedures. The court held that the debtor's conduct did not amount to a willful attempt to evade taxes. In re Fuller, 189 B.R. 352 (Bankr. W.D. Pa. 1995).

DISMISSAL. The debtors had filed for Chapter 11 and their plan was confirmed. During the plan, the debtors failed to pay post-petition income taxes incurred in their dairy farm operation. The IRS moved for dismissal of the case because the failure to pay the post-petition taxes represented a continuing loss of the estate and demonstrated that the debtors did not have a reasonable likelihood of a successful rehabilitation. The debtors responded that friends would give enough money to pay the taxes and that they could use carryforward losses to eliminate the tax liability. The court held that the case was dismissed because the debtors did not supply any evidence of the previous tax losses and the failure to pay the taxes demonstrated that the debtors could not successfully complete the plan. Matter of Berryhill, 189 B.R. 463 (N.D. Ind. 1995).

NOTICE TO IRS. The debtor filed for Chapter 7 and the notice for the filing of claims was sent to the IRS service center where the debtor sent tax returns. The IRS acknowledged receipt of the notice but failed to file a claim.
until 11 months after the bar date for claims. The IRS did not present any reason for the delay and did not request an extension of time to file the claim. The IRS argued that the notice was not adequate because the notice was not sent to the special procedures section in Pittsburgh. The court found that the local bankruptcy rules contained no provision for notices to the IRS in Pittsburgh and held that the notice to the service center was adequate. In re Benny's Leasing, Inc., 189 B.R.350 (W.D. Pa. 1995), aff'd on reconsideration, 187 B.R. 484 (W.D. Pa. 1995), aff'd, 166 B.R. 823 (Bankr. W.D. Pa. 1994).

FEDERAL AGRICULTURAL PROGRAMS

BRUCELLOSIS. The APHIS has issued interim regulations designating Georgia as a validated brucellosis-free state. 60 Fed. Reg. (Dec. 29, 1995).

The plaintiffs purchased dairy cattle from an Indiana dairy farmer. The Indiana State Board of Animal Health (the Board) had tested the dairy farm's herd and found three cows with brucellosis. The Board instructed the federal veterinarian to quarantine the cows which had contact with the diseased cows, but much of the dairy farmer's herd was not quarantined. The plaintiffs' dairy herd became contaminated with brucellosis and had to be destroyed. The plaintiffs sued under the Federal Tort Claims Act (FTCA) for damages caused by the negligence of the federal veterinarian. The court held that the federal veterinarian did not owe an special duty to the plaintiffs but was operating to protect the public in general; therefore, no recovery could be claimed from the federal veterinarian under the FTCA. Stratmeyer v. U.S., 67 F.3d 1340 (7th Cir. 1995).

MARKETING ORDERS-ALM § 10.05[1]. The plaintiffs were almond handlers who challenged an almond marketing order which required a handler to pay an advertising assessment unless the handler individually paid for “authorized” advertising. The plaintiffs challenged the order as violating their First Amendment rights. The court held that the advertising assessment violated the First Amendment free speech rights of the handlers and that the government failed to demonstrate that the assessment accomplished its purpose of increasing the sales of almonds. The case was remanded for imposition of a remedy. On remand the District Court ordered the USDA to refund the amounts the almond handlers had paid since 1980, to release all assessments in escrow and to reimburse the handlers for amounts spent on creditable advertising. The USDA argued that the doctrine of sovereign immunity barred the award of the reimbursement for creditable advertising paid for by the handlers, because the reimbursement would be an award of monetary damages. The appellate court agreed and held that, although the requirement that the handlers purchase advertising violated the Constitution, the doctrine of sovereign immunity barred reimbursement from the USDA because the USDA did not receive the money for the advertisements. The USDA also argued that the refund amount should be decreased by the amount of benefit the handlers received from the advertising, otherwise the handlers would be unjustly enriched. The court held that the doctrine of unjust enrichment did not apply to constitutional violations. Cal-Almond, Inc. v. U.S.D.A., 67 F.3d 874 (9th Cir. 1995), rev'd in part and aff'd in part unrep. D. Ct. dec. on remand from, 14 F.3d 429 (9th Cir. 1993).

PERISHABLE AGRICULTURAL COMMODITIES ACT-ALM § 10.05[2]. Potato producers had filed claims against a purchaser for the PACA trust funds. The purchaser had granted a security interest in its accounts receivable to secure a revolving line of credit. The secured creditor argued that it was a bona fide purchaser of the accounts receivable. The court found that, under the security agreement, the creditor had no interest in the accounts receivables unless the purchaser failed to repay the borrowed funds and that the creditor could demand repayment of the loan without first collecting from the accounts receivable. The court held that this arrangement was a security interest and was subordinate to the trust fund claims of the producers. The creditor also argued that some of the producers were not eligible for PACA trust funds because the commodities sold to the purchaser were not fresh vegetables. The court found that some of the potatoes were peeled, cut, blanched, and seared in oil in preparation for freezing and then sold frozen to the purchaser. The court held that these potatoes were eligible fresh vegetables and the producers could recover from the PACA trust. The court found that other potatoes were processed similarly but with the added processing of adding oil for home oven cooking or breading. The court held that these potatoes did not qualify as fresh vegetables and denied the producers' claim for PACA trust funds. Endico Potatoes, Inc. v. CIT Group/Factoring, Inc., 67 F.3d 1063 (2d Cir. 1995).

FEDERAL ESTATE AND GIFT TAX

GENERATION SKIPPING TRANSFERS-ALM § 5.04[6]. An irrevocable trust had been established in 1975 which was funded with corporate stock and which provided for payment of four years of college tuition and other expenses of the grantor's grandchildren. After the corporation was dissolved, the trustee petitioned a state court for interpretation of the trust. A college-aged grandchild also petitioned the state court for allowing the college tuition payments to apply to a five year college program. The IRS ruled that both amendments of the trust by the state court decisions did not subject the trust to GSTT. Ltr. Rul. 9602016, Oct. 11, 1995.

The decedent's share of community property passed to a trust for the surviving spouse. Under the trust provisions, if the marital share exceeded the GSTT exemption, the trust was to be split into an exempt GSTT marital share and a nonexempt GSTT marital share. The estate tax return Schedule R was filled out as if a reverse QTIP election was being made for the exempt GSTT marital share but the reverse QTIP election was not indicated. An attachment to the return allocated all of the GSTT exemption to the exempt GSTT marital share. The estate later filed an amended return to make the reverse QTIP election. The IRS ruled that an extension of time to make the election was allowed but ruled that the allocation of the exemption was irrevocable. Ltr. Rul. 9603021, Oct. 20, 1995.

*Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.
GIFT-ALM § 6.01. The taxpayer issued two $100,000 checks, one to each of the taxpayer's two children and the children signed no interest demand notes for repayment of the money. However, the taxpayer testified that the taxpayer had no intention of seeking repayment but intended to forgive the indebtedness after several years. In the subsequent years, the taxpayer sent letters to the children indicating how much of the loans was forgiven. The court held that the initial checks were gifts and not loans, based on several factors: (1) no interest was charged; (2) no security was required; (3) although the notes had fixed maturity dates, the taxpayer did not intend to enforce them; (4) no demand was made for repayment; (5) no repayments were made; (6) the taxpayer did not provide any evidence that the children had sufficient income or assets to repay the notes; (7) the "loans" were not consistently treated as such in the taxpayer's records; and (8) the taxpayer did not file gift tax returns for the loan forgiveness amounts in excess of the annual exclusion amount. Miller v. Comm'r, T.C. Memo. 1996-3.

LIFE INSURANCE. A parent created two identical irrevocable trusts, one for each child. The trusts provided that the grantor and beneficiary could not be a trustee. The trust also provided that the trustee could purchase life insurance on the life of the beneficiary and pay the premiums from trust principal. If the trust purchased life insurance on the life of the beneficiary, (1) the beneficiary could not transfer another life insurance policy to the trust if the beneficiaries paid for the premiums on that policy and (2) the beneficiary could not exercise any power of appointment over trust principal. Annual net trust income was to be distributed to the beneficiary and the trustee had absolute discretion to distribute trust principal. The IRS ruled that the a beneficiary would not be considered as having any incidents of ownership of the life insurance policies on the life of the beneficiary. Ltr. Rul. 9602010, Sept. 29, 1995.

MARITAL DEDUCTION-ALM § 5.04[3]. The decedent's will left property in trust to the decedent's spouse but the trust provided that the trustees, the decedent's sons, had absolute discretion for distributions from the trust to the surviving spouse. The executor of the decedent's estate petitioned the state probate court for an amendment of the trust to provide that all of the trust's net income be distributed to the surviving spouse at least annually. The probate court issued an order so amending the trust. The executor then filed the estate tax return and claimed the trust as QTIP. The court held that the state court order was not binding for federal estate tax purposes and was contrary to the clear language of the trust; therefore, the trust did not qualify as QTIP because all of the net annual income was not required to be distributed to the spouse. Estate of Rapp v. Comm'r, T.C. Memo. 1996-10.

POWER OF ATTORNEY. Two months before death, the decedent became seriously ill and executed a power of attorney in favor of the decedent's two daughters. Within the month before the decedent's death, one daughter wrote 16 $10,000 checks to various family members; however, the checks were not cashed until two days after the decedent's death. The court questioned the dates on the checks because the check numbers were higher than checks written by the decedent after the dates of the gift checks, indicating that the gift checks were written after the decedent became incapacitated and were written without the decedent's knowledge. The court found that the gift checks were not made with the decedent's intent to make the gifts. The court also held that, because the power of attorney did not expressly authorize gifts of the decedent's property, the gift checks were revocable by the decedent when made and were included in the decedent's gross estate. Estate of Goldman v. Comm'r, T.C. Memo. 1996-29.

RETURNS. The IRS has announced that existing Form 706 may be used for decedent's dying after December 31, 1965. Anew form will be available after enactment of amendments to the estate tax provisions. Ann. 96-1.

TRANSFERS WITH RETAINED INTERESTS-ALM § 15.02[3]. In 1951, the decedent and parent owned most of the stock of a family corporation. In order to meet the inheritance and control desires of the shareholders, the decedent and parent entered into an agreement for the transfer of the parent's stock at death to the decedent in trust for life with remainders to the parent's grandchildren. The decedent agreed to transfer the decedent's stock by will to the same trusts. The IRS argued that, although the agreement was reached in bona fide bargaining and the decedent did provide some consideration for the agreement, the consideration was not full and adequate; therefore, the stock in the trust was included in the decedent's gross estate. The court held that the value of the decedent's future contribution of stock was not sufficient consideration for the parent's agreement to transfer stock to the trust; therefore, the decedent's interest in the trust was not received for adequate consideration. The court included the value of the stock in the trusts in the decedent's gross estate, decreased by the value of the decedent's stock contributed to the trusts. Estate of Magnin v. Comm'r, T.C. Memo. 1996-25.

FEDERAL INCOME TAXATION

CONSERVATION EASEMENT. The taxpayer owned farmland and donated a conservation easement to the county. Although some of the land was tillable, much of it was wooded and hilly and had primarily scenic value. The easement generally prohibited development of the land but allowed some building of residences in areas not exposed to views from the neighboring road. The IRS ruled that the transfer was a qualified conservation contribution eligible for the charitable deduction. Ltr. Rul. 9603018, Oct. 19, 1995.

COURT AWARDS AND SETTLEMENTS-ALM § 4.02[14]. The taxpayer had settled a personal injury suit and the settlement included prejudgment interest. The state law characterized prejudgment interest as part of the compensation for lost time value of the injury award. However, the court held that prejudgment interest was not part of the personal injury award and was not excludible from gross income. Brabson v. U.S., 96-1 U.S. Tax Cas. (CCH) ¶ 50,038 (10th Cir. 1996), rev'g, 94-2 U.S. Tax Cas. (CCH) ¶ 50,446 (D. Colo. 1994).

The taxpayer's employment was terminated and the taxpayer sought restitution from the employer. After
settlement of the taxpayer's grievances. The taxpayer argued that the payment was excludible from gross income because the payment was made in settlement of several tort claims. The court held that the payment was includible in gross income because the only claims raised by the taxpayer in the negotiations were contract related and the employer was not aware of any tort claims. Foster v. Comm'r, T.C. Memo. 1996-26.

**EMPLOYEE BENEFITS.** The taxpayer was a company which provided its employees, spouses and dependents with a health care plan funded with after tax employee contributions and company contributions. The company planned to expand the definition of spouse to include domestic partners. The IRS ruled that if a domestic partner was considered a spouse under state law, the inclusion of coverage for domestic partners would not affect the qualification of the plan. Ltr. Rul. 9603011, Oct. 18, 1995.

**ENVIRONMENTAL CLEANUP COSTS.** The following letter ruling has been withdrawn for reconsideration. The taxpayer owned farm land which became contaminated with pesticides and chemicals when the land was used as an industrial waste site. The taxpayer donated the land to the county which attempted to convert the land to recreational use until the contamination was found and then the county resold the land back to the taxpayer for nominal consideration. The taxpayer was responsible for the cleanup of the land and sought to deduct the costs as ordinary business expenses under Rev. Rul. 94-38, 1994-1 C.B. 35. The IRS ruled that Rev. Rul. 94-38 did not apply because the land was not clean when the taxpayer reacquired the land. The IRS also ruled that the costs were capital costs not eligible for current deductions because the land was no longer used in a trade or business. Ltr. Rul. 9541005, Sept. 27, 1995.

**GROSS INCOME.** The taxpayer owned nonresidential rental properties with the taxpayer's spouse as tenants by the entireties. Under state law, each spouse was entitled to half of the rental income from the properties. The taxpayer filed income tax returns as "married filing separately." The court held that the taxpayer was taxable for only one-half of the rental income from the properties, even though the rent was paid by checks made out to the taxpayer. Ritter v. Comm'r, T.C. Memo. 1996-15.

**HOBBY LOSSES-AlM § 4.05[1].** The taxpayer was employed fulltime with the U.S. postal service. The taxpayer had inherited a ranch and raised about 40 head of cattle and grew hay on the property. The taxpayer had grown up on the ranch and had some high school education in agriculture. The taxpayer worked on the ranch several times a week and often stayed on the ranch on weekends. The ranch had never yeilded a profit or gross income and the taxpayer produced no credible evidence that the ranch would be profitable in the future. The taxpayer did not consult with experts and had no plan for producing a profit except for a vague plan to increase the herd size after some equipment loans were paid. The court held that the taxpayer could not claim any deductions in excess of ranch income because the taxpayer did not operate the ranch with an intent to make a profit. Scales v. Comm'r, T.C. Memo. 1995-544.

**HOME OFFICE-AlM § 4.03[13].** The taxpayer worked as a hydraulic engineer and taught college courses in hydraulic engineering. The taxpayer claimed a deduction for home office expenses related to the expenses of maintaining the residence. The taxpayer also deducted the legal fees incurred in a divorce suit and a criminal contempt case. The taxpayer determined the home office expense by an estimate of the rental cost of the space; however, the taxpayer did not obtain any professional appraisal. The court held that the allocation of house expenses by that method was not valid and allocated the expenses based on the number of rooms in the house. The court also held that the legal fees were not deductible because the fees were not incurred as part of a trade or business. Swain v. Comm'r, T.C. Memo. 1996-22.

**INVOLUNTARY CONVERSIONS.** The taxpayer had purchased property along a highway intersection and had planned a development of the land which included several commercial rental properties. The taxpayer was to provide management services for the tenants and to provide construction services for development of the site. The state highway department notified the taxpayer that it was expanding the highway intersection and would need to acquire a portion of the taxpayer's land. The highway department had condemnation powers but entered into negotiations with the taxpayer for purchase of the land needed for the intersection expansion. The taxpayer revised the original development plan to accommodate the smaller area involved. The plan provided for additional expenditures. The IRS cited Rev. Rul.67-254, 1967-2 C.B. 269 for the rule that replacement property could include additional expenditures on the remaining portion of partially condemned land if the additional expenditures were necessary to restore the property to the original usefulness. The IRS ruled that the land to be conveyed to the highway department was conveyed under threat of condemnation and that the additional expenditures made on the remaining property qualified as replacement property for purposes of the gain deferment provisions of I.R.C. § 1033. The IRS noted that the deferred gain was to be charged against the basis of the remaining property and that gain would be recognized to the extent the gain exceeded the basis of the remaining property. Ltr. Rul. 9603012, Oct. 18, 1995.

**MEAL EXPENSES.** The taxpayer owned and operated several manufacturing and office operations. The taxpayer provided onsite food facilities for its employees who were allowed 30 or 45 minute meal breaks. The employees were charged for the meals but at a cost less than the cost to the taxpayer. The major issue was whether the meals were furnished for a substantial noncompensatory business reason in order to qualify as provided for the convenience of the employer under I.R.C. § 119. The IRS ruled that (1) the shortened meal period was not required by any business need of the taxpayer and was required only to shorten the work day of employees; (2) the eating facilities were not required, since several commercial eating facilities were nearby; and (3) other taxpayer concerns, such as the availability of alcohol products at local restaurants and increased traffic in the area, were not sufficient business reasons for the shortened meal periods; therefore, the meals were not provided for a substantial noncompensatory...
business reason and the employees could not deduct the costs of the meals obtained at the taxpayer's facilities. Ltr. Rul. 9602001, Sept. 15, 1995.

LIFE INSURANCE. The IRS has announced that it will no longer issue letter rulings where life insurance is transferred to an unincorporated entity as to whether the entity is a partnership or whether the transfer is exempt from the transfer for value rules of I.R.C. § 101. Rev. Proc. 96-12, I.R.B. 1996-3.

PARTNERSHIPS-ALM § 7.03.*

LIMITED LIABILITY COMPANIES. The taxpayers converted a general partnership into a limited liability company (LLC). The IRS ruled that the LLC would be taxed as a partnership because (1) the LLC lacked the corporate characteristic of continuity of life since the state LLC law and the LLC agreement required the consent of all members to continue the partnership after a terminating event, and (2) the LLC lacked the corporate characteristic of transferability of interests because the Act and agreement provided that if any other member objected to the sale or assignment of a member's interest in the LLC, the transferee or assignee had no right to participate in the management of the LLC. The IRS also ruled that no gain was recognized from the conversion of the limited partnership to the LLC. Ltr. Rul. 9602018, Oct. 12, 1995.

PENSION PLANS. For plans beginning in December 1995, the weighted average is 7.09 percent with the permissible range of 6.38 to 7.73 percent (90 to 109 percent permissible range) and 6.38 to 7.80 percent (90 to 110 percent permissible range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). Notice 96-2.

The House has passed a bill limiting the states' authority to impose an income tax on any retirement income of an individual who is not a resident of the state. The Senate has passed similar bills. H.R. 394, 104th Cong., 1st Sess. 1996.

REFUNDS. The taxpayers had income taxes withheld from their wages in 1987 which exceeded their claimed tax liability for that year, but the taxpayers did not file an income tax return for 1987. On September 26, 1990, the IRS sent the taxpayers a notice of deficiency. The taxpayers responded by filing their 1987 tax return with a claim for a refund and a suit in the Tax Court for the payment of that refund. The court held that, because the taxpayers failed to file their return before the IRS filed a notice of deficiency, the Tax Court had no jurisdiction as to the refund claim for taxes paid more than two years before the deficiency notice was mailed. The court noted that the withheld taxes were deemed paid on the date the return was due for that taxable year, April 15, 1987. The court also noted that the three year limitation would have applied if the refund claim was brought in the District Court. Lundy v. Comm'r, 96-1 U.S. Tax Cas. (CCH) ¶ 50,035 (S. Ct. 1996).

RENT. The taxpayer owned a trucking business and entered into an agreement to lease a truck. The lease provided that, upon payment of all monthly payments, the taxpayer would be deemed to have exercised an option to purchase the truck without additional payments. The lease payments were equivalent to payments which would have been required by a conventional motor vehicle loan. The taxpayer received title to the truck and, as owner, registered the truck. The court held that the taxpayer could not deduct the rent payments because the transaction was actually a sale. In addition, the taxpayer realized gain from the sale of the truck when the taxpayer received insurance proceeds in excess of the taxpayer's basis in the truck. Tillman v. Comm'r, T.C. Memo. 1996-8.

The taxpayer used the owner's former residence as an office and storage area for a plumbing business. The taxpayer corporation claimed a deduction for the fair rental value of the residence. The court found that the IRS's appraisal expert was more believable than the taxpayer's and reduced the claimed deduction by almost one-half. Southern Boiler Sales & Service, Inc. v. Comm'r, T.C. Memo. 1996-13.

S CORPORATIONS-ALM § 7.02[3][c].* SHAREHOLDER'S BASIS. The taxpayer was the sole shareholder of an S corporation formed to purchase real estate. The taxpayer obtained an unsecured loan from a bank which was guaranteed by an unrelated third party. The loan proceeds were deposited into the corporation's bank account and the taxpayer withdrew amounts for personal and business expenses. The guaranty fee was paid by the corporation and the corporation made some payments on the loan. The taxpayer claimed that the loan was actually made by the taxpayer personally and the proceeds further loaned to the S corporation. The court held that the loan was made by the corporation and did not increase the taxpayer's basis in the corporation. Reser v. Comm'r, T.C. Memo. 1995-572.

SAFE HARBOR INTEREST RATES

<table>
<thead>
<tr>
<th>Month</th>
<th>Annual</th>
<th>Semi-annual</th>
<th>Quarterly</th>
<th>Monthly</th>
</tr>
</thead>
<tbody>
<tr>
<td>February</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AFR</td>
<td>5.32</td>
<td>5.25</td>
<td>5.22</td>
<td>5.19</td>
</tr>
<tr>
<td>110% AFR</td>
<td>5.86</td>
<td>5.78</td>
<td>5.74</td>
<td>5.71</td>
</tr>
<tr>
<td>120% AFR</td>
<td>6.40</td>
<td>6.30</td>
<td>6.25</td>
<td>6.22</td>
</tr>
<tr>
<td>Mid-term</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AFR</td>
<td>5.61</td>
<td>5.53</td>
<td>5.49</td>
<td>5.47</td>
</tr>
<tr>
<td>110% AFR</td>
<td>6.17</td>
<td>6.08</td>
<td>6.03</td>
<td>6.00</td>
</tr>
<tr>
<td>120% AFR</td>
<td>6.75</td>
<td>6.64</td>
<td>6.59</td>
<td>6.55</td>
</tr>
<tr>
<td>Long-term</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AFR</td>
<td>6.09</td>
<td>6.00</td>
<td>5.96</td>
<td>5.93</td>
</tr>
<tr>
<td>110% AFR</td>
<td>6.71</td>
<td>6.60</td>
<td>6.55</td>
<td>6.51</td>
</tr>
<tr>
<td>120% AFR</td>
<td>7.33</td>
<td>7.20</td>
<td>7.14</td>
<td>7.09</td>
</tr>
</tbody>
</table>

NEGLIGENCE

TRESPASSER. The plaintiff's decedent was injured when the decedent was riding a dirt bike on the defendant's farm land and struck a cable across an unpaved path. The decedent did not have premission to ride on the defendant's property. The defendant had posted the property with no trespassing signs and the cable had reflectors hanging on it. The path and cable were over 100 yards from the nearest highway. The court held that the defendant did not breach any duty to refrain from willfully or wantonly inflicting injury on a trespasser and affirmed a summary judgment for the defendant. Morrell v. Peed Bros., Inc., 462 S.E.2d 798 (Ga. Ct. App. 1995).
ZONING

HOG CONFINEMENT FACILITY. The defendants owned and operated a grain and livestock farm and constructed hog confinement buildings on the property in an area not zoned for such buildings. The defendants argued that Iowa Code § 335.2 exempted the facilities from zoning laws. The court held that the hog confinement operation was a part of the defendants' existing grain and livestock operation and qualified as an agricultural use exempt from zoning laws. The plaintiff county board of supervisors argued that Iowa Code § 172D.4(1) required that feedlots comply with zoning laws. The court held that a hog confinement facility was not a feedlot for purposes of Section 172D.4; therefore, the statute did not remove the agricultural use exemption and the confinement buildings were not subject to zoning requirements. Thompson v. Hancock County, 539 N.W.2d 181 (Iowa 1995).

ISSUE INDEX

Bankruptcy
General
   Estate property 18
   Exemptions
   Homestead 18
   Pre-petition conversions 19
   Revocation of discharge 19
Federal taxation
   Automatic stay 19
   Claims 19
   Discharge 19
   Dismissal 19
   Notice to IRS 19
Federal Agricultural Programs
   Brucellosis 20
   Marketing orders 20
   PACA 20
Federal Estate and Gift Tax
   Generation skipping transfers 20
   Gift 20
   Life insurance 21
   Marital deduction 21
   Power of attorney 21
   Returns 21
   Transfers with retained interests 21
Federal Income Taxation
   Conservation easement 21
   Court awards and settlements 21
   Employee benefits 22
   Environmental cleanup costs 22
   Gross income 22
   Hobby losses 22
   Home office 22
   Meal expenses 22
Life insurance 23
Partnerships
   Limited liability companies 23
   Pension plans 23
   Refunds 23
   Rent 23
   S Corporations
   Shareholder's basis 23
   Safe harbor interest rates
   February 1996 23
Negligence
   Trespasser 23
Zoning
   Hog confinement facility 24
Since the mid 1980s, the problem of income tax liability on discharge of indebtedness has taken on added significance. The focus on discharge of indebtedness has been partly because of the farm debt crisis of the mid 1980s, partly because of the savings and loan problems beginning the same decade and partly because of the widespread decline in real estate values since the late 1980s.

To assure that the Internal Revenue Service learns of debt discharge in a timely manner, Congress has required lenders to report debt discharge to IRS. A new set of final regulations has added considerable detail to the reporting requirements. It is important to note that the new regulations are effective only for discharges of debt after December 21, 1996. Until that time, the temporary regulations and the interim relief from penalties continue to apply.

**Reporting discharge of debt**

Under the statute, a financial entity that discharges $600 or more of indebtedness is required to report the discharge to the Internal Revenue Service. The information is filed on Form 1099-C with the Internal Revenue Service. Five items of information are to be provided — (1) the name, address and taxpayer identification number of each person for which there was an "identifiable event" during the calendar year; (2) the date on which the "identifiable event" occurred; (3) the amount of the discharged debt; (4) whether the "identifiable event" was a discharge of indebtedness in bankruptcy; and (5) other information required by the Form 1099-C or revenue procedures. Aggregation of multiple debt discharges of less than $600 generally is not required.

The regulations point out that the discharged indebtedness must be reported regardless of whether the debtor is subject to tax on the discharged debt. In general, discharge of indebtedness is treated as ordinary income to the debtor. However, there are special relief provisions for debtors in bankruptcy, insolvent debtors not in bankruptcy, holders of real property business debt, solvent farm debtors and those who negotiate a purchase price adjustment involving the reduction of purchase money debt.

Financial entities are also required to report to the debtor. That can be done by copy B of the Form 1099-C to the debtor.

**When debt is discharged**

Under the regulations, debt is considered discharged on the date on which an "identifiable event" occurs. Debt is considered discharged only if the following events occur —

- Debt is discharged in bankruptcy.
- Debt cancellation occurs as a result of a foreclosure or "similar proceeding,"
- The statute of limitations has run on the claim or on commencing a deficiency judgment claim.
- Debt cancellation has occurred under a creditor's election of foreclosure remedies.
- The debt becomes unenforceable as a result of a probate or "similar proceeding,"
- An agreement has been entered into between the financial entity and the debtor to discharge the debt at less than full consideration.
- The creditor made the decision to discontinue collection activity.
- The "nonpayment testing period" has expired. That is the period ending 36 months after the last payment received plus the months the creditor was precluded from engaging in any collection activity such as by the automatic stay in bankruptcy. There is a rebuttable presumption that the nonpayment testing period has expired if those conditions are met. However, the presumption may be rebutted if the creditor or a collection agency has engaged in "significant, bona fide collection activity at any time during the 12-month period ending at the close of the calendar year."
- The term "significant, bona fide collection activity" does not include nominal actions such as automated filings. The presumption can also be rebutted if facts and circumstances existing as of January 31 of the calendar year following expiration of the 36-month period indicate that the indebtedness has not been discharged. This can be shown through the existence of a lien or the sale or packaging for sale of the indebtedness by the creditor.

It is important to note that a guarantor is not considered a debtor for purposes of the reporting requirements. That is the case whether or not there has been a default and demand for payment made on the guarantor.
Reporting by secured lenders

Under another provision, secured lenders who acquire an interest in the property in full or partial satisfaction of the debt (or have reason to know the property was abandoned) are required to file a Form 1099-A with IRS and furnish a statement to the debtor. If the borrower is personally liable for repayment of the debt, the Form 1099-A is to state the fair market value of the property at the time the interest is acquired. In the absence of clear and convincing evidence to the contrary, the proceeds of sale on foreclosure, execution or other sale are considered to be the fair market value of the property.

The 1995 regulations make it clear that a financial entity is not required to file both a Form 1099-A and a Form 1099-C (showing discharge of indebtedness) for the same debtor. The filing requirements for secured lenders are satisfied if, in lieu of filing a Form 1099-A, a Form 1099-C is filed.

In conclusion

The new regulations, while effective only for discharges after December 21, 1996, will bring substantially greater certainty to this area. The facts and circumstances approach (with three identifiable events) of the temporary regulations left a substantial burden on creditors to ascertain when discharge had occurred. Under the final regulations, the list of eight identifiable events is an exclusive list.

FOOTNOTES

3 I.R.C. §§ 6050J, 6050P.
5 Treas. Reg. § 1.6050P-1(h).
8 I.R.C. § 6050P.
9 Treas. Reg. § 1.6050P-1(a)(1).
10 Id..

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

FEDERAL TAXATION-ALM § 13.03[7].

CLAIMS. Although the IRS was sent a notice of the claims bar date, the IRS failed to file a claim in the case until 21 months after the bar date due to a mistake by an IRS agent. The IRS filed a request to file the late claim based on excusable neglect. The court allowed the claim because the wording of the notice was not completely clear and because the claim was filed before the plan was confirmed. Matter of Papp International, Inc., 189 B.R. 939 (Bankr. D. Neb. 1995).

DISCHARGE. The debtors had timely filed their tax returns for 1990. In October 1991, the debtors filed for Chapter 13 and the case continued for 169 days until it was dismissed in April 1992. In September 1993, the IRS assessed the debtors for unpaid taxes for 1990. The assessment occurred more than 240 days before the instant bankruptcy case was filed. The IRS argued that, under Section 108(c) and I.R.C. § 6503(h), the intervening Chapter 13 case tolled the provisions in Sections 507(a)(8) and 523(a)(8)(B) which provide that taxes due more than three years prior to the bankruptcy filing were dischargeable. The court held that I.R.C. § 108(c) and I.R.C. § 6503(h) apply only to nonbankruptcy law limitation periods and that the 1990 taxes were dischargeable. In re Gore, 96-1 U.S. Tax Cas. (CCH) ¶ 50,069 (Bankr. N.D. Ala. 1995).

CONTRACTS

EXCUSE. The defendant was a grain farm partnership which contracted with the the plaintiff to sell 300,000

* Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.
bushels of corn to the plaintiff. A hail storm destroyed most of the defendant's corn crop such that the defendant was able to ship only 70,000 bushels. The parties attempted negotiations for the remainder of the contract amount but did not reach any settlement. The defendant purchased some corn on the market and resold it to the plaintiff under the contract and eventually failed to supply the entire contract amount. The plaintiff sued for damages resulting from its purchase of the remaining amount from other sources at a price higher than the contract price. The defendant argued that the contract was limited to corn grown by the defendant and that the hail storm excused performance of the contract. The court found that the contract contained no language restricting the source of the corn except that the corn be grown in the continental United States. Therefore, the court held that the source of the corn was not an essential element of the contract and the defendant was liable for the full 300,000 bushels. ConAgra, Inc. v. Bartlett Partnership, 540 N.W.2d 333 (Neb. 1995).

REJECTION. The plaintiff was a potato grower who contracted with the defendant, a manufacturer of potato chips, for the sale of chipping potatoes to the defendant. The contract required that the potatoes produce chips with at least #1 or #2 color on the 1978 Snack Food Association "Fry Color Chart." The plaintiff sent samples to the defendant who rejected the potatoes because the resulting chips did not meet the color standard. Several more loads were sent and each was rejected for the same reason. The color determination was made by the defendant's employees based on a visual inspection. The plaintiff had some potatoes tested with an Agtron machine, a photo electric refraction tester, and some of the potatoes tested within the #2 range but some did not. The court found that the use of visual testing was the norm for the industry at the time of the contract; therefore, the failure of the defendant to use the Agtron machine for testing was not a breach of the contract. The court held that the failure of the potatoes to meet the color requirement expressly included in the contract was a substantial impairment of the contract and justified the defendant's refusal to accept any of the plaintiff's potatoes. Hubbard v. UTZ Quality Foods, Inc., 903 F. Supp. 444 (W.D. N.Y. 1995).

ENVIRONMENTAL LAW

DAIRY FARM. The petitioner began construction of a factory dairy farm and at the first inspection by the Ohio Environmental Protection Agency (OEPA), the petitioner had stated that the farm would have over four thousand cows. The OEPA sent a letter to the petitioner requiring a permit for the construction of waste treatment facilities at the farm. The petitioner refused to comply with the request, arguing that it had reduced the number of anticipated cows to 400 and was eligible for the small farm exception to the permit requirement. However, the petitioner did not decrease the size of the facilities, including the waste treatment facilities. The state Environmental Board of Review (EBR) held a hearing and issued an order denying the exception and requiring the petitioner to obtain a permit. The court held that the exception applied only if the petitioner's facilities could support a maximum of less than 1000 "animal units" (with one cow equaling 1.4 animal units). The court found that the EBR's decision failed to identify the facts which supported its decision. The EBR decision was found to merely restate the evidence presented which was often contradictory as to whether the facility would support more than 714 cows. The EBR decision was reversed and remanded for specific findings of fact as to whether the petitioner's facility would support more than 714 cows. Red Hill Farm Trust v. Schregardus, 656 N.E.2d 1010 (Ohio App. 1995).

FEDERAL AGRICULTURAL PROGRAMS

GRAZING PERMITS. The defendants had obtained a permit to graze cattle on national forest land. A portion of the land was burned in a forest fire and the Forest Service prohibited any grazing on the burned portion until reseeding could be accomplished. The defendants complied for one year but began grazing the second year in violation of the Forest Service's order. The Forest Service revoked the defendants' permit and, after the defendants continued to graze cattle on the land, assessed the defendants for unauthorized grazing on the land. The defendants argued that the federal government did not own the land because the land was transferred to Nevada, under the "equal footing doctrine," when Nevada became a state. The court held that the "equal footing doctrine" did not apply to land within federally owned land in the state but referred to political equality with the other states. The court also rejected the defendants' argument that the years of grazing permits created a vested right to graze on the land. Finally, the court rejected any "necessity" defense because the defendants failed to show that the grazing was necessary to protect themselves or their cattle. United States v. Gardner, 903 F. Supp. 1394 (D. Nev. 1995).

MEAT INSPECTION. The AMS has adopted as final regulations removing the "B" maturity (30-42 months of age) carcasses with slight or small marbling degrees from the Choice and Select grades and moving them to the Standard grade. 61 Fed. Reg. 2891 (Jan. 30, 1996).

FEDERAL ESTATE AND GIFT TAX

LOANS WITH BELOW MARKET INTEREST RATES-ALM § 6.01[1][a]. * Certiorari has been requested in the U.S. Supreme Court in the following case. In 1980, the taxpayers transferred stock to trusts for the taxpayers' children in exchange for promissory notes with 6 percent interest. In 1981, the taxpayers made loans to two of the trusts with no interest charged. The IRS considered the first transactions as gifts to the extent the interest rate was less than 11.5 percent and the second transactions as gifts to the extent the interest rate was less than 12 percent in 1981, 10.6 in 1982 and 8.6 percent in 1983. The taxpayers argued that the test rate for both transactions was the 6 percent safe harbor rate of I.R.C. § 483. The trial and appellate courts agreed with the holding of Krabbenhoft v. Comm'r, 939 F.2d 529 (8th Cir. 1991) and held that I.R.C. § 483 applies to the entire tax code but did not apply to valuation of gifts with interest rates below the market rate. As to the second transaction, the taxpayers argued that the IRS's retroactive
application of News Release 84-60 for gifts made before 1984 was improper. The District Court cited Cohen v. Comm'r, 910 F.2d 422 (7th Cir. 1990) in support of its holding that the retroactive application of the 1984 method of valuing gifts made before 1984 was proper in that the method was consistent with the valuation rules passed by Congress for gifts after 1984. Schusterman v. U.S., 63 F.3d 986 (10th Cir. 1995), aff'd, 94-1 U.S. Tax Cas. (CCH) ¶ 60,161 (N.D. Okla. 1994).

MARITAL DEDUCTION-ALM § 5.04[3]. The taxpayer transferred stock in a closely-held corporation to a spouse, subject to a buy-sell agreement. Under the agreement, the taxpayer and the corporation had a right of first refusal to repurchase the shares at fair market value if (1) the spouse decided to sell the shares, (2) the taxpayer and spouse divorced, or (3) the spouse died and did not will the stock to the taxpayer. The IRS ruled that the transfer of stock to the spouse qualified for the federal gift tax marital deduction. Ltr. Rul. 9606008, Nov. 9, 1995.

VALUATION. The taxpayers, husband and wife, each established several grantor-retained annuity trusts funded with corporate stock. The annuities required quarterly payments of income; however, the stock had a history of no dividends and the taxpayers anticipated that this would continue through the term of the annuities. Therefore, the annuities provided that the taxpayers would loan cash to the annuities sufficient to make the required payments. The loans charged no interest so long as the trusts were grantor trusts. The IRS ruled that the taxpayers' retained interests were not qualified retained annuity interests because no amounts were payable from the trusts and the taxpayers' retained interests in the trust were not capable of valuation because of the loan provisions. Ltr. Rul. 9604005, Oct. 176, 1995.

The decedent had owned 50 percent of a trust which owned two parcels of rural land zoned as residential. The issue in the case was the highest and best use of the land for purposes of determining the fair market value of the parcels. The estate argued that the highest and best use of the land was for residential purposes because the land was zoned residential and any attempt to rezone the land for commercial purposes would be difficult. The court held that the evidence demonstrated that development from the nearby town toward the parcels was commercial and that a rezoning could be easily obtained; therefore, the fair market value would be determined on the basis of the commercial use value of the property. Estate of Lloyd v. Comm'r, T.C. Memo. 1996-30.

The taxpayers, husband and wife, owned residential property with equal undivided community property interests. The taxpayers each transferred their own interest in the property to separate 15 year trusts. The trusts provided that if the grantor died before the end of 15 years, the trust terminated and the assets reverted to the grantor's estate. The will of each grantor passed the revested interest to the surviving spouse. If the residence ceased to be the personal residence of the grantor, the trust was to be converted to an annuity trust. The IRS ruled that (1) the residence qualified as a personal residence under Treas. Reg. § 25.2702-5(c)(2); (2) the trusts were qualified personal residence trusts which qualified for the exception of I.R.C. § 2702(a)(3)(A)(ii) to the special valuation rules of I.R.C. § 2702(a)(2); and (3) because the value of each grantor's retained interest exceeded 5 percent of the value of the trust property, each grantor was considered the owner of the trust and would include trust income, deductions and credits against tax attributable to the trust under I.R.C. § 671. Ltr. Rul. 9606003, Nov. 7, 1995.

FEDERAL INCOME TAXATION

BAD DEBTS. The taxpayer was a 50 percent owner of a corporation in which the taxpayer served as employee, treasurer, and vice-president. The debtor performed engineering and accounting services for the corporation's business. The taxpayer's salary was $30,000 per year. The taxpayer loaned more than $600,000 to the corporation over several years in order to offset the corporation's difficulties with receiving payments from customers, some of which were other entities owned by the taxpayer. When several of the corporation's customers filed for bankruptcy, the taxpayer claimed the debt to the corporation as a business bad debt deduction, arguing that the loans were made to protect the taxpayer's employment with the corporation. The court held that the taxpayer's loans to the corporation were made with the intent to protect the taxpayer's investment in the corporation because the amount of the loans greatly exceeded the taxpayer's salary and the loans also protected the taxpayer's investments in the corporations which were served by the corporation receiving the loans. In re Mills, 189 B.R. 707 (Bankr. W.D. Tenn. 1995).

C CORPORATIONS

ACCOUNTING METHOD. A C corporation was a debtor in bankruptcy. The debtor had consistently used the cash method of accounting and the IRS used that method of accounting to determine its tax claims filed in the case. The bankruptcy trustee argued that under I.R.C. § 448, the debtor was required to use the accrual method of accounting; therefore, the federal tax claim should have been calculated using the accrual method of accounting. The court held that under I.R.C. § 448, an unauthorized method of accounting may be allowed if, in the opinion of the Commissioner, income is clearly reflected by the use of the method. In this case, the IRS agent testified that the cash method of accounting did clearly reflect the actual income of the corporation; therefore, the court held that the tax claim could be determined under the cash method of accounting. Morrissey v. IRS, 189 B.R. 821 (W.D. Okla. 1995).

COURT AWARDS AND SETTLEMENTS. When the taxpayer's employment was terminated, the taxpayer signed an agreement which contained provisions prohibiting the taxpayer from suing the employer for claims related to the employment termination, including claims arising under the Age Discrimination in Employment Act of 1967. The taxpayer received a lump sum payment representing 49 weeks of wages. The taxpayer excluded the payment from income, arguing that the payment was received in settlement of tort-like claims. The court held that the

**DEPRECIATION-ALM § 4.03[4].* **The taxpayer operated several businesses, including a law practice and several farms, which were operated by several corporations or by the taxpayer as sole proprietor. Although the taxpayer did not provide any direct evidence of the basis of a pickup truck used in one of the farms and for the law practice, the court determined that some basis did exist from the evidence that the taxpayer paid interest on a loan used to purchase the truck. The taxpayer was not allowed depreciation deductions for a tractor and other farm implements used on another farm because no evidence was presented that the taxpayer owned these items or that they were used in the taxpayer's sole proprietorship businesses and not in the businesses operated by the corporations. *Hall v. Comm'r*, T.C. Memo. 1996-27.

The IRS has issued tables, revised for inflation, detailing the limitation on depreciation deductions for automobiles first placed in service during 1996:

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

The IRS also issued tables providing the amounts to be included in income for automobiles first leased during 1996. *Rev. Proc. 96-25."

**EMPLOYEE BENEFITS.** The taxpayer was an officer and 51 percent shareholder of one corporation and 98 percent shareholder of a subsidiary corporation. The subsidiary purchased two paid-up life insurance policies on the life of the taxpayer. The policies were issued to a trust as owner and the trust entered into a split-dollar agreement with the subsidiary under which the trust agreed to repay the premium amounts paid by the subsidiary. The agreement was to terminate if (1) the subsidiary ceased to operate or filed for bankruptcy, (2) the taxpayer's employment terminated, or (3) the trust or taxpayer requested termination of the agreement. If the agreement terminated prior to the death of the taxpayer, the subsidiary would still receive reimbursement for premiums paid from the cash surrender value of the policy. The IRS ruled that *Rev. Rul. 64-328, 1964-2 C.B. 11* and *Rev. Rul. 66-110, 1966-1 C.B. 12* applied to require that the taxpayer must include in income the value of the cost-free insurance provided by the agreement plus any increase in the cash surrender value which exceeded the premiums paid by the subsidiary. For determining the value of the cost-free insurance to the taxpayer, the IRS referred the taxpayer to *Rev. Rul. 55-747, 1955-2 C.B. 228* and *Rev. Rul. 67-154, 1967-1 C.B. 11*. *Ltr. Rul. 9604001, Sept 8, 1995*.

**EXCISE TAX ON TRUCKS.** The taxpayer manufactured a semitrailer truck which was capable of loading and transporting round and square bales of hay. Although the vehicle was capable of traveling on highways at highway speeds, the vehicle could not be operated at night on highways and required special length, width and weight permits for most highway travel. The IRS ruled that (1) for purposes of Treas. Reg. § 48.4061(a)-1(d)(2)(ii)(A), the semitrailer was specially designed for the primary function of transporting hay other than over the highway; (2) the permits needed to use the vehicle loaded on the highway substantially impaired the vehicle's usage on highways for purposes of Treas. Reg. § 48.4061(a)-1(d)(2)(ii)(B); and (3) the vehicle came within the exception to the definition of highway vehicle under Treas. Reg. § 48.4061(a)-1(d)(2)(ii) and was not subject to the tax of I.R.C. § 4051(a)(1). *Ltr. Rul. 9605007, Nov. 3, 1995*.

**FALSE RETURNS.** The taxpayer had lost two farms to foreclosure. In an attempt to strike back at persons and entities which the taxpayer held responsible for the foreclosures, the taxpayer sent fictitious bills for rent to these parties. The taxpayer claimed the billed amounts as income and claimed withheld taxes from the bills. The taxpayer filed for income tax refunds based on the fictitious income and withheld taxes. The taxpayer was convicted of willfully filing false returns. The taxpayer appealed the conviction on the basis that the jury instruction regarding willfulness was erroneous in that it allowed the jury to consider the reasonableness of the taxpayer's belief that the taxes and deductions claimed were legitimate. The court held that the jury could consider the reasonableness of the taxpayer's beliefs in determining whether the beliefs were held in good faith. *United States v. Hilgerford, 96-1 U.S. Tax Cas. (CCH) § 50,068 (7th Cir. 1996)*.

**HOBBY LOSSES.** The taxpayer was a plastic surgeon employed by a corporation wholly-owned by the taxpayer. The taxpayer claimed that the taxpayer purchased farmland and horses to be trained as polo ponies with the intent to attract potential patients for the plastic surgery practice. The farmland, horses and equipment were purchased with the taxpayer's own funds and the taxpayer failed to produce any evidence that the polo pony business did attract any patients for the plastic surgery business. The court held that the two businesses could not be combined for purposes of determining the profitability of the horse farm. The court then examined the nine factors of Treas. Reg. § 1.183-2(b) to determine whether the horse farm was operated with the intent to make a profit. The court found that (1) the taxpayer did not keep adequate records or create a plan to make the operation profitable, (2) the taxpayer did not have sufficient expertise for operating a profitable polo pony training operation, (3) the taxpayer did not have a reasonable expectation of eventual profit from appreciation, (4) the farm had an extensive history of continuing and increasing losses, (5) the taxpayer had substantial income from the plastic surgery business, and (6) the taxpayer used the farm for primarily recreational purposes as part of the taxpayer's interest in playing polo. The court held that the polo pony farm activity was not entered into with the intent to make a profit and disallowed deductions in excess of income from the activity. *Wilkinson v. Comm'r*, T.C. Memo. 1996-39.

The taxpayer was employed fulltime as a veterinarian. The taxpayer purchased a farm and raised cattle for several years, but during the tax years in question, no farming or ranching operations occurred on the farm. However, oil was discovered on the property and the taxpayer entered into a royalty agreement with an oil production company which paid the taxpayer a royalty free of all production expenses. The taxpayer hired a manager who lived on the farm and
maintained the property but the manager performed no activities which affected the oil production. The taxpayers claimed the farm expenses against the oil income. The court held that because no farming operations were conducted on the farm, the expenses incurred by the taxpayer were not ordinary and necessary business expenses and were disallowed. The court also held that the expenses were unrelated to the oil production since the income received from the oil was free of production expense to the taxpayer and none of the manager's activities were related to the oil production. The taxpayer argued that deductions should have been allowed to the extent of the appreciation in the value of the farm. The court held that, under Treas. Reg. § 1.183-1(d)(1), a farming activity can be combined with holding land for investment only if the net farm income was sufficient to reduce the cost of retaining the land. Because the taxpayer only had net losses, farm expenses could not be claimed as an expense based on appreciation of the land. The taxpayer also purchased another farm which was used for a variety of farm and ranch operations, most of which ended with the taxpayer donating the livestock to a charitable organization. The taxpayer did not keep separate records for the farm nor did the taxpayer make any plan to determine the profitability of the various activities. The taxpayer formed an S corporation to operate that farm. The taxpayer did not have any expertise in the types of livestock operations attempted and did not seek expert advice. The taxpayer argued that because the Tax Court had not found any element of recreation or pleasure from the taxpayer's operation of the second farm, the farm must have been either a business or other profit-seeking activity. The court held that the recreation or pleasure element was only one of nine factors involved and held that on the basis of the other factors, the Tax Court's holding that the second farm was not operated with the intent to make a profit was not clearly erroneous. Westbrook v. Comm'r, 68 F.3d 868 (5th Cir. 1995).

PARTNERSHIPS-ALM § 7.03.*

CONTRIBUTIONS. A limited partnership was composed of an individual 99 percent limited partner and an S corporation as 1 percent general partner. The shareholders of the corporation were all siblings and the individual limited partner was a parent of the shareholders. The shareholders contributed identical portfolios of cash and marketable securities to the corporation which contributed a portion of the assets to the partnership. The portfolios satisfied the diversification standard of I.R.C. § 368(a)(2)(F)(ii). The limited partner also contributed stock and securities to the partnership sufficient to maintain the respective interests in the partnership as before the contributions. The limited partner's contributed portfolio did not satisfy the diversification standard of I.R.C. § 368(a)(2)(F)(ii). The IRS ruled that the transfers of the corporation and limited partner were not transfers to an investment company under I.R.C. § 351(e)(1) if the partnership was incorporated; therefore, no gain or loss would be recognized from the transfers. Ltr. Rul. 9606007, Nov. 9, 1995.

PENSION PLANS. The taxpayer received a check from a former employer's profit-sharing retirement plan almost two years after termination of employment. The taxpayer did not know about or contribute to the plan. The taxpayer deposited the check into the taxpayer's bank account and several months later sent a check for part of the amount back to the former employer, apparently as a belated investment in the plan. The court held that the distribution check was all included in the taxpayer's income because the taxpayer did not make any contribution to the plan before the distribution and did not roll over the distribution to a qualified retirement plan. Silver v. Comm'r, T.C. Memo. 1996-42.

For plans beginning in January 1996, the weighted average is 7.05 percent with the permissible range of 6.35 to 7.62 percent (90 to 109 percent permissible range) and 6.35 to 7.76 percent (90 to 110 percent permissible range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). Notice 96-9, I.R.B. 1996-6, 26. Note: The IRS has issued two notices numbered as 96-9.

S CORPORATIONS-ALM § 7.02[3][c].*

ADMINISTRATIVE ADJUSTMENTS. The petitioner was a shareholder of a dissolved S corporation. The corporation had designated another shareholder as the tax matters person for several years. The tax matters person signed an extension of time for the IRS to file a Notice Final S Corporation Administrative Adjustment as to the corporation. Prior to the signing, no other person had been designated as tax matters person, the tax matters person had not resigned, nor had the corporation revoked the tax matters person's designation. Therefore, the court held that the tax matters person was authorized to sign the extension. The decision has been designated as not for publication. Praxiteles, Inc. v. Comm'r, 96-1 U.S. Tax Cas. (CCH) ¶ 50,049 (9th Cir. 1996).

WITHHOLDING TAXES. The IRS has issued proposed regulations relating to when amounts deferred under or paid from certain nonqualified deferred compensation plans are taken into account as wages for purposes of the employment taxes imposed by FICA and FUTA. 61 Fed. Reg. 2194 (Jan. 25, 1996).

NEGLIGENCE

HERBICIDES. The plaintiffs were cotton growers whose cotton fields were damaged from the drifting on to their land of herbicides aerially sprayed on neighboring land. The plaintiffs included as defendants in their suit for damages the sellers of the herbicides to the aerial sprayer and the owners of the sprayed properties. The plaintiffs claimed liability of the sellers rested on negligence per se because the sellers sold the herbicides to an unlicensed applicator in violation of law. The court held that no statute or administrative regulation prohibited the selling of registered herbicides to unlicensed applicators. The administrative regulations did require the sellers to report all sales of herbicides and the report forms did have a space for the license number of the purchaser, but the regulations did not prohibit the sales if no license number was provided. The court also held that even if the sale to an unlicensed applicator was prohibited and the sale of the herbicide was negligence per se, the sale of the herbicide was not a direct cause of the damage to the plaintiffs' cotton crops; therefore, the sellers were not liable for the damage. The
plaintiffs also alleged that one seller violated federal law, 7 U.S.C. § 136j(a)(2)(F), (G), in that the seller did not "use" the federally registered herbicide in compliance with the label instructions when the seller sold the herbicide to an unlicensed applicator. The court held that the seller did not violate federal law in that (1) the sale of a herbicide was not a "use" of the herbicide and (2) the label allowed the sale of the herbicide to "commercial agricultural personnel" and did not restrict the sale only to licensed herbicide applicators. Ward v. Northeast Texas Farmers Co-op. Elev., 909 S.W.2d 143 (Tex. App. 1995).

PROPERTY

FENCES. The plaintiff owned land at the edge of a city and the defendant owned neighboring land just outside the city limits such that the property line between the two properties was the city limits. The defendant raised miniature horses on the property. The defendant requested the rural township trustees to mediate a dispute as to who should maintain the fence. The fence viewers ruled that each party would be required to maintain about half of the fence. The plaintiff appealed to the District Court which held that the application of Iowa Code Chapter 359A was unconstitutional in that the plaintiff received no benefit from the fence because the plaintiff did not use the property for raising livestock and because the defendant received a benefit unrelated to any governmental interest. The appellate court reversed, holding that a disparity between the benefits received by landowners separated by a mutual fence was not sufficient to make the fence law unconstitutional. In addition, the court held that the plaintiff failed to demonstrate that maintaining a portion of the fence was unduly oppressive which would amount to an unconstitutional exercise of governmental authority. The plaintiff also argued that the "home rule" statute, Iowa Code § 364.1, preempted the fence statute and applied here because the plaintiff lived within the city limits. The court held that the "home rule" law could not be applied where it conflicted with other law. Gravert v. Nebergall, 539 N.W.2d 184 (Iowa 1995).

HUNTERS. The defendant was a manager of a farm. The defendant confronted a party of hunters who were on a section line on the farm property. The hunters claimed that the defendant took pictures and drove a vehicle around them in an effort to prevent their successful hunting in the area. The defendant was convicted, under S.D. Cod. Laws § 41-9-8, of intentionally interfering with lawful hunting. The defendant argued that the hunters were not lawfully hunting, under S.D. Cod. Laws § 41-9-1.1. In order to get to the hunting area, the hunters traveled along a section line which, by statute, is a public highway unless vacated or abandoned. There was no evidence that the section line highway was vacated or abandoned in this case. However, lawful hunting can occur on a section line without the approval of the adjoining property owner only if the section line was improved for vehicular travel or was commonly used by the public for vehicular travel. In this case, a farm path created by the defendant's machinery was the only "improvement" to the section line and the hunters had to leave their vehicles because of marshy land in order to reach the hunting area. The court held that the farm path was not an improvement for vehicular travel; therefore, the hunters were not lawfully hunting and the defendant could not be convicted of interfering with lawful hunting. State v. Tracy, 539 N.W.2d 327 (S.D. 1995).

SECURED TRANSACTIONS

OWNERSHIP. The plaintiff claimed ownership of a farm tractor in which the defendant claimed a security interest through a security agreement covering farm equipment owned by the plaintiff's son. The tractor was purchased by the plaintiff using a tractor owned by the plaintiff's son as downpayment. The tractor was delivered to the son and the son gave the plaintiff a promissory note for part of the purchase price. The plaintiff paid for about half of the cost of the tractor. The son did pay off the note, claimed the tractor as a personal asset on financial statements, and claimed the depreciation deductions on federal income tax returns. The jury ruled for the plaintiff and the trial court denied a motion by the defendant for judgment notwithstanding the verdict. The lower appellate court held that the plaintiff did not retain any ownership interest in the tractor and did not perfect any purchase money security interest in the tractor by filing or possession; therefore, the tractor was owned by the son and was subject to the defendant's security interest. Therefore, a denial of the defendant's motion was improper. The Nebraska Supreme Court reversed, holding that there remained an issue of fact as to whether the plaintiff had given title to the tractor to the son; therefore, the denial of the motion was proper. Melcher v. Bank of Madison, 539 N.W.2d 837 (Neb. 1995), rev'd, 529 N.W.2d 814 (Neb. Ct. App. 1995).

REPOSSESSION. The debtor had granted a security interest in the debtor's registered shorthorn cattle to a creditor. The debtor defaulted on the loan secured by the cattle and after some delay while the debtor sought other financing, the creditor repossessed the cattle without notice to the debtor, as allowed by the security agreement. The creditor placed the cattle under the care of other ranchers while the creditor sought foreclosure. The debtor alleged that the repossession was improper and that the creditor failed to properly care for the cattle after repossession. The evidence showed that the caretakers failed to properly feed the cattle and breed the cattle indiscriminately, without preserving or recording the lineage of the calves born after the repossession. The court held that the repossession was improper because the lack of notice was allowed by the security agreement, the creditor did give the debtor time to cure the default, and no evidence was presented that the creditor repossessed the cattle with any intent to harm the debtor. The court also held that the debtor suffered damages to the value of the cattle and calves from the creditor's failure to properly feed and breed the cattle during its possession of the cattle. The court recognized the special value and needs of registered cattle and allowed the debtor an offset for damage to the cattle and calves against the creditor's claim. In re Krug, 189 B.R. 948 (Bankr. D. Kan. 1995).
STATE TAXATION

AGRICULTURAL USE. The taxpayer owned 11.75 acres in the city of Eagan which were unoccupied and dormant from 1960 through March 1993. In January 1993, the land was classified as industrial land. In April 1993, the taxpayer cash leased the land to a farmer who planted and harvested vegetables. Under Minn. Stat. § 273.111, the green acre statute, land may be eligible for special valuation and tax deferment if the land is agricultural land, meaning a "contiguous acreage of ten acres of more, primarily used during the preceding year for agricultural purposes." The court held that because the land was dormant in 1992, the land did not qualify for the green acres status in 1993. A footnote states that the county assessor did allow green acre status for the land in 1994.

McLean v. County of Dakota, 540 N.W.2d 76 (Minn. 1995).

CITATION UPDATES

Est. of Kurz v. Comm’r, 68 F.3d 1028 (7th Cir. 1995), aff’g, 101 T.C. 44 (1993) (power of appointment)
see Vol. 6, p. 182.


AGRICULTURAL LAW MANUAL

by Neil E. Harl

This comprehensive, annotated looseleaf manual is an ideal deskbook for attorneys, tax consultants, lenders and other professionals who advise agricultural clients. The book contains over 900 pages and an index.

As a special offer to Digest subscribers, the Manual is offered to new subscribers at $115, including at no extra charge updates published within five months after purchase. Updates are published every four months to keep the Manual current with the latest developments. After the first free update, additional updates will be billed at $100 per year or $35 each.

For your copy, send a check for $115 to Agricultural Law Press, P.O. Box 50703, Eugene, OR 97405.

Satisfaction guaranteed. 30 day return privilege.

ISSUE INDEX

Bankruptcy
Federal taxation
Claims 26
Discharge 26

Contracts
Excuse 26
Rejection 27

Environmental Law
Dairy farms 27

Federal Agricultural Programs
Grazing permits 27
Meat inspection 27

Federal Estate and Gift Tax
Loans with below market interest rates 27
Marital deduction 28
Valuation 28

Federal Income Taxation
Bad debts 28
C corporations
Accounting method 28
Court awards and settlements 28
Depreciation 29
Employee benefits 29
Excise tax on trucks 29
False returns 29
Hobby losses 29
Partnerships
Contributions 30
Pension plans 30
S corporations
Administrative adjustments 30
Withholding taxes 30

Negligence
Herbicides 30

Property
Fences 31
Hunters 31

Secured Transactions
Ownership 31
Repossession 31

State Taxation
Agricultural use 31
IS INTEREST ON TAXES DEDUCTIBLE?

— by Neil E. Harl

For months, the debate has raged over the question of whether interest on federal income taxes attributable to a business is deductible for federal income tax purposes.1 Much of the debate has focused on a North Dakota farm case2 although the Tax Court in early 1996 decided a case on the issue.3

Background

Before enactment of a different statutory provision in 1986, interest on tax deficiencies attributable to business income was deductible as an ordinary and necessary business expense.4 However, in the Tax Reform Act of 1986, Congress acted to prohibit a deduction for personal interest (except on a phase-out basis).5 The statute prohibiting a deduction for personal interest6 contained several exceptions, one of which was for "interest paid or accrued on indebtedness properly allocable to a trade or business....."7 The conference committee report8 and the General Explanation of the Tax Reform Act of 19869 (the "Blue Book") both took the position that personal interest included interest on tax deficiencies with the Blue Book stating specifically that interest on taxes is considered personal interest even though the taxes may have arisen in a trade or business.10

The temporary Regulations, issued in late 1987,11 provided that — "...personal interest includes interest...paid on underpayments of individual Federal, State or local income taxes and on indebtedness used to pay such taxes...regardless of the source of the income generating the tax liability...."12

At that point, it appeared that interest on unpaid taxes would not be deductible even if attributable to business income.

Miller I

In the first case to consider the issue, Miller v. United States,13 the U.S. District Court held the temporary regulation invalid and allowed a deduction for $367,332 in interest expense on the taxpayers’ state and federal income tax returns.14 The deficiency was related to their Schedule F. The court granted the government a 90 day continuance to complete discovery on the issue of whether the claimed interest deduction was "ordinary and necessary."15

Miller II

After the discovery under the granted continuance, the government took the position that the claimed interest deduction was not an ordinary and necessary business expense.16 The second round of hearings produced more facts about the nature of the transaction that produced the deficiency. The taxpayers had established a fiscal year farm corporation to market grain produced by the taxpayers. The income from the grain sold after the end of the corporation’s taxable year was treated as "loans" with the income deferred until the following year.17 The taxpayers, by the government's view, had failed to report approximately $1.5 million of income on their 1982 and 1983 returns. The court agreed that the deferral scheme was improper, stated that the tax deficiencies were based "on a clearly erroneous decision" by the taxpayers to underreport their income and held that the interest failed the test of being an "ordinary and necessary" business expense.18

That decision, Miller II, was appealed to the Eighth Circuit Court of Appeals. The Eighth Circuit agreed that the claimed deduction failed the "ordinary and necessary" test but held that the temporary regulation represented "a permissible construction" of the statute and was, therefore, valid.19

The Tax Court decision

Although the Tax Court had decided cases on the issue,20 not until the 1996 decision of Redlark v. Commissioner,21 did the Tax Court address the question of validity of the temporary regulation. The Redlark case22 involved adjustments from the correction of errors in shifting an unincorporated business from an accrual basis to the cash basis of accounting.23

The Tax Court held that the temporary regulation classifying all interest on back taxes as non-deductible personal interest24 constituted "an impermissible reading of the statute" and, therefore, was invalid.25 The Tax Court went on to state that the interest involved in Redlark26 was interest "on indebtedness properly allocable to a trade or business" and was deductible. The court acknowledged that

— by Neil E. Harl

Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
"there will be situations where a Federal income tax deficiency will not be as narrowly focused" and that interest paid on a tax deficiency may not be an ordinary and necessary business expense.27 The court specifically noted that Miller I and Miller II involved just such a situation.28

The Tax Court was badly divided in Redlark.29 Eight judges agreed with the majority opinion, six dissented and several wrote concurring opinions.

In conclusion

At the moment, for taxpayers in the Eighth Circuit Court of Appeals area, the regulation has been declared valid.30 Outside the Eighth Circuit, the Tax Court view prevails that the temporary regulation is invalid but that the interest must be an ordinary and necessary business expense to be deductible.31

But Redlark 32 may be appealed. In any event, the last word has probably not been written on this issue.

FOOTNOTES
5 Pub. L. 99-514, Sec. 511(b), 100 Stat. 2085, 2246, adding I.R.C. § 163(h).
6 I.R.C. § 163(h)(1).
10 Id.
14 Id.
15 I.R.C. §§ 62(a), 162.
16 Miller v. United States, 95-1 U.S. Tax Cas. (CCH) ¶ 50,068 (D. N.D. 1994).
17 Id.
18 Id.
19 Miller v. United States, 65 F.3d 687 (8th Cir. 1995).
20 Tippin v. Comm'r, 104 T.C. 518, 529 (1995) (taxpayer did not show relationship between interest expense and any business); Rose v. Comm'r, T.C. Memo. 1995-75 (taxpayer failed to show tax attributable to trade or business or investment activity); Crouch v. Comm'r, T.C. Memo. 1995-289 (deduction disallowed for portion of tax attributable to business because of failure of proof and interest was for previous year). See Sheerazi v. Comm'r, T.C. Memo. 1994-245 (personal interest).
22 Id.
23 Id.
26 Id.
27 Id.
28 Id.
29 Id.
30 Miller v. United States, 65 F.3d 687 (8th Cir. 1995).
32 Id.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ANIMALS

HORSES. The plaintiff was injured when the plaintiff's car struck a horse on a highway. The horse belonged to the defendant and had escaped after a parked truck rolled down a slope and crashed through the fence holding the horse. The evidence demonstrated that, except for the breach in the fence caused by the truck, the fence was in good repair and sufficient to prevent the horse from escaping. Although the jury found for the plaintiff, the trial court entered judgment for the defendant notwithstanding the verdict because the evidence showed that the fence was in good repair. The appellate court affirmed, agreeing that no evidence was presented that the defendant or any agent, employee or resident of the defendant was responsible for the breach in the fence. The evidence showed that the truck was parked on a slope in gear and with its parking brake engaged. After the accident, the truck was out of gear and the parking brake was off. Butcher v. White's Iowa Institute, 541 N.W.2d 262 (Iowa Ct. App. 1995).

BANKRUPTCY

GENERAL-ALM § 13.03.*

AVOIDABLE TRANSFERS. The debtor was a corporation which operated a feedlot. The corporation was wholly-owned by the defendant who was also the president and principal employee of the debtor. The defendant was convicted of a check kiting scheme using the debtor's funds. The trustee sought to recover prepetition payments made to creditors during the check kiting as fraudulent transfers. The trustee argued that the defendant's guilty plea in the check kiting case was prima facie evidence that the payments to creditors were made with intent to defraud creditors. The court held that the guilty plea was prima facie evidence of intent to defraud only as to the two banks used in the check
kiting scheme and that the defendant's intent as to the other creditors' payments was an issue of fact which precluded summary judgment on the issue of recovery of the payments as fraudulent transfers. In re KZK Livestock, Inc., 190 B.R. 626 (Bankr. C.D. Ill. 1996).

EXEMPTIONS

HOMESTEAD. The debtors owned 80 acres of rural land which included 78 acres used for the residence and cultivation and two acres used for an auto repair business. The debtors claimed the entire 80 acres as an exempt rural homestead. The trustee objected, arguing that the homestead exemption, Okla. Stat. tit. 31, § 2, limits the exemption to $5,000 where the homestead is also used for a business. The court noted that the cases which agreed with the trustee's argument involved only homesteads within city limits. The court held that the business use limitation did not apply to rural homesteads, based on statutory construction of the homestead exemption statute which appeared to distinguish between rural and city homesteads for purposes of the business limitation. As the debtor noted, the trustee's argument would deny a rural homestead exemption to all farms and ranches. In re Ward, 190 B.R. 427 (Bankr. W.D. Okla. 1995).

CHAPTER 12-ALM § 13.03[8].

DISMISSAL. A creditor had obtained a pre-petition judgment against the debtors and had docketed the judgment, creating a judgment lien against the debtors' property. The debtors subsequently filed for Chapter 12 and obtained a ruling voiding the judgment lien under Section 547. The Chapter 12 case was dismissed by the debtors and the debtors filed for Chapter 11 with the case eventually converted to Chapter 7. After the debtors received a discharge in the Chapter 7 case, the judgment creditor sought to vacate the Chapter 12 order voiding the judgment lien. The court held that, upon dismissal, a voided lien is automatically reinstated unless the debtors seek an order not to reinstate the lien; therefore, the burden is on the debtors to demonstrate a reason for not reinstating of the lien. In addition, the court held that the discharge in Chapter 7 had no effect on the reinstatement of the lien because the debtors did not seek an order not to reinstate the lien and because a discharge only affects the debtors' personal liability as to a lien and not the enforcement of the lien against property. The debtors also argued that the creditor had entered into a stipulation which was the basis of the original lien avoidance and which estopped the creditor from reinstating the lien. The court held that this issue could best be resolved in a state court when the creditor sought to enforce the lien. Finally, the court held that the debtors failed to demonstrate any unfairness to other creditors from allowing the reinstatement of the lien; therefore, the lien was reinstated by the Chapter 12 dismissal. In re Derrick, 190 B.R. 346 (Bankr. W.D. Wis. 1995).

PLAN. The debtors operated a citrus farm which had produced 3,800 boxes of fruit. The debtors had planted an additional 20 acres of new trees and projected steady increases in the number of boxes of fruit to be harvested during the Chapter 12 plan years with the third year producing almost three times as many boxes of fruit than the farm produced historically. The debtors did not plan any additional labor or equipment costs to cover the increased maintenance and harvesting costs of the additional fruit. The plan also provided only $480 per month for living expenses for three people, two residences and two automobiles. The court held that the plan was not confirmable because it was not feasible since the plan was overly optimistic about increased harvests from new trees without additional labor or equipment. The court also held that the plan failed to provide sufficient living expenses or provide any buffer against unexpected difficulties. In re Gough, 190 B.R. 455 (Bankr. M.D. Fla. 1995).

FEDERAL TAXATION-ALM § 13.03[7].

AUTOMATIC STAY. After the taxpayer filed for Chapter 7, the IRS sent the taxpayer a Notice of Proposed Assessment of the 100 percent penalty under I.R.C. § 6672 as a responsible person of a corporation which failed to pay employment taxes. The notice provided that if the debtor failed to protest the notice, the IRS would proceed with the assessment of the penalty. The court held that the notice was an attempt to initiate an assessment of a penalty and was void as a violation of the automatic stay. Riley v. Comm'r, 96-1 U.S. Tax Cas. (CCH) ¶ 50,090 (E.D. Mo. 1995).

DISCHARGE. The debtors owed taxes for 1989. In December 1990, the debtors filed for Chapter 13 and the case continued until it was dismissed in June 1992. The IRS assessed the debts for the unpaid 1989 taxes more than 240 days before the instant bankruptcy case was filed. The IRS argued that the debtors for the unpaid 1989 taxes more than 240 days before the instant bankruptcy case was filed. The IRS argued that, under Section 108(c) and I.R.C. § 6503(h), the intervening Chapter 13 case tolled the provisions in Sections 507(a)(8) and 523(a)(8)(B) which provide that taxes due more than three years prior to the bankruptcy filing were dischargeable. The court held that I.R.C. § 108(c) and I.R.C. § 6503(h) apply to toll the three year period of Section 507(a)(8) during the intervening Chapter 13 case; therefore, the 1989 taxes were nondischargeable because the tax return was due within three non-tolled years before the petition for the current case. In re Shedd, 190 B.R. 692 (Bankr. M.D. Fla. 1996).

PREFERENTIAL TRANSFERS. The debtor had made several payments of employment taxes to the IRS within 90 days before filing the Chapter 11 petition. The payments were not designated by the debtor and the IRS applied the payments to non-trust fund taxes owed by the debtor. The debtor sought to avoid and recover the payments as preferential under Section 547(b). The court found that the debtor was insolvent during the 90 day pre-petition period, the payments were made for the benefit of the IRS, and the IRS received more than it would have if the debtor filed for Chapter 7 before the payments were made. The court held, however, that the debtor had a beneficial interest in the payments only to the extent the payment represented the debtor's share of the social security tax on the wages paid. In addition, the court held that the payments were not made for an antecedent debt but were made for taxes due after the payments were made (an employer's social security taxes are due at the end of the employment quarter); therefore, the payments were not preferential under Section 547(b). After reconsideration, the court held that the
payments made after the date for which penalties would be assessed were payments made for an antecedent debt and were recoverable as preferential transfers. The IRS also argued that the late payments were excepted from the preferential transfer rules in that the payments were made in the ordinary course of business. The court held that the debtor had a history of making timely payments; therefore, the late payments were not made in the ordinary course of business. In re Pullman Const. Industries, Inc., 190 B.R. 618 (Bankr. N.D. Ill. 1996), aff’d in part and rev’d in part on reconsideration, 186 B.R. 88 (Bankr. N.D. Ill. 1995).

CONTRACTS

MERCHANT. The plaintiff was a university which purchased a grain dryer for use on its research farms. The defendant had manufactured a part in the dryer which failed, causing a fire which damaged the plaintiff’s property. The plaintiff sued in tort for damages to the other property and the defendant argued that the action was barred by Minn. Stat. § 604.10(a) because the purchase was made between merchants in the goods involved. The court held that the university was a merchant with respect to the dryer because (1) the university had purchased six units prior to the dryer involved, (2) the university was a sophisticated buyer and used a bid process, and (3) the university used an expert on grain dryers to make the purchase. Board of Regents of Univ. of Minn. v. Chief Industries, 907 F. Supp. 1298 (D. Minn. 1995).

RELEASE. The plaintiff had contracted with the defendant for the defendant to provide and apply fertilizer and the herbicide Treflan to 19 acres of safflower. The applicator hired by the defendant failed to properly clean the herbicide applicator equipment and the herbicide Velpar contaminated the fields, causing immediate damage to the safflower fields. The parties negotiated payment for the damage and the plaintiff signed a release which held the defendant harmless for "any and all damages caused by the spraying of my approximate nineteen acres of safflower." The plaintiff sued for breach of contract when it became clear that the contamination continued in subsequent crop years. The defendant first argued that the action was barred by the statute of limitations on tort actions. The court held that the action was not barred by the statute of limitation for tort actions because the plaintiff’s petition raised no tort issues and the facts and claims alleged by the plaintiff were consistent with a breach of contract action. The plaintiff sought to overcome the release by oral extrinsic evidence that the parties intended the release to apply only to the safflower crop and not to subsequent crops. The defendant argued that the statute of frauds prevented any extrinsic evidence. The court held that the language quoted above was sufficiently ambiguous to allow extrinsic evidence on the issue of the crop years covered by the release. Ward v. Intermountain Farmers Ass’n, 907 P.2d 264 (Utah 1995).

FEDERAL ESTATE AND GIFT TAX

APPORTIONMENT OF TAXES. The decedent’s estate included a QTIP trust received from the decedent’s predeceased spouse. The decedent’s will provided that “all transfer, estate or inheritance taxes…imposed by any taxing authority upon or in relation to…any trust…included as part of my taxable estate, shall be paid as an expense out of my residuary estate.” The estate had claimed the taxes attributable to the QTIP trust against the trust but the IRS argued that the will provision controlled and the taxes had to be paid out of the residuary estate, lessening charitable distributions from the residuary estate. Under Ohio Rev. Code § 2113.86(1), “the estate is entitled to recover from the persons holding or receiving the property any amount by which the estate tax payable exceeds the estate tax that would have been payable if the value of the property had not been included in the gross estate of the decedent. This division does not apply if a decedent provides otherwise in his will or another governing instrument and the will or instrument refers to either section mentioned in this division or to qualified terminable interest marital deduction property.” The court held that Ohio Rev. Code § 2113.86(1) required the decedent’s will to specifically mention the QTIP trust as relieved from its share of estate tax and that the will’s use of the term "any trust" was not specific enough to change the presumption that estate tax attributable to the QTIP trust was to be charged to the trust. Estate of Vahlteich v. Comm’r, 95-2 U.S. Tax Cas. ¶ 60,218 (6th Cir. 1995).

The decedent was the beneficiary of a QTIP trust established by the will of the predeceased spouse. Under the trust, at the decedent’s death accumulated income passed to the decedent’s estate and principal passed as directed by the predeceased spouse’s will. The decedent’s will contained a general “pay-all-taxes” clause which provided that the estate was to pay all estate and inheritance taxes "without seeking reimbursement from or charging any person therefor." The estate reduced the amounts paid to the trust remainder beneficiaries by the amount of estate and inheritance taxes attributable to the QTIP trust as relieved from its share of estate tax and that the will’s use of the term "any trust" was not specific enough to change the presumption that estate tax attributable to the QTIP trust was to be charged to the trust. Matter of Will of Cooney, 541 N.W.2d 467 (Wis. 1995).

GENERATION SKIPPING TRANSFERS-ALM § 5.04[6]." In December 1983, the grantors created an irrevocable trust for their child. The trust provided for the child to have a special power of appointment to appoint by will the trust corpus to the child’s heirs or to the grantors’ heirs. If the power of appointment was not exercised the trust passed to the child’s heirs, or if no heirs survived, to the

FEDERAL AGRICULTURAL PROGRAMS

PESTICIDES. See Hochberg v. Zoecon Corp. infra under Products Liability.
The trust could not be extended more than 21 years past the death of the last survivor of the heirs living in December 1983. The child had executed a will which appointed the trust to separate trusts for the child's heirs. The IRS ruled that the trust was not subject to GSTT because (1) it was irrevocable prior to September 25, 1985, (2) the power of appointment was not exercised in a manner which extended the life of the trust more than 21 years after the death of a person living in December 1983, and (3) the exercise of the power of appointment did not constitute a constructive addition to the trust. 

**IRA.** The decedent's estate included an IRA which had a trust as the remainder beneficiary. The trust provided that it was to be split into a marital trust and a residuary trust with the surviving spouse as the beneficiary and one of two cotrustees of both trusts. The marital trust was to be funded with the lesser of the maximum estate tax marital deduction or the amount necessary to reduce the estate tax to zero. The surviving spouse had the power to withdraw any marital trust property. The surviving spouse and the other cotrustee allocated the maximum amount of the IRA to the marital trust and then the surviving spouse withdrew the IRA funds and placed them in the surviving spouse's own IRA within 60 days. The IRS noted that the general rule is that the transfer of IRA funds to a third party would prevent the surviving spouse from rolling the funds over to another IRA without penalty. However, because the original trust was a beneficiary of the decedent's IRA, the surviving spouse would be treated as having received the IRA funds from the decedent and the rollover of the funds to the surviving spouse's IRA would not cause the IRA funds to be included in the surviving spouse's gross income. 

**POWER OF APPOINTMENT.** An irrevocable trust was created in 1974 by a now-deceased grantor. The trust provided for two individuals and one corporation as trustees. One of the trustees died and the remaining individual trustee appointed the grandchildren of the original grantor as cotrustees and amended the trust to provide that if an individual trustee removes the corporate trustee, the successor corporate trustee cannot be related or subordinate to the individual trustee. The IRS ruled that the new trustees did not have a power of appointment over trust principal. The IRS noted that its original position, as stated in Rev. Rul. 79-353, 1972-2 C.B. 325, has been changed by Rev. Rul. 95-38, I.R.B. 1995-36, 16, to provide that individual trustees do not have a power of appointment over trust principal where the trustee has the power to remove and replace another trustee so long as the successor trustee is not related or subordinate to the trustee. 

**TRUSTS.** The plaintiffs transferred their residence to a ten-year qualified personal residence trust as part of their estate planning. The trust provided that the plaintiffs retained a right to live on the property during the term of the trust. The plaintiffs were the cotrustees of the trust and as cotrustees applied for a homestead exemption from ad valorem state taxes in Florida. The county appraiser rejected the homestead exemption, arguing that the residence was not permanent because the plaintiffs only had the right to live on the property for a maximum of ten years. The court held that the exemption statute had no time limit for residency of the permanent resident and only required a beneficial interest in the property by the person claiming the exemption. The court held that a residence in a QPRT was eligible for the exemption. Robbins v. Welbaum, 664 So.2d 1 (Fla. Ct. App. 1995).

**VALUATION.** The decedent had received a portion of the predeceased spouse's estate in a QTIP trust. After the death of the predeceased spouse, the estate and the decedent formed two partnerships funded with the estate property and the decedent's own property. The estate then funded the QTIP trust with its shares of the partnerships; thus, the decedent owned a portion of the partnerships in fee and a portion through the QTIP trust. The IRS ruled that the partnership interests were to be aggregated for purposes of valuation for estate tax purposes in the decedent's estate. 

**FEDERAL INCOME TAXATION**

**BUSINESS DEDUCTIONS.** A corporation was not allowed deductions for repairs made to a house owned by the corporation but used by the corporation's sole shareholder as a residence. The court held that the deductions were disallowed because the repairs benefitted only the shareholder. In addition, the court held that the repairs constituted constructive dividends to the shareholder. 


**C CORPORATIONS-ALM § 7.02.**

CONVERSION. The Treasury Department has announced that it will propose legislation which would amend I.R.C. § 1374 to treat a conversion of a C corporation to an S corporation as a liquidation taxable at the corporate level followed by contribution of the assets to the S corporation. The new law would be effective only for tax years after January 1, 1997. TDNR RR-885.

LIQUIDATION. The taxpayer was the sole shareholder of a corporation which operated a campground and concert park. Because of litigation problems with the local government, the taxpayer decided to sell the property and purchase an amusement park elsewhere. A second corporation was formed for the purpose of acquiring the new property. The corporation's property was sold and on the advice of the corporation's accountant, the corporation was dissolved under state law, final income tax returns were filed and distributions were made to the taxpayer. The taxpayer originally listed these distributions as liquidating distributions from the corporation but later filed an amended return which did not include the distributions in income. The court held that the distributions were taxable as liquidating distributions because a clear intent to liquidate the first corporation was demonstrated by the (1) recitations in the board meeting minutes that the corporation was to liquidate...
in accordance with the accountant's advice, (2) the corporation filed final income tax returns, (3) the corporation dissolved under state law, and (4) the corporation sold all of its assets. Murphy v. Comm'r, T.C. Memo. 1996-59.

DISCHARGE OF INDEBTEDNESS-ALM § 4.02[15].* The taxpayers, husband and wife, were the sole shareholders of a C corporation which operated a national delivery service. The corporation made several distributions to the taxpayers which were characterized on the corporation's books as loans. The corporation had also prepared interest-bearing notes to bolster the evidence that the distributions were loans. During an IRS audit of the corporation's returns, the corporation and taxpayers took the position that the distributions were loans to the taxpayers. Some of the funds were repaid by the taxpayers but most of the distributions were eventually written off by the corporation. The corporation, however, characterized the written off amounts as dividends and not as loans. The court held that the write off of the distributions resulted in discharge of indebtedness income to the taxpayers because the taxpayers had claimed the distributions as loans in the audits. The court noted that the taxpayers had consistently claimed the distributions as loans until the statute of limitations had closed on the tax years involved. Schneller v. Comm'r, T.C. Memo. 1996-62.

HOBBY LOSSES-ALM § 4.05[1].* The taxpayer owned a small pet shop business which had experienced at least seven straight years of losses. The taxpayer also had full time employment elsewhere but did not receive a high income from that job. The Tax Court held that the taxpayer did not have a profit motive in operating the store because the taxpayer did not maintain an accurate recordkeeping system and did little to increase the store's profitability. The appellate court reversed, holding that the Tax Court did not give sufficient weight to other factors involved in the case, such as the taxpayer's modest income from other sources and the taxpayer's moving of the store to a more favorable location. On remand, the Tax Court affirmed its holding after reviewing all nine factors of Treas. Reg. § 1.183-2(b). The court acknowledged that the employment of the taxpayer's parent in the store could be considered involvement by the taxpayer but the court held that the parent's employment was primarily for the personal pleasure of the parent and for the taxpayer's satisfaction of finding employment for the parent. The Tax Court also held that the taxpayer's relocation of the store did not indicate a profit motive because the taxpayer did not attempt to move the store earlier when several years of losses had already occurred. The Tax Court did acknowledge that the taxpayer's modest income from other sources demonstrated that the store was not operated primarily as a tax shelter of the other income but held that this factor did not outweigh the other indicators that strongly showed no profit motive in operating the store. Ranciato v. Comm'r, T.C. Memo. 1996-67, on rem. from, 52 F.3d 23 (2d Cir. 1995), rev'g and rem'g, T.C. Memo. 1993-536.

The taxpayer had owned and operated a 150 acre farm for 37 years, with 36 of those years producing losses. The case involved only three of those years. In the first year, the taxpayer accepted a teaching job in another state which required the employment of caretakers and neighbors to attend the farm because the taxpayer was required to live in the other state. In holding that the farm was not operated with the intent to make a profit, the court examined the nine factors of Treas. Reg. § 1.183-2(b): (1) the taxpayer failed to keep records sufficient to evaluate the future success or failure of the operation and failed to make changes that would make the operation profitable; (2) the taxpayer had sufficient expertise to run the farm profitably; (3) the taxpayer spent little time on the farm during the tax years involved and the caretakers also spent little time in watching the farm; (4) the taxpayer had not made any other businesses profitable; (5) the farm had a long history of losses; (6) even though some expenses were unexpected, the absence of those losses would not have made the farm profitable; (7) although the land appeared to have appreciated during the taxpayer's ownership, the taxpayer failed to show that the appreciation exceeded the losses; (8) the farm losses generated substantial tax benefits from offsetting the taxpayer's nonfarm income; and (9) the taxpayer's operation of a nonprofitable farm for 37 years indicated that the taxpayer operated the farm primarily for pleasure. Pearson v. Comm'r, T.C. Memo. 1996-66.

PARTNERSHIPS-ALM § 7.03.* ADMINISTRATIVE ADJUSTMENTS. The taxpayers were limited partners who held 0.45 percent interests in a limited partnership with more than 100 partners; therefore, the taxpayers were non-notice partners who did not receive notice of an administrative adjustment filed with the tax matters partner (TMP). The TMP signed a settlement agreement which adjusted several items of partnership deductions which passed through to the taxpayers and resulted in deficiencies owed by the taxpayers. The taxpayers challenged the administrative adjustment of partnership items and the IRS moved for summary judgment, arguing that the Tax Court did not have jurisdiction over any challenge of the adjustments, except for mathematical errors. The Tax Court agreed with the IRS, holding that, because the taxpayers held less than a 1 percent interest in a partnership with more than 100 partners, the taxpayers were not required to receive notice of the administrative adjustment and were bound by the settlement agreed to by the TMP. Vander Heide v. Comm'r, T.C. Memo. 1996-74.

PASSIVE INVESTMENT LOSSES. The taxpayers owned several condominiums which were rented to third parties during the summer. The properties were managed by a management company which obtained the renters, cleaned the condominiums after each use and maintained the properties. The taxpayers claimed to have spent over 100 hours per year in maintenance of the condominiums, including repainting and cleaning. The court held that the losses from the rental activity of the condominiums were subject to the passive loss rules because (1) the taxpayers did not perform substantially all the participation in the operation of the rental activity since the management company provided many services; (2) the taxpayers did not preform more services than the management company, and (3) the taxpayers did not participate in the rental activity on

*Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.
SAFE HARBOR INTEREST RATES

<table>
<thead>
<tr>
<th>March 1996</th>
<th>Annual</th>
<th>Semi-annual</th>
<th>Quarterly</th>
<th>Monthly</th>
</tr>
</thead>
<tbody>
<tr>
<td>AFR 5.05</td>
<td>4.99</td>
<td>4.96</td>
<td>4.94</td>
<td></td>
</tr>
<tr>
<td>110% AFR</td>
<td>5.57</td>
<td>5.49</td>
<td>5.45</td>
<td>5.43</td>
</tr>
<tr>
<td>120% AFR</td>
<td>6.08</td>
<td>5.99</td>
<td>5.95</td>
<td>5.92</td>
</tr>
<tr>
<td>Mid-term</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AFR 5.45</td>
<td>5.38</td>
<td>5.34</td>
<td>5.32</td>
<td></td>
</tr>
<tr>
<td>110% AFR</td>
<td>6.01</td>
<td>5.92</td>
<td>5.88</td>
<td>5.85</td>
</tr>
<tr>
<td>120% AFR</td>
<td>6.56</td>
<td>6.46</td>
<td>6.41</td>
<td>6.37</td>
</tr>
<tr>
<td>Long-term</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AFR 6.07</td>
<td>5.98</td>
<td>5.94</td>
<td>5.91</td>
<td></td>
</tr>
<tr>
<td>110% AFR</td>
<td>6.69</td>
<td>6.58</td>
<td>6.53</td>
<td>6.49</td>
</tr>
<tr>
<td>120% AFR</td>
<td>7.31</td>
<td>7.18</td>
<td>7.12</td>
<td>7.07</td>
</tr>
</tbody>
</table>

S CORPORATIONS—ALM § 7.02[3][c].*

INADVERTENT TERMINATION. An S corporation amended its articles of incorporation to provide for two classes of stock, preferred stock and common stock. The two classes had different voting and economic rights. The corporation did not realize that the creation of the two classes of stock would terminate the Subchapter S corporation election until informed by counsel. The corporation immediately amended the articles of incorporation to eliminate the second class of stock. The IRS ruled that the termination of the S corporation status would be waived as inadvertent. Ltr. Rul. 9608012, Nov. 13, 1995.

PLANNED FUNDING LIMITATION UNDER I.R.C. § 412(C)(7).

PENSION PLANS. For plans beginning in February 1996, the weighted average is 7.01 percent with the permissible range of 6.31 to 7.57 percent (90 to 109 percent permissible range) and 6.31 to 7.71 percent (90 to 110 percent permissible range) for purposes of determining the permissible range of 6.31 to 7.57 percent (90 to 109 percent). Notice 96-11.

The decedent owned an interest in a qualified pension plan and an IRA. The surviving spouse was the beneficiary of both plans and elected to have the funds in the pension plan rolled over to the IRA and elected not to have the IRA transferred to the surviving spouse’s name. The IRS ruled that the surviving spouse did not recognize income from the rollover of the pension plan funds to the IRA, distributions from the IRA to the surviving spouse prior to the date that the surviving spouse reached age 59 1/2 were not subject to the 10 percent early distributions tax, and the IRA would not be treated as the surviving spouse’s IRA. Ltr. Rul. 9608042, Dec. 1, 1995.

PRODUCT LIABILITY

PESTICIDES. The plaintiff was injured after using a pesticide manufactured by the defendant. The pesticide was a dip used to remove fleas from the plaintiff’s dogs. The plaintiff did not wear protective clothing and suffered injury from skin exposure to the pesticide. The plaintiff sued for negligence and breach of implied warranty of merchantability. The defendant argued that the actions were prevented by the preemption of FIFRA because the actions were based on a failure to warn. The court held that the actions were preempted by FIFRA. Hochberg v. Zoecon Corp., 657 N.E.2d 1263 (Mass. 1995).
TRESPASS

TIMBER. The plaintiff sued the defendant for the unauthorized cutting of timber on the plaintiff’s property. The plaintiff sought and was awarded actual and punitive damages. The actual damages were trebled under W. Va. Code § 61-3-48a and the defendant argued that the punitive damage award was improper because the treble damages provision was already a punitive damage award. The court noted that the legislative purpose of the treble damage statute was to compensate more adequately the property owner for the loss of the trees because the normal measure of damages would not be sufficient after considering the litigation costs to the plaintiff. The court held that the plaintiff could receive punitive damages in an action for treble damages because the treble damages were only compensatory and not punitive. Bullman v. D & R Lumber Co., 464 S.E.2d 771 (W. Va. 1995).

CITATION UPDATES

Carroll v. Comm’r, 71 F.3d 1228 (6th Cir. 1995), aff’g, T.C. Memo. 1994-229 (S corporation election) see p. 15 supra.

AGRICULTURAL LAW MANUAL

by Neil E. Harl

This comprehensive, annotated looseleaf manual is an ideal deskbook for attorneys, tax consultants, lenders and other professionals who advise agricultural clients. The book contains over 900 pages and an index.

As a special offer to Digest subscribers, the Manual is offered to new subscribers at $115, including at no extra charge updates published within five months after purchase. Updates are published every four months to keep the Manual current with the latest developments. After the first free update, additional updates will be billed at $100 per year or $35 each.

For your copy, send a check for $115 to Agricultural Law Press, P.O. Box 50703, Eugene, OR 97405.

Satisfaction guaranteed. 30 day return privilege.

ISSUE INDEX

Animals
- Horses 34

Bankruptcy
- General
  - Avoidable transfers 34
  - Exemptions
  - Homestead 35
- Chapter 12
  - Dismissal 35
  - Plan 35
- Federal taxation
  - Automatic stay 35
  - Discharge 35
  - Preferential transfers 35

Contracts
- Merchant 36
- Release 36

Federal Agricultural Programs

Pesticides 36

Federal Estate and Gift Tax
- Apportionment of taxes 36
- Generation skipping transfers 36
- IRA 37
- Power of appointment 37
- Trusts 37
- Valuation 37

Federal Income Taxation
- Business deductions 37
- C corporations
  - Conversion 37
  - Liquidation 37
- Discharge of indebtedness 38
- Hobby losses 38
- Partnerships
  - Administrative adjustments 38
- Passive investment losses 38
- Pension plans 39

S corporations
- Inadvertent termination 39
- Stock redemption 39
- Safe harbor interest rates
  - March 1995 39
- Travel expenses 39
- Withholding taxes 39

Product Liability
- Pesticides 39

Trespass
- Timber 40
USING LIFE EXPECTANCY TABLES FOR PRIVATE ANNUITIES

— by Neil E. Harl

Private annuities are entered into for a variety of reasons. Some annuitants seek a stream of income that will continue until death of the annuitant — or annuitant and spouse under a joint and survivor annuity; others are moved by a desire to transfer significant assets such as farmland to someone in the next generation as obligor.

Another reason driving interest in private annuities is the motivation to enter into annuity arrangements after the onset of serious illness that has likely diminished life expectancy. If the obligor or obligors are family members, the result can be indeed favorable in terms of overall family wealth if the outcome is transfer of the property funding the private annuity for one or, at most, a few payments.

A set of new income tax, gift tax and estate tax regulations effective with respect to decedents dying after December 13, 1995 has altered the guidelines for determining when use of the life expectancy tables is appropriate.

"Death is imminent" rule

For many years, the question of when use of the life expectancy tables was appropriate has been made under a "death is imminent" rule. Under that approach, the IRS position emphasized a facts and circumstances test —

"...The current actuarial tables in the regulations shall be applied if valuation of an individual's life interest is required for purposes of the federal estate or gift taxes unless the individual is known to have been afflicted, at the time of transfer, with an incurable physical condition that is in such an advanced stage that death is clearly imminent. Death is not clearly imminent if there is a reasonable possibility of survival for more than a very brief period. For example, death is not clearly imminent if the individual may survive for a year or more and if such a possibility is not so remote as to be negligible. If the evidence indicates that the decedent will survive for less than a year, no inference should be drawn that death will be regarded as clearly imminent, because this question depends on all the facts and circumstances."4

An earlier ruling, Rev. Rul. 66-307, involved the valuation of property interests for purposes of the credit for tax on prior transfers. In the facts of that ruling, the life tenant-transferee was "afflicted with a ravaging and incurable disease of advanced state and could not survive a year." Indeed, the life tenant survived the transfer by less than four months. The life estate in the estate of the transferor had an actuarial value of about 52 percent but the life tenant received in benefits before death only about one percent of the value of the property. That ruling concluded that if it is known on the valuation date that a life tenant is afflicted with a fatal and incurable disease in its advanced stages and the individual cannot survive for more than a brief period of time, the value of the life or remainder interest should be determined "by reference to such known facts."8

The "new" approach

A 1993 Tax Court case, Estate of McClendon v. Commissioner, involved a taxpayer with an actuarial life expectancy of 15-years but who was suffering from a severe form of throat cancer. The court agreed that a substantially diminished life expectancy justified departure from the annuity tables. A "savings" clause in a private annuity entered into by the taxpayer provided for an adjustment if challenged. That clause was disregarded as against public policy.


Under the amendments to the regulations, the life expectancy tables and standard interest rate rules may not be used if an individual (who is a measuring life) dies or is terminally ill at the time the transfer is completed. An individual who is known to have an incurable illness "or other deteriorating physical condition" is considered terminally ill if there is at least a 50 percent probability that the individual will die within one year. However, if the individual survives for 18 months or longer after the date the transfer is completed, the individual is presumed to have not been terminally ill at the date the transfer was completed. That presumption can be overcome only by clear and convincing evidence to the contrary.

The regulations provide an example of how the regulatory language is to be applied —

---

Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
"The donor transfers property worth $1,000,000 to a child in exchange for the child's promise to pay the donor $103,000 per year for the donor's life. The donor is age 60 but has been diagnosed with an incurable illness and has at least a 50 percent probability of dying within 1 year. The section 7520 interest rate for the month of the transfer is 10.6 percent, and the standard annuity factor at that interest rate for a person age 60 in normal health is 7.4230. Thus, if the donor were not terminally ill, the present value of the annuity would be $764,569 ($103,000 x 7.4230). Assuming the presumption provided (in Treas. Reg. § 25.7520-3(b)(2)) does not apply, because there is at least a 50 percent probability that the donor will die within 1 year, the standard section 7520 annuity factor may not be used to determine the present value of the donor's annuity interest. Instead, a special section 7520 annuity factor must be computed that takes into account the projection of the donor's actual life expectancy." 23

In conclusion

The key provision in the new regulatory language is the 50 percent probability of death within on year.24 That is a substantially different rule from the "death is imminent" standard applicable previously.25

FOOTNOTES


8 Id.

9 T.C. Memo. 1993-459, rev'd and rem., 96-1 U.S. Tax Cas. (CCH) ¶ 60,220 (5th Cir. 1996) (see summary below).

10 Id.

11 Id.

12 Id.

13 Treas. Reg. § 1.7520-3(b)(3).

14 Treas. Reg. § 25.7520-3(b)(3).

15 Treas. Reg. § 20.7520-3(b)(3).

16 1980-1 C.B. 194.


19 E.g., Treas. Reg. § 25.7520-3(b)(3).

20 Id.

21 Id.

22 Id.


24 Treas. Reg. § 25.7520-3(b)(3).


CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-ALM § 13.03.*

AUTOMATIC STAY. The debtors had signed-up for the 1988 farm programs for their rice and wheat crops. The debtors had received an advance disaster payment for the rice crop. Although the debtors eventually applied for full disaster payments, the USDA denied all disaster payments based on the failure of the debtors to follow normal cultural practices in growing the rice. After the debtors filed for Chapter 12, the USDA set off the advance disaster payment for the rice crop against disaster payments owed to the debtors for the wheat crop losses. The USDA did not petition for relief from the automatic stay before the setoff. The court ruled that the setoff violated the automatic stay and the debtors sought an award of attorney's fees for challenging the setoff. The court awarded about one-third of the claimed fees at a rate of $90.00 per hour. The court noted that the USDA was primarily responsible for the protracted nature of the proceedings. In re Winchester, 191 B.R. 93 (Bankr. N.D. Miss. 1995).

AVOIDABLE TRANSFERS. The debtor was a producer of soybean seed and had contracted with a dealer to produce soybean seed from foundation seed owned by the dealer. The debtor also contracted with several growers to grow the seed. The debtor was to receive a premium on each bushel of seed delivered to the dealer and paid a premium to the growers out of the premium received from the dealer.

The debtor lost its state grain license and its business was operated under the state Department of Agriculture for the purpose of winding up the debtor's affairs. Although most of the contract had been performed by the time the debtor filed for bankruptcy, several payments were made within 90 days prior to the filing. The payments were made to the state Department of Agriculture and were not part of the debtor's bankruptcy estate. The trustee sought to recover those payments as either fraudulent or preferential. The trustee alleged that the seed contract with the dealer was void because it was not written as required by Ill. Cod. Stat. ch. 505, § 105/1. The court held that the statute did not provide that an unwritten contract was void but only provided penalties for failing to put a seed contract in writing. The court also argued that the payments were preferential. The court held that the payments were made in the ordinary course of business as part of the contract. In re Ostrom-Martin, Inc., 191 B.R. 126 (Bankr. C.D. Ill. 1996).

ESTATE PROPERTY. The debtor owned a tax deferred annuity contract which was tax qualified under I.R.C. § 403(b). The annuity contained a spendthrift clause which was effective under state law. The court held that the annuity contract was not estate property under Section 541(c)(2). In re Johnson, 191 B.R. 75 (Bankr. M.D. Pa. 1996).
EXEMPTIONS
HOMESTEAD. The debtors owned a residence on 2.8 acres of land just outside the limits of a city. The debtors constructed several buildings on the property which were used for a bus construction and renovation business. The debtor claimed the entire parcel of land as an exempt rural homestead. The court held that the debtors were limited to an urban homestead exemption because a portion of the property was used for business purposes, an equivalent to abandonment of that portion of the homestead, and the property was located sufficiently close to an urban center that the essential character of the property was urban. In re Evans, 190 B.R. 1015 (Bankr. E.D. Ark. 1995).

The debtors owned a residence on 9.7 acres of land outside a city limits. The land was not used for any agricultural purposes. The court characterized the area as part of a megalopolitan area between two cities which was continuously developed with residences and businesses. Although the debtor's residence was over a mile from banks, shops and gas stations, the city amenities were easily and quickly reached by car on good roads. The court held that the debtor was entitled to only an urban homestead exemption for the property. In re Oldner, 191 B.R. 146 (Bankr. E.D. Ark. 1995).

CHAPTER 12-ALM § 13.03[8].

TRUSTEE’S FEES. The debtors' Chapter 12 plan provided for some direct payments to creditors with impaired claims and some payments through the trustee. The trustee objected to the direct payments for impaired claims, arguing that the loss of the fees from the direct payments left insufficient compensation for the trustee's duties. The court sympathized with the trustee but held that, under In re Wagner, 36 F.3d 723 (8th Cir. 1994), a Chapter 12 debtor may make direct payments on impaired claims without paying the trustee's fee. The court suggested that the trustee obtain permission to hire an attorney to perform some of the trustee’s duties and charge the attorney’s fees to the estate. Query: will that work? In re Jennings, 190 B.R. 863 (Bankr. W.D. Mo. 1995).

FEDERAL TAXATION-ALM § 13.03[7].

TAX YEAR. The debtors filed their Chapter 11 petition on September 30, 1992 and did not make the I.R.C. § 1398(d)(2)(A) election to divide their 1992 tax year into two years, with the first year ending on the date of the petition. The IRS filed a claim for the 1992 taxes as an administrative claim. The debtors argued that the 1992 taxes attributable to the period from January 1, 1992 to September 30, 1992 were entitled only to the eighth priority as taxes which were imposed for the period from January 1, 1992 to September 30, 1992. The IRS argued that the 1992 taxes were due after the filing of the petition and were not allowed as an administrative claim. In re Johnson, 190 B.R. 724 (Bankr. D. Mass. 1995).

FEDERAL AGRICULTURAL PROGRAMS

DAIRY TERMINATION PROGRAM. The plaintiffs were dairy farmers who had signed up for the Dairy Termination Program. After an investigation, it was determined that the plaintiffs had not complied with the program requirements in that the plaintiffs sold some of the cows for purposes other than slaughter and failed to fully account for the sale for slaughter of all cows. The USDA ruled that these activities demonstrated that the plaintiffs participated in a scheme or device designed to defeat the purpose of the program. The USDA then refused to make any program payments to the plaintiff and assessed a fine of $871,000. The plaintiffs filed administrative appeals to the National Appeals Division (NAD) which affirmed the USDA decision, except that the penalty was reduced to $26,000. The court held that its review of the NAD decision was limited to whether the decision was arbitrary and capricious and did not allow any review of the NAD’s findings of fact. The court found that the NAD decision as to the “scheme or device” ruling was based on its finding that the plaintiffs had failed to prove otherwise. The NAD decision focused on the DTP requirement that applicants had the burden of demonstrating compliance. The court held that this ruling was improper, because the burden should have been on the USDA to prove by clear and convincing evidence the existence of the scheme or device. However, the NAD decision was upheld on the basis of the waiver issue. The plaintiffs argued that the plaintiffs had substantially and in good faith complied with the program requirements such that the USDA should have waived the small infractions. The NAD decision denying the waiver also was based on the plaintiffs’ failure to demonstrate full compliance with the program requirements. The court held that this part of the NAD ruling was proper in placing the burden on the plaintiffs to show compliance and eligibility for the waiver. The court upheld the penalty as consistent with the findings that the plaintiffs did not fully comply with the program requirements and did not make a food faith effort to comply. Vandervelde v. Espy, 908 F. Supp. 11 (D. D.C. 1995).

NATIONAL FORESTS. The plaintiffs were owners of ranches neighboring National Forest Service (NFS) land. The plaintiffs claimed vested rights to water which flowed over NFS land. The plaintiffs wanted to clear the ditches on the NFS land and otherwise develop the water rights for use on their ranches. The court assumed, for purposes of its ruling, that the plaintiffs did have vested water rights and the right to enter NFS land to clear the ditches. The plaintiffs sought an injunction against the NFS to prohibit any prosecution of the plaintiffs for their cleaning efforts. The court held that, although the plaintiffs had a vested right to the water and a right of way for the ditches, the plaintiffs were still subject to valid NFS regulations concerning actions on NFS land. Thus, the plaintiffs were required to obtain permits for entry on to the land and, if the permits were denied, were required to make administrative appeals. The court held that, because the plaintiffs had not applied for such permits or filed any administrative appeals, they were susceptible to prosecution if they entered the NFS land to clean the ditches. Therefore, the court denied an injunction against NFS prosecution of the plaintiffs. Elko County Bd. of Supervisors v. Glickman, 909 F. Supp. 759 (D. Nev. 1995).
**FEDERAL ESTATE AND GIFT TAX**

**ADMINISTRATIVE EXPENSES.** A portion of the decedent's estate passed under a revocable trust to the decedent's heirs. The trust was to be funded with an amount equal to the decedent's GSTT exemption amount. State law required the estate to pay to a trust 5 percent interest during the time between the decedent's death and the funding of the trust. The estate sought to claim the interest paid to the trust as an administrative expense. The IRS ruled that the state interest requirement was a method of insuring that trust assets would receive a share of the income from the trust assets from the date of the decedent's death; therefore, the "interest" was more similar to trust income than to trust assets from the date of the decedent's death; therefore, beneficiaries would receive a share of the income from the trust assets as an administrative expense. The IRS ruled that the state court order did not apply retroactively for purposes of determining whether the state court order did not apply retroactively for purposes of determining whether the property passing to the marital trust assets would be included in the taxpayer's gross estate. The IRS ruled that the state court order did not apply retroactively for purposes of determining whether the property passing to the marital trust assets would be included in the taxpayer's gross estate. Ltr. Rul. 9604027, Nov. 1, 1995.

**ANNUITY.** Within two months before death, the decedent transferred property to an annuity under a private annuity agreement with the decedent's heirs. The value of the annuity was calculated using a life expectancy of 15 years. Although the decedent's doctor had sent a letter stating that the decedent had a good chance for recovery from cancer, the decedent had been ill from the disease for some time. The Tax Court had found that the decedent's life expectancy was at least one year but denied the use of the life-expectancy tables in Treas. Reg. § 25.2512-5 because the decedent's death was imminent. The appellate court remanded the case back to the Tax Court for clarification as to the decedent's life expectancy at the time the annuity was purchased. The court noted that Rev. Rul. 80-80, 1980-1 C.B. 194 provides that death was not considered imminent if the decedent was expected to live for a year or more. See the lead article in this issue. McLendon Estate v. Comm'r, 96-1 U.S. Tax Cas. (CCH) ¶ 60,220 (5th Cir. 1996).

**GROSS ESTATE.** The surviving spouse was the surviving spouse of the decedent. The taxpayer petitioned for and obtained a state probate court order reforming the decedent's will to provide for a trust for the surviving spouse. The IRS ruled that the state probate court order did not apply retroactively for purposes of determining whether trust assets would be included in the taxpayer's gross estate. Ltr. Rul. 9609018, Nov. 27, 1995.

**IRA.** The decedent had commenced withdrawals from an IRA after age 70 1/2 and used the permissive recalculation rule for determining annual required distributions. The decedent's estate was the named beneficiary of the IRA and the decedent's daughter was the sole beneficiary of the decedent's estate. The IRS ruled that because no individual was a named beneficiary of the IRA, the recalculation rule continued to be used for post-death distributions, using a life expectancy of zero. Therefore, the entire IRA was required to be distributed to the estate. Ltr. Rul. 9609027, Nov. 1, 1995.

The decedent had owned funds in an IRA. The ruling does not disclose who the remainder beneficiary was of the IRA. The decedent's surviving spouse was the executrix of the estate and caused the IRA funds to be distributed to the executrix and then distributed to the executrix as an individual. The funds were then placed in an IRA in the surviving spouse's name. The IRS ruled that the IRA funds were not included in the surviving spouse's gross income. Ltr. Rul. 9609052, Dec. 7, 1995.

**MARITAL DEDUCTION—ALM § 5.04[3].** The decedent's will bequeathed property to the surviving spouse in trust. The will provided that the executor had the authority to determine how much of the decedent's residuary estate would be used to fund the trust. The IRS argued that the trust property was not QTIP because (1) the property did not vest in the surviving spouse as of the date of the decedent's death and (2) the property did not pass from the decedent to the surviving spouse but passed only by the actions of the executrix. The Tax Court acknowledged that its decisions in several cases in support of the IRS have been reversed on appeal and decided to follow the appellate cases, holding that the property passing to the marital trust for which the QTIP election was made was eligible for the marital deduction. See Estate of Robertson v. Comm'r, 98 T.C. 678 (1992), rev'd, 15 F.3d 779 (8th Cir. 1994); Estate of Clayton v. Comm'r, 97 T.C. 327 (1991), rev'd, 976 F.2d 1486 (5th Cir. 1992); Ext. of Spencer v. Comm'r, T.C. Memo. 1992-579, rev'd, 43 F.3d 226 (6th Cir. 1994). Note: The Digest will publish in the near future an article by Neil E. Harl on this issue. Estate of Clark v. Comm'r, 106 T.C. No. 6 (1996).

The decedent's estate included a remainder interest in property in which the decedent's parent held a life estate. The decedent's remainder interest passed to the decedent's surviving spouse and the executor elected QTIP treatment for the remainder interest and claimed the property as a marital deduction. The estate argued that the property was income producing because the age differences between the parent and surviving spouse made it likely that the spouse would receive the property. The IRS ruled that the remainder interests were not eligible for QTIP because the surviving spouse would not be entitled to all the income from the property. Ltr. Rul. 9604003, Oct. 10, 1995.

The decedent's will provided for a bequest to the surviving spouse based on a formula to decrease the decedent's estate tax to zero after providing for bequests eligible for the unified credit. The will gave the executor the sole power and discretion to determine what assets would be used to fund the marital bequest. The surviving spouse executed a written disclaimer of specific assets in the estate. The IRS argued that the disclaimer decreased the marital deduction because the executor had the sole power to determine what assets passed to the surviving spouse. The court agreed and held that the marital deduction was to be reduced by the value of the property disclaimed by the surviving spouse. Nix v. Comm'r, T.C. Memo. 1996-109.

The decedent had been married twice. When the first marriage was terminated, the decedent and spouse entered into a settlement agreement under which the children of that marriage were to receive one-half of the decedent's estate. The decedent remarried and provided in a will for two marital trusts which would qualify for the marital deduction. The decedent's first spouse and children challenged the will, asserting the divorce settlement agreement. The surviving spouse and the previous spouse and children entered into a settlement which provided for some property to be distributed to the children of the first marriage. The decedent's estate claimed a marital deduction for the

* * *
property which was distributed to the surviving spouse under the agreement. The IRS ruled that the property passing to the surviving spouse under the agreement was eligible for the marital deduction because the settlement was reached in good faith in settlement of enforceable rights.


The decedent died testate and the will provided for a marital trust and a family trust for the surviving spouse. The difference between the trusts was that the distributions to the spouse in the family trust were discretionary and the marital trust distributions were mandatory. The surviving spouse and the children petitioned the state probate court to not have the will probated, resulting in all of the estate passing to the surviving spouse outright. The IRS ruled that the property was not eligible for the marital deduction because the spouse did not obtain the property in settlement of enforceable rights in the property. In addition, the IRS ruled that the probate court petition was not a qualified disclaimer and could not be deemed a qualified disclaimer because some remainder holders under the original will did not join in the petition. Ltr. Rul. 9610004, Nov. 8, 1995.

SPECIAL USE VALUATION—ALM § 5.03[2]. The taxpayer was bequeathed farm land which had been valued for estate tax purposes under a special use valuation election. The taxpayer exchanged a portion of the land for another tract of farmland which the taxpayer would use in the taxpayer's farming operation. No additional property or cash was involved in the exchange. The IRS ruled that the exchange qualified for like-kind exchange treatment for income tax purposes and would not cause recapture of special use valuation benefits by the taxpayer. Ltr. Rul. 9604018, Oct. 30, 1995.

TAX LIEN. The decedent was the president of a corporation which owned 56 acres of land. The corporation transferred the land to two trusts. Each trust was established by the decedent for a granddaughter who also served as trustee with two other related persons. The trusts gave a promissory note in exchange for the land but did not make any payments on the notes. The trusts gave the corporation a mortgage to secure the notes. The IRS filed a tax lien against the property for estate taxes and the corporation would use in the taxpayer's farming operation. No additional property or cash was involved in the exchange. The IRS ruled that the exchange qualified for like-kind exchange treatment for income tax purposes and would not cause recapture of special use valuation benefits by the taxpayer. Ltr. Rul. 9604018, Oct. 30, 1995.

The IRS ruled that the property was not eligible for the marital deduction because the spouse did not obtain the property in settlement of enforceable rights in the property. Therefore, the mortgage given for the planning purposes and the corporation, which was without adequate consideration and promissory notes was without adequate consideration and promissory notes. Therefore, the mortgage given for the planning purposes and the corporation, which was a gift because the transfer was made for estate tax purposes based on an appraisal by a professional appraiser. The IRS sought an explanation of the valuation method in 1990 and the taxpayers obtained a second appraisal which gave the stock a $167.98 per share value. The taxpayers filed an amended return based on the second value which eliminated any gift tax due. The IRS appraised the stock at $445 per share. The taxpayers also presented evidence of a stock redemption five years before the gift transfer which redeemed the stock held by other family members at $98 per share. The court reviewed all of the appraisal methods at held that the stock had a fair market value of $296 per share. Cloutier Estate v. Comm'r, T.C. Memo. 1996-49.

In 1988, the taxpayer transferred shares of stock to the taxpayer's children. The taxpayers filed a gift tax return and claimed a value of $385 per share for the stock for gift tax purposes based on an appraisal by a professional appraiser. The IRS ruled that the property was not eligible for the marital deduction because the spouse did not obtain the property in settlement of enforceable rights in the property. Therefore, the mortgage given for the planning purposes and the corporation, which was a gift because the transfer was made for estate tax purposes based on an appraisal by a professional appraiser. The IRS sought an explanation of the valuation method in 1990 and the taxpayers obtained a second appraisal which gave the stock a $167.98 per share value. The taxpayers filed an amended return based on the second value which eliminated any gift tax due. The IRS appraised the stock at $445 per share. The taxpayers also presented evidence of a stock redemption five years before the gift transfer which redeemed the stock held by other family members at $98 per share. The court reviewed all of the appraisal methods at held that the stock had a fair market value of $296 per share. Cloutier Estate v. Comm'r, T.C. Memo. 1996-49.

In 1988, the taxpayer transferred shares of stock to the taxpayer's children. The taxpayers filed a gift tax return and claimed a value of $385 per share for the stock for gift tax purposes based on an appraisal by a professional appraiser. The IRS ruled that the property was not eligible for the marital deduction because the spouse did not obtain the property in settlement of enforceable rights in the property. Therefore, the mortgage given for the planning purposes and the corporation, which was a gift because the transfer was made for estate tax purposes based on an appraisal by a professional appraiser. The IRS sought an explanation of the valuation method in 1990 and the taxpayers obtained a second appraisal which gave the stock a $167.98 per share value. The taxpayers filed an amended return based on the second value which eliminated any gift tax due. The IRS appraised the stock at $445 per share. The taxpayers also presented evidence of a stock redemption five years before the gift transfer which redeemed the stock held by other family members at $98 per share. The court reviewed all of the appraisal methods at held that the stock had a fair market value of $296 per share. Cloutier Estate v. Comm'r, T.C. Memo. 1996-49.

FEDERAL INCOME TAXATION

BAD DEBT. The taxpayer loaned $10,000 to a friend in July 1988 to help the friend in business. The taxpayer intended to be repaid in 90 days but was not. The friend did not give a promissory note or other written repayment agreement for the money. The taxpayer continued to press for the repayment of the money but gave up in January 1989 when the friend's phone was disconnected. The court held that the debt became worthless in 1989. Schenk v. Comm'r, T.C. Memo. 1996-113.

DEPRECIATION. The taxpayer was a corporation which operated a nursery. The corporation owned some land and leased a contiguous parcel from its sole shareholder. The shareholder also was the president of the corporation. The president moved into a house on the corporation's land when the president assumed the duties of the foreman who had previously lived in the house. The president also owned a residence in the nearby city where the president's family lived during the week. The corporation paid for improvements to the residence, including a swimming pool and pool house. The corporation claimed depreciation deductions for the improvements. The court held that, because the president's duties as foreman required residence on the corporation's property, the improvements were allowable as business expenses. Maschmeyer's Nursery, Inc. v. Comm'r, T.C. Memo. 1996-789.

DISASTER AREAS—ALM § 4.05[2]. The IRS has announced the disaster areas designated by the President for 1995 for purposes of eligibility of taxpayers to qualify for I.R.C. § 165(i) deferral of claiming losses from those disasters. Rev. Rul. 96-13, I.R.B. 1996...
DISCHARGE OF INDEBTEDNESS. The taxpayer was the sole shareholder of a corporation which operated an insurance agency. The taxpayer had personally guaranteed amounts owed by the corporation to an insurance company. The corporation was dissolved after a dispute with the insurance company. The insurance company sued on the debt and eventually reached a settlement with the taxpayer for much less than the amount owed by the corporation. The court held that the taxpayer did not recognize discharge of indebtedness income from the settlement because the taxpayer did not receive any of the original loan amounts and was only relieved of an obligation to pay the debt. Whitmer v. Comm'r, T.C. Memo. 1996-83.

EMPLOYMENT TAXES. The IRS has issued procedures for a one year test program allowing early referral of employment tax issues to the Appeals Division while a taxpayer is audited at the District level. Ann. 96-13, I.R.B. 1996-12.

ENTERTAINMENT EXPENSES. The taxpayer corporation operated an oil and gas pipeline inspection company. The taxpayer sublet a ranch for use as a hunting area. The ranch included a cabin and the taxpayer built hunting blinds on the property. The taxpayer notified the ranch tenant when any hunting was to occur. The taxpayer claimed the rent as a business expense. The court stated that I.R.C. § 274(a)(1)(B) prohibited deductions with respect to a facility used for entertainment, amusement or recreation. The taxpayer argued that the sublease of the ranch was not a facility. The court held that the sublease of the ranch allowed the taxpayer exclusive rights to use the ranch for hunting; therefore, the sublet ranch was a facility and any expenses attributed to the use of the ranch were not allowed as a business deduction by the taxpayer. On Shore Quality Control Specialists, Inc. v. Comm'r, T.C. Memo. 1996-95.

GROSS INCOME. The taxpayer had entered into an installment contract to purchase real property from a third party. The taxpayer had to file three law suits to enforce the contract and eventually settled for a specific sum of damages. The third party paid most of the settlement amount to the taxpayer's children under an assignment executed by the taxpayer. The third party then submitted less than the remainder to the taxpayer but the taxpayer refused the partial payment in order to preserve the taxpayer's right to the entire settlement amount. The taxpayer did not include the payment to the children nor the partial payment in income. The taxpayer argued that the partial payment was not taxable because the amount was still subject to litigation. The court held that both amounts were includible in the taxpayer's gross income, the first as an assignment of income and the second because the taxpayer had an absolute right to the payment and had no obligation to repay the amount. Moorefield v. Comm'r, T.C. Memo. 1996-98.

HOME OFFICE. The taxpayer was a piano teacher who claimed expenses associated with the taxpayer's residence which were attributable to the giving of piano lessons in the taxpayer's home. The expenses were allocated based on the percentage of square feet in an area of the taxpayer's living room where a grand piano stood and was used for the lessons. The court held that the deductions were allowable, holding that the space used exclusively for a business need not be physically separated from the living areas of the home. Hewett v. Comm'r, T.C. Memo. 1996-110.

INDEPENDENT CONTRACTORS. The IRS has issued a training manual, "Employee or Independent Contractor?" containing guidance as to who is an employee and who is an independent contractor for federal tax purposes. Worker Classification Training Guide, 96 ARD 045-1.

INTEREST RATE. The IRS has announced that for the period April 1, 1996 through June 30, 1996, the interest rate paid on tax overpayments is 7 percent and for underpayments is 8 percent. The interest rate for underpayments by large corporations is 10 percent. The interest rate on corporate overpayments above $10,000 is 5.5 percent. Rev. Rul. 96-17, I.R.B 1996-__.

LIKE-KIND EXCHANGES. The taxpayer and five other related persons owned one-sixth interests in 23 parcels of farm property. The taxpayer exchanged the one-sixth interests in 20 of the properties for full fee interests in three of the properties. The value of the exchanged properties was of approximate equal value. The IRS ruled that the exchange was eligible for like-kind tax free treatment. Ltr. Rul. 9609016, Nov. 22, 1995.

PARTNERSHIPS-ALM § 7.03.*

ADMINISTRATIVE ADJUSTMENTS. The taxpayers were partners in a partnership which had claimed investment tax credit in one tax year and investment tax recapture in a subsequent year. After the IRS began an audit of the partnership, the taxpayers filed amended returns which did not include the investment tax credit for the first year and reduced recapture tax for the second year. The taxpayers then filed for bankruptcy. The IRS audit eventually did allow some of the investment tax credit but charged the partnership with additional recapture tax for the second year. The taxpayers argued that they were not liable for the additional recapture tax because they did not claim the investment tax credit in the first tax year. In addition, the taxpayers argued that the filing of the bankruptcy case removed their partnership items from consideration in the audit. The court held that the bankruptcy filing only removed the taxpayers as persons from the audit in order for the audit not to violate the automatic stay and that the investment tax credit remained a partnership item subject to the audit determination; therefore, the taxpayers remained liable for their share of the recapture tax. Phillips v. Comm'r, 106 T.C. No. 7 (1996).

The case involved two partnerships, each with two partners. The IRS had issued deficiency notices involving the taxpayers' partnership income or loss from their partnerships and did not issue a Notice of Final Partnership Administrative Adjustments (FPAA). The first partnership consisted of two partners, each with equal limited and general partnership interests. The first partnership had only net loss for the tax year and each partner received an equal portion of the loss. The partners argued that the partnership did not qualify as a small partnership because items such as guaranteed payments were not equal between the partners. One requirement for small partnership status is that the partners receive the same share of all partnership items. In both cases, the partnerships allocated to each partner a share of the net partnership income or loss. The court held that the

*Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.
partnership did qualify as a small partnership excepted from the FPAA requirements because items such as guaranteed payments are not considered for purposes of the same share requirement for small partnership status. The second partnership was similar to the first partnership, with the two partners receiving a share of the net income or loss from the partnership. The partners’ capital accounts, however, were charged differently. The court held that the second partnership qualified as a small partnership because the method of charging the capital accounts did not affect the same share rule for small partnership status. **Schwartz v. Comm'r, T.C. Memo. 1996-88.**

The taxpayers were partners in a partnership (first tier partnership) which was a partner in several other partnerships (second tier partnerships). The IRS conducted audits of the second tier partnerships but did not directly inform the taxpayers about the audit or the settlements reached with the second tier partnerships. The taxpayers were not identified on the second tier partnerships’ income tax returns nor did the tax matters partners of those partnerships send the IRS the names and addresses of the taxpayers. The court held that the IRS was not required to notify the taxpayers about the audit. **Walshall v. Comm’r, 96-1 U.S. Tax Cas. (CH) ¶ 50,101 (D. Alaska 1995).**

CONSTRUCTIVE DISTRIBUTIONS. The taxpayers were limited partners in a partnership formed to construct and operate an office building. The limited partners purchased their interests in the partnership with cash and promissory notes. The partnership purchased a financial security bond that would pay for any promissory note default by a limited partner. The taxpayers entered into an agreement with the bond holder for payment on the bond in settlement of their promissory notes. The court held that the taxpayers recognized income from the cancellation of the indebtedness. The court stated that, although the settlements were between the taxpayers and the bond holder, the result was a change in a partnership item and subject to the partnership income tax rules. **Dakota Hills Offices Limited Partnership v. Comm’r, T.C. Memo. 1996-35.**

DISTRIBUTIVE SHARE. The taxpayers were partners in a partnership in the business of providing accounting services including the preparation of tax returns. The IRS assessed deficiencies based on a reconstruction of partnership income and a redetermination of the distributive share of each taxpayer. The taxpayers failed to keep adequate records to account for the amount of time each spent on partnership business. The court found that the taxpayers' testimony about their business was contradictory and unreliable and that the taxpayers had failed to cooperate with the IRS in the audit. The court held that the IRS reconstruction of partnership and the taxpayers’ income was sufficient to support the assessment of deficiencies and also upheld the assessment of a penalty for intent to evade payment of taxes. The court noted that the taxpayers were tax professionals well aware of the recordkeeping requirements. **McDonald v. Comm’r, T.C. Memo. 1996-87.**

PENSION PLANS. The taxpayer and decedent were the sole shareholders of a corporation which owned a defined benefit pension plan. The decedent had received a distribution from the plan and did not include the payment in income. The decedent suffered from a diseased foot at the time of the distribution. The plan provided for payment from the plan for disabilities which prevented the recipient from working for more than 12 months. The court held that the plan was not an accident or health insurance plan because the plan provided no payments for injuries or sickness other than the 12 month disability; therefore, the payment to the decedent was included in gross income. **Estate of Hall v. Comm’r, T.C. Memo. 1996-93.**

RENT DEDUCTION. The taxpayer was a corporation which operated a nursery. The corporation owned some land and leased a contiguous parcel from its sole shareholder. The taxpayer based the rent upon several factors, including the potential of the land for residential development. The court disallowed a portion of the rent deduction because the taxpayer failed to demonstrate that the rent was based on the fair market rent of the property. **Maschmeyer's Nursery, Inc. v. Comm’r, T.C. Memo. 1996-789.**

TAX PROTESTORS. The taxpayer was assessed tax deficiencies for failure to report items of income. Although the taxpayer brought an action to challenge the assessments, the court found that the taxpayer presented only "nonsensical 'legal' tax protester arguments" in response to the court's questions about issues of fact. The court held that the taxpayer's action was little more than a delaying tactic and an attempt to espouse tax protester arguments; therefore, the court held for the IRS and assessed an additional penalty of $5,000 for the bringing of a frivolous suit. **Wesselman v. Comm’r, T.C. Memo. 1996-85.**

The taxpayer was assessed a tax deficiency, interest and penalties for failing to report wage income from the taxpayer's employment as an airline pilot. The taxpayer presented only "tax protester" arguments which the court summarily rejected. The court allowed the deficiency, interest and penalties and added a $10,000 penalty for bringing a frivolous suit. **Fox v. Comm’r, T.C. Memo. 1996-79.**

STATE REGULATION OF AGRICULTURE

APPLES. The plaintiff was an apple grower who challenged assessments made by the California Apple Commission. The plaintiff argued that the assessments on apples for the purpose of promoting the sale of California apples violated the plaintiff's First Amendment free speech and freedom of association rights and the Fourteenth Amendment equal protection rights. The defendant Commission argued that the federal courts did not have jurisdiction under the Tax Injunction Act, 28 U.S.C. § 1341, because the controversy involved a tax and the plaintiff had a remedy in the state courts. The court held that the assessment was not a tax because the assessment proceeds were not placed in the state general fund and were used to benefit a specific portion of the state population. **Bidart Bros. v. The California Apple Comm’n, 73 F.3d 925 (9th Cir. 1996).**

CITATION UPDATES

Brahson v. U.S., 73 F.3d 1040 (10th Cir. 1996), rev’g, 94-2 U.S. Tax Cas. (CCH) ¶ 50,446 (D. Colo. 1994) (court awards and settlements) see p. 21 supra.
SPEND A WEEK IN HAWAI’I IN JANUARY 1997! BALMY TRADE WINDS, 70-80 DEGREES, PALM TREES, WHITE SAND BEACHES AND THE REST OF PARADISE CAN BE YOURS; PLUS A WORLD-CLASS SEMINAR ON FARM ESTATE AND BUSINESS PLANNING BY DR. NEIL E. HARL. THE SEMINAR IS SCHEDULED FOR JANUARY 6-10, 1997 AT THE BEAUTIFUL OCEAN-FRONT ROYAL WAIKOLOA RESORT ON THE BIG ISLAND, HAWAI’I.

Seminar sessions run from 8:30 a.m. to 12:30 p.m. each day, Monday through Friday, with a continental breakfast and break refreshments included in the registration fee. Each participant will receive a copy of Dr. Harl’s 400 page seminar manual, *Farm Estate and Business Planning: Annotated Materials* which will be updated just prior to the seminar.

Here are the major topics to be covered:
• Introduction to estate and business planning.
• Liquidity planning with emphasis on 15-year installment payment of federal estate tax.
• Co-ownership of property, including discounts, taxation and special problems.
• Federal estate tax, including alternate valuation date, special use valuation, handling life insurance, marital deduction planning, disclaimers, planning to minimize tax over deaths of both spouses, and generation skipping transfer tax.
  • Gifts and federal gift tax, including problems with future interests, handling estate freezes, and “hidden” gifts.
  • Income tax aspects of property transfer, including income in respect of decedent, installment sales, private annuities, self-cancelling installment notes, and part gift/part sale transactions.
  • Using trusts, including funding of revocable living trusts.
  • Organizing the farm business—one entity or two, corporations, general and limited partnerships and limited liability companies.

The Agricultural Law Press has made arrangements for discount air fares on United Airlines and discounts on hotel rooms at the Royal Waikoloa, the site of the seminar.

The seminar registration fee is $645 for current subscribers to the *Agricultural Law Digest* or the *Agricultural Law Manual*. The registration fee for nonsubscribers is $695.

Watch your mail for more details in the next few weeks or call Robert Achenbach at 1-541-302-1958.
RENTING LAND TO A FAMILY PARTNERSHIP, CORPORATION OR LLC

— by Neil E. Harl

Farmers typically have several objectives in setting up multiple entities with the land rented to the production entity. One objective, in at least some instances, is to supplement retirement income with rents.

A Tax Court case, decided in late 1995, has called into question a strategy of receiving rents from a family-owned entity under what would appear to be a non-material participation lease entered into to avoid payment of self-employment tax on the rental payments (and, possibly, to avoid loss of social security benefits in retirement). Unless reversed on appeal, the case poses a significant risk to multiple entity arrangements treating lease payments as rent.

The Mizell case

The Tax Court decision, *Lee Mizell*, involved an Arkansas farmer who rented 731 acres of farmland to a family partnership operated with his three sons. The elder Mizell owned a 25 percent interest in the partnership. In typical fashion, the partnership agreement specified that each partner had an equal voice in the management of the partnership operation and in the conduct of the business. Each partner was required to devote full time to the operation. The elder Mizell was active in the partnership in the years in question and reported the distributive share of partnership income as net earnings from self-employment.

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 lease as a non-material participation lease and did not report the rental amounts as self-employment income.

The lease 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 well as under the lease. Therefore, the rental income under the lease was subject to self-employment tax. The court specifically declined to say whether the lease itself was a material participation or non-material participation lease, reasoning that this was no longer an issue in light of the court’s holding.

Is the Mizell holding correct?

The critical question with *Mizell* is whether involvement of a lessor of property in the operations of the lessee constitutes or contributes to “material participation” for purposes of imposition of self-employment tax.

As discussed in a 1995 article, for one to determine that service as a partner in a partnership, employee of a corporation or member of a limited liability company constitutes self-employment income under a lease would require that the landlord-tenant relationship be ignored as a relationship separate and distinct from the partner, employee or member relationship.

There is some authority for the “two hat” theory that a taxpayer may occupy two different positions without suffering an aggregation of effort.

• First, the regulations state that a trade or business carried on by an estate or trust is not included in determining the net earnings from self-employment of the individual beneficiaries of the estate or trust. This provides some support for the position that the intention is not to ignore established legal relationships.

• Second, the regulations recognize the possibility for separate status for a lessor of property in stating, “... where an individual or partnership is engaged in a trade or business the income of which is classifiable in part as rentals from real estate, only that portion of such income which is not classifiable as rentals from real estate, and the expenses attributable to such portion, are included in determining net earnings from real estate.”

• Finally, the holdings in two 1960 revenue rulings are consistent with maintaining the integrity of relationships. In *Rev. Rul. 60-170*, payments received by farmers under a “lease” agreement with a steel company were to compensate the farmers for damages to livestock, crops, trees and other vegetation because of chemical fumes and gases from a nearby plant. Even though the landowners continued to have full use of the land and the

*Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.*
improvements, the payments were not considered income from self-employment.\textsuperscript{13} By continuing to carry on farming operations and to raise whatever was possible under the circumstances, the landowner was arguably materially participating in the farming operation separately from the status of the individual as lessor of interests in the land to the steel company. In effect, the landowner-farmer was both lessor and farm tenant. The important point is that the taxpayer was allowed to wear two hats for purposes of liability for self-employment tax.

In the other 1960 ruling,\textsuperscript{14} a gasoline station owner had leased the station to an oil company under an “owner’s lease.” The station owner received a flat rental plus a percentage of gasoline sales. The rental payments were not considered to be income from self-employment regardless of whether the station owner or a third party operated the station. The station owner was materially participating in the business to which the station was effectively leased.\textsuperscript{15}

\section*{Importance of formalities}

For any situation in which an individual occupies a dual status, one status being a lessor, it is important for the lease to be in writing with standard terms and conditions calling for a reasonable rental. At the same time, it is important for the status as partner, employee or LLC member to be formally established and maintained.

\section*{In conclusion}

\section*{ADVERSE POSSESSION}

\section*{POSSESSION. The disputed strip of land was used by the plaintiffs or their predecessors for over 70 years for pasturing livestock, hunting, fishing, and harvesting timber. The disputed land was not fit for cultivation or development because it often flooded; thus, the primary usefulness of the land was for the purposes for which the plaintiffs used it. The court held that although the plaintiffs’ use of the land was sporadic, the plaintiffs’ use was sufficient given the nature of the land. The plaintiffs exercised exclusive possession by prohibiting the defendants from removing timber from the land. Until a few years before the action was brought and a survey was completed, the defendants and everyone else in the area considered the land as belonging to the plaintiffs. The court held that the plaintiffs had established title to the land by adverse possession.}

\textbf{Whiteside v. Rottger, 913 S.W.2d 114 (Mo. Ct. App. 1995).}

\section*{BANKRUPTCY}

\section*{GENERAL-ALM § 13.03.*}

\section*{ESTATE PROPERTY.} The debtor operated an auction business and performed an auction of a third party’s personal business property. The debtor deposited the proceeds of the auction in the debtor’s general bank account and later issued a check to the third party for the net proceeds. The check was issued within 90 days before the debtor filed for bankruptcy. The bankruptcy trustee sought to recover the payment as a preferential transfer. The lower courts had held that the transfer was not preferential because the relationship between the debtor and third party was an agent-principal relationship and not a debtor-creditor relationship. The trustee appealed, arguing that once the auction was over and the proceeds were deposited in the debtor’s bank account, the agency relationship terminated and the debtor and third party became debtor and creditor. The appellate court agreed with the trustee, noting that the debtor’s account showed a negative balance during a portion of the time between the deposit of the proceeds and the issuance of the check and the proceeds were not identifiable in the account. The court also placed emphasis on the third party’s lack of control over the proceeds once deposited by the debtor. The court acknowledged that an auctioneer is an agent of the owner of the property auctioned, but there is no discussion of how depositing the proceeds in a general bank account terminates the agency relationship. The holding here seems to have resulted from the court’s isolation of the issuance of the check from the auction transaction, based on a termination of the agency relationship sometime after the auction ended. \textit{In re Rine & Rine Auctioneers, Inc.,} 74 F.3d 854 (8th Cir. 1996).

\section*{JURISDICTION.} The debtor was a produce dealer licensed under the Perishable Agricultural Commodities Act. Several sellers of produce had filed claims against the PACA trust. The trust res was held by a secured creditor of

\begin{footnotes}
\footnote{Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.}

\footnote{1} See generally 6 Harl, Agricultural Law § 50.02 (1996); Harl, Agricultural Law Manual § 7.01 (1996). See also Harl, “Renting Property to One’s Corporation,” 6 Agric. L. Dig. 57 (1995).
\footnote{2} See 6 Harl, supra n. 1, § 50.02[2].
\footnote{3} Mizell v. Comm’r, T.C. Memo. 1995-571.
\footnote{4} Id.
\footnote{5} I.R.C. § 1402(a)(1).
\footnote{6} Id.
\footnote{7} Id
\footnote{8} Id
\footnote{9} Harl, “Renting Property to One’s Corporation,” 6 Agric. L. Dig. 57 (1995).
\footnote{10} Treas. Reg. § 1.1402(a)-2(b).
\footnote{11} Treas. Reg. § 1.1402(a)-4(d).
\footnote{12} 1960-1 C.B. 357.
\footnote{13} Id.
\footnote{15} Id.
the debtor and the sellers sought recovery from that res. The 
bankruptcy trustee brought an action in the debtor’s 
bankruptcy case to recover the PACA trust res from the 
creditor. The court held that it did not have core or other 
jurisdiction over the controversy because the PACA trust res 
was not bankruptcy estate property and resolution of the 
action would not assist in administration of the bankruptcy 

FEDERAL TAXATION-ALM § 13.03[7].*

AUTOMATIC STAY. After the debtors filed for 
bankruptcy, the IRS made an assessment of their taxes and 
filed a claim in the case. After the debtors objected to the 
claim, the IRS filed for retroactive relief from the automatic 
stay to validate the claim. The debtors argued that the 
assessment was void; however, the court held that the 
automatic stay would be retroactively lifted as to the IRS so 
that the assessment was valid. In re Siverling, 96-1 U.S. 
Tax Cas. (CCH) ¶ 50,134 (E.D. Calif. 1996).

CLAIMS. The case involved two bankruptcy cases, one 
with a claims bar date in November 1992 and one with a 
claims bar date in February 1995. The IRS received notice 
of both claims bar dates but did not file a claim in both cases 
until November 1995 for priority tax claims. In neither case 
had any distribution of estate property taken place before the 
IRS filed its claims. The court held that in both cases the 
IRS claims were allowed as tardily filed claims and that the 
lateness of the claims did not affect the claims’ priority 
status. In re M.A.P. Restaurant, Inc., 191 B.R. 519 

DISCHARGE. The debtor had failed to pay federal 
income taxes for several years and the IRS sought a ruling 
that the taxes were nondischargeable for willful attempt to 
evade taxes. The court found that the debtor knew that the 
taxes were owed and that the debtor had sufficient income 
to pay the taxes but used the income to pay discretionary 
personal expenses such as private college education for the 
debtor’s children and vacations. The court also found that 
the debtor took several actions to defeat IRS attempts to 
levy on the debtor’s property, such as not using any bank 
accounts. The court held that the taxes were nondischargeable for willful attempt to evade taxes. In re 

PASSIVE ACTIVITY LOSSES. The taxpayer filed for 
Chapter 11 in August 1991. The debtor had pre-petition 
passive activity losses and the bankruptcy estate had post-
petition passive activity losses. The Chapter 11 plan 
provided for transfer of estate property, including interests 
in a partnership, to the debtor prior to termination of the 
case. The IRS ruled that the retransfer of estate property to 
the taxpayer prior to termination of the case was not a 
taxable distribution of the property and that the PALs 
attributable to that property also passed to the taxpayer. Ltr. 

PRIORITY. The debtors were assessed for pre-petition 
income tax deficiencies resulting from investments in tax 
shelters. The assessments included interest under I.R.C. § 
6621(d) for substantial underpayments attributable to tax 
motivated transactions. The court held that the pre-petition 
interest was a priority tax claim. In re Hall, 191 B.R. 814 

The debtors had filed three previous bankruptcy cases 
between 1986 and the filing of the current case in November 
1994. Between the first and second case and between the 
third and present case only a few months passed. However, 
between the second and third cases, almost three years 
passed. The IRS had filed claims for 1984 taxes in all the 
cases. The IRS argued that the three year period of Section 
507(a)(8)(A)(i) was tolled during the previous bankruptcy 
cases and that the additional tolling period of six months 
allowed by I.R.C. § 6503 was created by each case. Thus, 
the IRS argument was that the total tolled period was the 
length of the bankruptcy cases plus 18 months. The court 
held that the IRS was not allowed an additional six month 
tolling period for each bankruptcy case filed. The court also 
held that, on equity grounds, the IRS would not allow 
priority status because the IRS had ample time of almost 
three years between the second and third cases to collect the 

FEDERAL AGRICULTURAL PROGRAMS

CROP INSURANCE. The FCIC has adopted as final 
regulations adding a noninsured crop disaster assistance 
program to protect producers of crops for which insurance is 

FEDERAL ESTATE AND GIFT TAX

CHARITABLE DEDUCTION. The decedent had 
created a revocable trust which became irrevocable upon the 
decedent’s death. The trust provided that the trust be divided 
into two trusts. The trusts provided for distribution of net 
income to the beneficiary, discretionary distribution of trust 
corpus and the remainder to a charitable organization. The 
beneficiaries disclaimed the right to the discretionary 
distributions of principal within nine months after the 
decedent’s death. The estate representative then petitioned 
the state probate court for reformation of the trusts to 
provide for annuity payments of 7.4 percent of the fair 
market value of the trust assets. The IRS ruled that the 
reformation qualified the trusts as charitable remainder 
unitrusts eligible for the charitable deduction. Ltr. Rul. 
9610005, Nov. 9, 1995.

DISCLAIMERS-ALM § 5.02[6].* The decedent’s 
spouse had died before the decedent and the decedent had 
instructed counsel to draw up a written disclaimer of a 
portion of the predeceased spouse’s estate. However, the 
decedent died before the disclaimer was written and 
executed. The heirs of the predeceased spouse and the heirs 
of the decedent agreed to a division of the estates which was 
similar to the division which would have occurred had the 
decedent executed the disclaimer. The agreement was 
submitted to a state probate court and signed by the heirs’ 
attorneys and some of the heirs. The court held that the 
agreement was not sufficient as a disclaimer because not all 
of the heirs signed the agreement and the agreement was not 
a disclaimer executed by the decedent’s heirs for the
executor or trustee the discretion as to how much trust
for the decedent's surviving spouse. The trust gave the
upon the decedent's death, a qualified terminable interest
decedent had established an inter vivos trust which created,
Cir. 1996),
Trust v. Comm'r, 96-1 U.S. Tax Cas. (CCH) ¶ 60,225 (2d
enactment of GSTT and did not violate the equal protection
because the tax resulted from the decedent's actions after
The court held that the decedent did not have a general power of appointment because the power to distribute trust corpus was subject to an ascertainable standard. Essentially, the court held that, under state (Nebraska) law, the inclusion of the term "comfort" did not extend the trustee's power to distribute corpus beyond the decedent's health, support and maintenance needs. Best v. U.S., 96-1 U.S. Tax Cas. (CCH) ¶ 60,223 (D. Neb. 1995).

POWER OF APPOINTMENT. The decedent's estate included an interest in a trust established by the decedent's predeceased spouse. The trust named the decedent as beneficiary and trustee and provided for the trustee to have the discretionary power to distribute trust corpus to the decedent as "may be reasonably necessary for her comfort, support and maintenance." The IRS claimed that the decedent had a general power of appointment over the trust corpus; therefore, the trust corpus was included in the decedent’s gross estate under I.R.C. § 2041(b). The court held that the decedent did not have a general power of appointment because the power to distribute trust corpus to the decedent's minor children of their interests in the decedent’s estate. The probate court granted the orders and the disclaimers were filed, resulting in passage of the property to the surviving spouse. The IRS argued that the disclaimers were invalid under state law because the disclaimers were not in the best interests of the children because the disclaimers would result in larger inheritances and would keep the family corporation within the family. The IRS has issued a nonacquiescence as to the case because the Tax Court used the wrong standard of appellate review of the state court decision. Est. of Goree v. Comm’r, T.C. Memo. 1994-331, nonacq., I.R.B. 1996—.

The decedent died within nine months after the death of the decedent’s spouse. The decedent and spouse had owned a joint bank account and joint certificates of deposit as tenants by the entireties, and the decedent’s executor filed a written disclaimer of half of the funds in the account and half of the certificates of deposit within nine months after the death of the spouse. The IRS ruled that, under Pennsylvania law, joint bank accounts and joint certificates of deposit were considered as contributed half by each joint owner; therefore, the disclaimers were effective. Note: the IRS position has been that interests in tenancy by the entirety property are not disclaimable by the surviving spouse, See e.g., Ltr. Rul. 9427003, March 30, 1994. Ltr. Rul. 9612002, Nov. 7, 1995.

GENERATION SKIPPING TRANSFERS—ALM § 5.04[6].* On the decedent’s death, the decedent held a lifetime income interest in an irrevocable marital trust established by the decedent’s predeceased spouse in 1974. The decedent held a testamentary general power of appointment over the trust corpus but did not exercise the power. The trust corpus passed to the predeceased spouse’s grandchildren. The court held that the trust was subject to GSTT because the decedent’s failure to exercise the general power of appointment was a constructive addition to the trust occurring after the effective date of the GSTT. The court also held that the application of GSTT to the trust did not violate the due process clause of the U.S. Constitution because the tax resulted from the decedent’s actions after enactment of GSTT and did not violate the equal protection clause because a rational basis supported the application of the tax to the decedent’s actions. E. Norman Peterson Marital Trust v. Comm’r, 96-1 U.S. Tax Cas. (CCH) ¶ 60,225 (2d Cir. 1996), aff’d, 102 T.C. 798 (1994).

MARITAL DEDUCTION—ALM § 5.04[3].* The decedent had established an inter vivos trust which created, upon the decedent’s death, a qualified terminable interest trust for the decedent’s surviving spouse. The trust gave the executor or trustee the discretion as to how much trust property to include in the QTIP trust. The IRS argued that the trust corpus was included in the QTIP trust. The IRS argued that the trustee had a power of appointment over the trust, disqualifying the trust as QTIP. The court cited cases from the Fifth, Sixth and Eighth Circuit Courts of Appeal which held that the power of an executor to determine how much property to transfer to a trust did not disqualify the trust as QTIP. The Tax Court followed those decisions. Mathis v. U.S., 96-1 U.S. Tax Cas. (CCH) ¶ 60,224 (N.D. Ind. 1996).

VALUATION. The decedent’s estate contained an interest in a promissory note issued by a corporation to the decedent’s predeceased spouse. The note was a private obligation in that the note did not include any protective language found in the public debt instruments issued by the corporation. The fair market value of the note was determined by comparing it to similar public debt instruments issued by the corporation. The estate argued that the estate tax valuation should be determined by discounting the fair market value of the note to account for the lack of protective documents found in the publicly traded debt instruments. The court agreed and accepted the estate’s valuation of the note. Smith v. U.S., 96-1 U.S. Tax Cas. (CCH) ¶ 60,222 (S.D. Miss. 1996).

The decedent was a majority shareholder in a small closely-held corporation. The shareholders had entered into a stock restrictive sale agreement in 1960 which provided for redemption of stock if a shareholder left the company. In 1987, after the death of the decedent’s spouse, the decedent executed another stock buy-sell agreement which established the value of the stock for redemption by the decedent’s estate. Any unredeemed stock was to pass to the employee. The corporation was required to redeem so much of the decedent’s stock as necessary to pay federal estate taxes on the estate. The court held that the agreement was not unenforceable because of I.R.C. § 2703, because the stock agreement was executed prior to the effective date of I.R.C. § 2703. However, the buy-sell agreement was held to be ineffective to set the stock value because the agreement had a testamentary purpose. Therefore, the stock was valued at fair market value at the time of the decedent’s death (actually, in this case the alternate valuation date was

* Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.
FEDERAL INCOME TAXATION

BUSINESS EXPENSE. The taxpayer was a general partner in a real estate development partnership. The debtor did not participate in the management of partnership affairs and only consulted with another general partner about partnership affairs. The taxpayer filed a suit for an accounting from the partnership and claimed the legal fees as a business deduction. The court held that the taxpayer’s involvement with the partnership was insufficient to qualify the taxpayer’s activities as a trade or business; therefore, the legal fees were not a deductible business expense. In re Hendrickson, 96-1 U.S. Tax Cas. (CCH) ¶ 50,133 (C.D. Calif. 1996).

The taxpayer was employed by OSHA and claimed deductions for charitable contributions and business expenses. The taxpayer had few records to support the claimed deductions and much of the charitable deduction was disallowed. One of the business expenses claimed was for a computer printer used by the taxpayer at home. The taxpayer admitted that the printer was not purchased as a condition of employment and was not required for the taxpayer’s employment. The court held that the cost of the printer was not an allowable business deduction. McCann v. Comm’r, T.C. Memo. 1996-120.

The taxpayers operated several businesses and claimed a variety of deductions, none of which was substantiated by written records during the IRS audit or before the trial in this case. However, on the last day of trial, the taxpayers presented 22 boxes of unorganized records as evidence to support their deduction claims. Although the court allowed some time to organize the records, the taxpayers failed to present the records in an organized fashion. The court held for the IRS on all deduction claims based on the taxpayers’ failure to provide evidence otherwise. Leavell v. Comm’r, T.C. Memo. 1996-117.

The taxpayer was a corporation owned by one shareholder. The shareholder owned several horses which the shareholder entered into various equestrian competitions. The shareholder originally owned a farm where the horses were bred and raised; however, the shareholder sold the farm and boarded the horses at a stable owned by other individuals. The shareholder caused the corporation to adopt a resolution to sponsor the horses owned by the shareholder in order to promote the corporation’s products through the naming of the horses after the corporation’s products. None of the horses was named after the corporation’s products, however. The corporation paid for advertisements in show horse industry publications and claimed the expenses as business expenses of the corporation. The court held that the expenses were not related to the corporation’s trade or business but were payments for the shareholder’s personal expenses and not deductible as business expenses. Midwest Industrial Supply, Inc., T.C. Memo. 1996-130.

C CORPORATIONS-ALM § 7.02.*

LOAN OR CAPITAL CONTRIBUTION. The taxpayer was an 80 percent owner of a family corporation. The taxpayer made several “loans” to the corporation over several years, none of which was repaid. Using a higher level of scrutiny for transactions between a shareholder and a closely-held corporation, the court held that the “loans” were actually capital contributions because (1) the corporation could not obtain loans from third parties, (2) the funds transferred had a high risk of nonrepayment, (3) the corporation was thinly capitalized with several years of negative equity, (4) the “loans” were subordinated to other corporation debt, and (5) no interest or return of principal was ever paid on the loans. The corporation had declared some of the loans as worthless and the taxpayer claimed a bad debt deduction. The deduction was denied because the loans were held to be capital contributions. Kadlec v. Comm’r, T.C. Memo. 1996-119.

CASUALTY LOSSES-ALM § 4.05[2][a].* The IRS has issued a Coordinated Issue Paper which restates the IRS position that no casualty loss deduction may be claimed for damage to standing timber from an epidemic attack of southern pine beetles. The IRS noted that a noncasualty loss may be allowed for timber which was damaged to the point of being unsalvageable. Nonrecognition of gain treatment for an involuntary conversion is not available for the cutting of healthy trees around an infected area with the proceeds used to purchase other timber property. “Forest Products Industry—Losses of Timber Following an Epidemic Attack of Southern Pine Beetles,” Coordinated Issue Paper, 96 ARD 050-10.

COOPERATIVES-ALM § 14.03.* The taxpayer was a rural telephone cooperative. The cooperative was not tax-exempt under I.R.C. § 501(c)(12) nor was the cooperative governed by subchapter T. The cooperative issued a “statement of Patronage Credit” to patrons instead of distributing the net proceeds. The IRS ruled that the cooperative could deduct the amount of the certificates from the cooperative’s gross income on Form 1120. Ltr. Rul. 9610001, Sept. 26, 1995; Ltr. Rul. 9610002, Sept. 26, 1995; Ltr. Rul. 9610003, Sept. 26, 1995.

DEPRECIATION. The following case citation in Vol 7, No. 6 was incorrect. Maschmeyer’s Nursery, Inc. v. Comm’r, T.C. Memo. 1996-78.

EMPLOYEE BENEFITS. The taxpayer was an employer whose severance plan provided coverage of terminated employees under the employer’s medical plan for 18 months after termination of employment. The medical plan was qualified under I.R.C. §§ 105 and 106 and provided for payment of 82 percent of the premiums for the first twelve months by the employer and full payment by the terminated employee for the last six months. The IRS ruled that the terminated employees would be considered employees such that the employer contributions would be excluded from the terminated employees’ gross income. Ltr. Rul. 9612008, Dec. 18, 1995.

LIKE-KIND EXCHANGES. The taxpayer owned an apartment complex and decided to sell the property in order to acquire other similar property. The sale agreement provided that the purchasers would participate in finding and purchasing, through an escrow agent, properties to
exchange for the apartment complex. However, the taxpayer made all the inquiries about suitable properties and presented a list of 20 properties to the escrow agent, two of which were selected and purchased with the escrow funds. The second property was not purchased until 194 days after the sale of the apartment complex. The court held that the first sale qualified for like-kind tax free treatment. The court noted that regulations promulgated after the transactions limit to three the number of properties that can be identified, Treas. Reg. § 1.1031(K)-1(c)(4), but that the statute did not contain a limit. The court held that the second sale did not qualify for like-kind exchange treatment because the sale occurred more than 180 days after the sale of the apartment complex. St. Laurent v. Comm’r, T.C. Memo. 1996-150.

MITIGATION CREDITS. The taxpayer owned some land next to one of its manufacturing plants. The taxpayer decided to restore the wetlands nature of the land to obtain wetlands mitigation credits for use against other developments of wetlands, sell a conservation easement on the property to the state, and eventually deed the property to the state when the credits are used up. The easement would leave the taxpayer with only bare title to the land. The IRS ruled (1) the sale of the easement would be considered a sale of the entire property, (2) the final deeding of the land to the state would not result in any gain or loss to the taxpayer, (3) the easement would be treated as a capital asset and the sale would produce capital gain or loss, (4) the exchange of wetland mitigation credits would qualify for like-kind exchange treatment, (5) the amounts expended to create the wetlands credit would be included in the basis of the credits, and (6) the taxpayer could recognize gain or loss on the sale or exchange of a mitigation credit. Ltr. Rul. 9612009, Dec. 18, 1995.

PENSION PLANS. For plans beginning in February 1996, the weighted average is 6.98 percent with the permissible range of 6.28 to 7.53 percent (90 to 109 percent permissible range) and 6.28 to 7.67 percent (90 to 110 percent permissible range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). Notice 96-16, I.R.B. 1996—.

RESCISSION. The taxpayer owned stock in a corporation and the stock was held by the taxpayer’s broker. In January 1989, the taxpayer gave the broker an order to sell $100,000 of the stock but the broker sold 100,000 shares of stock. The broker and taxpayer eventually negotiated a repurchase of most of the stock in the same corporation but not the repurchase of the same stock sold by mistake in January. The taxpayer argued that the repurchase of stock was a rescission of the sale of the original stock and entitled to nonrecognition of gain treatment to the extent of the repurchase of the stock. Under Rev. Rul. 80-58, 1980-1 C.B. 187 where a contract of sale is canceled or rescinded in the same year of the sale such that the buyer and seller are returned to their original status, the seller does not recognize gain on the original sale. The court held that Rev. Rul. 80-58 did not apply in this case because the original sale of stock was not canceled or rescinded as between the taxpayer and the buyers of the stock. The court also held that the gain could not be deferred as an involuntary conversion and substitution of equivalent property because the broker was never shown to be criminally or civilly liable for the sale of the stock. Hutcherson v. Comm’r, T.C. Memo. 1996-127.

RENT DEDUCTION. The following case citation in Vol 7, No. 6 was incorrect. Maschmeyer's Nursery, Inc. v. Comm’r, T.C. Memo. 1996-78.

RETURNS. The taxpayer sought to present evidence of the mailing of a tax return by oral testimony. The IRS argued that, under I.R.C. § 7502(c), the only exceptions to physical delivery of a tax return are a postmark on the envelope containing the return or a registration or certification of the package. Under the statute, a registration or certification is prima facie evidence of delivery to the IRS on the date of the registration or certification. The taxpayer argued that the common law rule that placing a postpaid and properly addressed envelope containing the return in a mailbox created a rebuttable presumption of delivery of the envelope. Although the court acknowledged contrary decisions in the Eighth and Ninth Circuit Courts of Appeal, the court held that the common law rule did not apply to federal tax returns which were governed exclusively by I.R.C. § 7502(c). In the matter of Beautiful Plants by Charlie, Inc., 96-1 U.S. Tax Cas. (CCH) ¶ 50,147 (Bankr. M.D. Fla. 1996).

S CORPORATIONS-ALM § 7.02[3][c].

PASSIVE INVESTMENT INCOME. The taxpayer owned an apartment building. The corporation provided heat and hot water to the tenants and managed the buildings through a management company, employees of the corporation and third party contractors. The IRS ruled that the rent from the buildings would not be passive investment income to the corporation. Ltr. Rul. 9610016, Dec. 6, 1995.

The taxpayer was an S corporation which owned an office building rented to business tenants. The corporation provided management, maintenance and services for the building and tenants and employed several people to perform these tasks. The management of the building was performed by a management company under contract with the taxpayer. The IRS ruled that the rent from the building would not be passive investment income to the corporation. Ltr. Rul. 9611009, Dec. 6, 1995.

REORGANIZATION. An S corporation reorganized into two corporations under I.R.C. § 368(a)(1)(D), a “type D” reorganization. During the reorganization, the initial S corporation held stock of both corporations for a short time. The IRS ruled that the ownership of the stock of both corporations during a “type D” reorganization did not terminate the original corporation’s subchapter S election. Ltr. Rul. 9611016, Dec. 11, 1995.

TRUSTS. The taxpayers created 23 non-reversionary, irrevocable trusts, one for each child and grandchild. The trusts were identical except for the trustee and beneficiary. The trusts provided (1) the trust would have only one beneficiary, (2) trust corpus could be distributed only to the current beneficiary, (3) the income interest terminated at the earlier of the death of the beneficiary or the termination of the trust, (4) if the trust terminated during the life of the beneficiary, the trust corpus was to be distributed to the beneficiary, and (5) all income was to be distributed currently. The IRS ruled that the trusts were qualified subchapter S trusts. Ltr. Rul. 9611021, Dec. 13, 1995.

SALE OF RESIDENCE. The taxpayer owned a residence prior to getting married. After the marriage, the...
taxpayer decided to sell the residence and move into the spouse’s residence. The old residence was sold for a gain. The spouse transferred a one-half interest in the marital house to the taxpayer in consideration for the taxpayer’s assumption of one-half of the outstanding mortgage on the house. The couple expended funds on the renovation of the marital house. The taxpayer claimed a deferral of gain on the sale of the old residence because the amount of the entire assumed mortgage plus the full costs of the renovations exceeded the net sale proceeds of the old residence. The court found that, under state law, the taxpayer was not liable for the entire mortgage amount and reduced that amount to one-half of the outstanding mortgage amount. The court also found that the taxpayer failed to demonstrate that the taxpayer individually paid for all of the renovations to the marital residence and reduced that amount to one-half of the total costs. Because the adjusted sales price of the old residence exceeded the taxpayer’s one-half share of the mortgage and renovation costs by more than the gain realized in the sale of the old residence, the taxpayer was required to recognize all of the gain on the sale of the old residence. Feldman v. Comm’r, T.C. Memo. 1996-132.

SAFE HARBOR INTEREST RATES

<table>
<thead>
<tr>
<th>April 1996</th>
<th>Annual</th>
<th>Semi-annual</th>
<th>Quarterly</th>
<th>Monthly</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AFR</td>
<td>5.33</td>
<td>5.26</td>
<td>5.23</td>
<td>5.20</td>
</tr>
<tr>
<td>110% AFR</td>
<td>5.87</td>
<td>5.79</td>
<td>5.75</td>
<td>5.72</td>
</tr>
<tr>
<td>120% AFR</td>
<td>6.41</td>
<td>6.31</td>
<td>6.26</td>
<td>6.23</td>
</tr>
<tr>
<td>Mid-term</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AFR</td>
<td>5.88</td>
<td>5.80</td>
<td>5.76</td>
<td>5.73</td>
</tr>
<tr>
<td>110% AFR</td>
<td>6.48</td>
<td>6.38</td>
<td>6.33</td>
<td>6.30</td>
</tr>
<tr>
<td>120% AFR</td>
<td>7.08</td>
<td>6.96</td>
<td>6.90</td>
<td>6.86</td>
</tr>
<tr>
<td>Long-term</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AFR</td>
<td>6.51</td>
<td>6.41</td>
<td>6.36</td>
<td>6.33</td>
</tr>
<tr>
<td>110% AFR</td>
<td>7.17</td>
<td>7.05</td>
<td>6.99</td>
<td>6.95</td>
</tr>
<tr>
<td>120% AFR</td>
<td>7.84</td>
<td>7.69</td>
<td>7.62</td>
<td>7.57</td>
</tr>
</tbody>
</table>

THEFT LOSSES. The taxpayer invested in a tax shelter for the sole purpose of gaining a deduction in excess of the investment. Although the taxpayer received advice from an accountant to be wary of such investments, the taxpayer made the investment without investigating the company or the tax consequences of the investment. The IRS rejected the taxpayer’s deductions based on the tax shelter investment. The taxpayer argued that the original investment was a theft loss because the tax shelter agent misled the taxpayer as to the deductibility of the tax shelter’s claimed deductions. The court held that the investment was not eligible for a theft loss deduction because the taxpayer failed to take reasonable steps to investigate the tax shelter and invested in the tax shelter after contrary advice from an accountant. Jones v. U.S., 96-1 U.S. Tax Cas. (CCH) ¶ 50,136 (N.D. Calif. 1996).

TRAVEL EXPENSES. The IRS has issued updated procedures for determining the amount of travel expense which will be deemed substantiated where a per diem allowance is made under a reimbursement or other expense allowance arrangement. The updated procedures also provide an optional method for employees and self-employed individuals for computing the deductible costs of business meal and incidental expenses incurred while traveling away from home. The new procedures are effective April 1, 1996. Rev. Proc. 96-28, I.R.B. 1996-14, revising Rev. Proc. 94-77, 1994-2 C.B. 825.

PRODUCTS LIABILITY

 DAMAGES. The plaintiffs were tomato growers who purchased a frost protection chemical manufactured by the defendant. Although the chemical was applied correctly, the crop received damage from the chemical. The plaintiffs sought recovery of lost profits, i.e. economic damages, in an action for negligent misrepresentation. The plaintiffs claimed that the advertising, labels and oral representations by the defendant’s representations were false and misleading. The issue, a certified question from the Sixth Circuit Court of Appeals, was whether the plaintiff had alleged sufficient facts to support an action for negligent misrepresentation. The cause of action for negligent misrepresentation is defined by Section 552 of the Restatement (Second) of Torts to involve the failure to exercise reasonable care or competence in obtaining or communicating information about a product. The court held that the plaintiffs had not alleged any facts supporting any claim that the defendant was negligent in communicating any information. Instead, the allegations supported the claim that the information itself was faulty. The court held that the allegations supported a claim for misrepresentation under Section 402B of the Restatement; however, no economic damages are allowed in an action under Section 402B. Therefore, the plaintiffs’ claim for negligent misrepresentation was not allowed. Ritter v. Custom Chemicides, Inc., 912 S.W.2d 128 (Tenn. 1995).

STATE REGULATION OF AGRICULTURE

IMPORT FEES. The California Department of Food and Agriculture imposed an inspection fee on ships and airplanes carrying agricultural goods into California from foreign countries. No such fee was imposed on agricultural goods carriers from other states, however, and the court held that the inspection fee violated the Foreign Commerce Clause of the U.S. Constitution because the state failed to demonstrate any justification for the discriminatory fee. Pacific Merchant Shipping Ass’n v. California, ARD (CCH) ¶ 402-818 (Calif. 1995).

TRESPASS

TIMBER. The plaintiff owned timber land neighboring the defendant’s timber land. The defendant contracted with a third party to harvest timber and hired a surveyor to mark the property line. The surveyor was found to have negligently failed to mark the line between the plaintiff’s and defendant’s properties, resulting in the taking of $4,500 of timber belonging to the plaintiff. The court held that Tenn. Code § 39-3-1316, effective at the time the timber was cut, allowed the plaintiff damages for double the value of the timber taken, because the timber was taken negligently. Ghant v. Morrow, 911 S.W.2d 733 (Tenn. Ct. App. 1995).
Spend a week in Hawai‘i in January 1997! Balmy trade winds, 70-80 degrees, palm trees, white sand beaches and the rest of paradise can be yours; plus a world-class seminar on Farm Estate and Business Planning by Dr. Neil E. Harl. The seminar is scheduled for January 6-10, 1997 at the beautiful ocean-front Royal Waikoloan Resort on the Big Island, Hawai‘i.

Seminar sessions run from 8:30 a.m. to 12:30 p.m. each day, Monday through Friday, with a continental breakfast and break refreshments included in the registration fee. Each participant will receive a copy of Dr. Harl’s 400 page seminar manual, Farm Estate and Business Planning: Annotated Materials which will be updated just prior to the seminar.

Here are the major topics to be covered:

- Introduction to estate and business planning.
- Liquidity planning with emphasis on 15-year installment payment of federal estate tax.
- Co-ownership of property, including discounts, taxation and special problems.
- Federal estate tax, including alternate valuation date, special use valuation, handling life insurance, marital deduction planning, disclaimers, planning to minimize tax over deaths of both spouses, and generation skipping transfer tax.
- Gifts and federal gift tax, including problems with future interests, handling estate freezes, and "hidden" gifts.
- 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.
- Using trusts, including funding of revocable living trusts.
- Organizing the farm business--one entity or two, corporations, general and limited partnerships and limited liability companies.

The Agricultural Law Press has made arrangements for discount air fares on United Airlines and discounts on hotel rooms at the Royal Waikoloan, the site of the seminar.

The seminar registration fee is $645 for current subscribers to the Agricultural Law Digest or the Agricultural Law Manual. The registration fee for nonsubscribers is $695.

Watch your mail for more details or call Robert Achenbach at 1-541-302-1958.
Title I — Agricultural Market Transition Act (Commodity Programs)

The act ends the traditional pattern of price and income support with respect to program crops effective for the 1996 crop and phases out government payments to farmers with payments ending in 2002. Act § 101(b)(1). The act suspends for seven years (but does not eliminate) the permanent law provisions of the Agricultural Adjustment Act of 1938 and the Agricultural Act of 1949. Act § 171(a), (b).

Production flexibility contracts. The act provides for seven year production flexibility contracts that offer payments to eligible owners and producers who agree to follow specified conservation and other requirements. Act § 111. The contracts begin with the 1996 crop (or the date a CRP contract was entered into or expanded) and end with the crop in 2002. Act § 112(b).

As for eligibility to enter into production flexibility contracts, the act specifies that owners and producers who agree to follow specified conservation and other requirements. Act § 111(d). In addition to those participating in the federal acreage reduction programs, owners and producers who have land in the Conservation Reserve Program (16 U.S.C. § 3931) where the term expired or was voluntarily terminated on or after January 1, 1995 or was released from coverage under a CRP contract during the period beginning on January 1, 1995, and ending August 1, 1996. Act § 111(d).

The acreage eligible for payments is the base acreage that would have been established for 1996 under programs preceding enactment of the act with an adjustment for existing CRP program acres. Act §§ 114(a), 102(4).

The act refers to “contract acreage” in calculating payments but then defines the term to mean “1 or more crop acreage bases established for contract commodities....” Id.

An owner or producer may enroll all or part of the eligible cropland on the farm. Act § 111(e). It is not necessary for owners or producers to purchase crop insurance as a condition of participating. Act § 111(b)(6).

As for landlords and tenants, the act specifies that an owner of farmland is eligible who assumes all or part of the risk of producing a crop. Act § 111(b)(1).

A tenant (as producer) on eligible cropland under a “share-rent” lease is eligible to enter into a contract, regardless of the length of the lease, if the owner enters into the same contract. Act § 111(b)(2).

A tenant who cash rents eligible cropland under a lease expiring on or after September 30, 2002, is eligible, in which case the owner is not required to enter into the contract. Act § 111(b)(3).

If a cash rent lease expires before September 30, 2002, the tenant may be eligible and the owner may enter into the same contract. Act § 111(b)(4). If the tenant enrolls less than 100 percent of the eligible cropland, the owner’s consent is required. Id.

If a cash rent lease expires before September 30, 2002, and the tenant declines to enter into the contract, the owner is eligible to enter into a contract with the payments under the contract not beginning until the lease ends. Act § 111(b)(5).

The legislation states specifically that the Secretary is to “provide adequate safeguards to protect the interests of tenants and sharecroppers.” Act § 111(b)(6). Under a crop-share arrangement, the payment must be shared with the tenant. It is clear that payments follow the land. However, it is not clear if a lease can be terminated with the landowner shifting to custom farming and collecting the entire payment.

The act specifies that an annual contract payment is to be made not later than September 30 of each year through 2002. Act § 112(d)(1).

The total amount available for all contract payments is—

- $5,570,000,000 for FY 1996
- $5,385,000,000 for FY 1997
- $5,800,000,000 for FY 1998
- $5,603,000,000 for FY 1999
- $5,130,000,000 for FY 2000
- $4,130,000,000 for FY 2001
- $4,008,000,000 for FY 2002

Act § 113(a). Refunds of unearned 1995 advance deficiency payments are to be deducted from contract payments.

The amounts are to be allocated among the program crops on the following basis (with various adjustments) —

<table>
<thead>
<tr>
<th>Crop</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corn</td>
<td>46.22%</td>
</tr>
<tr>
<td>Wheat</td>
<td>26.26%</td>
</tr>
</tbody>
</table>

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
For each contract, the payment is based on 85 percent of the contract acreage times the farm program payment yield. Act § 114(a).

The act specifies that contract payments are to be shared between owners and producers on “a fair and equitable basis.” Act § 114(g).

The payment limitation per person “under 1 or more production flexibility contracts” is reduced to $40,000 under the legislation. Act § 115(b)(1). The “three entity” rule continues to apply. The limitation on gains from marketing loans and loan deficiency payments remains at $75,000. Act § 115(b)(2). Contract payments withheld because of the payment limitation contribute to deficit reduction rather than being redistributed among contract holders.

**Violations and transfers.** An owner or producer who violates a contract requirement may suffer a termination of the contract. Act § 116(a). That results in forfeiture of rights to receive future contract payments with a refund required of all contract payments received during the period of violation with interest. Id.

If the contract acreage is foreclosed upon, the owner or producer is not required to repay if forgiving the payments “is appropriate to provide fair and equitable treatment.” Act § 116(c)(1). If the owner or operator resumes operations, the provisions of the contract apply. Act § 116(c)(2).

A transfer of an interest in land covered by a contract results in termination of the contract unless the transferee agrees to assume all obligations under the contract. Act § 117(a). If an owner or producer dies, becomes incompetent or otherwise is unable to receive contract payment, payments are to be made as provided in regulations to be written. Act § 117(c).

On contract acres, any crop can be planted without limitation (other than fruits and vegetables). Act § 118(b)(1).

Fruits and vegetables (other than lentils, mung beans and dry peas) cannot be grown on contract acres unless there is a history of double cropping a program crop with fruits and vegetables. Act § 118(b)(2)(A). If the farm or the producer has a history of planting fruits and vegetables, the producer can plant fruits or vegetables on contract acres subject to an acre-for-acre reduction in contract payments. Act § 118(b)(2)(B), (C).

Haying and grazing is permitted on contract acreage without restriction. See Act § 118(a).

The programs 0/85, 50-85, 0-92 and 50/92 are all eliminated.

An owner or producer must —
- Comply with applicable conservation requirements. Act § 111(a)(1).
- Comply with applicable wetland protection requirements. Act § 111(a)(2).
- Comply with planting flexibility requirements. Act § 111(a)(3).

---

**Grain sorghum** 5.11%

**Barley** 2.16%

**Oats** 0.15%

**Upland cotton** 11.63%

**Rice** 8.47%

Act § 113(b).

For wheat, feedgrains and cotton, loan rates are capped at 1995 levels ($1.89 per bushel for corn, $2.58 per bushel for wheat, 51.92 cents per pound for upland cotton and $6.50 per hundredweight for rice). Act § 132. The loan rate is to be based upon the average price received by producers over the preceding five years, excluding the highest and lowest years. Id. The Secretary of Agriculture may make adjustments downward in the loan rate based upon the stocks-to-use ratio. Id.

For soybeans, the loan rate is set at 85 percent of the five-year average of market prices (excluding the high and low years) but not more than $5.26 per bushel and not less than $4.92 per bushel. Id.

For other oilseeds, the range is 8.7 cents to 9.3 cents per pound.

Except for upland cotton and extra long staple cotton, the loan is limited to a nine month term beginning with the first of the month after the month the loan is made. Act § 133(a). Cotton loans are for 10-months. Act § 133(b).

The Farmer-Owned Reserve is suspended for the 1996-2002 crops.

**Repayment.** For loans on wheat, feedgrains and oilseeds, the loan is to be repaid at the loan rate plus interest or a rate set by the Secretary of Agriculture that takes into account potential loan forfeitures, minimizes the accumulation of stocks, minimizes the cost to the federal government of commodity storage and allows the commodity to be marketed freely and competitively. Act § 134(a).

For upland cotton and rice, repayment is to be at the loan rate plus interest or the prevailing world market price for the commodity. Act § 134(b).

Loans on extra long staple cotton are to be repaid at the loan rate plus interest. Act § 134(c).

Except for extra long staple cotton, the Secretary has the authority under the legislation to make loan deficiency payments to producers who agree to forego obtaining a loan for the commodity. Act § 135(a). The payment is based on the loan rate multiplied by the amount eligible to be placed under loan. Act § 135(b). A special marketing loan provision is available for upland cotton involving marketing certificates or cash payments to domestic users and exporters. Act § 136.

For high moisture corn and grain sorghum, recourse loans are available. Act § 137(a). Recourse loans are also available (for seed cotton) for both upland cotton and extra long staple cotton. Act § 137(b).

**Dairy.** The dairy price support program is extended through 1999. Act § 141. Price support levels are reduced as follows —

<table>
<thead>
<tr>
<th>Year</th>
<th>Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>CY 1996</td>
<td>$10.35</td>
</tr>
<tr>
<td>CY 1997</td>
<td>10.20</td>
</tr>
<tr>
<td>CY 1998</td>
<td>10.05</td>
</tr>
<tr>
<td>CY 1999</td>
<td>9.90</td>
</tr>
</tbody>
</table>
Beginning in 2000, the price support program is replaced by a recourse loan program for butter, nonfat dry milk and cheese at the 1999 price support level. Act § 142.

The federal milk marketing order program under prior law is continued. See Act § 143.

The Secretary of Agriculture is required to reform and consolidate the 33 existing milk marketing orders into not less than 10 and not more than 14 over the next three years. Act § 143(a)(1).

If not completed and implemented within three years, the Secretary is to administer milk marketing orders from Agricultural Marketing Service funds of USDA. Act § 143(c).

Not later than April 1, 1997, USDA is to submit to Congress a report reviewing the federal milk marketing order system. Act § 143(d).

The fluid milk promotion program funded by processors is extended until 2002. Act § 146.

The legislation grants Congressional consent to the Northeast Interstate Dairy Compact as approved by the legislatures of Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island and Vermont. Act § 147.

However, the Secretary of Agriculture must find that there is a compelling public interest in the Compact region for the Compact to be implemented. Act § 147(1).

The Compact is limited to class I milk in the six New England states and is not to prohibit or in any way limit the marketing of milk produced in any other production area. Act § 147(2), (7).

The states of Delaware, New Jersey, New York, Pennsylvania, Maryland and Virginia are the only additional states that may join the Compact. Act § 147(4).

Peanuts. The peanut program is continued through the 2002 crop with several changes. Act § 155.

The quota support price is reduced by the legislation to $610 per ton from the 1995 level of $678 per ton. Act § 155(a)(2).

The floor under prior law of 1.35 million tons on the national poundage quota is eliminated. Act § 155(i)(2).

This allows the Secretary to establish the quota to match demand. Act § 155(i)(3).

Persons who are not peanut producers and who reside in another state and government entities are prevented from holding peanut quotas. Act § 155(i)(1)(v).

The proportion of the peanut quota in a county that can be sold or leased outside the county is increased from 15 percent in 1996 to 40 percent by 2000. Act § 155(i)(6).

Sugar. The sugar program is continued through the 2002 crop with several amendments —

The national average loan rates are frozen at 18 cents per pound for raw cane sugar and 22.9 cents per pound for refined beet sugar, the 1995 levels. Act § 156(a), (b). The Secretary is to reduce the loan rate if it is determined that negotiated reductions in export subsidies and domestic subsidies provided for sugar of other major sugar growing, producing and exporting countries exceed the commitment in the Uruguay Round trade agreement. Act § 156(c)(1).

Recourse loans are to be made when the tariff-rate quota is 1.5 million short tons or less and nonrecourse loans when the tariff-rate quota is greater than 1.5 million short tons. Act § 156(e)(1), (2). When a nonrecourse loan is in effect, there is a one-cent per pound penalty on forfeited cane sugar (and a comparable penalty for beet sugar). Act § 156(g).

The nonrefundable marketing assessment for deficit reduction is raised to 1.375 percent of the loan rate for cane sugar and 1.47425 percent of the loan rate for beet sugar. Act § 156(f).

The system of marketing allotments is eliminated.

Crop insurance. Several changes are made in the federal crop insurance program —

Under the legislation, producers are not required to purchase crop insurance to be eligible for commodity program benefits. Act § 193(a)(2). However, producers opting not to purchase insurance are required to waive all federal disaster assistance. Act § 193(a)(2), amending 7 U.S.C. § 1508(b)(7)(A)(ii).

Under the legislation, USDA is not permitted to deliver crop insurance from county offices except in states where the Secretary of Agriculture determines that catastrophic coverage from approved insurance providers is not “sufficiently available....” Act § 193(a)(1).

Under the 1996 act, the crop insurance program is to be administered by an independent Office of Risk Management. Act § 194(a).

Under the Noninsured Assistance Program, coverage is broadened to include seed crops and aquaculture. Act § 196(a)(2)(B). The Program is to be administered through the Farm Service Agency. Act § 196(a)(1).

The legislation authorizes the Secretary to make a prevented planting noninsured crop disaster assistance payment if the producer is prevented from planting more than 35 percent of the acreage intended for the eligible crop because of drought, flood or other natural disaster. Act § 196(c)(2).

Farm yields for noninsured crop disaster assistance are to be established based on the actual production history of the producer over a period of not less than the four previous consecutive crop years and not more than 10 consecutive crop years. Act § 196(e).

Title II — Trade

The 1996 legislation amends a number of trade and food aid programs with programs reauthorized through 2002.


The Market Promotion Program is targeted toward small businesses, cooperatives and producer associations. Act § 244(b). The program is capped at $90 million per year. Act § 244(c).

The Secretary of Agriculture is directed to establish a reserve stock of “wheat, rice, corn or sorghum” or any combination totaling not more than 4,000,000 metric tons to meet emergency humanitarian needs in developing countries. Act § 225(a).

The legislation contains a sense of the Congress resolution that the House and Senate Agriculture
Committees should conduct “a thorough review of agricultural export and food aid programs” not later than December 31, 1998. *Act § 241(b).*

The legislation reauthorizes agricultural trade and aid programs including P.L. 480. *Act § 217.* The concessional-loan part of P.L. 480 is reoriented toward greater market development. *Act § 203.*

The act places new emphasis on high-value products in the GSM-102 export credit guarantee program. *Act § 243.*

The 1996 legislation contains additional protection to farmers against unilateral export embargoes. *Act § 249.* The act provides for trade compensation assistance if exports are embargoed unilaterally for reasons of national security or foreign policy if, within 90 days, no other country “with an agricultural economic interest” agrees to participate in the suspension. *Id.* The program does not apply to suspension of trade “due to a war or armed hostility.” *Id.*

**Title III — Conservation**

The 1996 legislation extends a number of existing soil conservation and water quality programs, many with amendments. The act also creates new programs to focus on important environmental concerns.

**Conservation Reserve Program (CRP).** The Conservation Reserve Program (CRP) was enacted as part of the 1985 farm bill and was continued in 1990. *16 U.S.C. § 3831, added by P.L. 99-198, Sec. 1231, 99 Stat. 1508 (1985).* The 1996 legislation continues the program through 2002. *Act § 332.*

Enrollment in CRP is capped at 36.4 million acres. *Act § 332(b).*

Participants in CRP may terminate contracts entered into before January 1, 1995, provided the contract has been in effect for at least five years. *Act § 332(c).* The contract termination is effective 60 days after the notice is submitted by the owner or operator. *Id.* Some land is not eligible for the early termination provision — (1) filterstrips, waterways, strips adjacent to riparian areas, windbreaks and shelterbelts; (2) land with an erodibility index of more than 15; and (3) other lands of “high environmental value.” *Id.*

No higher conservation requirements could be imposed on land exiting CRP than on other land in conservation compliance plans. *Id.*

**Wetlands Reserve Program (WRP).** The Wetlands Reserve Program, which has been controversial in many agricultural areas, has been reauthorized through 2002 with numerous modifications. *Act § 333(b).* The Secretary of Agriculture is directed to enroll not more than 975,000 acres by 2002. *Act § 333(a).*

To the “maximum extent practicable,” the Secretary is to enroll into the WRP one-third of the acres through the use of permanent easements, one-third in 30-year easements and one-third through the use of restoration cost-share agreements. *Id.* After October 1, 1996, no new permanent easements may be enrolled until 75,000 acres are enrolled through the use of temporary easements. *Id.*

**Environmental Quality Incentive Program (EQuIP).** The Environmental Quality Incentive Program has been created to assist crop and livestock producers in dealing with environmental concerns. *Act § 334.*

The act combines into a single program several provisions that have provided cost sharing and technical assistance to producers implementing practices to protect soil, water and related resources. *Id.*

Specifically, the program includes the agricultural conservation program, the Great Plains conservation program, the water quality incentives program and the Colorado River Basin salinity control program. *Id.*

The objective is for the various initiatives to be carried out in a manner that maximizes the environmental benefits per dollar expended, encourages environmental enhancement, provides assistance to producers in making cost-effective changes in their crop and livestock production systems and reduces administrative burdens on producers. *Id.*

As for funding, the Commodity Credit Corporation is to provide $130 million in fiscal year 1996 and $200 million per year thereafter in mandatory funding with one-half of the money going to crop producers and one-half to livestock producers. *Act § 334.*

The federal share of cost-share payments is not more than 75 percent of the projected cost, taking into consideration any payment from state or local governments. *Act § 334.*

A producer who owns or operates a “large confined livestock operation” is not eligible for cost share payments to construct an animal waste management facility. *Id.* The definition of “large confined livestock operation” is to be defined by the Secretary in regulations. *Id.*

The total amount of cost-share and incentive payments paid to a producer may not exceed $10,000 for any fiscal year or $50,000 for a multi-year contract. *Id.* Larger payments may be approved on a case-by-case basis. *Id.* The term “livestock” means dairy cattle, beef cattle, laying hens, broilers, turkeys, swine, sheep “and such other animals as determined by the Secretary.” *Id.*

**Other environmental provisions.** The Conservation Farm Option Pilot Program is to provide producers of wheat, feedgrains, cotton and rice a flexible, simplified approach to solving their farm conservation needs. *Act § 335.*

Owners and producers with contract acreage enrolled in the transition program are eligible to participate in the conservation farm option. *Id.*

Participants in the program are required to submit to the Secretary of Agriculture a conservation farm plan that becomes a part of the conservation farm option contract. *Id.*

The contract is to be for a duration of 10 years and may be renewed for a period of not to exceed five years. *Id.*

The Commodity Credit Corporation is to make funds available to the program —

<table>
<thead>
<tr>
<th>Amount</th>
<th>Fiscal Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>$7,500,000</td>
<td>FY 1997</td>
</tr>
<tr>
<td>$15,000,000</td>
<td>FY 1998</td>
</tr>
<tr>
<td>$25,000,000</td>
<td>FY 1999</td>
</tr>
<tr>
<td>$37,500,000</td>
<td>FT 2000</td>
</tr>
<tr>
<td>$50,000,000</td>
<td>FY 2001</td>
</tr>
<tr>
<td>$62,500,000</td>
<td>FY 2002</td>
</tr>
</tbody>
</table>

*Act § 335.*

Not more than 25 percent of the cropland in any county may be enrolled in the conservation reserve and wetlands reserve programs. *Act § 341.* Not more than 10 percent of the cropland in a county may be subject to an easement.
under the act unless approved as an exception by the Secretary. Id.

Tenants and sharecroppers are to be protected under the various programs with an assurance of sharing, on a fair and equitable basis, in payments under the programs. Id.

A nonprofit foundation, the Natural Resources Conservation Foundation, is established to “promote innovative solutions to the problems associated with the conservation of natural resources on private lands....” Act § 353(a), (b).

Under the Flood Risk Reduction Program, producers on a farm with contract acreage under the transition program have the option of receiving a payment that is not more than 95 percent of projected contract payments under the transition program (if the producer agrees to forego any payment under the farm program, crop insurance and disaster programs) on “frequently flooded” land. Act § 385(a), (b).

Under a new program on conservation of private grazing land, the Secretary is authorized to establish a voluntary program of “technical, educational, and related assistance” to owners and managers of private grazing land and public agencies. Act § 386(d). The Secretary may also establish two grazing management demonstration districts. Act § 386(e)(2).

The activities of a grazing management district are to be scientifically sound activities. Act § 386(e)(3)(F).

The area proposed to be included in a grazing management district is to be determined by the Secretary on the basis of a petition by farmers or ranchers. Act § 386(e)(3)(D).

An amount of $20,000,000 is appropriated for the program for FY 1996, $40,000,000 for FY 1997 and $60,000,000 for FY 1998 and subsequent fiscal years. Act § 386(f).

Under the Wildlife Habitat Incentive Program, cost-share assistance is to be provided to landowners to develop and protect wildlife. Act § 387(a).

A total of $50,000,000 is to be made available for fiscal years 1996 through 2002. Act § 387(c).

Cost-share payments are to be made to landowners to develop “upland wildlife, wetland wildlife, threatened and endangered species, fish, and other types of wildlife habitat approved by the Secretary.” Act § 387(b).

The Farmland Protection Program is established to purchase “conservation easements or other interests in not less than 170,000, nor more than 340,000, acres of prime, unique, or other productive soil that is subject to a pending offer from a state or local government for the purpose of protecting topsoil by limiting nonagricultural uses of the land. Act § 388(a).

Any highly erodible cropland for which a conservation easement or other interest is purchased is subject to the requirements of a conservation plan that requires the conversion of cropland to less intensive uses. Act § 388(b).

Up to $35,000,000 of Commodity Credit Corporation funds are made available to the program. Act § 388(c).

An amount of $200,000,000 is appropriated to carry out the provisions of the Everglades Ecosystem Restoration Program. Act § 390(a). The funds are to be used to conduct restoration activities and fund resource protection and resource maintenance activities in the Everglades. Act § 390(b).

The legislation encourages the Secretary of Agriculture to continue to strengthen “vital research efforts related to agricultural air quality.” Act § 391(b). The sense-of-the-Congress provision refers to allegations that agriculture is the source of some types of emissions. Act § 391(a).

Title IV — Nutrition

The 1996 legislation reauthorizes the food stamp program through September 30, 1997, with several amendments. Act § 401.

Grants may be made to eligible private nonprofit entities to establish and carry out “community food projects.” Act § 401(h).

An amount of $1,000,000 is made available for this purpose in FY 1996 and $2,500,000 for each fiscal year 1997 through 2002.

The legislation reauthorizes the following programs for seven years —

The Puerto Rico Nutrition Assistance Program. Act § 401(f).

The Commodity Supplemental Food Program. Act § 402(a).

The Emergency Food Assistance Program. Act § 403(a).


The Children Nutrition Programs (including school lunch and the Women, Infants and Children Program (WIC)) were reauthorized in 1994 and did not require legislative action in 1996.

Title V — Agricultural Promotion

Programs for the promotion of agricultural commodities funded by mandatory assessments on producers or processors are addressed in the legislation. Act § 501.

Each commodity board operating pursuant to a commodity promotion law is to authorize and fund an independent evaluation of programs not less than once every five years. Act § 501(c).

Title VI—Credit

The 1996 legislation reauthorizes farm lending programs of the US Department of Agriculture with new restrictions on the purposes for which loans can be made and imposes new restrictions on borrowers who have previously defaulted. Act §§ 601-663. The legislation also places new limits on the amounts that can be loaned to a borrower and implements new rules on the sale of forfeited property.

Direct ownership loans. Under the legislation, direct loans may be made to a farmer or rancher who has operated a farm or ranch for not less than three years and — (a) is a qualified beginning farmer or rancher, (b) has not previously received a direct farm ownership loan or (c) has not received a direct ownership loan more than 10 years before the date the new loan would be made. Act § 601. The operation of a farm by a youth is not considered the operation of a farm or ranch for this purpose. Id.

Direct loans may be used for — (a) acquiring or enlarging a farm or ranch; (b) making capital improvements to a farm or ranch; (c) paying loan closing costs related to acquiring, enlarging or improving a farm or ranch; or (d) paying for activities to promote soil and water conservation and protection. Act § 602(a).
A loan may not be made to a farmer or rancher unless the borrower has agreed to obtain hazard insurance on any real estate to be acquired or improved with the loan.  

_ACT § 602(b)._  

If a direct farm ownership loan is made as a part of a joint financing arrangement, and the amount of the direct farm ownership loan does not exceed 50 percent of the total principal amount financed, the interest rate on the direct farm ownership loan is to be at least four percent annually.  

_ACT § 604(2)._  

Guaranteed loans.  A farmer or rancher may use a guaranteed loan for — (a) acquiring or enlarging a farm or ranch; (b) making capital improvements to a farm or ranch; (c) paying loan closing costs related to acquiring, enlarging or improving a farm or ranch; (d) paying for activities to promote soil and water conservation and protection; or (e) refinancing indebtedness.  

In making or guaranteeing a loan for the purchase of a farm or ranch, preference is to be given to a person who — (a) has a dependent family; (b) to the extent practicable is able to make an initial down payment on the farm or ranch; or (c) is an owner of livestock or farm or ranch equipment necessary successfully to carry out farming or ranching operations.  

_ACT § 605._  

A contract of insurance or guarantee is specifically made an obligation supported by the full faith and credit of the United States and is incontestable except for fraud or misrepresentation.  

Amount of the guarantee —  

• Beginning farmer loans may be guaranteed up to 95 percent of (1) a farm ownership loan for a borrower participating in the down payment loan program; or (2) an operating loan to a borrower who is participating in the down payment loan program made during the period that the borrower has a direct loan outstanding for acquiring a farm or ranch.  

_ACT § 606._  

• Refinanced loans may be guaranteed at the 95 percent level of — (1) the principal and interest due on a loan that refinances a direct loan; or (2) the portion of a loan used for multiple purposes that refinances the principal and interest due on a direct loan that is outstanding on the date the loan is guaranteed.  

• Otherwise, the loan guarantee can be for not more than 90 percent of the principal and interest due on the loan.  

Operating loans. Under the 1996 act, direct loans may be made to a farmer or rancher who — (1) is a qualified beginning farmer or rancher who has not operated a farm or ranch or who has operated a farm or ranch for not more than five years, (b) has not received a previous direct operating loan, or (c) has received a previous direct operating loan made during six or fewer years.  

_ACT § 611(a)._ The term “direct operating loan” does not include a loan made to a youth.  

_ACT § 611(b)._  

A direct operating loan may be made for — (1) paying the costs involved in reorganizing a farm or ranch for more profitable operation; (2) purchasing livestock, poultry or farm or ranch equipment; (3) purchasing feed, seed, fertilizer, insecticide or farm or ranch supplies or to meet other essential operating expenses (including cash rent); (4) financing land or water development, use or conservation; (5) paying loan closing costs; (b) assisting in changing the operation to comply with OSHA standards; (7) training a “limited resource” borrower in maintaining records of farming and ranching operations; (8) training a borrower under section 359 of the Consolidated Farm and Rural Development Act; (9) refinancing indebtedness if the borrower has refinanced a loan not more than four times previously and has suffered a Presidentially-declared natural disaster loss or is refinancing a debt obtained from another creditor; or (10) providing other “farm, ranch, or home needs, including family subsistence.”  

_ACT § 612._  

An operating loan may be guaranteed for — (a) paying the costs in reorganizing a farm or ranch for more profitable operation; (b) purchasing livestock, poultry or farm or ranch equipment; (c) purchasing feed, seed, fertilizer, insecticide or supplies or to meet other “essential farm or ranch operating expenses” (including cash rent); (d) financing land or water development, use or conservation; (e) refinancing indebtedness; (f) paying loan closing costs; (g) complying with OSHA standards; (h) training a borrower under Section 359 of the Consolidated Farm and Rural Development Act; or (i) providing other farm ranch or home needs including family subsistence.  

_ACT § 612(a)._  

A condition of loans is that the farmer or rancher has or agrees to obtain hazard insurance on the property.  

The rules provide specifically that a portion of a loan may be placed in an unsupervised bank account that may be used at the borrower’s discretion for “basic family needs of the borrower and the immediate family of the borrower.”  

_ACT § 614._ If a payment required on a line-of-credit loan is not paid on time, the borrower may not take an advance or draw on the line unless the failure to pay was attributable to “unusual conditions” the borrower “could not control” and the borrower will reduce the line of credit to the scheduled level at the end of the production cycle or by the marketing of the borrower’s agricultural products.  

The 1996 legislation provides specifically that loans or guarantees may be in the form of a line-of-credit loan of up to five years maturity.  

In general, loans are not to be guaranteed for any year after the fifteenth year that a loan is made to, or a guarantee is provided with respect to, the borrower.  

Emergency loans. The legislation imposes new limitations on emergency loans —  

An emergency loan may not exceed the actual loss caused by the disaster and loans may not be made that would cause the borrower’s indebtedness for emergency loans to exceed $500,000.  

The act makes it clear that the value of assets for emergency loan purposes is to be the value as of the day before the occurrence of the disaster.  

The authority to waive application of the “credit elsewhere” test is narrowed by reducing the “$300,000 or less” requirement to $100,000 or less.  

_ACT § 622._ That
requirement relates to the loan level above which two written declinations are required. 7 U.S.C. § 1962(b).

Hazard insurance is required as a condition to receiving an emergency loan. Act § 621(a). The amount of insurance is to be determined by the Secretary of Agriculture. Id.


The act mandates an annual review of the credit history and business operations of borrowers. Act § 635(a).


Not later than 15 days after acquiring real property, the property is to be advertised for sale. Act § 638, adding 7 U.S.C. § 1985(c)(1)(A).

Not later than 75 days after acquiring the real property, the land is to be offered for sale to a qualified beginning farmer or rancher at current market value based on a current appraisal. Act § 638, adding 7 U.S.C. § 1985(c)(1)(B). If there is more than one qualified buyer, the selection is to be on a random basis. Id. A random selection or denial of a beginning farmer or rancher for farm inventory property is final and not administratively appealable. Id.

If no acceptable offer is received from a qualified beginning farmer or rancher within the 75 day period, not later than 30 days later the property is to be sold after public notice at a public sale. Act § 638, adding 7 U.S.C. § 1985(c)(1)(C). If no acceptable bid is received, the property is to be sold at a negotiated sale at the best price obtainable. Id.

For acquired property that was not being leased on April 4, 1996, not later than 60 days after the date of enactment of the legislation (which was April 4, 1996), the property is to be offered for sale under the above rules not later than 60 days after the lease expires. Act § 638, adding 7 U.S.C. § 1985(c)(2)(A).

Land conveyances are to include all interests in the land including mineral rights except that for conservation purposes an “easement, restriction, development right or other similar right” may be given to a state, political subdivision of a state or a private non profit organization. Act § 638, adding 7 U.S.C. § 1985(c)(3).

In general, acquired property is not to be leased except that land may be leased or sold on contract to a beginning farmer or rancher if the borrower qualifies for a credit sale or direct farm ownership loan but credit sale authority for loans or direct farm ownership loan funds is not available. Act § 638, adding 7 U.S.C. § 1985(c)(5).

Wetland conservation easements are not to be given on land held in inventory by USDA if the land was cropland on the date the property entered into inventory or was used for farming at any time during the five year period before entering into inventory. Act § 639.

The legislation redefines “debt forgiveness” as to direct or guaranteed loans to include (a) writing down or writing off the loan; (b) compromising, adjusting, reducing or charging off a debt or claim (under the Consolidated Farm and Rural Development Act, Sec. 331); (c) paying a loss on a guaranteed loan; or (d) discharging a debt as a result of bankruptcy. Act § 640(2). The term “debt forgiveness” does not include consolidation, rescheduling, reamortization or deferral. Id.

Borrowers who have received debt forgiveness on a guaranteed or direct loan —

May not receive a direct or guaranteed loan other than a farm operating loan for paying annual farm or ranch operating expenses of a borrower. Act § 648(b).

May not receive more than one debt forgiveness on a direct loan. Id.

Amount authorized for loans. The legislation sets the following limits on loans —

<table>
<thead>
<tr>
<th>Total Amount</th>
<th>Direct Loans</th>
<th>Guaranteed Loans</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Farm Ownership</td>
<td>Operating</td>
</tr>
<tr>
<td>FY 1996</td>
<td>3,085,000,000</td>
<td>85,000,000</td>
</tr>
<tr>
<td>FY 1997</td>
<td>3,165,000,000</td>
<td>85,000,000</td>
</tr>
<tr>
<td>FY 1998</td>
<td>3,245,000,000</td>
<td>85,000,000</td>
</tr>
<tr>
<td>FY 1999</td>
<td>3,325,000,000</td>
<td>85,000,000</td>
</tr>
<tr>
<td>FY 2000</td>
<td>3,435,000,000</td>
<td>85,000,000</td>
</tr>
<tr>
<td>FY 2001</td>
<td>3,435,000,000</td>
<td>85,000,000</td>
</tr>
<tr>
<td>FY 2002</td>
<td>3,435,000,000</td>
<td>85,000,000</td>
</tr>
</tbody>
</table>

Act § 641

The legislation mandates that a specified percentage of the direct farm ownership and operating loans and guaranteed loans be reserved for beginning farmers or ranchers. Act § 641.

Credit study. The legislation mandates a study on the demand for and availability of credit in rural areas for agriculture, housing and rural development. Act § 650(a).

The study is to focus particularly on the role of the Farm Credit System, banks and USDA. Act § 650(b).

The legislation authorizes the electronic filing of financing statements under the Food Security Act of 1985 (7 U.S.C. § 1631(c)(4)) if the state allows electronic filing. Act § 662.

Title VII — Rural Development


Rural Investment Partnerships. Act § 701.


Rural Wastewater Circuit Rider Program. Act § 703.

Teledmedicine and Distance Learning. The legislation amends the provisions in the 1990 farm bill to encourage
and improve telemedicine services and distance learning services in rural areas. Act § 704.

The act authorizes grants or cost-of-money loans or both to finance the construction of facilities and systems to provide telemedicine services and distance learning services in rural areas. Id.

The Secretary is to establish the minimum amount of financial assistance to be made available to individual recipients not more than 45 days after funds are made available for the fiscal year. Id.

The Secretary of Agriculture is to develop a streamlined, simplified and uniform application for an array of federal programs or other agencies approved by the Secretary to — (a) identify and analyze business opportunities that will use local rural economic and human resources; (b) identify, train and provide technical assistance to existing or prospective rural entrepreneurs and managers; (c) establish business support centers and otherwise assist in creating and financing new rural businesses; (d) conduct regional, community and local economic planning and coordination and leadership development; and (e) establish centers for training, technology and trade to provide training to rural businesses in using interactive communications technologies to develop international trade opportunities and markets. Act § 741(a)(3). A total of $7,500,000 is appropriated for each of the fiscal years 1996 through 2002. Id.

An amount of $35,000,000 is appropriated for the Emergency Community Water Assistance Grant Program. Act § 742. The Emergency Community Water Assistance Grant Program for Smallest Communities is repealed. Act § 742.

The provision authorizing Insured Watershed and Resource Conservation and Development Loans is repealed. Act § 746.

The Rural Industrialization Assistance Program is amended. Act § 747.

Language has been added to include facilitating economic opportunity for industries undergoing adjustment from terminated federal farm price and income support programs or increased competition from foreign trade. Act § 747(a)(1). Grants may be made to facilitate those types of projects. Act § 747(a)(3).

Grants may be made to nonprofit institutions to establish and operate centers for rural cooperative development. Act § 747(a)(4). An amount of $50,000,000 is appropriated for this purpose. Id.

Loans may be guaranteed to individual farmers for the purpose of purchasing start-up capital stock of a farmer cooperative established for the purpose of processing an agricultural commodity. Act § 747(a)(7).

The legislation establishes a Rural Development Certified Lenders Program for the guarantee of rural development loans. Act § 752.

The act establishes a National Sheep Industry Improvement Center. Act § 759.

Rural Community Advancement Program. The legislation creates a new program, the Rural Community Advancement Program. Act § 761. The purpose of the program is to provide grants, loans, loan guarantees and other assistance to meet the rural development needs of local communities. Id.

For this purpose, “rural” and “rural area” includes a city, town or unincorporated area with a population of 50,000 or less (other than an urbanized area immediately adjacent to an area with a population of more than 50,000). Id.

The national objectives of the program are to —

• Promote strategic development activities and collaborative efforts by state and local communities and federally recognized Indian tribes to maximize the impact of federal assistance;

• Optimize the use of resources;

• Provide assistance in a manner that reflects the complexity of rural needs including the needs for business development, health care, education, infrastructure, cultural resources, the environment and housing;

• Advance activities that empower and build the capacity of state and local communities to design unique responses to the special needs of the state and local communities, and federally recognized Indian tribes, for rural development assistance; and

• Adopt flexible and innovative approaches to solving rural development problems. Id.

A Rural Development Trust Fund is established to hold funds to be used in the program. Id. The Fund has five accounts —

• Rural community facilities,

• Rural utilities,

• Rural business and cooperative development,

• National reserve, and

• Federally recognized Indian tribe. Id.

Up to 10 community development venture capital organizations may be designated to demonstrate the utility of guarantees to attract increased private investment in rural private business enterprises. Id.

The Secretary of Agriculture is to develop a streamlined, simplified and uniform application for an array of federal programs. Act § 762.

A Community Facilities Grant Program is authorized to make grants, up to $10,000,000 for any fiscal year, to associations, units of local government, nonprofit corporations and federally recognized Indian tribes to
provide the federal share of the cost of developing specific essential community facilities in rural areas. Act § 763.
The amount of a grant may not exceed 75 percent of the cost of developing the facility. Id.

The legislation specifically prohibits conditioning assistance under any rural development program on any requirement that the recipient of the assistance accept or receive service from any particular utility, supplier or cooperative. Act § 778.
Fund for Rural America. An account is established to be known as the Fund for Rural America. Act § 793(a).
The account is to be funded with $100,000,000 on January 1, 1997, October 1, 1998 and October 1, 1999. Act § 793(b).

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

BANKRUPTCY
GENERAL-ALM § 13.03.*

EXEMPTIONS
IRA. In 1991, the debtor rolled over funds from a terminated pension plan to an IRA. The debtor filed for Chapter 7 in 1994 and claimed $286,000 in the IRA as exempt under Mass. Gen. Law, ch 235, § 34. The trustee objected to the exemption to the extent the rolled-over amount exceeded 7 percent of the debtor’s total income for the five years before the bankruptcy filing. The debtor argued that the 7 percent limit did not apply to rolled-over funds but only applied to new deposits. The court held that the statute was unambiguous and limited the IRA funds but only applied to new deposits. The court held that Section 507(a)(5)(A) exempted to an amount equal to 7 percent of the debtor’s income for the five pre-petition years. In re Goldman, 192 B.R. 1 (D. Mass. 1995), aff’g, 182 B.R. 622 (Bankr. D. Mass. 1995).

GRAIN STORAGE FACILITY. The debtor’s business consisted primarily of purchasing grain for conditioning and resale as seed, either to third parties or the producer of the grain. The debtor also sold farm equipment and various farm inputs. Several creditors sought a fifth priority under Section 507(a)(5)(A) for their claims against the debtor as a grain storage facility. The court held that claims from creditors who purchased, but did not receive, farm equipment and farm inputs were not entitled to the priority because the claims did not involve grain or the proceeds of grain. The court also denied fifth priority to claims for unpaid wages. The court denied a fifth priority to claims for the prepayment for seed which was not delivered to creditors who were not producers of grain but who sold the seed to third parties. The last group of creditors was grain producers who sold grain to the debtor and who were not paid. Some of the grain was processed for seed but some was resold to third parties to the extent not needed for the seed inventory. The court held that Section 507(a)(5)(A) was not intended to apply to situations where grain was sold to the storage facility with title passing to the facility. The court assumed that the debtor qualified as a grain storage facility, although doubted that the debtor qualified as a grain storage facility. The court held that in order for a producer to be entitled to the fifth priority, the producer must have retained title to the grain while the grain was in the storage facility. In re Mickelson, 192 B.R. 516 (Bankr. D. N.D. 1996).

PLAN. The debtor filed for Chapter 13 and one of the secured claims was held by the FmHA (now the FSA). The debtor’s plan provided for payment of the claim at 6.5 percent interest. The debtor argued that the FmHA offered 5 percent loans to new farmers and 8 percent loans to established farmers. The debtor argued that if the FmHA had been able to foreclose on the debtor’s property, the land would have been offered to new farmers first at the 5 percent rate and, only if no new farmers were found, would the 8 percent rate be applied for a loan to purchase the debtor’s land. Therefore, the debtor proposed a rate halfway between the two rates as a reasonable compromise. The Bankruptcy and District Courts held for the debtor; however, the appellate court reversed, holding that the plan was to provide a market rate of interest and by definition, the 5 percent rate was not a market rate of interest but a subsidized rate. In addition, the debtor was not a new farmer and could not qualify for the lower rate; therefore, the lower rate should not have been considered in determining the market rate of interest to be paid during the plan. In re Roso, 76 F.3d 179 (8th Cir. 1996).

CHAPTER 12-ALM § 13.03[8].

DISCHARGE. The debtor was divorced in 1984. A 1986 amendment to the property settlement gave the former spouse a judgment lien against the debtor’s farm real and personal property to the extent of the unpaid property settlement. In April 1995, the former spouse obtained a monetary judgment for the unpaid property settlement and in May 1995, the debtor filed for Chapter 12. Soon after the
divorce decree, the debtor quitclaimed the farm homestead of 480 acres back to the debtor’s parents from whom the debtor had purchased the farm on installment contract. The farm homestead was worth several times what remained owed on the debt. After the farm homestead was deeded back to the parents, the debtor continued to live and farm on the homestead without payment of rent. The debtor also transferred livestock to the parents for consideration far below the value of the livestock. During all of these transfers, the former spouse held a judgment lien on the property but did not receive any payment on the debt. The former spouse sought to have the property settlement debt declared nondischargeable under several theories. First, the former spouse argued that the debt was nondischargeable under Section 727(a)(5) because the debtor failed to adequately explain the loss of assets. The court held that the transfers occurred too long before the bankruptcy case to apply Section 727. Second, the former spouse argued that the debt was nondischargeable under Section 523(a)(4) because of fraud or defalcation while acting as a fiduciary. The court held that the debtor was not a fiduciary as to the former spouse as to the property settlement. Third, the former spouse argued that the debt was nondischargeable under Section 523(a)(6) for willful and malicious injury to the property of another. The court held that in transferring the farm homestead and livestock for less than adequate consideration while retaining the use of the property and without compensating the former spouse for the security interest lost in the transfers, the debtor willfully and maliciously damaged the former spouse’s security interest in the property with full knowledge that the transfers would injure the former spouse’s rights in the property. The court also held that the debt would be nondischargeable under Section 523(a)(15) because the debtor would have sufficient income after the discharge of other bankruptcy debts to pay the property settlement. In re Straub, 192 B.R. 522 (Bankr. D. N.D. 1996).

REOPENING CASE. The debtors had reached an agreement with the Commodity Credit Corporation (CCC) in their Chapter 12 case for the deposit of the proceeds of collateral in an account pending the debtors’ appeal of a cash collateral decision. The appeals were decided in favor of the CCC and the CCC obtained disbursement of the proceeds. However, at the time of the disbursement, the proceeds had grown because of accrued interest and the entire amount was distributed to the CCC. The debtors did not challenge the distribution and the case was eventually closed. Three years after the distribution, the debtors sought to reopen the bankruptcy case to challenge the distribution of the interest to the CCC, claiming excusable neglect for the late challenge. The court held that although a case could be reopened for excusable neglect, the three year delay was too long to allow reopening a case for excusable neglect. In re Watford, 192 B.R. 276 (Bankr. M.D. Ga. 1996).

FEDERAL TAXATION-ALM § 13.03[7].*

DISCHARGE. The debtor filed for Chapter 11 and the IRS and state of Illinois filed claims for employment taxes not paid by the debtor. The debtor’s plan provided for full payment of the tax claims and the plan was confirmed. After the debtor paid the tax claims, the state filed a claim for additional prepetition employment taxes and the IRS filed a claim for additional FUTA taxes based on the additional state claim. The debtor argued that the claims were barred by the confirmation of the plan. The court held that, because the tax claims were priority nondischargeable claims, whether or not filed, the confirmation of the plan did not affect the status of the claims and the claims were allowed after confirmation of the plan. The court also held that the governmental units were not estopped from bringing the claims because the debtor failed to show any misrepresentation by the government entities or any reliance by the debtor on the filed claims. In re McConahey, 192 B.R. 187 (Bankr. S.D. Ill. 1996).

The debtors filed for Chapter 11 and the IRS filed a claim for secured, unsecured priority and general unsecured tax claims. The debtors’ plan provided for full payment of the claims over the six years of the plan with interest from the date of confirmation. The IRS then sought post-petition, preconfirmation interest on its claims. The court held that, because the plan provided for full payment of the tax claims, no post-petition, preconfirmation interest was allowed. The court noted that such interest would be allowed if the plan did not provide for full payment. In re Heisson, 192 B.R. 294 (Bankr. D. Mass. 1996).

The debtor filed for Chapter 13 and the IRS filed a claim for taxes owed more than three years before the petition date. The tax claim involved unreported income resulting from the debtor’s embezzlement of funds. The taxes were considered as taxes for which the debtor filed a fraudulent return or willfully attempted to evade, under Section 523(a)(1)(C). The court held that, under the plain language of Section 1328(a), the taxes were dischargeable in Chapter 13. In re Zieg, 96-1 U.S. Tax Cas. (CCH) ¶ 50,161 (Bankr. D. Neb. 1996).

The debtor had a previous Chapter 13 case which was dismissed. The debtor filed the current Chapter 13 case and the IRS filed a claim for 1987 and 1988 taxes. The debtor argued that the taxes were dischargeable because the taxes were for years more than three years before the current bankruptcy filing. The court held that the first bankruptcy filing tolled the three year period in Section 507(a)(8)(A) during the first bankruptcy case. Because less than three years passed after the taxes were due and the filing of the second case, less the duration of the first bankruptcy case, the taxes were dischargeable. In re Taylor, 96-1 U.S. Tax Cas. (CCH) ¶ 50,181 (3d Cir. 1996).

FEDERAL AGRICULTURAL PROGRAMS

CONSERVATION RESERVE PROGRAM. The CCC has issued interim regulations, effective immediately, which allow producers with CRP contracts which expire on September 30, 1996 to terminate the contracts early. The producers may then use the land for farming, haying or grazing under approved conditions. If the land is highly erodible, the land may be farmed if farmed under an Alternative Conservation System as determined by the NRCS. If the land is used for haying or grazing, the use must be according to a plan determined by the NRCS. Land not eligible for the early termination includes land with an

* Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.
erodibility index greater than 15, land within an average of 100 feet of a stream or other permanent water body, land subject to a CRP easement and land containing grass waterways, filter strips, shallow water areas for wildlife, bottomland timber, field windbreaks and shelterbelts. Land for which an early release has been granted will not be eligible for reenrollment. 61 Fed. Reg. 10671 (March 15, 1996).

**GRAIN HANDLING FACILITIES.** The OSHA has adopted as final regulations governing protection of employees who enter flat storage structures for grain. 61 Fed. Reg. 9578 (March 8, 1996).


**FEDERAL ESTATE AND GIFT TAX**

**CHARITABLE DEDUCTION.** The decedent’s estate created a trust with the decedent’s daughter as income beneficiary with a remainder to a charitable organization. The trust originally provided for all net income to be paid to the beneficiary and provided the trustee with the power to amend the trust to insure that the trust qualified as a charitable remainder unitrust. The trustee petitioned a state court to amend the trust to provide annual payments to the beneficiary expressed as a percent of the fair market value of the trust’s assets. The IRS ruled that because the change in the beneficiary’s interest was less than 5 percent of the value of the trust assets, the amendment qualified the trust as a charitable remainder unitrust. Ltr. Rul. 9613012, Dec. 26, 1995.

**GIFTS OF COMMODITY FUTURES CONTRACTS.** The taxpayer donated commodities futures contracts to a private foundation. Because of I.R.C. § 1256, the taxpayer could not donate the 40 percent portion of the contract eligible for only short term capital gain or loss treatment; therefore, the taxpayer treated only the 60 percent portion of the contracts eligible for long term capital gain or loss treatment as donated to the foundation. The IRS objected to the charitable deduction for the 60 percent portion under two theories: (1) the transfers were not eligible for the deduction because the gifts represented only partial interests in the contracts and (2) the marked-to-market rules of I.R.C. § 1256 required the taxpayers to recognize any income or loss upon the transfer of the contracts to the foundation. The trial court held that the transfers of 60 percent of the futures contracts were not partial interests because the taxpayer retained no interest in the transferred portion. The trial court held that the imposition of the 60-40 limitations on capital gain or loss treatment of futures contracts did not affect the charitable deduction of transfers divided according to the 60-40 split. The trial court also held that the marked-to-market rules did not apply to gift transfers. The appellate court reversed on the last two issues, holding that I.R.C. § 1256 applied to recognize gain upon donation of the futures contracts. Greene v. U.S., 96-1 U.S. Tax Cas. (CCH) ¶ 50,180 (2d Cir. 1996), rev’g, 864 F. Supp. 407 (S.D. N.Y. 1994).

**SPECIAL USE VALUATION-ALM § 5.03[2].** The IRS has issued the 1996 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>Columbia</td>
<td>8.98</td>
</tr>
<tr>
<td>Omaha</td>
<td>8.38</td>
</tr>
<tr>
<td>Sacramento</td>
<td>9.28</td>
</tr>
<tr>
<td>St. Paul</td>
<td>8.73</td>
</tr>
<tr>
<td>Spokane</td>
<td>8.48</td>
</tr>
<tr>
<td>Springfield</td>
<td>8.59</td>
</tr>
<tr>
<td>Texas</td>
<td>8.86</td>
</tr>
<tr>
<td>Wichita</td>
<td>8.44</td>
</tr>
</tbody>
</table>


**TRANSFERS WITH RETAINED INTERESTS.** The decedent had transferred the decedent’s residence, valued at $1.3 million, to the decedent’s sons for a promissory note for $337,000, with a retained life estate for the decedent. The sons’ income from the family corporation was insufficient to make the payments on the note until the decedent forgave one year’s payment and increased the sons’ compensation and bonuses from the corporation. The decedent also transferred the note to the corporation. The note was paid off by the time of the decedent’s death due to large bonuses paid to the sons. The court held that the value of the residence, less the amounts paid by the sons, was included in the gross estate under I.R.C. § 2036(a) because the consideration for the transfer was only 26 percent of the full value of the property. Wheeler v. U.S., 96-1 U.S. Tax Cas. (CCH) ¶ 60,226 (W.D. Tex. 1995).

**VALUATION.** The decedent’s estate consisted of 50 percent of the voting stock of a family owned corporation in which the decedent’s heirs owned all of the nonvoting stock and the other 50 percent of the voting stock. The estate was allowed a 25 percent discount in the value of the decedent’s stock for lack of marketability but the IRS denied a discount of 10 percent for a minority interest. The court held that the allowance of a lack of marketability discount did not preclude allowance of a minority discount. Because a 50 percent interest in the voting stock was insufficient to control corporate affairs, the decedent’s estate was allowed a 10 percent discount for a minority interest. Wheeler v. U.S., 96-1 U.S. Tax Cas. (CCH) ¶ 60,226 (W.D. Tex. 1995).

The decedent owned unregistered voting stock in a corporation in which the decedent was an affiliate under federal securities law. The stock was subject to federal security law restrictions on the sale of the stock during the decedent’s life but the restrictions did not apply to the decedent’s estate. The estate argued that the stock should be valued for estate tax purposes with a discount for the restrictions in effect during the decedent’s life. The court ruled that the valuation was to be determined by reference to the interest which passed by reason of the decedent’s death; therefore, because the stock passed to the estate without the restrictions, no discount for the restrictions could be applied to the value of the stock. Estate of McClatchy v. Comm’r, 106 T.C. No. 9 (1996).
The decedent owned a 67 percent interest in a leasehold in a parking garage. The executors valued the leasehold for estate tax purposes based on a pending offer to purchase the leasehold. The sale did not occur, however, and the leasehold was sold to the decedent’s son for much less than the estate tax value. The executors sought to amend the estate tax return to decrease the value. The trial court denied the lower value, holding that the executors failed to rebut the IRS valuation of the leasehold at the value originally claimed by the estate. The appellate court affirmed, holding that the executors failed to show that the trial court’s decision was erroneous. Wrona v. U.S., 96-1 U.S. Tax Cas. (CCH) ¶ 60,227 (Fed. Cir. 1996).

FEDERAL INCOME TAXATION

DEPRECIATION. The taxpayers used a home office for their financial services activity and for managing two residential rental properties. The taxpayers claimed depreciation deductions for computer equipment used exclusively for those business activities. The taxpayers did not keep any records to substantiate the computer business use. The taxpayers were allowed home office deductions for the home office. The court held that the computer equipment was not “listed property” under I.R.C. § 280F(d)(4)(B) requiring substantiation records because the equipment was used at a regular business establishment which included a home office. Zeidler v. Comm’r, T.C. Memo. 1996-157.

NET OPERATING LOSSES. The taxpayer had claimed a NOL carryover from 1990 to 1991; however, the taxpayer failed to timely file the 1990 tax return. The court held that the taxpayer failed to timely file the waiver to carryback NOL because the tax return was not timely filed. The Tax Court had disallowed any carryback because the taxpayer failed to substantiate the carryback to the three years before 1990. The appellate court affirmed on the first issue and reversed on the second issue, holding that the Tax Court had not given the taxpayer sufficient opportunity to demonstrate that the NOLs could not have been carried back. Moretti v. Comm’r, 96-1 U.S. Tax Cas. (CCH) ¶ 50,162 (2d Cir. 1996).

SOCIAL SECURITY. Congress has passed new limits on the maximum amount of annual earnings before reduction of benefits for persons who reach retirement age:

<table>
<thead>
<tr>
<th>Year</th>
<th>1997</th>
<th>2000</th>
<th>2002</th>
<th>2003</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$12,500</td>
<td>$15,500</td>
<td>$17,000</td>
<td>$25,000</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

H.R. 3136.

NEGLIGENCE

AERIAL SPRAYING. The plaintiffs grew tomatoes and jalapenos peppers which suffered damage from exposure to herbicide. The plaintiffs sued in negligence the defendants who had sprayed neighboring fields with herbicide. The court focused on the plaintiffs’ presentation of evidence to rebut the defendant’s testimony that the defendant used reasonable care in spraying the neighboring fields. The court found that the plaintiffs failed to provide expert testimony as to the care used by the defendant in applying the herbicide. The plaintiffs had provided expert testimony as to the effect of the herbicide on the tomatoes and jalapenos but the testimony did not cover the reasonableness of the defendant’s care in applying the herbicide. The court held that the trial court should have entered a directed verdict for the defendant because the plaintiffs failed to provide evidence that the spraying was not done with reasonable care. Hager v. Romines, 913 S.W.2d 733 (Tex. Ct. App. 1995).

CITATION UPDATES

TRANSFERRING FARM PROPERTY IN A DIVORCE

— by Neil E. Hart

The rising tide of divorces and separations in recent years has not bypassed the farm sector. In many instances, the problems of property division are more severe where a farm business is involved because typically most of the available assets are being used in the business. A loss of the assets can pose significant problems of economic survival for the farming operation; increasing the debt load to avoid loss of productive assets can pose equally serious problems.

Tax-free transfers

The problems of property division were eased substantially with enactment of I.R.C. § 1041 in 1984. Prior to that time, a transfer of appreciated property to a spouse or former spouse in exchange for marital claims resulted in recognition of gain to the transferor. The receiving spouse recognized no gain because the transaction was viewed as an exchange for marital rights. It was assumed that marital rights were worth at least as much as a property given in exchange so there was no gain to the spouse receiving the property. The recipient spouse took the property with an income tax basis equal to fair market value. Under the pre-1984 state of the law, losses could not be recognized on such interspousal transfers.

For transfers of property (but not services) after July 18, 1984, no gain or loss is recognized for sales or exchanges (or gifts) between spouses. This is usually the case without regard to type of property. The income tax basis for the spouse receiving the property is the basis in the hands of the transferor spouse immediately prior to the transfer. Even if the transfer is by sale, the carryover basis applies and the purchasing spouse does not receive a new income tax basis in the property. In the event that liabilities assumed exceed the income tax basis in an outright transfer, the transferee still takes the property with a basis the same as the basis of the asset in the hands of the transferor spouse. No gain is recognized where liabilities exceed the basis. That rule does not apply if the transfer is in trust.

The same treatment applies to a transfer of property to a former spouse if the transfer is incident to a divorce.

Although the nonrecognition treatment applies generally to all types of property, special attention should be given to items of property involving deferred income such as interest on government bonds. In a 1987 ruling, IRS held that the accrued interest on U.S. savings bonds was includible in the transferor’s gross income in the taxable year the bonds were transferred to the transferor’s spouse even though coming within the nonrecognition rules otherwise. The transferee’s basis in the bonds after the transfer was equal to the transferor’s basis in the bonds increased by the interest amount included in the transferor’s income as a result of the transfer.

Property transfers are incident to a divorce if the transfer occurs within one year after the divorce or are “related to the cessation of the marriage.” A transfer is related to the cessation of a marriage if the property is transferred under a divorce or separation instrument and within six years after the date of the divorce. Any transfer not pursuant to a divorce or separation instrument and any transfer more than six years after the cessation of marriage are presumed not to be related to the cessation of the marriage. The presumption may be rebutted only by showing that the transfer was made for the purpose of dividing the property owned by the former spouses at the time the marriage ceased. Thus, the presumption may be rebutted by showing that the transfer occurred promptly after the impediment to transfer was removed.

The nonrecognition treatment applies only to real or personal property, tangible or intangible, and does not apply to services. Moreover, the nonrecognition provisions do not apply to transfers to a spouse or former spouse who is a nonresident alien. In that event, gain or loss is recognized at the time of transfer of the property if no other nonrecognition provision applies.

It is important to note that, to be eligible for nonrecognition treatment, it is not necessary for the property to have been owned by the spouses or the transferor spouse during the marriage. Property acquired after the marriage ceases may also be eligible for nonrecognition treatment.

Neither the statute nor the regulations define “cessation of marriage” although the regulations do state that annulments and the cessation of marriages that are void ab initio constitute marriages for this purpose.

A transfer of property from a person other than a former spouse may qualify for nonrecognition of gain if it results from the cessation of the marriage. Such transfers may

---

Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
qualify for the special nonrecognition treatment if — (1) the transfer to the third party is required by a divorce or separation instrument, 23 (2) the transfer to the third party is pursuant to a written request of the other spouse or former spouse or (3) the transferor receives from the other spouse or former spouse a written consent or notification of the transfer to the third party. 29 In all three situations, the transfer of property is treated as made directly to the nontransferring spouse or former spouse and the transfer to the third party. 30 The deemed transfer from the nontransferring spouse or former spouse to the third party does not qualify for nonrecognition treatment unless covered by another nonrecognition provision. 31

As an example of a third party transfer, in one IRS letter ruling a promissory note was transferred from one spouse’s wholly-owned corporation to the other spouse. 32 IRS held that the obligation arose from the termination of the marriage, not from dealings with the corporation, and the transfer did not result in recognition of gain or loss. 33 The transfer was considered to have been incident to the divorce.

Corporate stock redemptions pose special problems. 34 In one case, gain was not recognized on stock redemption when a corporation was required by a divorce instrument to redeem the wife’s half of the stock in the corporation. 35 The former husband had an obligation to the wife under the property settlement agreement to purchase the wife’s stock. The wife’s transfer of the stock was treated as a constructive transfer to the former husband who then transferred the stock to the corporation. 36

In a later case, a wife was required to recognize gain on redemption of her stock by a corporation owned with the former husband. 37 The redemption was incident to the divorce decree but it failed to qualify for nonrecognition treatment because the wife did not transfer the redeemed stock to the corporation on behalf of her former husband. The transaction was viewed as no more than a transaction between the corporation and the wife and did not satisfy any obligation or liability of the husband. 38

**Records and notices**

The transferor of property, at the time of the transfer, is required to provide records sufficient to show the adjusted income tax basis and holding period of the property as of the date of the transfer. 39 The records must be preserved and kept accessible by the transferee. 39

**FOOTNOTES**

4. 2 I.R.C. § 1041(a)(1).
5. 3 I.R.C. § 267.
6. 4 I.R.C. § 1041(a)(2).
7. 5 I.R.C. § 1041(b).
8. 6 I.R.C. § 1041(e).
10. Id., Q&A 12.
12. I.R.C. § 1041(e).
14. Rev. Rul. 87-112, 1987-2 C.B. 207 (Series E and EE bonds). It is not known whether such treatment would extend to all items of income-in-respect-of-decedent property, not just accrued interest on U.S. Government savings bonds but transfers of such property including installment land contracts and stored grain and growing crops produced under a nonmaterial participation lease should be avoided where possible. See 6 Harl, Agricultural Law § 47.03 (1996); Harl, Agricultural Law Manual § 6.02[1] (1996).
15. Id.
17. Temp. Treas. Reg. § 1.1041-1T(b), Q&A 7. A divorce or separation instrument includes a modification or amendment of a decree or instrument. Id.
18. Id.
19. Id.
20. Id.
22. I.R.C. § 1041(d).
25. Id.
28. See Ingham v. United States, 96-1 U.S. Tax Cas. (CCH) ¶ 50,131 (W.D. Wash. 1996) (decree of dissolution ambiguous as to whether sale of property was required by divorce decree; government’s motion to dismiss denied because taxpayer had alleged facts entitling her to relief).
29. Id.
32. Id. IRS declined to rule on whether the note might represent earned or accrued income subject to the assignment of income principle. Rev. Rul. 87-112, 1987-2 C.B. 207.
33. See Ltr. Rul. 9046004, July 20, 1990 (redemption of corporate stock treated as transfer of corporate stock to former spouse followed by redemption of stock by corporation).
34. Arnes v. United States, 981 F.2d 456 (9th Cir. 1992).
35. Id. See Hayes v. Comm’r, 101 T.C. 593 (1993) (wife shielded from recognizing gain on redemption of stock as transfer of property between spouses incident to divorce; corporation’s redemption of wife’s stock constituted constructive dividend to husband where husband obligated to redeem stock pursuant to divorce decree).
37. Id.
39. Id.
ADMINISTRATIVE EXPENSES. The debtor was a ranch partnership with almost 1600 co-owners. The debtor’s Chapter 11 plan called for the forced sale of the co-owners’ interests. An association of the co-owners engaged legal counsel for the co-owners. The co-owners’ counsel filed a motion for the creation of a creditors’ committee formed of co-owners or, in the alternative, for attorney’s fees and costs as administrative expenses. The court held that the co-owners were not creditors of the debtor and that the services provided by the co-owners’ counsel did not benefit the bankruptcy estate; therefore, no attorney’s fees or costs would be allowed as administrative expenses. In re Warner Springs Partnership, 193 B.R. 28 (Bankr. S.D. Cal. 1995).

ASSessment. The debtors filed for Chapter 13 and objected to claims for taxes filed by the IRS, arguing that the debtors were not taxpayers or subject to the federal income tax laws (a form of tax protester argument). The court rejected the argument as frivolous. The debtors also argued that the assessment was not valid because the notice was merely a computer printed form without a signature from an agent. The court also rejected this argument, holding that the statute and regulations do not require a signature on an assessment notice. In re Hopkins, 192 B.R. 760 (D. Nev. 1995).

AUTOMATIC STAY. After the debtor filed for Chapter 7, the IRS sent the debtor a Notice of Proposed Assessment of an I.R.C. § 6672 penalty as a responsible person in a corporation which failed to pay employee taxes. The IRS argued that the Notice did not amount to an assessment or attempt to collect the penalty. The court noted, however, that the Notice threatened collection if the debtor did not pay the penalty or file a protest within 30 days, and the court held that the Notice was an assessment of a penalty in violation of the automatic stay. The court also held that actions which violated the automatic stay were void ab initio; therefore, the IRS penalty assessment was void. Riley v. United States, 192 B.R. 727 (E.D. Mo. 1995).

The debtors filed for Chapter 13 on February 16, 1993 and on May 17, 1993, the IRS assessed the debtors for taxes owed for 1974 through 1982. The trustee and debtors argued that the assessment was void for violation of the automatic stay and the IRS sought retroactive relief from the stay. The court held that the retroactive relief would be denied because the IRS had notice of the bankruptcy filing and had made several similar assessments in other cases, indicating a disrespect for the bankruptcy rules. In re Murray, 193 B.R. 20 (Bankr. E.D. Cal. 1996).

DISCHARGE. The IRS assessed the debtor for 1980-1982 taxes in August 1993. The debtor filed for Chapter 7 193 days later and received a discharge in June 1994. A second bankruptcy case was filed in August 1994 but that was dismissed in October 1994. The debtor filed the current case in September 12, 1995 and argued that the 1980-1982 taxes were no longer entitled to a priority under Section 507(a)(8)(A)(ii) because more than 240 days had passed since the assessment. The IRS argued that Section 108(c) and I.R.C. §§ 6503(b), (h) tolled the 240 period during the previous bankruptcy cases. The court held that the plain language of Section 507(a)(8)(A)(ii) limits any suspension of the 240 day period only where an offer in compromise is pending; therefore, the taxes were no longer entitled to priority status. In re Macko, 193 B.R. 72 (Bankr. M.D. Fla. 1996).

TAX LIEN. The IRS had filed prepetition tax liens against the debtor’s property which included exempt assets and a monthly government pension. The pension was payable only to the debtor, extinguished at the debtor’s death and could not be assigned. The debtor argued that the IRS bankruptcy tax claim was secured only to the extent of the monthly pension amount because the pension terminated at the debtor’s death. The IRS argued that the tax claim was secured to the extent of the payments receivable over the debtor’s remaining life expectancy. The court found only cases agreeing with the IRS view and held that the tax claim was secured to the extent of the value of the payments over the debtor’s remaining life expectancy. In re Wesche, 193 B.R. 76 (Bankr. M.D. Fla. 1996).

CONTRACTS

ENTRUSTMENT. The defendant purchased two mating pairs of ostriches and boarded them with a neighboring farmer who had raised ostriches for six years and who had boarded other livestock for the defendant. The farmer sold the ostriches to the plaintiffs who left the birds with the farmer for breeding and boarding. A dispute arose as to the ownership of the birds kept by the farmer and the defendant removed several birds. The plaintiffs brought an action for replevin to recover the birds they had purchased. The court held that the plaintiffs had superior title to the birds under Iowa Code § 554.240(2) in that they purchased them in good faith from the farmer whom the court found was a merchant of ostriches under Iowa Code § 554.2104(1). Prenger v. Baker, 542 N.W.2d 805 (Iowa 1995).

IMPLIED WARRANTY-ALM § 13.02[2]." The plaintiff purchased nine ostriches from the defendants for use as breeders. The sales contract merely listed the birds to be sold and their purchase price. After the birds were delivered, the plaintiff discovered that several were in ill health. The plaintiff brought an action for breach of implied warranty of fitness for a particular purpose under Mo. Rev. Stat. § 400.2-315. The defendants argued that Mo. Rev. Stat. § 400.2-316(5) specifies that a seller of livestock is not liable for any breach of any implied warranty of fitness for a particular purpose unless the sales contract contains a written statement of the implied warranty. Prior to the
transaction. Mo. Rev. Stat. § 277.020(1) defined livestock to include exotic animals. The statute was changed shortly after the transaction to include ostriches as livestock. The plaintiff argued that the change indicated that ostriches were not livestock before the change. However, the legislature also amended Mo. Rev. Stat. § 277.022 to include ostriches as livestock instead of as exotic animals. The court held that this change indicated that before the changes, ostriches were considered exotic animals which were considered livestock under Mo. Rev. Stat. § 400.2-316(5); therefore, the defendants were not liable for any implied warranty because the sales contract did not contain any written warranty of fitness for a particular purpose. Surface v. Kelly, 912 S.W.2d 646 (Mo. Ct. App. 1995).

**FARMER AS MERCHANT-ALM § 13.02[1].** The plaintiffs raised horses and purchased 275 bushels of feed corn from the defendant. The corn was tested for aflatoxin and was shown to be free of aflatoxin. After several of the plaintiffs’ horses died, tests demonstrated that the horses died from leukoencephalomalacia which can result from ingestion of Fumonisin B-1 produced by Fusarium Moniliforme mold commonly found on corn. However, the Fumonisin B-1 is produced by the mold only if the corn is stored at high temperatures with 20 percent humidity. At the time of the corn sale, neither party was aware of the dangers of the mold; however, the defendant did dry the corn and store it in ventilated bins. The plaintiffs sued the defendant for breach of implied warranty of merchantability and under the Alabama Extended Manufacturer’s Liability Doctrine (AEMLD). The court held that the defendant was not liable for any breach of implied warranty of merchantability because the defendant was not a merchant under the U.C.C. since the defendant made only occasional sales of corn. The court indicated that it felt that farmers generally are not considered merchants under the U.C.C. unless they perform additional marketing activities. The court also held that the defendant was not liable under the AEMLD because the defendant had no knowledge of the danger to horses presented by the mold and, therefore, had no opportunity to inspect the corn for presence of the toxin. Huprich v. Bitto, 667 So.2d 685 (Ala. 1995).

**FEDERAL AGRICULTURAL PROGRAMS**

Federal Agriculture Improvement and Reform Act of 1996

by Neil E. Harl

**CUT-OFF OF LOANS.** The 1996 legislation revisited an amendment phasing out operating loans for long time borrowers. Under the 1992 law, if a borrower had obtained an operating loan for five or more years, or a guaranteed loan for 10 or more years, a loan was not to be made to the borrower after the fifth year occurring after October 28, 1992. The regulations interpreted the provision to mean that the borrower had five years of eligibility after October 18, 1992, and a year did not count if no operating loans were outstanding as of that year. 7 C.F.R. § 1941.17 (1995).

Under the 1996 rule, if a farmer or rancher, as of October 28, 1992, had received a direct or guaranteed operating loan during each of 10 or more previous years, the borrower is eligible to receive a guaranteed operating (but not a direct loan) during five additional years. Act § 617. Those five additional years run from October 28, 1992. Id.

If loans were outstanding during each of those years, it appears that time would run out for the borrower for even guaranteed loans on October 18, 1997. Id.

As for farm ownership loans, the 1996 legislation provides that if, as of April 4, 1996, a farmer or rancher had a direct farm ownership loan outstanding for less than five years, a loan is not to be made after April 4, 2006. Act § 601. In the event a borrower had a direct farm ownership loan outstanding for five years or more, as of April 4, 1996, a loan is not to be made after April 4, 2001. Id.

The 1996 law also specifies that direct operating loans are not to be made to a borrower who is delinquent on any direct or guaranteed loan. Act § 648(b). This provision became effective on the date of enactment, April 4, 1996. Act § 663.

**BRUCELLOSIS.** The APHIS has adopted as final regulations adding Georgia to the list of brucellosis-free states. 61 F.R. 15305 (April 10, 1996).


**MEAT INSPECTION.** The AMS has adopted as final regulations which change some certificate forms, remove two outdated official stamp imprints, and added three new official stamp imprints. 61 Fed. Reg. 11504 (March 21, 1996).

**PERISHABLE AGRICULTURAL COMMODITIES ACT-ALM § 10.05[2].** The Secretary of Agriculture has adopted as final regulations which provide for the adjudication of the issue of whether a person is “responsibly connected” with a commission merchant, dealer or broker in the same disciplinary proceedings against the commission merchant, dealer or broker. The regulations also provide that the adjudication be made by an Administrative Law Judge. 61 Fed. Reg. 11501 (March 21, 1996).

The AMS has adopted as final regulations adding oil-blanch frozen fruits and vegetables as commodities covered by PACA. 61 Fed. Reg. 13385 (March 27, 1996).

**WHEAT AND FEED GRAINS.** The CCC has adopted as final regulations which allow producers to extend maturing wheat, corn, grain sorghum, barley, oat and rye price support loans in times of abnormal marketing conditions. 61 Fed. Reg. 11514 (March 21, 1996).

**FEDERAL ESTATE AND GIFT TAX**

**IRA.** The decedent’s will bequeathed estate property to the surviving spouse and established a trust for the surviving spouse funded by two IRAs owned by the decedent. The surviving spouse disclaimed the interest in the trust and the decedent’s heirs disclaimed any remainder interest in the trust as well as any intestate interest in the decedent’s estate. The IRAs, therefore, passed to the surviving spouse by intestate succession. The surviving spouse rolled over the two IRAs to an IRA owned by the spouse. The IRS ruled that the IRAs were not inherited IRAs and that the surviving spouse should not include the IRAs in gross income. Ltr. Rul. 9615043, Jan. 17, 1996.
VALUATION. The decedent’s estate included a 78 percent interest in the common stock of a corporation which owned a 1300 acre ranch, a one-third interest in a closely-held corporation which owned wetlands used for hunting, and 41.8 percent of a liquidating trust. The court rejected the estate’s liquidation valuation and comparative property valuation of the ranch and wetlands because the properties were not going to be sold and the comparable properties used were not sufficiently similar. The corporation was valued using the value of the corporation’s assets less a 20 percent discount for lack of marketability, based on the nonliquid nature of the assets because the land was subject to state restrictions. The estate was allowed a 20 percent discount for a minority interest and a 15 percent discount for lack of marketability of the wetland, also because the land was subject to state restrictions. The value of the interest in the liquidating trust was discounted 10 percent for lack of marketability but the court did not allow any discount for a minority interest because minority interest holders were protected by the trustee’s fiduciary duty. A supplemental ruling involved a stipulation which determined the effect on stock valuation of a loan from a related corporation. Luton v. Comm’r, T.C. Memo. 1994-539, supp. by T.C. Memo. 1996-181.

The decedent had received a life estate in a residence with the remainder passing to charitable organizations. When a maintenance trust began to run out of funds for maintaining the residence, the parties established a liquidating trust to sell the residence and personal property. The estate argued that the decedent’s interest in the trust should have been discounted for the minority interest and the lack of marketability of the interest. The estate argued that the decedent’s interest should be treated the same as a minority shareholder’s interest in a corporation. The IRS argued that the trust was not a trade or business and that a buyer would be concerned only with the value of the delay in liquidating the trust assets before realizing the value of the decedent’s interest in money. The court held that the liquidating trust interest could not be discounted for the same factors as a shareholder’s interest but allowed the discount for the time delay in liquidating trust assets. Estate of Casey v. Comm’r, T.C. Memo. 1996-156.

FEDERAL INCOME TAXATION

IRS AUDIT GUIDELINES

In early December 1995, the IRS issued “Market Segment Specialization Program Paper on Grain Farmers.” The 16 chapter publication was apparently written by IRS personnel in the Kansas District with little review above the District level.

Unfortunately, the publication contains numerous errors and misstatements. Inasmuch as the publication is in the hands of IRS examining agents, it is being cited in audits. Before reliance is placed on the information in the publication, the statements should be checked carefully.

Dr. Neil E. Harl has prepared a 10 page commentary on the publication, which has been forwarded to the IRS. For a copy of the commentary, send a SASE (55 cents postage) to The Agricultural Law Press, P.O. Box 50703, Eugene, OR 97405.

COOPERATIVES. The taxpayer was a state-wide tax-exempt agricultural cooperative which formed a second agricultural cooperative which operated on a state regional basis. The taxpayer provided educational and promotional services for the subsidiary cooperative. The court held that the fees received for the services were not unrelated business income to the taxpayer. Ohio Farm Bureau Fed., Inc. v. Comm’r, 106 T.C. No. 11 (1996).

DEFINITION OF FARMING. The taxpayer fenced rural land and stocked the property with select wild deer for the purpose of managing the breeding and development of the deer to produce “trophy” deer, deer with larger antlers and bodies than normal wild deer. The taxpayer consulted an expert on deer to develop methods to accomplish those purposes. The taxpayer charged hunters for the right to hunt selected deer each year. The IRS ruled that the taxpayer’s activities were farming for purposes of Treas. Reg. § 1.162-12. Query, whether the hunters’ activities can be called hunting. Ltr. Rul. 9615001, Oct. 17, 1995.

HOBBY BUSINESS. The taxpayer operated a small metals reclamation business in a barn on a rural residential property provided by the taxpayer’s parents. The taxpayer’s spouse was employed elsewhere fulltime. Although the business generated several years of profit early on, the last seven years all had losses. The losses were due primarily to increased environmental regulations and their enforcement against the taxpayer’s business. The taxpayer made some attempt to comply with the regulations. The court held that the business was not operated for profit in that the business suffered several years of losses, the environmental regulations made the business unlikely to ever be profitable, the taxpayer continued the business primarily for pleasure, the taxpayer had other sources of income from the spouse’s wages and the free use of the residence and barn, and the taxpayer made no attempt to change the business to make it more profitable. Massingill v. Comm’r, T.C. Memo. 1996-162.

INJURY. The taxpayer’s business involved raising ornamental plants which produced cuttings for resale. The taxpayer purchased a pesticide which was applied to the plants. The pesticide caused the plants to become stunted or die and contaminated the soil, requiring cleaning or replacement of the soil. The taxpayer filed a suit against the pesticide manufacturer and obtained a settlement award, although the manufacturer did not admit to any negligence. For the purposes of the ruling, the IRS assumed that the pesticide caused the damage to the plants. The IRS ruled that the damage to the plants destroyed the plants, making the loss of the plants an involuntary conversion under I.R.C. § 1033(a)(2)(A) into money. The IRS ruled that if the taxpayer makes the appropriate and timely election and purchases replacement property within the two years after the destruction of the plants, the amount of gain is only the amount by which the settlement award exceeds the cost for the replacement property. Ltr. Rul. 9615041, Jan. 16, 1996.

LEGAL FEES. A shareholder of the taxpayer S corporation was the subject of an SEC investigation. The corporation paid for the legal costs of the shareholder’s defense. The corporation claimed the legal expenses as a business deduction, arguing that because the SEC investigation would affect the corporation, the fees were
deductible by the corporation. The court held that the basis of the deductibility of the fees was the underlying legal action. Because the legal action involved the shareholder, the corporation could not deduct the legal fees as a business expense or as compensation to the shareholder. The court held that the legal fees were deductible by the shareholder.


PASSIVE ACTIVITY LOSSES-ALM § 4.05[3]." The taxpayer owned a condominium which was rented to others during the year; however, the taxpayer’s unit was not rented to others more than seven days per year. The management and other services provided for the unit by a management company and other persons exceeded the amount of time spent managing the unit by the taxpayer. The court held that the taxpayer did not materially participate in the rental of the condominium unit and any losses were passive activity losses. Mordkin v. Comm’r, T.C. Memo. 1996-187.

PENSION PLANS. For plans beginning in March 1996, the weighted average is 6.95 percent with the permissible range of 6.26 to 7.51 percent (90 to 109 percent permissible range) and 6.26 to 7.65 percent (90 to 110 percent permissible range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). Notice 96-24, I.R.B. 1996-16,23.

SAFE HARBOR INTEREST RATES

<table>
<thead>
<tr>
<th>May 1996</th>
<th>Annual</th>
<th>Semi-annual</th>
<th>Quarterly</th>
<th>Monthly</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Short-term</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AFR</td>
<td>5.76</td>
<td>5.68</td>
<td>5.64</td>
<td>5.61</td>
</tr>
<tr>
<td>110% AFR</td>
<td>6.35</td>
<td>6.25</td>
<td>6.20</td>
<td>6.17</td>
</tr>
<tr>
<td>120% AFR</td>
<td>7.52</td>
<td>7.38</td>
<td>7.31</td>
<td>7.27</td>
</tr>
<tr>
<td></td>
<td>Mid-term</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AFR</td>
<td>6.36</td>
<td>6.26</td>
<td>6.21</td>
<td>6.18</td>
</tr>
<tr>
<td>110% AFR</td>
<td>7.01</td>
<td>6.89</td>
<td>6.83</td>
<td>6.79</td>
</tr>
<tr>
<td>120% AFR</td>
<td>7.65</td>
<td>7.51</td>
<td>7.44</td>
<td>7.40</td>
</tr>
<tr>
<td></td>
<td>Long-term</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AFR</td>
<td>6.83</td>
<td>6.72</td>
<td>6.66</td>
<td>6.63</td>
</tr>
<tr>
<td>110% AFR</td>
<td>7.53</td>
<td>7.39</td>
<td>7.32</td>
<td>7.28</td>
</tr>
<tr>
<td>120% AFR</td>
<td>8.22</td>
<td>8.06</td>
<td>7.98</td>
<td>7.93</td>
</tr>
</tbody>
</table>

S CORPORATIONS-ALM § 7.02[3][c]." SHAREHOLDER. The taxpayer was a member of a law firm which was an S corporation. In August 1989, the corporation agreed to sell 1,000 shares of stock to the taxpayer and the taxpayer was made president, managing partner and chief financial officer of the corporation. The corporation changed its name to include the taxpayer’s name and filed form K-1 for 1989 and 1990 for the taxpayer as a shareholder. The price for the shares was to be paid in the future but the taxpayer did not make the payment and in June 1990 left the firm. The court held that actual issuance of the shares was not necessary for the taxpayer to be treated as a shareholder. The court held that the actions of the parties indicated that the taxpayer was a shareholder as of the date of the agreement and should have included the taxpayer’s share of the corporation income in the taxpayer’s gross income for 1990. Pahl v. Comm’r, T.C. Memo. 1996-176.

SALE OF RESIDENCE-ALM § 6.03." The taxpayers sold their residence on January 31, 1990. The taxpayers had previously purchased a house and an adjoining lot in another state but had rented that house to others until the first house was sold. The taxpayer began construction of a house on the lot in 1989 and as of January 31, 1992, much of the house was completed but the new house was still undergoing interior and exterior construction. The electrical and gas service was not connected and the taxpayers had not moved their furniture and other personal property to the new residence until after January 31, 1992. The taxpayers had told an IRS agent that they moved into the new house in June 1992. The court held that the taxpayers failed to comply with the I.R.C. § 1034 requirement that the new residence be constructed within two years after the sale of the first residence and that the taxpayer were not eligible for deferral of gain on the sale of the first residence. Skorniak v. Comm’r, T.C. Memo. 1996-178.

TRANSFERS INCIDENT TO DIVORCE. The taxpayer owned a sole proprietorship and an interest in a partnership. As part of a divorce, the taxpayer transferred one half of the sole proprietorship and one half of the partnership interest to the former spouse. The taxpayer’s share of liabilities in both interests exceeded the taxpayer’s basis. The taxpayer and former spouse held the interests in the sole proprietorship as a partnership. The IRS ruled that the taxpayer did not recognize gain or loss from the transfers. See article by Harl in this issue. Ltr. Rul. 9615026, Jan. 2, 1996.

PRODUCTS LIABILITY

HERBICIDE. The plaintiffs were cotton farmers who purchased the insecticide Thimet and the herbicide Direx and applied both chemicals to their fields prior to emergence of the cotton plants. The plaintiffs claimed damage to the cotton crops from the combination of chemicals and brought actions for failure to warn about the possible damages from mixing the chemicals, failure to test for the possible damages from mixing the chemicals, negligence in selling a defective product, and breach of express warranty by the seller that the chemicals were safe when used together. The court held that the actions based on the failure of the defendant manufacturers to warn about the mixing of the chemicals were preempted by FIFRA. The court also held that the claim that either or both chemicals were defective for use on cotton crops was not preempted by FIFRA. The court upheld the jury verdict for the plaintiffs on this issue. The breach of warranty action was remanded for determination of whether sufficient evidence was presented to support the jury verdict for the plaintiffs. Hopkins v. American Cyanamid Co., 666 So.2d 615 (La. 1996).

MANURE HANDLING SYSTEM. The decedents’ plaintiffs operated a dairy farm and purchased a prefabricated manure handling system for their farm. The components were manufactured by several parties and were assembled by one of the defendants. The decedents, two brothers, were operating the system when one was overcome by fumes and fell in a holding tank, with the other brother killed when he attempted to rescue the other. The plaintiffs sued all parties involved in the sale, manufacture and assembly of the system and most defendants were granted a summary judgment. The plaintiffs, however, did not allege that any of the parts were defective, but relied primarily on the defendants’ failure to warn or properly instruct about the use of the system. The manufacturers of the component parts were held not to have any duty to warn or instruct about potential dangers of a system in which the
parts were used because the component manufacturers did not participate in the design or assembly of the finished system. The plaintiffs alleged that the instruction books and manuals accompanying the system were defective products. The court held that the manuals were not products and that the plaintiffs’ action was actually a claim for failure to warn. The court held that the seller of the system was liable for failure to warn only if the seller provided instructions for the assembly of the system. Because the seller was not shown to have provided any defective manual as to the assembly of the system, the court held that the seller had no duty to warn about the use of the system. Shaffer v. A.O. Smith Harvestore Products, Inc., 74 F.3d 722 (6th Cir. 1996).

PROPERTY
FENCES. The parties owned neighboring rural land and their predecessors in interest had, some 20 and 40 years previous, agreed to each maintain one-half of the fence between their properties. The agreements were oral and at the times, both parties raised livestock on their properties. The fence eventually fell into disrepair and the parties’ predecessors in interest stopped raising livestock until 1994 when the plaintiff’s predecessor in interest wanted to pasture livestock again. The defendant’s predecessor in interest refused to help maintain the fence. The parties agreed to have fence viewers determine the parties’ responsibilities for the fence. The fence viewers determined that the plaintiff should be responsible for maintaining all of the fence since the plaintiff would reap the only benefit from the fence. The defendant was required to keep the fence clear of brush. The plaintiff argued that the prior agreements should have been enforced by the fence viewers. The court held that the fence maintenance agreements were no longer enforceable because the agreements were not written and had an implied termination as of the date either of the parties did not benefit from the agreement (i.e., when the parties stopped raising livestock). The court also held that the agreement did not run with the land because the predecessors in interest had no privity of estate (e.g., landlord and tenant or grantor-grantee). The court also upheld the fence viewers’ determination as fair and equitable, noting that the statute, 765 Ill. Cod. Stat. § 130/8, upheld the fence viewers’ determination as fair and equitable, noting that the statute, 765 Ill. Cod. Stat. § 130/8, did not require an equal sharing of responsibility for the fence. Matter of Estate of Wallis, 659 N.E.2d 423 (Ill. Ct. App. 1995).

SECURED TRANSACTIONS
FILING. The debtor had granted a security interest in all farm equipment to the Farm Service Agency. Later, the debtor borrowed funds from a bank which were used to purchase a tractor. The bank sent a signed financing statement and filing fee by mail to the Register of Deeds but the financing statement was not filed. The tractor was sold during the debtor’s Chapter 7 bankruptcy case and the bank sought a priority purchase-money security interest in the tractor. The court held that mere mailing of the financing statement and filing fee was insufficient presentation of the statement to constitute filing under Wis. Stat. § 409.403. The court also rejected the bank’s argument that priority should be granted under the doctrine of unjust enrichment. The court held that the use of the unjust enrichment doctrine would undermine the certainty and orderliness of the U.C.C. system of security interest priorities. In re Wright, 192 B.R. 946 (W.D. Wis. 1996).

SUBORDINATION AGREEMENT. Two brothers owned four parcels of farmland inherited from their parents. When the first brother divorced, one parcel was transferred to their children with the brother retaining a life estate in the parcel. The brothers formed a corporation which borrowed from the FmHA (now FSA) and granted the FmHA a mortgage on all the parcels. The children signed a subordination agreement which subordinated their remainder interests to the FmHA mortgage. The parcels were eventually foreclosed upon and the amount of the original mortgage was satisfied from the sale of the other three parcels. The children argued that the subordination agreement subordinated their remainder interests only as to the principal of the loan outstanding when the mortgage was granted; therefore, their remainder interests now have priority over the remaining amount which they viewed as the interest on the low. The court held that a mortgage included both principal and interest and the remainder interests were subordinate to the mortgage securing the remaining balance on the loan. Donald Newby Farms, Inc. v. Stoll, 543 N.W.2d 289 (Iowa Ct. App. 1995).

STATE TAXATION
AGRICULTURAL USE. The taxpayer operated a greenhouse which grew tropical foliage and flowering plants for decorative purposes and sold through other retail outlets. Under Kan. Stat. § 79-3606, the sale of natural gas, electricity and farm machinery for agricultural use is not subject to sales tax. However, the regulations of the Kansas Department of Revenue defined “agriculture” to exclude nurseries for the production of plants for decorative purposes. The court held that the regulations were more restrictive in defining agriculture than the statute and were invalid to deny the taxpayer the sales tax free purchase of natural gas, electricity and farm machinery. Appeal of Alex R. Masson, Inc., 909 P.2d 673 (Kan. Ct. App. 1995).

EQUALIZATION VALUATION. The county director of equalization surveyed the assessed property values in relation to the sale prices of county range and crop land and noted that several sections of the county with similar types of soil conditions were assessed at only 62 percent of the market price of the land, whereas other county land was assessed at 92 percent of the market price. The director divided the county into sections, depending upon the soil conditions, and raised the value of the land in the plaintiffs’ township, particularly where the land was suitable for crops, although the land was currently used as range land and had been so used for 25 years. The assessments were appealed and the trial court reversed the assessments as not based on the actual use of the land as range land. The appellate court reversed the trial court and reinstated the assessments, holding that the director’s assessments were properly based on the best use of the land as crop land and were adjusted in accordance with the prevailing market prices for similar land. Lincoln Township v. S.D. Bd. Of Equalization, 543 N.W.2d 256 (S.D. 1996).
SEMINAR IN PARADISE

FARM ESTATE AND BUSINESS PLANNING by Dr. Neil E. Harl

January 6-10, 1997

Spend a week in Hawai‘i in January 1997! Balmy trade winds, 70-80 degrees, palm trees, white sand beaches and the rest of paradise can be yours; plus a world-class seminar on Farm Estate and Business Planning by Dr. Neil E. Harl. The seminar is scheduled for January 6-10, 1997 at the beautiful ocean-front Royal Waikoloa Resort on the Big Island, Hawai‘i.

Seminar sessions run from 8:30 a.m. to 12:30 p.m. each day, Monday through Friday, with a continental breakfast and break refreshments included in the registration fee. Each participant will receive a copy of Dr. Harl's 400 page seminar manual, Farm Estate and Business Planning: Annotated Materials which will be updated just prior to the seminar.

Here are the major topics to be covered:
- Introduction to estate and business planning.
- Liquidity planning with emphasis on 15-year installment payment of federal estate tax.
- Co-ownership of property, including discounts, taxation and special problems.
- Federal estate tax, including alternate valuation date, special use valuation, handling life insurance, marital deduction planning, disclaimers, planning to minimize tax over deaths of both spouses, and generation skipping transfer tax.
- Gifts and federal gift tax, including problems with future interests, handling estate freezes, and "hidden" gifts.
- 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.
- Using trusts, including funding of revocable living trusts.
- Organizing the farm business--one entity or two, corporations, general and limited partnerships and limited liability companies.

The Agricultural Law Press has made arrangements for discount air fares on United Airlines and discounts on hotel rooms at the Royal Waikoloa, the site of the seminar.

The seminar registration fee is $645 for current subscribers to the Agricultural Law Digest or the Agricultural Law Manual. The registration fee for nonsubscribers is $695.

For more information call Robert Achenbach at 1-541-302-1958.

ISSUE INDEX

Bankruptcy
- General
  - Administrative expenses 71
- Federal taxation
  - Assessment 71
  - Automatic stay 71
  - Discharge 71
  - Tax lien 71

Contracts
- Entrustment 71
- Implied warranty 71
- Farmer as merchant 72

Federal Agricultural Programs
- FAIR 1996 72
- Brucellosis 72
- Herbicides 72
- Meat inspection 72
- PACA 72
- Wheat and feed grains 72

Federal Estate and Gift Tax
- IRA 72
- Valuation 72

Federal Income Taxation
- Audit guidelines 73
- Cooperative 73
- Definition of farming 73
- Hobby losses 73
- Involuntary conversions 73
- Legal fees 73
- Passive activity losses 74
- Pension plans 74
- Safe harbor interest rates
  - May 1996 74

S corporations
- Shareholder 74
- Sale of residence 74
- Transfers incident to divorce 74

Products Liability
- Herbicide 74
- Manure handling system 74

Property
- Fences 75

Secured Transactions
- Filing 75
- Subordination agreement 75

State Taxation
- Agricultural use 75
- Equalization valuation 75
HAZARDS OF HEDGE-TO-ARRIVE CONTRACTS
— by Neil E. Harl

In the same manner as others bearing price risks, farmers buy and sell commodity futures to hedge against fluctuating prices. Likewise, farm taxpayers sometimes engage in speculative transactions.

A principal matter of concern from an income tax perspective is the line between hedging and speculation. Hedging transactions are defined in terms of reducing the risk of price (or interest rate) fluctuations in the ordinary course of the taxpayer’s business. Both sets of issues are discussed in this article.

What are “hedge-to-arrive” contracts?

Hedge-to-arrive or HTA contracts emerged about a decade ago in the Eastern Cornbelt and have since spread unevenly over much of the grain-producing regions of the country. The contracts operate in a manner similar to a hedge except — (1) the buyer (often the local elevator) has usually borne the margin deposits rather than the seller (as under a hedge) and (2) the seller can benefit from a narrowing of the basis in the commodity. Although the buyer shoulders the margin calls, those costs are ultimately passed to the seller. In recent months, the mounting margin calls and the costs incurred in rolling the contracts to a later futures month have risen to such a level as to raise a question whether the seller has sufficient assets to pay the obligation. In some instances, lenders supplying credit to elevators and other buyers obligated under HTA contracts have been requesting additional collateral to back lines of credit to the buyers. Losses of as much as a half million bushel on HTA contracts have been charged back to sellers.

HTA contracts were conceived and flourished in times of relative stability in commodity prices. Few anticipated the extreme price patterns seen during the first four months of 1996.

Regulatory framework governing hedge-to-arrive contracts

The Commodity Futures Trading Commission (CFTC) has been given statutory authority over “accounts, agreements ... and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market.” Federal law specifies that these “futures” contracts are illegal “off-exchange” contracts unless offered and sold on CFTC-designated boards of trade. Bona fide hedging transactions are specifically exempted from the legislation.

Cash forward contracts are excluded from the definition of futures contracts and thus are not subject to CFTC regulation. These are “any sale of any cash commodity for deferred shipment or delivery.” The exclusion for cash forward contracts is predicated upon the fact that both parties to the contract contemplate future delivery of the actual commodity and intend that delivery of the actual commodity occur. The exclusion is not available to cover contracts of sale for commodities sold for speculative purposes and which are not based upon the expectation that delivery of the actual commodity by the seller would occur in the future.

Origin of cash forward contract rule. The exclusion for cash forward contracts originated in the Futures Trading Act of 1921. Excessive speculation and price manipulation had been occurring on the grain futures markets. In an attempt to limit the observed abuses in the futures markets, Congress imposed a tax at prohibitive levels (20 cents per bushel) on all futures contracts with two exceptions. Under one exception, the 1921 legislation exempted from the tax future delivery contracts entered into by owners and growers of grain, owners and renters of land on which the grain was produced and associations comprised of such persons. The legislation also exempted from the tax future delivery contracts made through (or by) members which had been designated as contract markets. As a result of objections raised on behalf of farmers and grain elevators, the Senate added language to the pending legislation excluding “any sale of cash grain for deferred shipment” from the term “future delivery.” In the hearings, it was made clear that the additional language on cash forward contracts was premised on the fact that both parties to the contracts deal in and contemplate future delivery of the actual grain. The Futures Trading Act of 1921 was declared unconstitutional in 1922 as an impermissible attempt to regulate using the taxing power. The Congress then enacted the Grain Futures Act of 1922 which regulated grain futures trading under the Commerce Clause of the US Constitution. The cash forward contract exclusion was included in the 1922 legislation. The exclusion was reworded in the Commodity Exchange Act of 1936 to except “any cash commodity for deferred shipment or delivery.” The 1936 legislation also deleted the express exemption for owner and growers of grain, owners and renters of land and associations of such persons. That move was justified on the grounds that the legislation excluded...
cash commodity contracts for deferred shipment or delivery; the specific exemption was, therefore, not needed. 21

The language excluding cash commodities for deferred shipment or delivery has been continued to the present. The 1974 amendments to the legislation reaffirmed that, in a cash forward contract, the parties contemplate transfer of the actual commodity. 22 As the courts have noted, nothing in the legislative history suggests that Congress intended for the exclusion to embrace agreements for the future delivery of commodities sold for purposes of speculation. 23

The CFTC has issued several interpretative releases in recent years on the scope of cash forward contracts and the delivery requirement.

• In 1985, the CFTC tried to distinguish cash forward contracts from option contracts. 24 The CFTC referred to a forward contract as “a binding agreement on both parties to the contract; one must agree to make delivery and the other to take delivery of the commodity.” 25 The Commission also stated that the parties to the contracts must be “commercial entities that have the capacity to make or take delivery” and that delivery routinely occurs. 26

• In 1987, the Commission again addressed cash forward contracts — “Although such transactions may be settled other than by delivery on more than an occasional basis, it appears that departure from the traditional requirement of settlement by delivery of the physical commodity occurs on the basis of privately negotiated agreements by principals who have the capacity to make or take delivery, who contemplate actual delivery or acceptance of delivery in some of those transactions, but who may be unable to determine at the inception of the transaction that delivery will not be required.” 27

• In 1990, CFTC took a somewhat more relaxed view of the delivery obligation by noting that in specific cases “... the transactions may ultimately result in performance through the payment of cash as an alternative to actual physical delivery or delivery of the commodity.” 28 The Commission went on to state — “...while such agreements may extinguish a party’s delivery obligation, they are separate, individually negotiated, new agreements, there is no obligation or arrangement to enter into such agreements, they are not provided for by the terms of the contracts as initially entered into, and any party that is in a position in a distribution chain that provides for the opportunity to book-out with another party or parties in the chain is nevertheless entitled to require delivery of the commodity to be made through it, as required under the contracts.” 29

Further guidance may be forthcoming from CFTC on the regulatory status of “cash forward contracts.”

Applicability to hedge-to-arrive contracts. An important question is whether the so-called “hedge-to-arrive” contracts are considered to be cash forward contracts and, therefore, within the statutory exception. For such contracts extending two to three years into the future, with rollovers permitted to later contract months, and with no expectation of delivery, it would seem that such contracts might not come within the exception. That outcome seems indeed likely if the seller does not have sufficient commodity on hand or expected to be produced to cover the amount specified in the contract. Thus, it would appear that at least some of the contracts may be “off-exchange” contracts which, as noted above 30 may be illegal. A contract involving an off-exchange futures contract or trade option runs the risk of being held unenforceable by federal and state courts.

A careful review of contracts with legal counsel and those knowledgeable about risk management strategies is suggested. Contracts with the potential for deepening losses need immediate attention.

Income tax treatment

Hedges produce ordinary gains and ordinary losses and are not subject to the loss deferral rules and the “mark-to-market” provisions that are applicable to speculative transactions. 31 Indeed, gains and losses from hedge transactions are treated like gains and losses from transactions involving the actual commodities. Losses from hedge transactions can be used to offset ordinary income from grain sales and from sales of livestock held for sale in the ordinary course of business.

Speculative transactions are treated differently. Gains from speculative transactions are treated as capital gains; losses are reported as capital losses. In general, positions in regulated futures contracts are subject to the “mark-to-market” rules and are treated as if sold on the last day of the year. 32 Gains or losses arising under those calculations are treated as if they were 60 percent long-term and 40 percent short-term without regard to the actual holding period. Hedging transactions are exempt from these rules. 33

Long-term capital losses can be used to offset long-term capital gains and, for individuals, up to $3,000 of ordinary income each year. 34 Excess capital losses can be carried forward indefinitely for individuals 35 and for up to five years for corporate taxpayers. 36 Losses from regulated futures contracts can be carried back by individuals to the three prior years. 37 The maximum loss that may be carried back to any carryback year is the regulated futures gain in that year (without regard to regulated futures losses) that is the lesser of the net capital gain for the year, taking into account only gains and losses from regulated futures contracts or the net capital gain income for the tax year. 38

Requirements for a hedge

To be considered a hedge, the futures transaction must have the effect of reducing price (or interest rate) risk. Courts have emphasized two tests in evaluating commodity futures transactions as hedges or speculative venture.

Insurance test. If futures trading is used to offset price changes in actual commodities (the “actuals”), the transactions should be viewed as hedges. 39 That means gains on the actual commodities should be offset by losses on the futures trade. Similarly, losses on the actual commodities should be offset by gains on the futures transactions.

Typically, someone purchasing a commodity would sell a contract on the futures market in order to avoid price risk. When the commodity is sold, the futures contract is repurchased. Gains on one offset losses on the other. Thus, hedges usually involve ownership of actual commodities.

Direct relation test. Under the direct relations test, there must be a reasonable relationship between the amount of actuals involved and the amount of the trading in the futures market. 40 In cases where the volume of futures trading

---

*Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.*
greatly exceeded the amount of actuals, the transactions have been held to be speculative in nature.41

Recently issued regulations

Final regulations were issued in late 1994 providing guidance on reporting hedging and speculative transactions involving futures.42 Taxpayers other than farmers and other small businesses are required to take gains and losses from hedges into account in the same period as the income, deductions and gains or losses on the item hedged.43 However, for farm and small business taxpayers on the cash method of accounting, the simpler methods used previously and allowing the reporting of gains and losses on a cash accounting basis can continue to govern the reporting of hedge transactions if the taxpayer has no more than $5,000,000 of gross receipts.44

Taxpayers are required to identify hedges when entered into, along with the item or items hedged.45

FOOTNOTES

2 I.R.C. § 1256(e)(2).
3 7 U.S.C. § 2(i).
5 CFTC v. Co Petro Mktg. Group, Inc., 680 F.2d 573, 579 (9th Cir. 1982).
9 See Cong. Rec. 4762, Aug. 9, 1921.
11 See Cong. Rec. 4762, Aug. 9, 1921.
12 Futures Trading Act of 1921, Sec. 4(a), 42 Stat. 187 (1921).
13 Id.
14 Id., Sec. 4(b).

ANIMALS

CATTLE. The plaintiff was injured when the plaintiff’s car struck a steer owned by the defendant on a public highway. The steer had wandered 1400 feet to the highway through an open gate. The defendant had testified that the gate was closed when the defendant last used it the day before the accident. The plaintiff provided no evidence of any negligent act by the defendant which resulted in the gate being left open. After noting that Fla. Stat. § 588.15 required a showing of intentional or negligent act by the defendant before liability would attach for livestock running at large on a public road, the trial court granted summary judgment for the defendant. The plaintiff argued that the statute, as interpreted by the trial court, placed too high a burden on the plaintiff. The plaintiff also argued that the “dog bite” statute subjected dog owners to a strict liability standard; therefore, the plaintiff argued that Section 588.15, as interpreted by the trial court, violated the plaintiff’s equal
protection rights. The court noted that a similar case was decided in 1973 and that the legislature had not changed the statute after that decision; therefore, the lack of legislative action implied acceptance of the ruling. The court held that absent some evidence of the defendant’s intentional or negligent actions causing the gate to be open, the defendant was not liable for the accident. Fisel v. Wynns, 667 So.2d 761 (Fla. 1996).

**BANKRUPTCY**

**FEDERAL TAXATION-ALM § 13.03[7].**

**COMPROMISE OFFERS.** The debtors had made an offer to compromise prior to assessment of back taxes and the compromise was rejected by the IRS. After the assessment, IRS alleged that the debtors had made an oral second offer of compromise and the debtors’ attorney had sent a letter appealing the rejection of the second offer. The court held that the first offer did not extend the period for making pre-petition assessments under Section 507(a)(7)(A)(ii) (now 507(a)(8)(A)(ii)) because it occurred prior to the assessment, the oral second offer was not a valid offer because it was not made on IRS forms, and the appeal of the second rejection did not constitute an offer for purposes of Section 507. In re Aberl, 78 F.3d 241 (6th Cir. 1996), aff’d, 175 B.R. 915 (N.D. Ohio 1994), aff’d, 159 B.R. 792 (Bankr. N.D. Ohio 1993).

**DISCHARGE.** The debtor was found to have concealed assets from the IRS during tax years in which the debtor failed to pay taxes and during which the IRS had outstanding assessments against the debtor for previous years. The debtor argued that concealment of assets was insufficient to make the taxes for those years nondischargeable under Section 523. The court held that concealment of assets was sufficient evidence of an attempt to evade taxes to make the taxes nondischargeable. Dalton v. I.R.S., 77 F.3d 1297 (10th Cir. 1996).

**REFUND.** The debtor filed for Chapter 7 in February of 1995 and filed a 1994 joint return with the nondebtor spouse in April 1995, claiming a refund. The tax return reflected items of income and loss from the debtor’s law practice, rental activity, farming activity and the nondebtor spouse’s coffee shop business which had a significant loss for the year. The debtor had paid $8,000 in estimated taxes but the nondebtor spouse had not paid any estimated taxes. The debtor argued that one-half of the refund was not estate property and belonged to the spouse because the refund resulted from the losses incurred by the spouse’s business. The court held that the proration of a refund was to be made by comparing the income of each spouse to the amount of estimated or withheld taxes paid by each. Because the spouse did not make any tax payments, none of the refund was allocated to the spouse, resulting in the total refund being included in the bankruptcy estate. In re Gleason, 193 B.R. 387 (Bankr. D. N.H. 1996).

**TAX LIENS.** The debtors were spouses married to two brothers who had received farm property by inheritance. The property became subject to a judgment lien after a judgment was entered against two other brothers who also inherited part of the property. The debtors sought protection of their dower rights in the farm property as superior to the judgment lien. The IRS filed tax liens against the property for federal estate taxes due from the estates of the parents. The debtors then filed for bankruptcy. The debtors prevailed in the state court adjudication of the dower rights which provided for compensation from the foreclosure sale to the debtors’ dower rights. The IRS then filed a claim in the bankruptcy case, asserting a security interest in the compensation to be received for the dower rights. This series of events produced a circular priority of security interests with the judgment lien superior to the IRS lien, the dower rights superior to the judgment lien and the tax lien superior to the dower rights. The court held that the circuitry was resolved by first setting aside the judgment lien priority amount, then allowing the IRS its priority in the remaining amount, with the dower rights receiving a priority in the remainder. If any funds remained, they belonged to the judgment creditor. In re Stump, 193 B.R. 261 (Bankr. N.D. Ohio 1995).

**CONTRACTS**

**BREACH OF CONTRACT.** The plaintiff contracted with the defendant to find a 10 year old gelding trained as a hunter-jumper for about $10,000. The defendant located a horse in another state which was purported to be 11 years old. Both parties traveled to the owner’s farm and viewed the horse. The plaintiff arranged to have the owner’s “barn vet” examine the horse to determine its age. The veterinarian stated that the horse was 11 years old and the plaintiff agreed to purchase the horse. About one year later, the horse was re-examined and found to be almost 20 years old and the plaintiff sued the defendant for breach of contract, arguing that it was the defendant’s responsibility to verify the horse’s age. The court held that the Arkansas products liability statutes did not apply because the defendant was not the seller of the horse. The court also held that once the plaintiff arranged for a veterinarian to determine the horse’s age, accepted that determination and purchased the horse, the defendant’s duties under the contract were fulfilled and the defendant was not liable if the horse later turned out to be older. Mason v. Jackson, 914 S.W.2d 728 (Ark. 1996).

**FEDERAL AGRICULTURAL PROGRAMS**

**EGGS.** Puerto Rico promulgated a Market Regulation, Number 3, section X(F) which required all eggs imported from the continental United States to be labeled with the two letter state postal abbreviation of its state of origin. The plaintiff challenged the regulation as violating the Dormant Commerce Clause because it imposed a substantial burden on interstate commerce. The Puerto Rico Department of Agriculture argued that the regulation was allowed by the Egg Products Inspection Act, 21 U.S.C. § 1052(b)(2) which allowed noncontiguous states to require labeling showing the state or area of production. The court noted that Section 1052(b)(2) was worded as an exemption from the labeling restrictions of the Act and could not be read so as to exempt noncontiguous states from the Dormant Commerce Clause protections. Therefore, the court held that the regulation was subject to the Dormant Commerce Clause. The court further held that the regulation violated the Commerce Clause because it placed a burden on commerce from other states and the defendant failed to prove a legitimate local purpose.
United Egg Producers v. Puerto Rico Department of Agriculture, 77 F.3d 567 (1st Cir. 1996).

EXPERIENCE OF RUSSIAN CATTLE. The plaintiff was a Russian cattle breeder who sought to purchase breeding stock in the United States. The plaintiff chose three heifers from one farm and contracted with a veterinarian to test the animals for bovine leucosis because animals with or exposed to animals with this disease could not be imported into the United States. The three heifers tested positive for the disease and three other heifers were selected from the same herd. The animals tested negative for the disease but were not vaccinated and therefore were not eligible for the GSTT exemption and that the inclusion ratio of the GSTT trust was zero.

The IRS ruled that the first trust was funded with a specific amount over the total trust value. The other trust was funded with the estate equal to the amount of the GSTT exemption plus the inclusion ratio of the GSTT trust. The IRS held that the first trust was funded with a specific amount over the total trust value. The other trust was funded with the estate equal to the amount of the GSTT exemption plus the inclusion ratio of the GSTT trust.

The court held that the plaintiff’s action was barred as a matter of law under the “good Samaritan” rule, and the USDA was not liable for the first trust. The USDA certified the cattle for export to Zimbabwe. The court held that the trial court’s summary judgment for the plaintiff was affirmed in Burke v. United States, 994 F.2d 1576 (1993). The court held that the USDA had no duty to the plaintiff because it did not undertake any examination of the cattle. The court held that the only possible negligent party was the examining veterinarian. The veterinarian argued that the examining veterinarian owed no duty to the plaintiff because the veterinarian was hired by the seller of the cattle. The court held that the trial court’s summary judgment for the defendant veterinarian was improper because the plaintiff could provide evidence that the examining veterinarian was hired for the purpose of fulfilling a part of the sales contract, benefiting the plaintiff.

The court held that the IRS value was to be used to value the parcels. However, both parties agreed that a comparable sales approach would produce the most accurate valuation. The taxpayer’s appraiser claimed that no comparable sales were available and used an income-producing approach to value the parcels. The court held that the IRS value was to be used to value the gifts. In re Taylor, 96-1 U.S. Tax Cas. (CCH) ¶ 60,229 (Bankr. M.D. Fla. 1996).

FEDERAL ESTATE AND GIFT TAX

GENERATION SKIPPING TRANSFERS-ALM § 5.04[6]. The decedent’s estate included the decedent’s interest in an inter vivos trust which became irrevocable upon the decedent’s death. At the decedent’s death, the trust was to receive the remainder of the estate. The trustee funded the trusts with non-prorata shares of the estate property but the property chosen for each trust fairly represented the appreciation or depreciation which had occurred since the decedent’s death. The IRS ruled that the first trust was not reduced by the expenses because that trust was funded with a specific amount over the total trust value. The second trust was to receive the residuum of the trust property, the expenses, whether paid from principal or income, reduced the amount of the estate that was eligible for the GSTT exemption and that the inclusion ratio for that trust was zero. Ltr. Rul. 9617029, Jan. 26, 1996.

MARITAL DEDUCTION-ALM § 5.04[3]. The decedent’s estate included the decedent’s interest in an inter vivos trust which became irrevocable upon the decedent’s death. Upon the decedent’s death, the trust passed to the surviving spouse and was split into two trusts, a marital GSTT exemption trust and a marital share trust. The decedent’s will bequeathed an amount of trust property equal to the GSTT exemption amount to the GSTT trust. The remainder of the trust property passed to the marital share trust. The decedent’s will provided that estate, inheritance and other taxes, and all debts, funeral expenses, last illness expenses and administrative expenses were to be paid from trust principal except to the extent the executor elects to pay such expenses from trust income generated during the time between the decedent’s death and the distribution to the two trusts but only if such election did not diminish the marital deduction. The IRS cited Estate of Street v. Comm’r, 974 F.2d 723 (6th Cir. 1992) for the rule that all estate expenses are considered to have accrued as of the decedent’s date of death; therefore, such expenses diminish the estate before any bequests are satisfied, regardless of whether the expenses are paid from estate property or income from estate property. The IRS held that the marital GSTT trust was not reduced by the expenses because that trust was funded with a specific bequest; however, because the marital trust received the residue of the trust property, the expenses, whether paid from principal or income, reduced the amount of the estate passing to the surviving spouse and eligible for the marital deduction. Ltr. Rul. 9617003, Jan. 3, 1996.


VALUATION. The taxpayer received several parcels of land as gifts, with the donor retaining a life estate in each parcel. The IRS used several sales of comparable nearby land to determine the fair market value of the parcels. The taxpayer’s appraiser claimed that no comparable sales were available and used an income-producing approach to value the parcels. However, both parties agreed that a comparable sales approach would produce the most accurate valuation. The court held that the IRS value was to be used to value the gifts. In re Taylor, 96-1 U.S. Tax Cas. (CCH) ¶ 60,229 (Bankr. M.D. Fla. 1996).

FEDERAL INCOME TAXATION

BAD DEBT-ALM § 4.03[7]. The taxpayers obtained a default judgment in 1991 against another person for general and punitive damages; however, the taxpayers were unable to collect on the judgment. The taxpayers claimed the general and punitive damages as a nonbusiness bad debt on their 1991 tax return. The taxpayers argued that the damage awards became a debt which was not collectible. The court held that because the taxpayers did not include the damage awards in income, no deduction was allowed. The taxpayers also claimed that the taxpayers failed to show any tax basis in the debt or that the debt became worthless in 1991. Walter v. Comm’r, T.C. Memo. 1996-200.

CAPITAL EXPENSES. The taxpayer was a commercial airline. The taxpayer was required by the FAA
DEPRECIATION-ALM § 4.03[4]. The IRS has issued procedures for obtaining automatic consent to change a taxpayer’s method of accounting in order to claim allowable depreciation or amortization where the taxpayer has claimed less than the allowable depreciation or amortization. The omitted depreciation or amortization is taken into account through an I.R.C. § 481(a) adjustment. Taxpayers may also elect to make the change through the procedures provided in Rev. Proc. 92-20, 1992-1 C.B. 685. The procedure is available for property (1) for which less than allowable depreciation or amortization was claimed due to the accounting method used by the taxpayer, (2) to which I.R.C. §§ 167, 168, 197 or 168 (prior to amendment in 1986) apply, and (3) which is held by the taxpayer at the beginning of the year of the change in accounting method. The procedure does not apply to (1) property subject to I.R.C. § 1016(a)(3); (2) intangible property subject to I.R.C. § 167 (except § 167(f)); (3) property for which the taxpayer is seeking to revoke a timely election or to make a late election under I.R.C. §§ 167, 168, former 168 or 197; (4) property for which the taxpayer is seeking to change the estimated life (except property subject to I.R.C. §167(f); (5) property for which the use is changing; (6) changes in accounting involving a change from deducting the cost or other basis of any property as an expense to capitalizing and depreciating the cost or other basis; (7) changes from a permissible method to another permissible method; and (8) changes affecting items other than depreciation. Rev. Proc. 96-31, I.R.B. 1996-20.

INSTALLMENT REPORTING-ALM § 6.03[1]. The taxpayer was an employee of a corporation and acquired stock in the corporation which was subject to a repurchase agreement if the taxpayer’s employment terminated. The taxpayer division in the corporation was sold to another company and the taxpayer entered into an agreement to resell the stock to the corporation for cash and a promissory note. The note provided for annual payments during the following two years. The corporation had significant legal problems in the year of the stock repurchase agreement and filed for bankruptcy before paying anything on the promissory notes. The taxpayer did obtain some recovery in the bankruptcy case. The first issue was whether the stock repurchase agreement was an installment contract. The taxpayer argued that the agreement was not an installment contract because the promissory note did not qualify as an installment “payment.” The court held that, although a promissory note itself would not qualify as an installment payment, the payments on the note would; therefore, the repurchase agreement was an installment contract. The taxpayer claimed the note as a bad debt deduction for the year of the stock repurchase agreement, arguing that the corporation’s legal troubles indicated that no payments would be made on the note. The court held that the taxpayer failed to prove that the note was worthless in the year claimed since the corporation did continue in business for two years before filing for bankruptcy. Barrett v. Comm’r, T.C. Memo. 1996-199.

FARM EXPENSES. The taxpayers purchased a rural residence on 113 acres. The taxpayer claimed that they intended to start a farming operation on the land and incurred equipment and maintenance expenses related to the farm. The court found that the taxpayers failed to provide any evidence to support their claimed expenses or that the expenses were related to farming. Therefore, the deductions for the expenses were denied. Mitchell v. Comm’r, T.C. Memo. 1996-217.

LEGAL FEES. The taxpayer was a residuary legatee of an estate. The estate included rental property which was sold by the executors. The taxpayer filed a suit against the executors for mismanagement of the estate, including the loss of income from the rental property. The taxpayer won a portion of the suit and claimed the legal fees and costs incurred as a deduction. The taxpayer argued that because a portion of the estate included business income property, the legal fees were incurred for the protection of income. The court held that the underlying cause of the action pursued by the taxpayer was the mishandling of the estate by the executors causing a reduction of the residuary estate passing to the taxpayer; therefore, the legal fees were incurred primarily to protect the taxpayer’s interests in the estate and the legal fees were not deductible. Looby v. Comm’r, T.C. Memo. 1996-207.

PARTNERSHIPS-ALM § 7.03.*

LIMITED LIABILITY COMPANIES. A general partnership converted to a limited liability company with all assets and liabilities passing to the new organization. The IRS ruled that no gain or loss would be recognized from the conversion and the partners’ basis in the LLC would be the same as in the partnership. Ltr. Rul. 9618021, Feb. 2, 1996; Ltr. Rul. 9618022, Feb. 2, 1996; Ltr. Rul. 9618023, Feb. 2, 1996.

S CORPORATIONS-ALM § 7.02[3][c].*

ELECTION. The taxpayers claimed to have timely mailed a Form 2553 to the IRS but the IRS claimed to have not received it. The court found that the taxpayers presented credible evidence that the form was mailed but that the IRS provide sufficient evidence to rebut the presumption of the mailing. The court also held that I.R.C. § 7502(a) did not apply because the taxpayers did not provide any evidence of a postmark. The appellate decision is designated as not for publication. Smith v. Comm’r, 96-1 U.S. Tax Cas. (CCH) ¶ 50,232 (9th Cir. 1996), aff’g, T.C. Memo. 1994-270.

SALE OF RESIDENCE. The taxpayer had purchased rental real estate with the taxpayer's parents as tenants in common. The purchase was made with a loan for which the taxpayer was personally liable. The taxpayer then sold the tenant's personal residence. The taxpayer gave the parents the taxpayer's interest in the rental property but remained liable on the debt. The taxpayer then repurchased the rental property from the parents for use as the personal residence and assumed the entire remaining balance of the loan. The court held that taxpayer could not include the assumed debt in calculating the tax gain or loss deferment on the sale and repurchase of a personal residence because the assumed debt was not incurred within two years of the sale and repurchase, since the taxpayer became liable on the debt many years before the sale of the personal residence.

*Agricultural Law Manual (ALM): For information about ordering the Manual, see the last page of this issue.
DunneGAN v. Comm’r, 96-1 U.S. Tax Cas. (CCH) ¶ 50,234 (3d Cir. 1996), aff’g, T.C. Memo. 1995-167.

SOCIAL SECURITY BENEFITS. In 1991, the taxpayers received Social Security disability benefits but did not include any of the benefits in gross income. The taxpayers stated that they relied on a Form 886-A from an audit of the taxpayers’ 1987 tax returns which stated that Social Security disability payments were nontaxable. The court held that one-half of the benefits were included in gross income and upheld the IRS assessment of an accuracy-related penalty under I.R.C. § 6662(a). Maki v. Comm’r, T.C. Memo. 1996-209.

LANDLORD AND TENANT

LEASE. The plaintiff corporation was formed to operate a hydroponics greenhouse on land owned by the defendants. The shareholders were also shareholders in the plaintiff corporation and the parties entered into an “Incorporators’ Letter of Agreement” which provided for the construction of the greenhouse and lease of the land and greenhouse to the corporation. However, several aspects of the lease were not spelled out in the Agreement and the Agreement listed several other issues which needed to be agreed to before the lease could be executed. The court held that the Agreement did not create a binding lease because the Agreement, the actions of the parties (including the failure to charge any rent), and the negotiations leading to the Agreement indicated that the lease was yet to be negotiated. Therefore, the defendants’ eviction of the plaintiff corporation was not a breach of any lease. Waterfall Farm Systems, Inc. v. Craig, 914 F. Supp. 1213 (D. Md. 1995).

NEGLIGENCE

ATTRACTIVENUISANCE. The plaintiff’s son was injured when the son trespassed on the defendant’s land, climbed into the second story of a barn and fell through a hole made when the son removed a floor board. The plaintiff sued, arguing that the barn was an attractive nuisance and that the defendant failed to exercise reasonable care to eliminate the danger or protect children who might be attracted to the barn. The court held that the attractive nuisance doctrine did not apply because the barn was not an artificial condition on the land which was used as a farm. In addition, the court held that the barn did not impose an unreasonable risk for trespassing children because the danger of falling through a hole in a floor after removing a plank was an open and obvious danger to children. Cruce v. Kennington, 467 S.E.2d 227 (Ga. Ct. App. 1996).

PATENTS

HYDROPONIC SYSTEM. The plaintiff corporation had acquired the rights to develop and market a hydroponic growing system which it had acquired from one of its shareholders who held the original patent. The system was constructed in a greenhouse on land owned by two other shareholders. After a dispute among the shareholders became irreconcilable, the land and greenhouse owners evicted the plaintiff and continued the operation of the greenhouse using the hydroponic system. The plaintiffs sued for violation of the patent. The defendants argued that the patent was invalid, under 35 U.S.C. § 102(b), because the inventor had sold a system more than one year before applying for the patent. The court agreed that the testimony of the inventor demonstrated that the patent was invalid because a sale of the system was made more than one year before the inventor applied for the patent. Waterfall Farm Systems, Inc. v. Craig, 914 F. Supp. 1213 (D. Md. 1995).

PRODUCTS LIABILITY

CULTIVATOR. The plaintiff was injured while replacing a hydraulic cylinder on one wing of a cultivator manufactured by the predecessor in interest to the defendant. The plaintiff sued for negligence in failing to provide a warning that the new cylinder had to be fully charged before removing the pin which held the wing in an upright position. The defendant was found to be 67 percent at fault and the plaintiff was awarded actual and punitive damages. The cultivator had been manufactured by a company which was sold or consolidated with other companies over several years, with the defendant being the current owner of the rights to produce the cultivator used by the plaintiff. Although only one similar accident occurred during the life of the original manufacturer, by the time the defendant acquired the manufacturing rights, several accidents had occurred but the defendant had not made any attempt to warn current cultivator owners about the dangers of replacing hydraulic cylinders. The defendant argued that it had no duty to warn in this case because it did not manufacture the cultivator. The court held that because the defendant had knowledge of the accidents and received a current benefit from selling cultivators with the same name, the defendant was liable for failing to warn current owners. The court noted that the jury had allocated liability among the various owners of the manufacturing company. The court upheld the jury allocation of fault based on sufficient evidence. The court upheld the jury award of punitive damages because the evidence demonstrated wanton conduct by the defendant in failing to warn cultivator owners after the defendant had knowledge of several similar accidents. Patton v. TIC United Corp., 77 F.3d 1235 (10th Cir. 1996).

HERBICIDE. The plaintiff purchased a herbicide manufactured by one defendant and sold by the other defendant. The plaintiff applied the herbicide to a corn crop and claimed that the herbicide damaged the crop. The plaintiff sued in negligence, products liability, and breach of express and implied warranty. The actions were based on claims that the defendants failed to warn about the damage caused by the herbicide and that the herbicide was defectively designed and manufactured. The defendants argued that the actions were preempted by FIFRA. The court held that the actions for failure to warn were preempted by FIFRA but the actions for defective design and manufacture were not preempted. Eide v. E.I. Du Pont de Nemours & Co., 542 N.W.2d 769 (S.D. 1996).
PROPERTY

**USUFRUCT (LIFE ESTATE).** The plaintiff owned naked title (vested remainder interest) in timberland in which the defendant owned an usufruct (life estate). The defendant had contracted for the clear cutting of 113 acres of the land and the plaintiff objected to anything more than selective cutting. The land was not actively managed as a tree farm but was merely an old stand of trees which had naturally grown on the property. The court held that because the land was not managed as a tree farm with periodic harvesting of the trees, the usufruct owner did not have a right to harvest all of the trees but could harvest only so much as a prudent administrator would harvest in order to provide a regular income but also preserve the substance of the property for the naked title owner. The court found that a clear cut would impair the value of the property for almost 40 years until another stand of marketable trees would be produced. Thus, the court allowed the defendant to selectively harvest the timber on the 113 acres such that the stand would still produce such income when the land passed to the naked title owner. **Kennedy v. Kennedy,** 668 So.2d 485 (La. Ct. App. 1996).

STATE TAXATION

**SALES TAX.** The Washington legislature has passed an exemption from sales tax for labor and services for constructing, repairing or improving new and existing agricultural employee housing and for the sale of personal property which becomes an ingredient or component of the housing. **Ch. 117, Laws 1996,** eff. March 20, 1996.

CITATION UPDATES

**Moretti v. Comm’r,** 77 F.3d 637 (2d Cir. 1996) (net operating losses) see p. 68 *supra.*

AGRICULTURAL LAW MANUAL

by Neil E. Harl

This comprehensive, annotated looseleaf manual is an ideal deskbook for attorneys, tax consultants, lenders and other professionals who advise agricultural clients. The book contains over 900 pages and an index.

As a special offer to Digest subscribers, the Manual is offered to new subscribers at $115, **including at no extra charge updates published within five months after purchase.** Updates are published every four months to keep the Manual current with the latest developments. After the first free update, additional updates will be billed at $100 per year or $35 each.

For your copy, send a check for $115 to Agricultural Law Press, P.O. Box 50703, Eugene, OR 97405.

**Satisfaction guaranteed. 30 day return privilege.**

ISSUE INDEX

<table>
<thead>
<tr>
<th>Animals</th>
<th>Federal Estate and Gift Tax</th>
<th>Sale of residence 82</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cattle 79</td>
<td>Generation skipping transfers 81</td>
<td>Social security benefits 83</td>
</tr>
<tr>
<td>Bankruptcy</td>
<td>Marital deduction 81</td>
<td>Landlord and Tenant</td>
</tr>
<tr>
<td>Federal taxation</td>
<td>Valuation 81</td>
<td>Lease 83</td>
</tr>
<tr>
<td>Compromise offers 80</td>
<td><strong>Federal Income Taxation</strong></td>
<td>Negligence</td>
</tr>
<tr>
<td>Discharge 80</td>
<td>Bad debt 81</td>
<td>Attractive nuisance 83</td>
</tr>
<tr>
<td>Refund 80</td>
<td>Capital expenses 81</td>
<td>Patents 83</td>
</tr>
<tr>
<td>Tax liens 80</td>
<td>Depreciation 82</td>
<td>Hydroponic system 83</td>
</tr>
<tr>
<td>Contracts</td>
<td>Farm expenses 82</td>
<td>Products Liability</td>
</tr>
<tr>
<td>Breach of contract 80</td>
<td>Installment reporting 82</td>
<td>Cultivator 83</td>
</tr>
<tr>
<td>Federal Agricultural Programs</td>
<td>Legal fees 82</td>
<td>Herbicide 83</td>
</tr>
<tr>
<td>Eggs 80</td>
<td>Partnerships</td>
<td>Property</td>
</tr>
<tr>
<td>Export of cattle 81</td>
<td>Limited liability companies 82</td>
<td>Usufruct 84</td>
</tr>
<tr>
<td>Herbicides 82</td>
<td>S corporations</td>
<td>State Taxation 84</td>
</tr>
</tbody>
</table>

Printed on recycled paper using soy ink
DEPRECIATING PROPERTY ACQUIRED FROM RELATED PARTIES

— by Neil E. Harl*

Traditionally, a substantial amount of farm property is transferred within the family.1 A major issue is how depreciation is claimed on the items following the transfer.2 Expense method depreciation

Property acquired from a related party is not eligible for expense method depreciation.7 For this purpose “related party” includes a spouse, ancestors, lineal descendants and controlled entities.9

Regular depreciation

For purposes of regular depreciation under MACRS (Modified Accelerated Cost Recovery System) the question is whether the “anti-churning” rules apply.6 Those provisions, originally added in 1981, identified six classes of property that were not eligible for the more rapid depreciation allowances under ACRS (Accelerated Cost Recovery System).5 Those rules were extended by the Tax Reform Act of 1986 to include property placed in service after 1986 under MACRS (or on an item by item basis after July 31, 1986) with two exceptions — (1) the anti-churning rules were not extended to residential rental property or nonresidential real property;7 and (2) the anti-churning rules were not extended to property placed in service after 1986 under MACRS (or on an item by item basis after July 31, 1986) with two exceptions — (1) the anti-churning rules do not apply to property where, for the first full taxable year after being placed in service, the depreciation deductions under rules in effect before the Tax Reform Act of 1986 was enacted would be greater than the amount allowable under the 1986 legislation using the half-year convention.8 In general, that condition is met inasmuch as MACRS depreciation under the Tax Reform Act of 1986 provided for less rapid depreciation than under the ACRS system applicable before 1987.9 If either condition is met, the same depreciation rules apply to property acquired from a related party as from an unrelated transferor. Thus, for “property used in a farming business,”10 which is defined as used in the “trade or business of farming,”11 the maximum depreciation is 150 percent declining balance for 3, 5, 7 and 10 year property.12 The same 150 percent declining balance rate is the maximum allowable for 15 and 20-year property.13

If the two conditions in the Tax Reform Act of 198614 are not met, the anti-churning rules apply.

Anti-churning rules

Of the five anti-churning rules applicable to Section 1245 property,15 the one most likely to cause problems in related party transactions is the “related party” rule.16 Under that provision, the term “recovery property” does not include Section 1245 class property if the property was owned or used at any time during 1980 (or 1986) by the taxpayer or a related party.17 The term “related party” for this purpose includes brothers or sisters, whether of the whole or half blood; spouse; lineal ancestors and lineal descendants.18 Apparently, in that event the depreciation is calculated using pre-1981 rules for property not classified as “recovery property.”19 The related party anti-churning rule does not apply if the property is acquired from the estate of a related party where the property received a new income tax basis at death.20 Thus, property acquired from the estate of a closely-related person is eligible for cost recovery even though acquisition of the property during life from the same individual would have barred cost recovery under ACRS (or MACRS) if the property had been owned or used by the related person in 1980 (or 1986).21 The term “related party” does not include a divorced spouse22 but the term does include those engaged in trades or businesses under common control.23

The anti-churning rules also apply to property placed in service before 1981 (or before 1987) which was acquired by the taxpayer after 1980 (or 1986) in various types of tax-free exchanges.24 The third anti-churning rule covers property acquired from a person who owned the property at some time during 1980 (or 1986) and, as part of the transaction, the user of the property did not change.25 The fourth anti-churning rule applies to property leased to a person (or a person related to that person) who owned or used the property at any time during 1980 (or 1986).26 Finally, the anti-churning rules reach property acquired in a transaction as part of which the user does not change and the property is not “recovery property” in the hands of the person from whom it was acquired by reason of the third or fourth anti-churning rules.27

Two additional anti-churning rules are applicable to Section 1250 property acquired after 1980 if — (1) the property comes under the first, second or fourth anti-churning rules for Section 1245 property, or (2) the property was acquired in a tax-free exchange, involuntary conversion

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
reinvestment, reacquisition for indebtedness or low income housing reinvestment to the extent the basis represents the basis of other property owned by the taxpayer or a related person during 1980 (or 1986). The latter rule could apply to tax-free exchanges involving farm buildings (20-year property).

FOOTNOTES
2 See 4 Harl, supra n. 1, ch. 29; Harl, supra n. 1, § 4.03[4].
3 I.R.C. § 179(d)(2)(A), (B).
9 For a comparison of the two depreciation systems, see 4 Harl, supra n. 1, §§ 29.05[2][c], 29.05[2][d].
11 I.R.C. § 263A(e)(4)(A). The definition also includes operating a nursery or sod farm; the raising or harvesting of trees bearing fruit, nuts or other crops; and ornamental trees (other than evergreen trees more than six years old when severed from the roots). I.R.C. § 263A(e)(4)(B).
14 See ns. 7 and 8 supra.
15 See n. 5 supra.
17 Id.
22 See Drake v. United States, 642 F. Supp. 830 (N.D. Ill. 1986) (taxpayer’s interest in condominium purchased from divorced spouse in 1981 eligible as recovery property where spouse’s interest in condominium held with taxpayer during marriage as tenants by entirety).
29 I.R.C. § 168(c)(1).

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

ADVERSE POSSESSION

FENCE. The plaintiffs had purchased their land in 1967 with a barbed wire fence around it. The land was used to graze cattle and the plaintiff planted trees along one portion of the fence. In 1988, the defendant purchased neighboring land and had the land surveyed. The survey showed the fence to be on the defendant’s land and the defendant removed the fence from the defendant’s land and replaced it with a wooden fence. The plaintiff claimed ownership of the disputed strip by adverse possession. The court held that the common ownership of both the tracts destroyed the acquiescence of the fence as the boundary between the tracts; however, in 1977 both tracts were owned by one company for 15 days. In the history of the tracts, all the conveyances and deeds described the boundary truthfully without mentioning the fence which was about 100 feet on to the defendant’s property. The court held that the common ownership of both tracts destroyed the acquiescence of the fence as the boundary and started the time limits for adverse possession anew; therefore, the plaintiff did not acquire title to the disputed land by adverse possession. Salazar v. Terry, 911 P.2d 1086 (Colo. 1996), aff’d, 892 P.2d 391 (Colo. Ct. App. 1994).

ANIMALS

ANIMAL NUISANCE. The defendant was convicted twice of violating Revised Ordinance of Honolulu §§ 7-2.2(a), 7-2.3 for keeping roosters which were noisy in the early morning. In both cases the convictions arose from a complaint of a neighbor and a single citation from an investigating officer. The defendant argued that both
convictions were improper in that the defendant was not given a warning citation which provided specific instructions as to what the defendant was required to do in order not to be in violation of the ordinance. The court agreed and held that in both cases, the ordinance required a warning citation before a conviction for animal nuisance could be imposed. The defendant also argued that the keeping of roosters was a “permitted use” of the property which prevented any conviction for animal nuisance. The court held that the city zoning ordinances allowed the raising of livestock on the property for commercial or food raising purposes and that an issue of fact remained as to whether the defendant was raising all of the roosters for commercial or food raising purposes. The court noted that the defendant gave some testimony that some of the roosters were raised for showing and held the raising of roosters for showing was not a permitted use under the city ordinances. State v. Nobriga, 912 P.2d 567 (Hawai’i Ct. App. 1996).

BANKRUPTCY

CHAPTER 12-ALM § 13.03[8].”

ELIGIBILITY. The debtors had been sugarcane farming since 1972. In 1991, the debtors purchased a tractor in order to begin converting their operation to raising soybeans. In 1994, the year before the filing of the Chapter 12 petition, the debtors were able to plant only a small sugarcane crop and a late planted soybean crop; however, the debtors produced gross income from farming of $25,000. The debtors also had $1,400 of rental income from a sharecropping arrangement. Because the income from farming was low, the debtors sold the tractor and harvester in 1994 which produced taxable gain of $31,000. In 1993, the debtors began full-time off-farm employment and in 1994, earned combined wages of $37,000. A creditor objected to the debtors’ plan, arguing that the debtors were not eligible for Chapter 12 because more than 50 percent of their income came from nonfarm sources. The creditor argued that the equipment sales and sharecropping payments were not farm income. The court held that the debtors were engaged in farming in 1994 because they were at risk for the crops they planted and the crop produced by the sharecropper. The court also held that the equipment sales were included in farm income because the equipment was sold in order for the debtors to continue their farming operation, albeit at a reduced level. The creditor also argued that the determination of farm income could only be based on the debtors’ 1994 Schedule F items of income. The court rejected this argument as not required by the Bankruptcy Code. Cottonport Bank v. Dichiara, 193 B.R. 798 (W.D. La. 1996).

FEDERAL TAXATION-ALM § 13.03[7].”

ADMINISTRATIVE EXPENSES. The debtor originally filed for Chapter 11 but converted the case to Chapter 7 after two years. The IRS filed a claim in the Chapter 7 case for post-petition, preconversion taxes plus interest and penalties. The parties agreed that the taxes and interest were entitled to administrative expense priority but disagreed as to the penalties. The court held that under Section 503(b), the penalties were entitled to the same priority as the taxes to which the penalties applied. However, the court applied Section 510(c)(1) and subordinated the penalties to all other priority claims, thus causing the penalties to be paid pro rata with other second priority claims. The IRS had also filed a claim after the claims bar date in the Chapter 7 case for additional taxes for the same period. The court allowed the additional claim as an amendment to the original timely filed claim because the amendment related to the same type of tax and the same taxable period. The court also subordinated the penalties associated with the additional taxes. The Supreme Court reversed, holding that the Bankruptcy Court did not have the authority to change the statutory priority order. United States v. Noland, 96-1 U.S. Tax Cas. (CCH) ¶ 50,252 (S. Ct. 1996), rev’g In re First Truck Lines, Inc., 48 F.3d 210 (6th Cir. 1995), aff’g unrep. D. Ct. dec. aff’g, 141 B.R. 621 (Bankr. S.D. Ohio 1992).

PRIORITY. The IRS filed an unsecured claim for unpaid taxes resulting from the debtor’s embezzlement of funds. The debtor argued that the taxes were not entitled to priority because the taxes were due more than three years before the filing of the petition and because no priority is provided for taxes which the debtor attempted to evade or which resulted from a fraudulent return. The IRS argued that the taxes were entitled to priority because the taxes were assessable after the case was filed, under the extended limitations period of I.R.C. § 6501(e)(1)(A), because the embezzled funds exceeded 25 percent of the debtor’s reported income. The court held, however, that under Section 523(a)(1)(C) the taxes are not entitled to priority because the debtor filed a fraudulent return and willfully attempted to evade payment of the taxes by not reporting the embezzled funds as income. Matter of Zieg, 194 B.R. 469 (Bankr. D. Neb. 1996).

REOPENING CASE. The debtors filed for Chapter 13 and listed a claim for federal taxes with the amount set at zero. The IRS was notified of the case and the deadline for filing claims but did not file a claim until three months after the bar date for claims. The debtors’ plan was confirmed without objection from the IRS and provided for no payment on the tax claim. At the end of the plan, the trustee filed a report showing all plan payments had been made and that the IRS claim was filed late and was not paid. The IRS was notified about this report and failed to object. The trustee’s report was approved, the debtors were discharged, and the case was closed. Seven months later, the IRS filed a motion to reopen the case, under Section 350(b), and vacate the discharge. The court held that, because the order of confirmation was within the jurisdiction of the Bankruptcy Court and did not deprive the IRS of due process, the confirmation order could not be voided and a reopening of the case was futile. The court rejected the IRS argument that the failure of the debtors to provide for payment of priority tax claims was a jurisdictional defect voiding the confirmation order. In re Puckett, 193 B.R. 842 (Bankr. N.D. Ill. 1996).

STATUTE OF LIMITATIONS. The debtor was assessed for FICA taxes in November 1981 and for FUTA taxes in July 1983. The debtor executed a waiver in June 1986 which provided for an extension to December 1992 of the period for collection of the taxes if an offer of compromise was made, with an additional extension after that date to equal the period of the pending offer plus one
The debtor submitted an offer of compromise in October 1986 and withdrew the offer in June 1987. In March 1993, the debtor filed for Chapter 7 and received a discharge in July 1991. In August 1994, the extension period under the waiver expired. On September 13, 1994, the IRS attached the debtor’s assets for collection of the taxes and on September 15, 1994, the debtor filed the instant Chapter 13 case. The IRS argued that the Chapter 7 case tolled the collection period under Section 108(c). The court held that Section 108(c) did not apply because the waiver agreement did not incorporate the extension provided by Section 108(c) and because the end of the waiver period did not occur during the Chapter 7 case. Because the period for collection had expired prior to the Chapter 13 case, the IRS had no viable claim for the taxes. In re Klingshirn, 194 B.R. 154 (Bankr. N.D. Ohio 1996).

**CONTRACTS**

**NONCOMPETITION AGREEMENT.** The plaintiff had been a 50 percent shareholder and officer in the defendant corporation. The plaintiff’s employment was terminated and a stock purchase agreement was executed which prohibited the plaintiff from engaging in the processing or sale of citrus concentrate or fresh juices for three years. The plaintiff purchased a cold-storage facility without objection from the defendant. The cold-storage facility did some mixing of juices as part of its ordinary services for its storage customers. The defendant refused to make payments under the stock purchase agreement, claiming that the plaintiff breached the noncompetition clause because the mixing of juices was equivalent to processing of juices. The court upheld the trial court’s ruling that the mixing of juices did not violate the noncompetition clause because the mixing was incidental to the cold-storage business which was not prohibited by the noncompetition clause. Becker Holding Corp. v. Becker, 78 F.3d 514 (11th Cir. 1996).

**FEDERAL AGRICULTURAL PROGRAMS**

**AGRICULTURAL LABOR.** The plaintiff was injured while working on the defendants’ tobacco and sweet potato farm and sued for violations of the Migrant and Seasonal Agricultural Workers Protection Act (MSAWPA) and negligence. The plaintiff was hired and worked under the supervision of a farm labor contractor and the plaintiff claimed that the defendants were liable as a joint employer of the plaintiff. The court held that the defendants were joint employers of the plaintiff with the labor contractor under the supervision of a farm labor contractor and the plaintiff. The court held that the Chapter 7 case tolled the collection period under Section 108(c). The court held that Section 108(c) did not apply because the waiver agreement did not incorporate the extension provided by Section 108(c) and because the end of the waiver period did not occur during the Chapter 7 case. Because the period for collection had expired prior to the Chapter 13 case, the IRS had no viable claim for the taxes. In re Klingshirn, 194 B.R. 154 (Bankr. N.D. Ohio 1996).

**BRUCELLOSIS.** The APHIS has adopted as final regulations changing Wisconsin from an accredited-free state to an accredited-free (suspended) state. 61 Fed. Reg. 16617 (April 16, 1996).

**GRAIN STANDARDS.** The Grain Inspection, Packers and Stockyards Admin. (GIPSA) has adopted as final regulations amending the grain standards for barley to include two classes, malting barley and barley; to remove the U.S. Choice grade for two-row malting barley; and to revise several grading procedures and inspection standards. 61 Fed. Reg. 18486 (April 26, 1996).

**HANDBOOKS.** The plaintiff challenged the Forest Service’s issuance of a special use permit for construction of a communications tower on a butte on which the plaintiff also had a tower. The plaintiff claimed that the permit violated a Manual and Handbook published by the Forest Service for use by its employees. The court held that the Manual and Handbook was not entitled to any force or effect of law because the book was not issued in accordance with the procedural requirements of the Administrative Procedures Act and was not issued under any statutory authority. This case has similar implications for the FSA handbooks. Western Radio Services Co., Inc. v. Espy, 79 F.3d 896 (9th Cir. 1996).


**MILK.** The FSA has adopted as final regulations continuing the Dairy Indemnity Payment Program to the extent of the recently appropriated funds. 61 Fed. Reg. 18485 (April 26, 1996).

**VACCINES.** See Lynnbrook Farms v. Smithkline Beecham Corp., 79 F.3d 620 (7th Cir. 1996) infra under Products Liability.

**FEDERAL ESTATE AND GIFT TAX**

**INSTALLMENT PAYMENT OF ESTATE TAX.** The decedent owned interests in several rental properties. The decedent or the decedent’s daughter performed various activities in managing the properties including (1) interviewing prospective tenants, (2) enforcing lease terms, (3) collecting rent payments, (4) various bookkeeping and regulatory functions, and (5) making or contracting for maintenance of the properties. However, the tenants provided landscaping; snow and trash removal; air conditioning, plumbing, painting, and electrical maintenance; and fire insurance. The IRS ruled that the decedent’s interests in the properties were not interests in closely held businesses for purposes of I.R.C. § 6166. Ltr. Rul. 9621007 (Feb. 13, 1996).

**JOINT TENANCY PROPERTY.** The decedent’s deceased spouse had inherited real property and transferred the property to both of them as tenants by the entirety in 1955. The spouse died in July 1989 and 50 percent of the value of the property was included in the spouse’s estate. The decedent sold the property in 1990 and

---

*Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.*
used the estate tax value for 50 percent of the property (under the “fractional share” rule) as the basis for determining gain from the sale. The decedent’s executor filed an amended income tax return for the year of the sale to use a basis of the full estate tax value of the property, under the “consideration furnished rule, removing all gain from the sale transaction. The issue was whether ERTA 1981 amendments to I.R.C. § 2040 providing for the fractional share rule replaced the former “consideration furnished” rule for pre-1977 joint tenancy transfers. The court cited Gallenstein v. United States, 975 F.2d 286 (6th Cir. 1992) to support its holding that the 1981 amendment did not completely replace the previous rule and the decedent was entitled to include the entire value of the property for estate tax purposes as the property’s basis in the sale. Patten v. United States, 96-1 U.S. Tax Cas. (CCH) ¶ 60,231 (W.D. Va. 1996).

**VALUATION.** The IRS has issued proposed regulations which would allow reformation of a personal residence trust within 90 days after a gift tax return is due for the trust creation. The proposed regulations also provide that a qualified personal residence trust cannot allow the transfer of the residence to the grantor, the grantor’s spouse or any entity controlled by the grantor or the grantor’s spouse. This could have important implications for buying back the residence after the period of the retained interest. See Harl, “Reacquiring the Residence from a GRIT,” 6 Agric. L. Dig. 137 (1995). 61 Fed. Reg. 16623 (April 16, 1996), amending Treas. Reg. § 25.2702-5.

The taxpayer donated stock to a university in 1976 and valued the shares at $10.00 each for federal income tax charitable deduction purposes. The trial court used evidence of subsequent sale transactions to determine the value of the stock on the date of the gift. Although the appellate court upheld the use of subsequent events to prove the value of the gift, the case was remanded because the trial court’s valuation was not based on the evidence and was too speculative. On remand, the court valued the stock based on an adjusted net worth analysis with a discount for the taxpayer’s minority interest. The value of intangibles was not included for lack of evidence of their values and the price determined by a buy-sell agreement was ignored because of no evidence that the agreement was executed. Krapf v. U.S., 96-1 U.S. Tax Cas. (CCH) ¶ 50,249 (Fed. Cls. 1996), on rem. from, 977 F.2d 1454 (Fed. Cir. 1992), rem’g, 17 Cl. Ct. 750 (1989).

**FEDERAL INCOME TAXATION**

**BAD DEBT.** The taxpayer was an anesthesiologist who purchased stock in a small corporation which operated a printing business. The taxpayer made several loans to the corporation which eventually became worthless and the taxpayer claimed a business bad debt deduction for the amount of the worthless loans. The court held that the taxpayer was not entitled to a business bad debt deduction because the taxpayer was not in the business of lending money to corporations. Gubbini v. Comm’r, T.C. Memo. 1996-221.

The taxpayer was a corporation which owned several subsidiary corporations, one of which operated a lingerie store. The taxpayer made payments on several expenses incurred by the subsidiary while the subsidiary was remodeling its store and the taxpayer received promissory notes in return. When the store failed, the taxpayer claimed the amounts owed on the notes as business bad debts. The court examined 11 factors used in Roth Steel Tube Co. v. Comm’r, 800 F.2d 625 (6th Cir. 1986), aff’g T.C. Memo. 1985-58 to determine whether the amounts paid by the taxpayer were debt or equity. The court held that the amounts were equity because (1) the subsidiary did not make any principal or interest payments on the notes, (2) the subsidiary was thinly capitalized, (3) the subsidiary’s business was closely aligned with the taxpayer’s, (4) no security was provided for the notes, (5) the subsidiary would not have been able to obtain financing under similar terms offered by the notes, (6) the funds were used for capital expenses, and (7) the subsidiary did not maintain any sinking fund for repayment of the notes. Deja Vu, Inc. v. Comm’r, T.C. Memo. 1996-234.

**BUSINESS EXPENSES.** The taxpayer was a corporation in the ready-mix concrete business. The taxpayer rented trucks from a related corporation and the lease provided that the lessor corporation was responsible for the expenses for the tires on the trucks. The taxpayer claimed that the lease was orally modified to make the taxpayer responsible for the tire expenses. The court held that the taxpayer failed to present sufficient evidence to contradict the lease terms and disallowed a deduction for the tires. Fountain Valley Transit Mix, Inc. v. Comm’r, T.C. Memo. 1996-244.

**CAPITAL LOSSES.** The taxpayer owned an 83 percent interest in a partnership. The taxpayer established a trust for the taxpayer’s grandchildren and named two unrelated individuals as trustees. The taxpayer then sold the partnership interest to the trust for adequate consideration, a promissory note, which was less than the taxpayer’s income tax basis in the partnership interest. The taxpayer argued that, because the partnership interest was sold to the trustees, the taxpayer was not considered the grantor of the trust property and the transaction was not subject to the I.R.C. § 267(a) disallowance of the capital loss on the sale of the partnership interest to a related party. The court held that the substance of the transaction was a sale of property to the trust and, in such cases, the seller is considered the grantor of the property and cannot recognize any capital loss on the transaction under I.R.C. § 267(a). Meek v. Comm’r, T.C. Memo. 1996-236.

**COURT AWARDS AND SETTLEMENTS.** The taxpayer sued a previous employer for breach of contract and for racial discrimination. The parties reached a negotiated settlement with payment of two $70,000 checks to the taxpayer. The settlement agreement did not allocate any of the checks to the racial discrimination claim. The taxpayer had no other evidence that one-half of the money was paid for the racial discrimination claim; therefore, the court held that none of the settlement amount could be allocated to the racial discrimination claim. The case is designated as not for publication. Strong v. Comm’r, 96-1 U.S. Tax Cas. (CCH) ¶ 50,223 (9th Cir. 1996).
HEALTH INSURANCE. After retiring, the taxpayer began a boat charter and brokerage business as a sole proprietorship. In 1990, the taxpayer financed a portion of the business with interest income from a pension but the business claimed a net loss on Schedule C. The taxpayer claimed a deduction for health insurance premiums paid in 1990, arguing that the taxpayer’s income included the interest income contributed to the business. The court held that the deduction was not allowed because the taxpayer had a net loss for the tax year. King v. Comm’r, T.C. Memo. 1996-231.

HOME OFFICE. The taxpayer was an anesthesiologist who performed medical services primarily at a hospital. The hospital provided only minimal office services for the taxpayer and the taxpayer performed all recordkeeping and billing out of a home office. The taxpayer argued that the taxpayer’s anesthesiology services were a separate business from the billing business; therefore, the principal place of business for the billing services was the home office, allowing the taxpayer to claim deductions for expenses relating to the home office. The court disagreed, holding that the taxpayer’s principal business was anesthesiology, that the principal place of that business was the hospital and that the home office expenses were not deductible. Chong v. Comm’r, T.C. Memo. 1996-232.

After retiring, the taxpayer began a boat charter and brokerage business as a sole proprietorship. In 1990, the taxpayer financed a portion of the business with interest income from a pension but the business claimed a net loss on Schedule C. The taxpayer claimed deductions for expenses associated with a home office, arguing that the taxpayer’s income included the interest income contributed to the business. The court held that the deductions were not allowed because the taxpayer had a net loss for the tax year. King v. Comm’r, T.C. Memo. 1996-231.

INTEREST. The taxpayer was a corporation to which real property was contributed by a shareholder in exchange for the corporation’s note. The corporation made no payments on the debt to the shareholder until 12 years later. The court held that the corporation could not have obtained similar shareholder owned almost all of the corporation’s stock, and the payments on the note depended upon the corporation’s expenses associated with a home office, arguing that the taxpayer’s income included the interest income contributed to the business. The court disagreed, holding that the taxpayer’s principal business was anesthesiology, that the principal place of that business was the hospital and that the home office expenses were not deductible. Chong v. Comm’r, T.C. Memo. 1996-232.

After retiring, the taxpayer began a boat charter and brokerage business as a sole proprietorship. In 1990, the taxpayer financed a portion of the business with interest income from a pension but the business claimed a net loss on Schedule C. The taxpayer claimed a deduction for contributions to an IRA, arguing that the taxpayer’s income included the interest income contributed to the business. The court held that the deduction was not allowed because the taxpayer had a net loss for the tax year. King v. Comm’r, T.C. Memo. 1996-231.

LIKE-KIND EXCHANGES. The taxpayers were shareholders in a corporation which attempted to sell real property in a like-kind exchange using an escrow account because the buyer did not own any suitable exchange property. The corporation placed the cash from the sale into the escrow account which had no restrictions on its use except that the corporation was to designate the property to be purchased with the funds within 180 days. The court held that the escrow account had insufficient restrictions to qualify the transactions as a like-kind exchange for federal income tax purposes. Miller v. Comm’r, T.C. Memo. 1996-214.

The taxpayer owned ranch land which was actively used in the business of breeding, raising and selling cattle. The county in which the land was located wanted to obtain a scenic easement on the property and the taxpayer wanted to obtain suitable like-kind property in exchange for the easement. The taxpayer planned to obtain timber, farm or ranch land in a three-party exchange and use the land for the production of timber, crops or cattle. The IRS ruled that a fee interest in timber, farm or ranch land would qualify as like-kind property in exchange for the scenic conservation easement on the ranch property. Ltr. Rul. 9621012, Feb. 16, 1996.

PARTNERSHIPS-ALM § 7.03.*

TAX MATTERS PARTNER. The taxpayer was a partner in a tax shelter partnership in which another partner was the tax matters partner (TMP). The TMP became the subject of a criminal investigation by the IRS and during this investigation, the TMP consented to an extension of the limitations period for assessing taxes attributable to partnership items. During the extension but after the normal period for assessments had expired, the taxpayer signed a closing agreement which included deficiencies owed by the taxpayer relating to partnership items. The taxpayer argued that the closing agreement should be voided because the IRS failed to inform the taxpayer about the criminal investigation of the TMP which prohibited the TMP from acting as TMP thus invalidating the extension of the assessment period. The taxpayer argued that the IRS had a fiduciary duty to inform the taxpayer since no other TMP was designated. The court held that there was no statutory or other authority that imposed a fiduciary duty on the IRS to inform the taxpayer since no other TMP was designated. The court held that there was no statutory or other authority that imposed a fiduciary duty on the IRS to inform the taxpayer since no other TMP was designated. Therefore, the closing agreement was valid. The case is designated as not for publication. In re Miller, 96-1 U.S. Tax Cas. (CCH) ¶ 50,236 (9th Cir. 1996).

PENSION PLANS. For plans beginning in April 1996, the weighted average is 6.93 percent with the permissible range of 6.24 to 7.49 percent (90 to 109 percent permissible range) and 6.24 to 7.63 percent (90 to 110 percent permissible range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). Notice 96-32, I.R.B. 1996-22, 7.
The taxpayer was the sole shareholder of a corporation which had established a defined benefit pension plan for all employees, including the taxpayer. The plan prohibited the assignment or alienation of vested benefits by any participant. When the corporation ran into financial difficulty, the taxpayer decided to provide additional cash to the corporation by waiving the taxpayer’s interest in the pension plan. The court held that the waiver resulted in the value of the taxpayer’s interest in the plan being included in the taxpayer’s gross income because the waiver was a prohibited attempt to assign or alienate the interest in the plan. Gallade v. Comm’r, 106 T.C. No. 20 (1996).

SAFE HARBOR INTEREST RATES

<table>
<thead>
<tr>
<th></th>
<th>June 1996</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Annual</td>
</tr>
<tr>
<td>AFR</td>
<td>5.88</td>
</tr>
<tr>
<td>110% AFR</td>
<td>6.48</td>
</tr>
<tr>
<td>120% AFR</td>
<td>7.08</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Mid-term</td>
<td></td>
</tr>
<tr>
<td>AFR</td>
<td>6.58</td>
</tr>
<tr>
<td>110% AFR</td>
<td>7.26</td>
</tr>
<tr>
<td>120% AFR</td>
<td>7.93</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Long-term</td>
<td></td>
</tr>
<tr>
<td>AFR</td>
<td>7.04</td>
</tr>
<tr>
<td>110% AFR</td>
<td>7.75</td>
</tr>
<tr>
<td>120% AFR</td>
<td>8.47</td>
</tr>
</tbody>
</table>

S CORPORATIONS-ALM § 7.02[3][c].

SECTION 1244 STOCK. The taxpayer was a shareholder in an S corporation which terminated without repaying the shareholders for their stock. The taxpayer claimed the loss as an ordinary loss under I.R.C. § 1244. The court disallowed the loss deduction because the taxpayer failed to provide sufficient evidence of the stock basis. Gubbini v. Comm’r, T.C. Memo. 1996-221

UNRELATED BUSINESS INCOME. The taxpayer was a nonprofit school which was established in 1909 through a gift of agricultural land. The school originally provided a rural agricultural education but currently provides a broader curriculum. Over the years the school acquired additional tracts of farm land for teaching use but the reduction in agricultural education courses made the land an economic burden on the school. The school decided to sell much of the land in small parcels over several years to maximize the sale price and to minimize the effect on other land prices in the community. The school also wanted to maintain control over development near the school to maintain the school’s rural atmosphere. The IRS ruled that the sales of the property would not amount to a trade or business and the income from the sales would not be unrelated business income to the school. Ltr. Rul. 9619069, Feb. 13, 1996.

PRODUCTS LIABILITY

HERBICIDE. The plaintiff purchased the herbicide Scepter which was manufactured by the defendant. The plaintiff applied the herbicide to soybean fields in one crop year after being told by the seller that it was safe to plant corn on treated acres within 12 months after applying the herbicide. The plaintiff testified that this information came from the seller and not from any advertisements. However, the same information was on the printed label on the product. The plaintiff sought to hold the defendant liable for negligent misrepresentation in advertising and the statements of the seller. The defendant claimed that the action was preempted by FIFRA. The court acknowledged a split of authority on this issue as to advertisements and other written materials not on the label; however, the court held that the action was preempted, especially where, as here, the plaintiff had not seen or relied on the advertisements. Kuiper v. American Cyanamid Co., 913 F. Supp. 1236 (E.D. Wis. 1996).

VACCINES. The plaintiff vaccinated cattle with two vaccines produced by the defendant. Some of the cattle died, either from failure of the vaccine to prevent disease or a defect in the vaccines that caused the deaths directly. The plaintiff sued the defendant in strict liability, misrepresentation, false advertising, and breach of implied warranties of merchantability and fitness for a specific purpose. The vaccines were licensed under the Virus-Serum-Toxin Act by APHIS and the defendant argued that regulations issued by APHIS completely preempted the plaintiff’s causes of action. The plaintiff challenged the authority of APHIS to make such a regulation and the scope of the regulation as to state common law causes of action. The court upheld the preemption regulation as a rational and necessary part of the authority granted to APHIS to control and license vaccines. The court noted that a license by APHIS was a determination by APHIS that the vaccine was safe and effective; therefore, any state action which challenged the safety or effectiveness of a licensed vaccine was preempted by the APHIS regulations. The ruling leaves little chance that any state law cause of action will be allowed against a defective licensed animal vaccine. Lynnbrook Farms v. Smithkline Beecham Corp., 79 F.3d 620 (7th Cir. 1996).

STATE REGULATION OF AGRICULTURE

NONRESIDENT ALIEN OWNERSHIP OF LAND. The Iowa legislature has passed legislation allowing nonresident alien businesses which do not actively engage in farming to own up to 1,000 acres and lease up to 280 additional acres of land in an economic development area. House File 2234, enacted May 2, 1996.

STATE TAXATION

AD VALORUM TAXES. The plaintiff owned a grain storage facility used to collect, inspect, clean, blend and store grain which was loaded on to ocean ships for export. Under Art. 7, § 21(d)(2) of the Louisiana Constitution, grain held for export was exempt from Louisiana ad valorem taxes. The plaintiff’s county assessor determined that the plaintiff’s facility did more than hold grain for export and that the action was preempted, especially where, as here, the plaintiff had not seen or relied on the advertisements. Gisclair v. Bunge Corp., 668 So.2d 1179 (La. Ct. App. 1996).
AGRICULTURAL USE. The taxpayer owned two parcels of land, each used only for growing pine trees. The properties were rezoned as residential but the properties contained no residences or habitable structures. The county assessor then assessed the properties reflecting their use as residential property based on the zoning change. The taxpayer argued that the assessments should have been made based on the actual use of the property. The court held that Miss. Code § 27-35-50 required property assessments to be made on the basis of the actual current use of the property and that the growing of timber was included in the definition of agricultural use. *Riley v. Jefferson Davis County*, 669 So.2d 748 (Miss. 1996).

**CITATION UPDATES**

*E. Norman Peterson Marital Trust v. Comm’r*, 78 F.3d 795 (2d Cir. 1996), *aff’g*, 102 T.C. 798 (1994) (generation skipping transfers) see p. 52 *supra*.


**AGRICULTURAL LAW MANUAL**

by Neil E. Harl

This comprehensive, annotated looseleaf manual is an ideal deskbook for attorneys, tax consultants, lenders and other professionals who advise agricultural clients. The book contains over 900 pages and an index.

As a special offer to Digest subscribers, the *Manual* is offered to new subscribers at $115, including *at no extra charge* updates published within five months after purchase. Updates are published every four months to keep the *Manual* current with the latest developments. After the first free update, additional updates will be billed at $100 per year or $35 each.

For your copy, send a check for $115 to Agricultural Law Press, P.O. Box 50703, Eugene, OR 97405.

Satisfaction guaranteed. 30 day return privilege.

**ISSUE INDEX**

Adverse Possession
- Fence 86

Animals
- Animal nuisance 86

Bankruptcy
- Chapter 12
  - Eligibility 87
- Federal taxation
  - Administrative expenses 87
  - Priority 87
  - Reopening case 87
  - Statute of limitations 87

Contracts
- Noncompetition agreement 88

Federal Agricultural Programs
- Agricultural labor 88
- Brucellosis 88
- Grain standards 88
- Handbooks 88
- Herbicides 88
- Milk 88
- Vaccines 88

Federal Estate and Gift Tax
- Installment payment of estate tax 88
- Joint tenancy property 88
- Valuation 89

Federal Income Taxation
- Bad debt 89
- Business expenses 89
- Capital losses 89
- Court awards and settlements 89
- Health insurance 90
- Home office 90
- Interest 90
- Interest rates 90
- IRA 90
- Like-kind exchanges 90
- Partnerships
  - Tax matters partner 90
- Pension plans 90
- Safe harbor interest rates
  - June 1996 91
- S corporations
  - Section 1244 stock 91

Unrelated business income 91

Products Liability
- Herbicide 91
- Vaccines 91

State Regulation of Agriculture
- Nonresident alien ownership of land 91

State Taxation
- Ad valorem taxes 91
- Agricultural use 92
INSTALLMENT SALES OF COMMODITIES AND AMT

— by Neil E. Harl*

Since 1986, installment sales of commodities have run the risk of alternative minimum tax liability.1 If alternative minimum taxable income exceeds the exemption amount ($40,000 for corporations, $45,000 for individuals filing a joint return),2 alternative minimum tax is imposed.3

A late 1995 technical advice memorandum4 has confirmed that AMT liability may be imposed on commodity sales where payment is deferred beyond the year of sale. A letter to the Iowa District Director in early 1993 had reached the same conclusion as the late 1995 TAM.5

Background on AMT liability

The problem with possible AMT liability arose with a provision in the Tax Reform Act of 1986.6 As amended in 1987, that provision specifies that —

"In the case of any disposition after March 1, 1986, of any property described in [I.R.C.] section 1221(1), income from such disposition shall be determined without regard to the installment method under [I.R.C.] section 453...."

Property "described in section 1221(1)" is basically inventory property and property held for sale to customers in the ordinary course of business.8 Therefore, sales of farm commodities on the installment method appear to fall within the provision.

In letters to Members of Congress in 1989, IRS agreed that installment sales of farm products could generate AMT liability.9 In a memorandum dated January 14, 1993,10 IRS stated —

"A taxpayer that sells agricultural commodities pursuant to a fixed price contract may use the installment method for purposes of computing taxable income. However, because this type of property is described in [I.R.C.] section 1221(1), the installment method may not be used in computing AMTI."

Thus, IRS has consistently taken the position that installment sales, at least of agricultural commodities, were subject to AMT liability.

The two deferral methods

Dating back more than four decades, a substantial body of case law12 and rulings13 supported the deferral of income through deferred payment and deferred pricing14 contracts. The Internal Revenue Service, in Rev. Rul. 58-162,15 ruled that a binding contract for the sale of grain with payment in the following year could effectively defer income until the year of actual receipt.16

Deferred payment contracts, as those deferral arrangements come to be known, were subject to challenge on two grounds —

• A deferred payment sale to a purchaser considered to be an agent of the seller was viewed by IRS as ineligible for deferral of income tax liability.17 That position prevented many livestock sales from being eligible for deferral.18 A US District Court disagreed, however, and held that a farmer on the cash method of accounting should be taxed in the year payment was received, which was the year following delivery of livestock to a market corporation which sold the livestock through an auction market.19

• The second basis for challenge was that if the contract could be assigned at fair market value, that value had to be taken into account in the year of sale.20 In a 1979 private letter ruling, a farmer on the cash method of accounting entered into a sales contract for grain which was delivered to the buyer in the year of the transaction but for which payment was deferred for two years.21 The contractual right to payment was deemed to have a fair market value with income recognized in the year of sale.22

The fall-out from the 1979 letter ruling was directly responsible for enactment of the second deferral option in 1980.23 Congress amended the then-pending Installment Sales Revision Act of 1980,24 to provide that a taxpayer receiving gain from the sale of property may report the transaction on the installment method with the gain taxable as payments are received by the seller (except for recapture income required to be recognized in the year of sale) so long as the property was not required to be included in inventory under the taxpayer’s method of accounting.25 Thus, farmers and ranchers on the cash method of accounting could report the sales of grain, soybeans, livestock and other commodities under the regular installment reporting rules.26

The 1995 TAM

The late 1995 technical advice memorandum27 involved a husband and wife who operated a potato farm and sold potatoes to various buyers under agreements which deferred some portion of the selling price until the following tax

---

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
The IRS examining agent did not object to the deferral for regular income tax purposes but took the position that the arrangement was subject to the alternative minimum tax rules applicable to “the installment method under [I.R.C.] section 453.” The Service agreed with the agent, relying on Warren Jones Co. v. Commissioner in concluding that the tax treatment of a deferred payment obligation depends upon whether the fair market value of property received in exchange can be ascertained.

The Service analysis is surprising, perplexing and questionable. That may explain why the TAM has not yet been released.

The Service did not need the Warren Jones Co. case to hold the deferral arrangement subject to AMT. That outcome is a matter of statutory interpretation; the outcome has been clear since 1986. What the Warren Jones Co. analysis does is to challenge the regular tax deferral. That was the holding in the late 1979 private letter ruling that led to enactment of the installment reporting rules in 1980.

Yet regular tax deferral was not part of the holding in the late 1995 TAM.

An obvious question is where this leaves deferred payment arrangements based upon pre-1980 authority. Some have hypothesized that such arrangements are still available, are not subject to “the installment method under [I.R.C.] section 453,” and thus are not subject to AMT. A passage in the Senate Finance Committee Report on the Installment Sales Revision Act of 1980 states —

Under the bill, gain from the sale of property which is not required to be inventoried by a farmer under his method of accounting will be eligible for installment method reporting as gain from a casual sale of personal property even though such property is held for sale by the farmer. The committee also intends that deferred payment sales to farmer cooperatives are to be eligible for installment reporting as under present law. (Rev. Rul. 73-210, 1973-1 C.B. 211).

The TAM relegates Rev. Rul. 58-162 and Rev. Rul. 73-210 to a footnote with the dismissive comment that those authorities and others failed to apply I.R.C. § 1001.

The obvious question is whether a deferred payment arrangement that is specifically made non-assignable and non-transferable (which has been the standard suggestion for such arrangements since issuance of the 1979 letter ruling) continues to be deferrable for regular tax purposes and, further, whether such arrangements are subject to “the installment method under [I.R.C.] section 453” and thus subject to AMT. The fact that such arrangements predated the 1980 enactment of the “installment method” rules suggests that deferred payment contracts were not and are not “installment method” sales. That, however, continues to be unclear.

Unfortunately, the TAM provides no insight into the important unanswered questions and has needlessly muddied further waters that were already far from clear.

Finally, the Service ruled in the TAM that the outcome of the ruling involves a change of accounting method.

Further, IRS indicated that I.R.C. § 481 applies in determining the farmers’ tax for the year of change.

FOOTNOTES


2. I.R.C. § 55(d)(1), (2).

3. I.R.C. § 55(b). The tax rate is 20 percent for corporations. I.R.C. § 55(b)(1)(B). For individuals, the rate is 26 percent up to $175,000 and 26 percent above that level.

4. TAM __________, December 21, 1995 (the technical advice memorandum has not been released by the Internal Revenue Service; a copy is available from Agricultural Law Press; send SASE).


6. Sec. 701, adding I.R.C. § 56(a)(6), as amended by the Revenue Act of 1987, Sec. 10202(d).


8. See I.R.C. § 1221(1).


10. See n. 5 supra.

11. Id.


14. Applegate v. Comm’r, 94 T.C. 696 (1990), aff’d, 980 F.2d 1125 (7th Cir. 1992) (contracts were not obligations payable on demand).


16. See also Rev. Rul. 73-210, 1973-1 C.B. 211 (deferred payment contract with cooperative entered into before delivery of commodity directed to defer income recognition to following year; under pre-existing marketing agreement with cooperative, seller entitled to advance payment equal to government loan).


20. Ltr. Rul. 8001001, Sept. 4, 1979. See Warren Jones Co. v. Comm’r, 524 F.2d 788 (9th Cir. 1975), rev’d and rem’g, 800 F.2d 1125 (7th Cir. 1992) (contracts were not obligations payable on demand).


27. See n. 4 supra.

28. Id.

29. Id.

30. 524 F.2d 788 (9th Cir. 1975).

31. See n. 4 supra.

32. See n. 29 supra.

33. See n. 6 supra and accompanying text.

34. See n. 29 supra.

35. See n. 19 supra.

36. See n. 22 supra and accompanying text.
was executed. That the homestead objection was limited to the homestead objection to the homestead exemption. The court also held vehicle exemptions was denied as untimely but allowed the last amendment but more than 30 days after the first filed an objection to the exemptions within 30 days after the homestead exemption in both amendments. The creditors vehicles only in the second amendment and changed the claimed exemption amount for the motor vehicles. The exemption schedules were amended twice and

Theriot, 670 So.2d 783 (La. Ct. App. 1996) constitutional and barred the plaintiff's recovery. The court held that the ordinance was unconstitutional in not prohibiting negligent conduct. The plaintiff argued that there was no evidence of the defendant's knowingly or willfully allowing the cow on to the highway. The defendant argued that the agreement was entered into in Section 3:2803. The accident occurred in Cameron Parish which had an Ordinance § 4-42 which prohibited livestock owners from willfully or knowingly allowing their livestock on to highways. The defendant argued that there was no evidence of the defendant's knowingly or willfully allowing the cow on to the highway where the accident occurred. The plaintiff argued that the ordinance was unconstitutional in not prohibiting negligent conduct. The court held that the ordinance was constitutional and barred the plaintiff's recovery. Bolzoni v. Theriot, 670 So.2d 783 (La. Ct. App. 1996).

BANKRUPTCY

GENERAL-ALM § 13.03.*

EXEMPTIONS

OBJECTIONS. The debtors filed for Chapter 7 and claimed exemptions for a homestead and two motor vehicles. The exemption schedules were amended twice and changed the claimed exemption amount for the motor vehicles only in the second amendment and changed the homestead exemption in both amendments. The creditors filed an objection to the exemptions within 30 days after the last amendment but more than 30 days after the first amendment. The court held that the objection to the motor vehicle exemptions was denied as untimely but allowed the objection to the homestead exemption. The court also held that the homestead objection was limited to the homestead exemption amount allowed when the mortgage on the home was executed. In re Ahmed, 194 B.R. 540 (Bankr. D. Conn. 1996).

FEDERAL TAXATION-ALM § 13.03[7].

ASSESSMENT. During an audit of their 1981 taxes, the debtors signed an IRS Form 870-AD Offer of Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and of Acceptance of Overassessment. The debtors claimed the form was signed and delivered to the IRS in 1988 but did not produce a copy of the signed form. The IRS formally made assessments against the debtors in August 1989 and the debtorsfiled for Chapter 7 in March 1990, within 240 days after the assessment. The debtors argued that the filing of the Form 870-AD was an assessment of the taxes and made the taxes nondischargeable. The court held that only the formal assessment by the IRS was considered for purposes of determining the discharge of the taxes. In re Lilly, 194 B.R. 885 (Bankr. D. Idaho 1996).

AVOIDABLE TRANSFERS. The debtor’s residence was foreclosed upon by the IRS to satisfy the debtor’s individual tax debt. The debtor’s spouse also owned one-half of the residence but was not liable for the taxes. The debtor and IRS entered into an agreement to split the proceeds of the sale of the residence, with one-half paid to the IRS and one-half paid to the spouse. The debtor then filed for bankruptcy and sought to recover, under Section 522(h), the amount paid to the IRS as a transfer of exempt property. The court held that the agreement was entered into voluntarily by the debtor; therefore, no recovery could occur. In re Dalip, 194 B.R. 597 (Bankr. N.D. Ill. 1996).

CLAIMS. The IRS filed an untimely priority claim in the debtor’s Chapter 7 case and the debtor sought to have the claim allowed only as a general unsecured claim. The court held that the timeliness of an IRS tax claim did not affect the priority status of the claim. In re Davis, 81 F.3d 134 (11th Cir. 1996).

DISCHARGE. The debtors filed their 1991 tax returns on April 15, 1992 and the debtors filed for Chapter 13 on April 30, 1992. The IRS obtained permission to assess taxes for 1990 and 1991 on May 11, 1992. The debtors converted the case to Chapter 7 in November 1992 and received a discharge in February 1993. The IRS began collection efforts after the discharge but the debtors filed for Chapter 13 in April 1995. The debtors argued that the taxes were now dischargeable because the return was filed more than three years before the petition. The IRS argued, and the court agreed, that the intervening Chapter 13 and 7 cases tolled the limitations period of Section 507(a)(8)(A) to increase the period by the length of those cases. In re Strickland, 194 B.R. 888 (Bankr. D. Idaho 1996).

The court held that the debtor’s previous bankruptcy case tolled the three year period of Section 507(a)(8)(A) for purposes of a second case. In re Taylor, 81 F.3d 20 (3d Cir. 1996).

DISMISSAL. The debtor, a tax protester, had failed to file income tax returns or pay taxes on wages for seven years. The debtor filed a Chapter 7 case and received a discharge, except for the income taxes. The debtor then filed for Chapter 13 and sought to discharge the taxes. The IRS
moved to dismiss the case for bad faith. The court held that failure to file returns and pay wages and the failure of the debtor to provide for any payment of the taxes in the Chapter 13 plan were sufficient cause to dismiss the case for bad faith filing. In re Greatwood, 194 B.R. 637 (Bankr. 9th Cir. 1996).

REFUND. In an effort to pay employment taxes owed by the debtor’s business, the debtor sold the business and paid the IRS from the sale proceeds an amount based on what an IRS agent stated was the amount owed. In spite of this, the IRS continued to assess interest and penalties on additional employment taxes owed by the business. When the debtor filed for bankruptcy, the IRS filed a claim for the amount of taxes, interest and penalties still owed. The debtor presented the evidence of the payment from the sale proceeds and the IRS failed to provide any evidence of how the proceeds were applied, if at all, to the debtor’s taxes. The Bankruptcy Court held that the debtor provided sufficient evidence to rebut the IRS claim and disallowed the claim. The appellate court reversed, holding that the burden of proof remained with the debtor to rebut the IRS claim. In re Ford, 194 B.R. 583 (S.D. Ohio 1996), rev’d, 168 B.R. 173 (Bankr. S.D. Ohio 1994).

SECURED CLAIMS. The debtors filed for Chapter 13 and the IRS filed a claim for taxes which was partially secured. The debtors’ plan provided for payment of the secured tax claim to the extent the claim was secured by nonexempt property. Citing In re Barbier, 896 F.2d 377 (9th Cir. 1990), the IRS argued that the claim was to be considered secured to the extent of all property subject to the prepetition tax lien. The court agreed, holding that a claim was secured to the extent of all property in which the estate had an interest on the date of the petition, which would include property which the debtors would later claim as exempt. In re May, 194 B.R. 853 (Bankr. D. S.D. 1996).

CONTRACTS

SALE OF GOODS. The plaintiffs entered into a contract to purchase 10 emu chicks from the defendants. The defendant delivered only one healthy chick and the plaintiffs sued for damages. The trial judge refused to allow jury instructions involving damages allowed under the UCC because (1) the transaction was not between merchants and (2) emu chicks were not goods for purposes of the UCC. The jury awarded the plaintiffs damages and the defendants appealed. On appeal, the plaintiffs conceded the error of the first point. The court reversed the jury verdict and held that emu chicks were goods for purposes of the UCC and that the instructions concerning UCC measure of damages should have been allowed. Sanders v. Barton, 670 So.2d 880 (Ala. 1995).

FEDERAL AGRICULTURAL PROGRAMS

GRAIN STANDARDS. The Grain Inspection, Packers and Stockyards Admin. (GIPSA) has adopted as final regulations amending the grain standards for barley to include two classes, malting barley and barley; to remove the U.S. Choice grade for two-row malting barley; and to revise several grading procedures and inspection standards. The GIPSA has announced that the new barley standards will not be implemented until June 1, 1997. 61 Fed. Reg. 24663 (May 16, 1996).


IRRADIATION. The APHIS has issued a policy statement concerning the use of irradiation as a treatment for plant pests of quarantine significance. 61 Fed. Reg. 24246 (May 15, 1996).

PERISHABLE AGRICULTURAL COMMODITIES ACT-ALM § 10.05[2]. In 1986, the debtor, a perishable agricultural commodities dealer subject to PACA, purchased several interests in a marketing terminal cooperative which entitled the debtor to lease shops in the terminal market. In 1989 and 1991, the debtor purchased perishable agricultural commodities from several sellers who were not paid for the produce. The sellers filed notices of intent to claim part of the PACA trust before the debtor filed for bankruptcy. The sellers sought to include in the PACA trust, the proceeds from the bankruptcy trustee's sale of the terminal shops' interests held by the debtor. The sellers argued that the rent paid for the shops was derived from the sale of the produce purchased from the sellers. The District Court held that the interests themselves could not be subject to the PACA trust because the interests were purchased before the commodities were purchased from the sellers. In addition, the rent payments were not included in the PACA trust because the payments were bona fide and made in the normal course of business. In reversing and remanding the District Court decision, the appellate court held that the PACA trust, once established by a sale on credit, continued until all unpaid sellers were paid, even though the unpaid sellers changed over time. This made the PACA trust’s existence independent of each commodity transaction but also terminated the trust once all unpaid sellers were paid. Therefore, the court reasoned, the interests purchased by the debtor could be subject to the PACA trust if any unpaid sellers existed when the interests were purchased, the interests were purchased with PACA trust assets, and the PACA trust did not terminate for any period after the interests were purchased. The case was remanded to determine whether these factors existed. In re Kornblum & Co., Inc., 81 F.3d 280 (2d Cir. 1996), rev’d and rem’d, 177 B.R. 187 (S.D. N.Y. 1995).

FEDERAL ESTATE AND GIFT TAX

GIFT-ALM § 6.01. The decedent and spouse gave their son $72,000 in exchange for title to the son’s house, although the son and spouse continued to live in the house. The decedent and spouse claimed deductions attributed to the property and paid property taxes on the property. The son decided to sell the house and the decedent and spouse transferred the house to the son for no consideration before the sale occurred. The decedent filed a gift tax return for the transaction, valuing the gift at the fair market value of the house, based on the sale price to the third parties. The estate argued that the transfer of title back to the son was not a gift because the son retained possession of the house and, under...
I.R.C. § 2036(a) would have had to include the house in the son’s estate for estate tax purposes. The court cited Estate of Durkin v. Comm’r, 99 T.C. 561 (1992) for three factors in holding that the decedent’s estate was barred from challenging the gift tax treatment of the transaction: (1) the decedent had filed a gift tax return consistent with a gift transaction, (2) the decedent had treated the first transaction as a sale and the second as a gift in local records, and (3) the tax treatment of the transactions was challenged only after an IRS audit. Estate of Corbett v. Comm’r, T.C. Memo. 1996-255.

REFUNDS. The decedent’s estate filed and received an extension to file the federal estate tax return. Prior to the new due date, the estate made a payment of $30,000 designated as an estimated estate tax payment. On the new due date, the estate filed a Form 706 which listed the values of estate property but did not include any schedules to support the valuations. The form was accompanied by a $15,000 check and a letter explaining that the estate was complicated such that final asset values could not be determined and that an amended return would be filed if necessary. Over five years later, the estate filed an amended return which claimed a refund. The court held that the filing of the Form 706 was sufficient to start the limitation periods for refund requests under I.R.C. § 6511(b)(2)(A). Zeier v. United States, 80 F.3d 1360 (9th Cir. 1996).

FEDERAL INCOME TAXATION

AUDITS. The IRS has issued a Market Segment Specialization Program (MSSP) audit guide for auditing of cattle auction barns to detect schemes to underreport cattle sale income from cash transactions. IRS’ Market Segement Specialization Program Training Guide—Cattle Auction Barns, 96 ARD 108-3.

The IRS has announced a three part test for determining whether a Field Service Advice (FSA) or Technical Advice Memorandum (TAM) should be requested by field agents. Under the first factor, an FSA would be best if the issue is still undergoing factual development. An FSA would also be more appropriate if the requested information applied to case development or strategy. The third factor favors a TAM if the issue is novel or complex. Field Service Advice/Technical Advice—Summary of Chief Counsel Notice, 96 FED (CCH) ¶ 46,409.

CASUALTY LOSSES. The taxpayer suffered damages to business property in an earthquake which was declared a disaster by the President. The taxpayer wanted to make an election under I.R.C. § 165(i)(1) to have the losses deducted in the prior tax year but the tax advisor was misinformed as to the election deadline. The taxpayer sought an extension of time to file the election. The IRS granted the extension because the taxpayer’s actions were always consistent with the intent to make the election, the taxpayer’s actions were reasonable, and the government’s interests were not jeopardized by granting the extension. Ltr. Rul. 9622020, Feb. 24, 1996.

CORPORATIONS.

SMALL BUSINESS STOCK. The IRS has issued proposed regulations which permit a corporation to redeem a de minimis amount of small business stock without violating the anti-evasion rules of I.R.C. § 1202(c). The proposed rules also allow redemptions which are unlikely to result in evasion of the original issue requirement, such as redemptions upon termination of the shareholder’s employment or upon the shareholder’s death, disability or mental incompetency. The proposed rules allow redemptions where the shareholder sells stock to an employee. 61 Fed. Reg. 28821 (June 6, 1996).

COURT AWARDS AND SETTLEMENTS—ALM § 4.02[14].* The taxpayer sued a former employer for wrongful discharge, breach of contract and violation of RICO. After the jury found that the discharge was improper, the taxpayer and employer negotiated a settlement which allocated a portion of the payment to the wrongful discharge claim. The Tax Court held that the taxpayer would be allowed to exclude the payments for wrongful discharge based on the settlement allocation because the settlement was reached by arm’s length negotiations by adverse parties. The appellate court reversed, holding that under Commission v. Schleier, 115 S. Ct. 2159 (1995), the award was included in gross income because the settlement was not received on account of personal injuries. The decision is designated as not for publication. McKay v. Comm’r, 96-1 U.S. Tax Cas (CCH) ¶ 50,279 (5th Cir. 1996), rev’g, 102 T.C. 465 (1994).

EMPLOYMENT BENEFITS. The IRS has adopted as final regulations governing the eligibility of reimbursed working condition fringe benefits for exclusion from an employee’s gross income where the benefits are not deductible in full or part by the employer. Specifically, the regulations allow reimbursed meal and entertainment expenses which qualify as working condition fringes to be excluded even though the employer may only deduct 50 percent of such expenses. The same rule applies for club memberships and payment of travel expenses of an employee’s spouse. 61 Fed. Reg. 27005 (May 30, 1996).

HOBBY LOSSES. The taxpayer was a surgeon who also spent about 10 hours a week in breeding, training and riding “cutting horses,” primarily for competition. For the ten years of this activity, the taxpayer had some income but only net losses. The court held that the taxpayer was not entitled to deduct expenses in excess of income from the cutting horse activity because the activity was not entered into with an intent to make a profit since (1) the taxpayer failed to make any market study of the profitability of such an activity, (2) the taxpayer failed to maintain complete and accurate records, (3) the taxpayer had to rely on others for any expertise in the business, (4) the taxpayer’s involvement in the activity was primarily riding the horses in competition and for pleasure, (5) the taxpayer presented no evidence that the assets of the activity would appreciate in value sufficient to recover the losses incurred, (6) the activity sustained several years of consistent losses, and (7) the taxpayer had substantial income from other activities. The taxpayer was also assessed penalties for substantial understatement of tax.

AGRICULTURAL LAW DIGEST

CASUALTY LOSSES

The IRS has announced a three part test for determining whether a Field Service Advice (FSA) or Technical Advice Memorandum (TAM) should be requested by field agents. Under the first factor, an FSA would be best if the issue is still undergoing factual development. An FSA would also be more appropriate if the requested information applied to case development or strategy. The third factor favors a TAM if the issue is novel or complex. Field Service Advice/Technical Advice—Summary of Chief Counsel Notice, 96 FED (CCH) ¶ 46,409.

EMPLOYMENT BENEFITS

The IRS has adopted as final regulations governing the eligibility of reimbursed working condition fringe benefits for exclusion from an employee’s gross income where the benefits are not deductible in full or part by the employer. Specifically, the regulations allow reimbursed meal and entertainment expenses which qualify as working condition fringes to be excluded even though the employer may only deduct 50 percent of such expenses. The same rule applies for club memberships and payment of travel expenses of an employee’s spouse. 61 Fed. Reg. 27005 (May 30, 1996).

COURT AWARDS AND SETTLEMENTS—ALM § 4.02[14].* The taxpayer sued a former employer for wrongful discharge, breach of contract and violation of RICO. After the jury found that the discharge was improper, the taxpayer and employer negotiated a settlement which allocated a portion of the payment to the wrongful discharge claim. The Tax Court held that the taxpayer would be allowed to exclude the payments for wrongful discharge based on the settlement allocation because the settlement was reached by arm’s length negotiations by adverse parties. The appellate court reversed, holding that under Commission v. Schleier, 115 S. Ct. 2159 (1995), the award was included in gross income because the settlement was not received on account of personal injuries. The decision is designated as not for publication. McKay v. Comm’r, 96-1 U.S. Tax Cas (CCH) ¶ 50,279 (5th Cir. 1996), rev’g, 102 T.C. 465 (1994).

The IRS has issued a Market Segment Specialization Program (MSSP) audit guide for auditing of cattle auction barns to detect schemes to underreport cattle sale income from cash transactions. IRS’ Market Segment Specialization Program Training Guide—Cattle Auction Barns, 96 ARD 108-3.

The IRS has announced a three part test for determining whether a Field Service Advice (FSA) or Technical Advice Memorandum (TAM) should be requested by field agents. Under the first factor, an FSA would be best if the issue is still undergoing factual development. An FSA would also be more appropriate if the requested information applied to case development or strategy. The third factor favors a TAM if the issue is novel or complex. Field Service Advice/Technical Advice—Summary of Chief Counsel Notice, 96 FED (CCH) ¶ 46,409.

The taxpayer suffered damages to business property in an earthquake which was declared a disaster by the President. The taxpayer wanted to make an election under I.R.C. § 165(i)(1) to have the losses deducted in the prior tax year but the tax advisor was misinformed as to the election deadline. The taxpayer sought an extension of time to file the election. The IRS granted the extension because the taxpayer’s actions were always consistent with the intent to make the election, the taxpayer’s actions were reasonable, and the government’s interests were not jeopardized by granting the extension. Ltr. Rul. 9622020, Feb. 24, 1996.

The taxpayer suffered damages to business property in an earthquake which was declared a disaster by the President. The taxpayer wanted to make an election under I.R.C. § 165(i)(1) to have the losses deducted in the prior tax year but the tax advisor was misinformed as to the election deadline. The taxpayer sought an extension of time to file the election. The IRS granted the extension because the taxpayer’s actions were always consistent with the intent to make the election, the taxpayer’s actions were reasonable, and the government’s interests were not jeopardized by granting the extension. Ltr. Rul. 9622020, Feb. 24, 1996.

The IRS has announced a three part test for determining whether a Field Service Advice (FSA) or Technical Advice Memorandum (TAM) should be requested by field agents. Under the first factor, an FSA would be best if the issue is still undergoing factual development. An FSA would also be more appropriate if the requested information applied to case development or strategy. The third factor favors a TAM if the issue is novel or complex. Field Service Advice/Technical Advice—Summary of Chief Counsel Notice, 96 FED (CCH) ¶ 46,409.

The taxpayer suffered damages to business property in an earthquake which was declared a disaster by the President. The taxpayer wanted to make an election under I.R.C. § 165(i)(1) to have the losses deducted in the prior tax year but the tax advisor was misinformed as to the election deadline. The taxpayer sought an extension of time to file the election. The IRS granted the extension because the taxpayer’s actions were always consistent with the intent to make the election, the taxpayer’s actions were reasonable, and the government’s interests were not jeopardized by granting the extension. Ltr. Rul. 9622020, Feb. 24, 1996.

The taxpayer suffered damages to business property in an earthquake which was declared a disaster by the President. The taxpayer wanted to make an election under I.R.C. § 165(i)(1) to have the losses deducted in the prior tax year but the tax advisor was misinformed as to the election deadline. The taxpayer sought an extension of time to file the election. The IRS granted the extension because the taxpayer’s actions were always consistent with the intent to make the election, the taxpayer’s actions were reasonable, and the government’s interests were not jeopardized by granting the extension. Ltr. Rul. 9622020, Feb. 24, 1996.

LIKE-KIND EXCHANGES. The taxpayer owned a business property and wanted to sell it in a like-kind exchange. The buyers of the property agreed to participate in a three-party exchange and the property was transferred to the buyers in 1988 for no consideration. Within 45 days after the transactions, the taxpayer identified 19 properties which were suitable for an exchange and six properties were transferred through third party facilitators to the taxpayer. However, the transfers did not start until April 25, 1989 and were completed in June 1989, all after the taxpayer’s filing of the 1988 federal tax return. Under I.R.C. § 1031(a)(3), the replacement property must be acquired within the earlier of the due date (including extensions) of the tax return for the year of the first transfer or 180 days after the transfer. The taxpayer argued that, because a four month automatic extension was possible, the due date determination should have been made based on the possible extension. The court held that the extension increase was available only if the taxpayer actually applied and met the requirements for the extension. The court noted that, although the extension was automatic, the extension still had some requirements to be met before the extension occurred. Therefore, the transfers were not eligible for like-kind exchange treatment. The transfers, however, were held to be eligible for installment treatment. Christensen v. Comm’r, T.C. Memo. 1996-254.

PARTNERSHIPS—ALM § 7.03.*

LIMITED LIABILITY COMPANIES. Two corporations formed a limited liability company under the Louisiana Limited Liability Company Act with each corporation owning 50 percent of the LLC. The IRS ruled that the LLC was taxable as a partnership because (1) the LLC lacked centralized management since, under the LLC agreement, the LLC was to be managed by the members, and (2) the LLC lacked continuity of life since the LLC agreement required the dissolution of the LLC by the death, bankruptcy, incompetency or withdrawal of a member unless a majority of the remaining members agreed to continue the LLC. Ltr. Rul. 96220007, Feb. 21, 1996.

TERMINATION. The IRS has issued proposed regulations governing the effect of a termination of a partnership caused by the sale or exchange of 50 percent or more of the total interests in partnership capital and profits. The proposed regulations provide that, upon the termination, the partnership is deemed to have transferred all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership. The terminated partnership is deemed to have immediately thereafter distributed the interest in the new partnership to the purchasing and remaining partners. The new rule means that there is no longer the possibility of gain under I.R.C. § 731(a), no change in the basis of partnership assets, and no new five-year period for purposes of I.R.C. §§ 704(c)(1)(B), 737. I.R.C. § 704(c) property held by the terminated partnership continues as I.R.C. § 704(c) property in the new partnership.

Regulations under I.R.C. §§ 704, 731, 737 were also changed to reflect the new rules. 61 Fed. Reg. 21985 (May 13, 1996).

PASSIVE ACTIVITY LOSSES. The IRS has released a revised Market Segment Specialization Program Report audit guide for passive activity losses. IRS’s Market Segment Specialization Program Training Guide—Passive Activity Losses, IRPO ¶ 216.001.

PENSION PLANS. The IRS has issued revised Forms 5300, 5303, 5307 and 5310 for requests for determination letters for qualified employee benefit plans. The revised forms include Schedule Q which satisfies the attachments required by Rev. Proc. 93-39, 1993-2 C.B. 513.

A corporation established a deferred compensation plan intended to be an eligible deferred compensation plan under I.R.C. § 457(a). The benefits of the plan were available to participating employees in the event of retirement, separation from service or for unforeseeable emergencies. The plan funds were held in a trust which provided that the trust funds were subject to the claims of the employer’s general creditors; thus, in the case of bankruptcy, the plan funds would be paid first to the employer’s creditors. The IRS ruled that the deferred compensation placed in the plan would be income to the employees when distributed or otherwise made available for the employees’ use. Ltr. Rul. 9622021, Feb. 28, 1996.

INSURANCE

COVERAGE. The plaintiffs had joined together to raise sheep and decided to do some custom sheep feeding for another corporation. As the plaintiffs were starting their joint effort, the plaintiffs talked to the defendant’s agent about insurance coverage for their sheep operation. Although there was some discussion of whether the plaintiffs would be engaging in any custom feeding, the plaintiffs had not begun any custom feeding at the time of the insurance application. The testimony from the parties involved in the application was inconclusive on this point but the court found that the plaintiffs could not have had any expectation of coverage of their custom feeding operation. An ice storm hit the plaintiffs’ area after the plaintiffs accepted over 1,000 sheep from another corporation and many of the sheep were lost. The corporation sued the plaintiffs for breach of contract and was awarded damages. The plaintiffs sought contribution from the defendant insurance company under the policy. The case was complicated somewhat by the fact that the insurance policy was not delivered to the plaintiffs until after the disaster. The court held that the insurance policy did not provide coverage for the plaintiffs’ liability under the contract because the policy only covered property damage and the plaintiffs had no reasonable expectation that the policy would cover personal liability for the custom feeding operation. Ide v. Farm Bureau Mut. Ins. Co., 545 N.W.2d 853 (Iowa 1996).

MORTGAGES

REDEMPTION. The debtors owned six tracts of farm land which became subject to a judgment lien to satisfy a loan from the creditor. The debtors filed for Chapter 7
bankruptcy and the creditor obtained relief from the automatic stay to pursue foreclosure of the judgment lien. The land was sold at a foreclosure sale, but before the right of redemption period expired, several third parties deposited funds with the clerk of court for the debtors to use to redeem the properties. The bankruptcy trustee indicated that the funds may be included in the bankruptcy estate. The creditor argued that the deposited funds were insufficient for redemption because (1) the trustee could recover the funds from the creditor for inclusion in the bankruptcy estate and (2) any of the third parties could withdraw their funds. Before the trial court confirmed the sale, denying the redemption, the bankruptcy trustee filed an abandonment of the properties involved. The appellate court reversed the denial of the redemption, holding that (1) the trustee’s abandonment of the property placed all rights of redemption with the debtors and (2) a debtor may use funds from third parties to make a redemption. Farm Credit Services v. Dues, 663 N.E.2d 379 (Ohio Ct. App. 1995).

PRODUCTS LIABILITY
HERBICIDE. The plaintiff purchased the herbicide Canopy, manufactured by the defendant, and applied the herbicide to soybean crops. The herbicide was advertised by print and by the local dealer as allowing a farmer to plant corn on treated fields in following crop years. The plaintiff alleged that the herbicide had a carryover effect which damaged subsequent corn crops. At trial the defendant moved to exclude all evidence of the herbicide label, arguing that all questions concerning the label were federal questions and the state court had no jurisdiction over federal questions. In the appeal of the trial court judgment for the plaintiff, the defendant argued for the first time that FIFRA preemption deprived the state court of jurisdiction over the case. The court held that FIFRA has no provision giving federal courts exclusive jurisdiction over claims involving FIFRA. The court also held that the issue of FIFRA preemption was an affirmative defense which was required to be raised at the trial level; therefore, the defendant had waived this defense after the trial judgment was entered. Dickman v. Du Pont de Nemours & Co., 663 N.E.2d 507 (Ill. Ct. App. 1996).

PROPERTY
FENCES. The plaintiffs wanted to build a 650 foot partition fence between the plaintiffs’ and defendants’ properties. The plaintiffs sought a ruling from the township board of trustees that the defendants should contribute one-half of the cost of the fence. The plaintiffs provided only nonexpert personal opinion that the cost of the fence to the defendants was less than the increase in property value to the defendants’ property. The defendants also offered only nonexpert testimony that the fence would not add any value to their property. The defendants claimed that the fence would not add any value because the defendants did not have any livestock on the property. Under Ohio law, livestock owners were prohibited from allowing livestock to run at large. The court held that the defendants provided sufficient evidence to uphold the trustees’ ruling that the defendant was not required to contribute to the cost of the fence. Wurzelbacher v. Colerain Twp. Bd., 663 N.E.2d 713 (Ohio Ct. App. 1995).

WORKERS’ COMPENSATION
STATUTORY EMPLOYEE. The plaintiff worked as an itinerant “ring man” for livestock auctions around the country. The plaintiff would work for the defendants about three times a year for five to six days at a time. The defendants were livestock and exotic animal dealers and part of the business was an auction of the animals. The plaintiff was performing the services as a ring man for an exotic animal auction held by the defendants when the plaintiff was injured by one of the animals being auctioned. The plaintiff sued the defendants for negligence and strict liability. The defendants claimed that the plaintiff was a statutory employee entitled only to workers’ compensation benefits. The court held that the plaintiff was a statutory employee because (1) the plaintiff’s services were performed under a contract, (2) the injury occurred on the employer’s premises, and (3) the work performed by the plaintiff was within the usual course of the defendants’ business. Zerebco v. Lolli Bros. Livestock Market, 918 S.W.2d 931 (Mo. Ct. App. 1996).

ZONING
AGRICULTURAL USE. The defendant owned a 23 acre farm on land zoned residential. The defendant used the farm primarily for boarding horses, breeding rabbits, growing hay and offering pony rides. The defendant began offering hayrides to the general public, incorporating holiday themes into the rides. For Halloween, the ride involved music and lights in the woods and actors portraying a variety of Halloween figures. Part of the defendant’s barn was used as a pre- and post-ride lounge and included vending and game machines. After complaints from neighbors, the county zoning inspector ordered the defendant to cease and desist the haunted Halloween rides and to stop serving food. The defendant argued that hayrides were included in the definition of agricultural use and that Ohio Rev. Code § 519.21 prohibited zoning restrictions on agricultural use of property. The court held that although hayrides were normally included in the definition of agricultural use, the defendant’s hayrides had expanded to something which was no longer compatible with an agricultural use. The court noted that the loud noises and lights disturbed the neighbor’s animals. Columbia Twp. Bd. Of Zoning Appeals v. Otis, 663 N.E.2d 377 (Ohio Ct. App. 1996).

CITATION UPDATES
JOURNAL ARTICLES

The inaugural issue of the *Drake Journal of Agricultural Law* has been published, with an introduction by Neil E. Harl and the following articles:

- Becker, John C. And Haas, Robert G., “The Status of Workers as Employees or Independent Contractors.”
- McBeth, Daryn, “Public Need and Private Greed—Environmental Protection and Property Rights.”

Subscription information may be obtained from the *Drake Journal of Agricultural Law*, Drake University Law School, Opperman Hall, Suite 187, Des Moines, IA 50311. Ph. 515 271-4969. E-mail: agjourn@acad.drake.edu

AGRICULTURAL LAW MANUAL

by Neil E. Harl

This comprehensive, annotated looseleaf manual is an ideal deskbook for attorneys, tax consultants, lenders and other professionals who advise agricultural clients. The book contains over 900 pages and an index.

As a special offer to Digest subscribers, the Manual is offered to new subscribers at $115, including at no extra charge updates published within five months after purchase. Updates are published every four months to keep the Manual current with the latest developments. After the first free update, additional updates will be billed at $100 per year or $35 each.

For your copy, send a check for $115 to Agricultural Law Press, P.O. Box 50703, Eugene, OR 97405.

Satisfaction guaranteed. 30 day return privilege.

ISSUE INDEX

<table>
<thead>
<tr>
<th>Animals</th>
<th>PACA 96</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cows 95</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Bankruptcy</th>
<th>Mortgages</th>
</tr>
</thead>
<tbody>
<tr>
<td>General</td>
<td></td>
</tr>
<tr>
<td>Exemptions</td>
<td>Redemption 98</td>
</tr>
<tr>
<td>Objections 95</td>
<td></td>
</tr>
<tr>
<td>Federal taxation</td>
<td></td>
</tr>
<tr>
<td>Assessment 95</td>
<td></td>
</tr>
<tr>
<td>Avoidable transfers 95</td>
<td></td>
</tr>
<tr>
<td>Claims 95</td>
<td></td>
</tr>
<tr>
<td>Discharge 95</td>
<td></td>
</tr>
<tr>
<td>Dismissal 95</td>
<td></td>
</tr>
<tr>
<td>Refund 96</td>
<td></td>
</tr>
<tr>
<td>Secured claims 96</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Federal Agricultural Programs</th>
<th>Products Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Grain standards 96</td>
<td>Herbicides 99</td>
</tr>
<tr>
<td>Herbicides 96</td>
<td></td>
</tr>
<tr>
<td>Irradiation 96</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Contracts</th>
<th>Property</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale of goods 96</td>
<td></td>
</tr>
<tr>
<td>Federal Income Taxation</td>
<td>Workers’ Compensation</td>
</tr>
<tr>
<td>Audits 97</td>
<td></td>
</tr>
<tr>
<td>Casualty losses 97</td>
<td></td>
</tr>
<tr>
<td>Corporations</td>
<td></td>
</tr>
<tr>
<td>Small business stock 97</td>
<td></td>
</tr>
<tr>
<td>Court awards and settlements 97</td>
<td></td>
</tr>
<tr>
<td>Employment benefits 97</td>
<td></td>
</tr>
<tr>
<td>Hobby losses 97</td>
<td></td>
</tr>
<tr>
<td>Like-kind exchanges 98</td>
<td></td>
</tr>
<tr>
<td>Partnerships</td>
<td></td>
</tr>
<tr>
<td>Limited liability companies 98</td>
<td></td>
</tr>
<tr>
<td>Termination 98</td>
<td></td>
</tr>
<tr>
<td>Passive activity losses 98</td>
<td></td>
</tr>
<tr>
<td>Pension plans 98</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Insurance</th>
<th>Zoning</th>
</tr>
</thead>
<tbody>
<tr>
<td>Coverage 98</td>
<td></td>
</tr>
<tr>
<td>Agricultural use 99</td>
<td></td>
</tr>
</tbody>
</table>

Printed on recycled paper using soy ink.
IDENTIFYING REPLACEMENT PROPERTY
IN A LIKE-KIND EXCHANGE

— by Neil E. Harl*

Like-kind exchanges have been important in agriculture for decades.1 While like-kind machinery exchanges are clearly the most common type of tax-free exchange,2 like-kind exchanges of interests in real property have been on the increase in recent years.

A major concern is when the replacement property must be identified and when the replacement property must be received.3 A 1996 Tax Court case has examined those requirements.4

Statutory requirements

In 1984, Congress amended the tax-free exchange rules4 to address the issue of how quickly the replacement property must be identified and received.6 Congressional concern had arisen because of a Ninth Circuit Court of Appeals decision, Starker v. United States,7 which approved an exchange where the replacement property was not received for several years.

The 1984 amendments specified that like-kind exchange property had to be identified and the exchange completed not more than 180 days after transfer of the exchanged property.8 Moreover, property is not treated as like-kind property if (1) it is not identified as exchange property on or before 45 days after the day the property relinquished is given up9 or (2) the property is received after the earlier of 180 days after the property relinquished is given up or the due date (with extensions) for the transferor’s federal income tax return for the year the transfer of the relinquished property occurs.10

The statute is silent on the number of replacement properties that may be identified.

Regulations

In 1991, the Internal Revenue Service issued regulations providing, in general, that a taxpayer is in compliance with the identification requirement in the statute if the taxpayer identifies either — (1) a maximum of three properties as replacement properties or (2) any number of properties, provided the fair market value11 of the designated properties does not exceed 200 percent of the fair market value of all properties relinquished by the taxpayer in the exchange.12 The regulations applied prospectively only, to transfers on or after June 10, 1991.13

Tax Court decision

In the 1996 decision, the Tax Court was faced with a fact situation arising before the effective date of the regulations but after the enactment of the statute.14 In that case, St. Laurent v. Commissioner,15 the taxpayer had identified 20 replacement properties.16 IRS contended that the number of replacement properties identified exceeded the number contemplated by the statute.17

The Commissioner relied upon a passage in the conference committee report —

“The conferees note that the designation requirement in the conference agreement may be met by designating the property to be received in the contract between the parties. It is anticipated that the designation requirement will be satisfied if the contract between the parties specifies a limited number of properties that may be transferred and the particular property to be transferred will be determined by contingencies beyond the control of both parties.”18

The taxpayer argued that the statute did not expressly limit to less than 20 the number of replacement properties that could be designated.19

The Tax Court agreed with the taxpayer.20 The court indicated its belief that Congress intended that taxpayers identify a finite number of replacement properties and noted that any other interpretation would render the identification requirement meaningless.21 The court found the identification of 20 replacement properties in St. Laurent22 was made in good faith and did “not cause an absurd result, given the fact that the statute is silent as to the permissible number and the legislative history is an unreliable indicator of the property limitation.”23 The court pointed out that the regulation limiting the number of identified replacement properties was issued some time after the identification was made by the taxpayer in the St. Laurent case.24

Implications for the regulations

Obviously concerned that the decision in St. Laurent25 could be interpreted as calling into question the validity of the regulation in providing a specific limit on the number of
replacement properties that could be identified, the Tax Court in a footnote stated clearly that the decision should not be interpreted as inferring that the regulation “is not a valid exercise of the Commissioner’s authority to interpret a statute which is silent on the matter.”

FOOTNOTES
2 4 Harl, supra n. 1, § 29.04[1][b].
3 I.R.C. § 1031(a)(3).
4 St. Laurent v. Comm’r, T.C. Memo. 1996-150.
5 I.R.C. § 1031.
7 602 F.2d 1341 (9th Cir. 1979).
8 I.R.C. § 1031(a)(3).
11 Fair market value is determined without regard to the liabilities secured by the property. T.D. 8346, April 25, 1991.

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

ANIMALS

HORSES. The plaintiff was injured when the plaintiff’s automobile struck two of the defendant’s horses on a public highway. The plaintiff sued in absolute liability under Baltimore County Ordinance 6-204 which made animal owners liable for damages caused by the animals. The ordinance did not restate state law which provided only for liability by negligence or strict liability. The defendant argued that the ordinance could not create a new cause of action involving an area of statewide concern. The court agreed, holding that the absolute liability of the ordinance was a new cause of action because it imposed liability without a showing of negligence or that the defendant knew that the horses had a propensity to escape, which was required for imposition of strict liability. Gunpowder Stables v. State Farm, 673 A.2d 721 (Md. Ct. App. 1996).

BANKRUPTCY

GENERAL-ALM § 13.03.*

AUTOMATIC STAY. Prior to filing for bankruptcy, the Chapter 11 farmer debtor signed an agreement with a secured creditor not to file a voluntary bankruptcy petition and not to oppose any motion for relief from the automatic stay filed by the creditor if the debtor did file for bankruptcy. The court held the contractual waiver of the automatic stay unenforceable because (1) the debtor lacked the capacity to waive the rights of the debtor in possession, (2) the waiver was unenforceable under several provisions of the Bankruptcy Code, and (3) the Bankruptcy Code invalidates contractual provisions which waive the debtor’s bankruptcy rights. Matter of Pease, 195 B.R. 431 (Bankr. D. Neb. 1996).

CHAPTER 12-ALM § 13.03[8].*

PLAN MODIFICATION. The debtors had completed their Chapter 12 plan payments and received their discharge. The plan had provided for payment of a secured claim over 30 years. The claim was secured by a lien against farm real and personal property. Three years after the discharge, the debtors sought to modify the plan by selling the collateral real estate, paying a portion of the proceeds on the secured claim and providing a substitute lien on other real estate. The rest of the proceeds would be used to pay off other debts and for operating expenses. The court held that the plan could not be modified because the original five years of the plan had passed and because the debtors had no change in circumstances which supported a needed modification of the plan. The court noted that the debtors could satisfy the debt from the proceeds of the sale of the land and use the other real estate as collateral for other loans for operating expenses. Matter of Schnakenberg, 195 B.R. 435 (Bankr. D. Neb. 1996).

TRUSTEE FEES. The Chapter 12 debtor’s plan provided for most of the plan payments to be made directly to creditors and the plan was confirmed over the objection of the trustee. The trustee’s appeals of the ruling were fruitless and the trustee sought, under the equitable powers of the court, compensation for the substantial expenses incurred in administering the case. The trustee argued that the court had the authority, under Section 105, to provide for adequate compensation of the trustee where the plan did not provide for payments through the trustee’s office. The court held that Section 105 could be used only to enforce or

**FEDERAL TAXATION-ALM § 13.03[7].**

**ADMINISTRATIVE EXPENSES.** The debtor originally filed for Chapter 11 but converted the case to Chapter 7 after two years. The IRS filed a claim in the Chapter 7 case for post-petition, preconversion taxes plus interest and penalties. The parties agreed that the taxes and interest were entitled to administrative expense priority but disagreed as to the penalties. The Bankruptcy Court held that under Section 503(b), the penalties were entitled to the same priority as the taxes to which the penalties applied. However, the Bankruptcy Court applied Section 510(c)(1) and subordinated the penalties to all other priority claims, thus causing the penalties to be paid pro rata with other second priority claims. The IRS had also filed a claim after the claims bar date in the Chapter 7 case for additional taxes for the same period. The Bankruptcy Court allowed the additional claim as an amendment to the original timely filed claim because the amendment related to the same type of tax and the same taxable period. The Bankruptcy Court also subordinated the penalties associated with the additional taxes. The U.S. Supreme Court reversed, holding that the IRS claims could not be subordinated where the priority was specifically determined by statute. *In re First Truck Lines, Inc.*, 116 S.Ct. 1524 (1996), rev’d, 48 F.3d 210 (6th Cir. 1995), aff’d unrep. D. Ct. dec. aff’d, 141 B.R. 621 (Bankr. S.D. Ohio 1992).

**AVOIDABLE LIENS.** The IRS had filed prepetition tax liens against the debtor’s property. The debtor and trustee sought to avoid the liens, under Section 545(2) and I.R.C. § 6323(b) as to an automobile and household goods with individual values of $250 or less. The trustee argued that the trustee’s status as a bona fide purchaser of the estate property was sufficient to give the trustee priority over the property under I.R.C. § 6323(b). The court held that I.R.C. § 6323(b) also required that the trustee have taken possession of the property and obtained the property by purchase without actual knowledge of the tax lien. Because the trustee did not obtain the property by purchase and had knowledge of the lien, the tax lien was not avoidable by the trustee. *I.R.S. v. Diperna*, 195 B.R. 358 (E.D. N.C. 1996).

**CLAIM.** The debtors filed for Chapter 12 and the IRS filed a claim for taxes based on an investigation of the debtors’ corporations. The IRS determined that the debtors had received income through payments made to corporations which were wholly-owned by the debtors. The corporations had not filed income tax returns and the debtors had not claimed much income during the years involved. The debtors attempted to rebut the IRS claim by presenting testimony of the income tax preparer who testified that any income tax returns filed were based on information given by the debtors and was not based on any independent evidence. The court held that the debtors failed to provide sufficient evidence of the separateness of the corporations or that the debtors did not have income during the years involved. The court noted that the IRS claim had a prima facie presumption of correctness, and the debtors had the opportunity to rebut the claim but merely failed to provide sufficient independent evidence for rebuttal. *In re Brown*, 82 F.3d 801 (8th Cir. 1996).

**DISCHARGE.** The debtors timely filed their income tax returns for several tax years more than three years before the filing of the petition. In 1986 and 1988, the debtors filed a Chapter 7 and a 13 case which were dismissed. The IRS assessed the debtors for additional taxes for these tax years more than 240 days before the current case was filed in 1990, and more than three years after the tax returns were filed. The IRS argued that, under Section 108(c) and I.R.C. § 6503(h), the first two bankruptcy cases tolled the three year period of Sections 507(a)(7)(A)(i) and 523(a)(7)(B) such that the taxes were not dischargeable under those sections. The court held that the plain language of Section 108(c) and I.R.C. § 6503(h) indicates that those laws do not apply to bankruptcy provisions. The court also denied relief to the IRS on equitable grounds, noting that the IRS had several years to collect the taxes while the debtor was not in bankruptcy. The court noted a significant split in the cases on this issue. *In re Turner*, 195 B.R. 476 (Bankr. N.D. Ala. 1996), aff’d on reconsideration, 182 B.R. 317 (Bankr. N.D. Ala. 1995).

**PLAN.** The debtor’s Chapter 13 plan provided for full payment of a secured federal tax claim over the length of the plan at 7 percent interest. The IRS argued that the rate of interest should be the interest rate of I.R.C. § 6621(a)(2) for underpayments at the time of the petition. The debtor argued that the IRS was entitled only to a market rate of interest. The court held that the Section 6621(a)(2) interest rate, at the effective date of the plan, would be a presumptive market rate of interest subject to the debtor’s proof of a more accurate market interest rate. Because the debtor failed to demonstrate the market interest rate, the court held that the Section 6621(a)(2) rate on the effective date of the plan was to be used. *In re Cheek*, 195 B.R. 151 (Bankr. W.D. Okla. 1996).

This case involved two Chapter 11 plans. The first plan provided for payment of a secured federal tax claim over six years at 8 percent and an unsecured priority claim over five years at 8 percent. The second plan provided for payment of the secured tax claim over ten years and the unsecured claim over five years, both at 8 percent. The IRS argued that the tax claims were entitled to absolute priority, but the court held that, under Section 1129, secured claims were not entitled to absolute priority. The IRS also argued that it was entitled to compound interest on its claims, but the court held that compound interest was not required for plan payments to meet the “indisputable equivalent requirement.” The court also held that the second plan’s payment term of ten years for the secured claim was too long in that the collateral’s value would not protect the claim over that many years. *United States v. Creamer*, 195 B.R. 154 (M.D. Fla. 1996).

**TAX LIENS.** The debtor received payment for a workers’ compensation claim and purchased a house with the proceeds. The IRS then filed notices of tax liens against
the debtor’s property for taxes owed for several years. However, one of the notices identified the wrong tax year involved. The debtor sought to avoid the tax liens against the house as exempt property and for the failure of one of the notices to be accurate. The court held that the error involving the tax year was minor and insufficient to void the notice. The court also held that the house was exempt from levy but not from the lien which continued after the bankruptcy case. Matter of Sills, 82 F.3d 111 (5th Cir. 1996).

**FEDERAL AGRICULTURAL PROGRAMS**

**CROP INSURANCE.** The FCIC has issued proposed regulations which provide specific provisions for sugar beets to the Common Crop Insurance Policy. 61 Fed. Reg. 27315 (May 31, 1996).

The FCIC has issued proposed regulations which provide specific provisions for Texas citrus fruit to the Common Crop Insurance Policy. 61 Fed. Reg. 28512 (June 5, 1996).

**SOILS.** The NRCS has issued a revised list of hydric soils in the United States. 61 Fed. Reg. 29050 (June 7, 1996).

**FEDERAL ESTATE AND GIFT TAX**

**CHARITABLE DEDUCTION.** The grantor had established a trust for the grantor with a remainder to the decedent and further remainders to charities and the grantor’s heirs. The grantor died first, with the decedent dying within six months thereafter and before the grantor’s estate tax return was filed. The trust did not qualify for the charitable deduction but was reformable under I.R.C. § 2055(e)(3). The IRS ruled that because the charitable interest passed before the grantor’s estate tax return was filed or due, the charitable gift did not need to be reformed in order to qualify for the charitable deduction. Ltr. Rul. 9623019, March 6, 1996.

**CLAIMS AGAINST ESTATE.** The taxpayer was the spouse of the decedent and the two had executed a prenuptial agreement under which the taxpayer waived any divorce or dower rights in the decedent’s estate and received, in return, a life estate in the decedent’s apartment if the two were married when the decedent died. The couple were still married when the decedent died and the estate claimed the life estate as a claim against the estate eligible for a deduction for estate tax purposes. The court acknowledged that the Tax Court, several Circuit Courts of Appeal and the IRS had determined that the waiver of dower and/or divorce rights was sufficient consideration for a prenuptial agreement transfer of property; however, the court held that the life estate was taxable in the estate because the taxpayer had not given anything of value for the life estate. The court focused on the lack of any gain of property for the estate from the waiver and the significant tax advantage to the estate and gain to the surviving spouse from the prenuptial agreement. Estate of Herrmann v. Comm’r, 96-1 U.S. Tax Cas. (CCH) ¶ 60,232 (2d Cir. 1996).

**DISCLAIMERS-ALM § 5.02[6].** The decedent’s will bequeathed the entire estate to the decedent’s siblings with any remainder to pass to the children of the siblings. One sibling disclaimed any interest in the estate, causing the entire estate to pass to the other sibling. The other disclaimed a one-half interest in the estate. The disclaimed portion of the estate passed to the children who disclaimed any interest in the estate. The ruling is silent as to whom the disclaimed property passed. The IRS ruled that the disclaimers were effective. Ltr. Rul. 9625033, March 22, 1996.

**EXECUTOR LIABILITY.** The decedent’s will provided for passing of estate property to a trust for the decedent’s heirs. The taxpayer was an heir and executor of the estate. After the estate tax return was filed in 1976, the IRS claimed a deficiency was due. The parties continued discussions about the matter but in 1977, the heirs agreed to distribute the estate among themselves, without paying the claimed deficiency. Some of the property received by the taxpayer was subject to liens and the taxpayer intentionally defaulted on the loans and had a wholly-owned corporation purchase the property in the foreclosure sales, transactions which the court found to be fraudulent conveyances. The court held that the taxpayer was personally liable for the estate taxes owed because the heir agreement made the estate insolvent at a time when the taxpayer knew that a tax claim was being made against the estate. United States v. Coppola, 96-1 U.S. Tax Cas. (CCH) ¶ 60,233 (2d Cir. 1996).


**IRA.** The decedent’s will bequeathed the residuary estate to a trust for the surviving spouse with remainders to the decedent’s children. The residuary estate included three IRAs owned by the decedent. The surviving spouse disclaimed an interest in the trust equal to the value of the IRAs and the children disclaimed any remainder interest in the disclaimed interest. Thus, an amount equal to the value of the IRAs passed by intestacy to the surviving spouse and the executor funded the intestacy bequest with the amounts in the IRAs. The surviving spouse deposited the funds in an IRA in the spouse’s name. The IRS ruled that the disclaimers were effective, the IRA funds were treated as passing directly to the surviving spouse and the surviving spouse did not need to include the IRA funds in gross income. Ltr. Rul. 9623064, March 14, 1996.

**JOINT TENANCY PROPERTY.** The decedent’s predeceased spouse had purchased real property and transferred the property to both of them as tenants by the entirety in 1958. The spouse died in January 1987 and 50 percent of the value of the property was included in the spouse’s estate. The decedent sold the property in 1990 and used the estate tax value for 50 percent of the property
LIFE INSURANCE. The taxpayer was a general partner in a partnership which owned a life insurance policy on the life of the taxpayer. The partnership paid all premiums on the insurance policy. The partnership agreement provided that upon the death of a partner, the proceeds of a life insurance policy on that partner would be held by the partnership to the extent needed to cover partnership obligations, with the remainder distributed to the other partners to the extent necessary to purchase the deceased partner’s interest in the partnership. The IRS ruled that the taxpayer did not have any incidents of ownership in the policy and the taxpayer’s interest in the partnership included in the gross estate would include the insurance proceeds to the extent of the taxpayer’s proportionate share of the partnership.

The taxpayer was a shareholder in a corporation which executed a buy-sell agreement with a trust in which the shareholders were trustees. The trust purchased life insurance policies on all shareholders and the corporation paid the premiums under a split-dollar agreement under which, upon the death of a shareholder, the corporation would receive an amount equal to the premiums paid with the trust receiving the remainder in order to repurchase the stock of the deceased shareholder. If any proceeds yet remained, those proceeds were paid to the remaining shareholders. All trust actions required a majority of the vote of trustees and no shareholder could act in regards to the life insurance policy on that shareholder. The IRS ruled that the proceeds of the life insurance policy on the life of a shareholder were not included in that shareholder’s gross estate. The corporation converted to a limited liability company which was taxable as a partnership. The IRS ruled that the same holding applied after the conversion.

The decedent left a holographic will which bequeathed the entire estate to the surviving spouse “to be used to maintain the family & educate our children.” The IRS ruled that under Virginia law, the quoted language did not bequeath any specific interest in the estate to the decedent’s children but bequeathed a fee simple interest in the property to the surviving spouse. Therefore, the bequeathed property was eligible for the marital deduction.

The taxpayer was a decedent’s estate. The decedent’s will bequeathed all of the estate to the surviving spouse and provided for all expenses and debts to be paid from the residuary estate. The estate paid the executor $62,000 as a personal representative’s fee. The estate had over $105,000 in income during its administration. The estate argued that the estate income was part of the residue of the estate and that the fee could be charged against that income. The court held that, under Wisconsin law, the estate income was not part of the estate principal; therefore, the executor’s fee was chargeable against the estate principal and diminished the amount available for the marital deduction.

The decedent’s will bequeathed property to the decedent’s surviving spouse in trust until the spouse dies or remarries, with the remainder to pass to named charities. The IRS denied any marital deduction because the spouse’s interest was contingent upon the spouse’s not remarrying. The IRS also denied the charitable deduction because the trust did not qualify as charitable remainder trust. The estate argued that the I.R.C. allowed for marital and charitable deductions so at least one or the other or both deductions should be allowed. The court held that the unambiguous language of the statutes prevented any marital deduction for contingent interests or charitable deductions where the value of the charitable interest could not be determined when the estate tax return was filed.

POWER OF APPOINTMENT. The decedent’s will bequeathed property to the decedent’s surviving spouse in trust. The trust gave the taxpayer a “limited power of appointment” over trust corpus but limited the power to the decedent’s lineal descendants, which included the taxpayer, thus making the power a general power of appointment. The taxpayer claimed that the trust document contained a scrivener’s error such that the power of appointment was to be limited to the taxpayer’s lineal descendant’s, which excluded the taxpayer. The taxpayer proposed to obtain a state probate court order amending the trust document to correct the error. The IRS ruled that if the trust obtains the state probate court order revising the trust document, the taxpayer will be considered to have only a limited power of appointment over the trust corpus.

TRUSTS. A trust had ten equal share beneficiaries who had the power to require full or partial distribution of their shares by written request to the trustees. Two beneficiaries made such a request and the trustee proposed to make an equal but non-pro rata distribution of assets. Both the trust instrument and state law allowed non-pro rata distributions but the state law required an adjustment for any adverse tax liabilities resulting from the non-pro rata distribution. The trustee made adjustment for the tax differences.
ruled that no gain was realized from the distributions and that the basis and holding periods of the assets were transferred to the beneficiaries. Ltr. Rul. 9625020, March 20, 1996.

FEDERAL INCOME TAXATION

BAD DEBTS. The taxpayer had loaned money to their son-in-law or guaranteed loans made by the son-in-law to support the son-in-law’s jewelry business. The taxpayer eventually became liable for more than $2.1 million. The taxpayer claimed the loans became worthless in 1986 when it became clear that the loans would not be repaid. However, in 1986 through 1988, the taxpayers received over $400,000 in payments from the son-in-law and the son-in-law’s bankruptcy case. The payments from the son-in-law, however, came from funds embezzled from the son-in-law’s deceased spouse’s estate and from failure to pay federal taxes. The court held that the taxpayers could not claim a worthless debt deduction for any of the debt because the debt was never worthless, since the taxpayers did receive partial repayment. The court also held that the source of the payments was irrelevant to the deductibility of the debt. Buchanan v. United States, 96-1 U.S. Tax Cas. (CCH) ¶ 50,334 (7th Cir. 1996).

CASUALTY LOSSES. This ruling examined two scenarios: (1) a taxpayer’s dwelling was destroyed by a tornado and the taxpayer later sold the land and used the proceeds plus insurance proceeds to buy another existing home; (2) a taxpayer’s residence was destroyed by an earthquake and the taxpayer was unable to rebuild until 22 months later because of the widespread destruction. Both casualties were declared disasters by the president and both properties were subject to qualified personal residence indebtedness. In the first circumstance, the IRS ruled that the sale of the land would be included in the involuntary conversion of the residence allowing deferral of gain if the cost of the new residence exceeded the proceeds from the land sale and insurance. In the second case, the IRS ruled that interest paid on the qualified personal residence indebtedness continued to be deductible during the rebuilding period because the home was rebuilt within a reasonable period under the circumstances. Rev. Rul. 96-32, 1996-25, 5.

COURT AWARDS AND SETTLEMENTS. The taxpayer was a corporation with one shareholder. The corporation sued several other parties for breach of contract, malicious prosecution, intentional interference with a business relationship, fraud, and violation of fiduciary and statutory duties. The parties agreed to a settlement which did not specify any allocation of the settlement to the various causes of action. The IRS denied any exclusion of the settlement from the taxpayer’s gross income, except for the legal expenses incurred. The court agreed, holding that I.R.C. § 104 allowed exclusion of the settlement only for compensation for personal injury and a corporation could not suffer a personal injury. The court rejected the taxpayer’s argument that the settlement included payment for personal injuries because the corporation only had one shareholder and the shareholder was actually the one who suffered from the other parties’ actions. P & X Markets, Inc. v. Comm’r, 106 T.C. No 26 (1996).

DEMOLITION. I.R.C. § 280B requires any costs or losses incurred on account of the demolition of any structure to be capitalized into the land upon which the demolished structure was located. The IRS has issued proposed regulations defining what “structure” means for purposes of Section 280B. The proposed regulations define the term “structure” for purposes of Section 280B as a building and its structural components as those terms are defined in Treas. Reg. § 1.48-1(e). Thus, under section 280B, a structure will include only a building and its structural components and not other inherently permanent structures such as oil and gas storage tanks, blast furnaces, and coke ovens. 61 Fed. Reg. 31473 (June 20, 1996).

HOBBY LOSSES. After the taxpayer began receiving substantial royalties from oil and gas on their land, the taxpayer started a cow-calf operation on the same land. The taxpayer had substantial losses from the farm operation for 16 years, primarily from depreciation. The court used the nine factors from Westbrook v. Comm’r, 68 F.3d 868 (5th Cir. 1995), aff’g, T.C. Memo. 1993-634 to determine that the cow-calf operation was not entered into for profit, resulting in disallowance of farm deductions in excess of farm income. The factors supporting the holding were (1) failure to keep full and accurate records, (2) the lack of appreciation of the farm assets, (3) the taxpayer’s lack of any other successful farming operations, (4) the extensive and continuous losses from the farm operation, and (5) the taxpayer’s personal pleasure from the farm. Vallette v. Comm’r, T.C. Memo. 1996-285.

PARTNERSHIPS-ALM § 7.03.*

ADMINISTRATIVE ADJUSTMENTS. The IRS began an administrative adjustment audit of a general partnership and needed more time to complete the audit. The IRS sent a Form 870-0 to the partnership to obtain consent for an extension of time. A tax matters partner had not been selected by the partnership so a general partner signed the form. The general partner did not have the largest general partnership interest in the partnership and was not selected by the partners as TMP. The court held that the partnership was estopped from claiming that the extension was improperly filed and that the general partner was not authorized to act as TMP because (1) the IRS reasonably relied on the general partner’s assertions that the general partner had authority to sign the consent form and (2) the other partners knew that the IRS was relying on the actions of the general partner as TMP. Cascade Partnership v. Comm’r, T.C. Memo. 1996-299.

PENSION PLANS. For plans beginning in June 1996, the weighted average is 6.92 percent with the permissible range of 6.23 to 7.48 percent (90 to 109 percent permissable range) and 6.23 to 7.61 percent (90 to 110 percent permissable range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). Notice 96-36, L.R.B. 1996-____, __.

RETURNS. The IRS has adopted as final regulations governing the requirements for furnishing a taxpayer

*Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.
identification number for resident and nonresident aliens who cannot otherwise obtain a social security number. The regulations provide for issuance by the IRS of an IRS individual taxpayer identification number. The regulations also provide that any resident or nonresident alien who files an income, gift or estate tax return must provide a taxpayer identification number. 61 Fed. Reg. 26788 (May 29, 1996).

SAFE HARBOR INTEREST RATES
July 1996

<table>
<thead>
<tr>
<th></th>
<th>Annual</th>
<th>Semi-annual</th>
<th>Quarterly</th>
<th>Monthly</th>
</tr>
</thead>
<tbody>
<tr>
<td>AFR</td>
<td>6.04</td>
<td>5.95</td>
<td>5.91</td>
<td>5.88</td>
</tr>
<tr>
<td>110% AFR</td>
<td>6.66</td>
<td>6.55</td>
<td>6.50</td>
<td>6.46</td>
</tr>
<tr>
<td>120% AFR</td>
<td>7.27</td>
<td>7.14</td>
<td>7.08</td>
<td>7.04</td>
</tr>
<tr>
<td>Mid-term</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AFR</td>
<td>6.74</td>
<td>6.63</td>
<td>6.58</td>
<td>6.54</td>
</tr>
<tr>
<td>110% AFR</td>
<td>7.42</td>
<td>7.29</td>
<td>7.22</td>
<td>7.18</td>
</tr>
<tr>
<td>120% AFR</td>
<td>8.12</td>
<td>7.96</td>
<td>7.88</td>
<td>7.83</td>
</tr>
<tr>
<td>Long-term</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AFR</td>
<td>7.12</td>
<td>7.00</td>
<td>6.94</td>
<td>6.90</td>
</tr>
<tr>
<td>110% AFR</td>
<td>7.85</td>
<td>7.70</td>
<td>7.63</td>
<td>7.58</td>
</tr>
<tr>
<td>120% AFR</td>
<td>8.58</td>
<td>8.40</td>
<td>8.31</td>
<td>8.26</td>
</tr>
</tbody>
</table>

S CORPORATIONS
ELECTION. The U.S. Supreme Court has denied certiorari in the following case. The taxpayer was a shareholder of a corporation which claimed to have timely filed a Form 2553 Subchapter S Election for 1986. However, the IRS claimed to have not received the form. The taxpayer presented extensive testimony by the form preparer that the form was timely mailed, and the Tax Court acknowledged that this testimony was believable. However, the court held that a presumption of delivery was not available to the taxpayer and that the requirements of I.R.C. § 7502 were the only means of proving delivery of a mailing. Section 7502 requires direct evidence of a postmark on the document involved, which the court stated could only be met, in cases of lost documents, by the record of registered or certified mail. The taxpayer also presented some evidence that the IRS had later mailed forms to the taxpayer with information allegedly obtainable only from the disputed Form 2553, thus proving IRS receipt of the Form 2553. The court rejected the significance of this evidence because the taxpayer failed to demonstrate that the information was not supplied to the IRS by some other means. As the Tax Court warns at the end of the opinion, taxpayers assume the full risk of IRS's nonreceipt of loss of filings unless the filings are mailed by registered or certified mail. Carroll v. Comm'r, __ S.Ct. __ (1996), denying cert., 96-1 U.S. Tax Cas. (CCH) ¶ 50,010 (6th Cir. 1995), aff'g, T.C. Memo. 1994-229.

TRUSTS. The taxpayer was the beneficiary of an irrevocable trust funded with nonvoting S corporation stock. The taxpayer had the right to withdraw contributions to the trust within 60 days after the contribution. Upon the later of the death of both grantors or the taxpayer’s reaching age 35, the trust corpus was to be distributed to the taxpayer. The IRS ruled that the taxpayer was deemed the owner of the trust; therefore, the trust was a QSST. The IRS also ruled that contributions to the trust were eligible for the gift tax annual exclusion. The IRS also ruled that the trust would not be included in the estate of either grantor. Ltr. Rul. 9625031, March 21, 1996.

SALE OF RESIDENCE. The taxpayers purchased a new residence; however, because the real estate market was depressed, the taxpayers were unable to sell their old home within the time period required by I.R.C. § 1034. The taxpayer sold their old residence to their wholly-owned corporation within the time required. The ruling does not mention the amount of any consideration paid by the corporation. The IRS ruled that, because I.R.C. § 1034 had no prohibition against sales to related parties, any gain from the sale was to be deferred by the taxpayers. Ltr. Rul. 9625035, March 22, 1996.

NEGLIGENCE
CONTAMINATION OF GROUNDWATER. The plaintiff was an experienced and successful cattle farmer when the plaintiff purchased a farm in 1971. The plaintiff purchased 100 young calves from Wisconsin which were shipped by truck to the Colorado farm. Several of the calves became ill or died and the plaintiff suspected that the ground water well was contaminated by leaking chemicals from a nearby Army arsenal. The evidence demonstrated that several contaminants where in the water but none was at a level considered toxic to humans or animals. In addition, the plaintiff failed to provide any evidence that the calves died from exposure to any of the known contaminants. The court held that the plaintiff failed to prove that the water was contaminated by the arsenal with any substance which harmed the plaintiff’s calves. Land v. U.S., 35 Fed. Cl. 343 (1996).

PROPERTY
FIXTURES. The plaintiffs purchased real estate from a bank. On the real estate was a grain storage facility which the defendant had built on the property under a lease with the previous owners. The defendant claimed ownership of the facility, primarily grain bins, and the plaintiffs evicted the defendant, arguing that the grain bins were fixtures sold with the land. The lease had given the defendant the right to build the facility and to remove the facility at the termination of the lease. The court held that the grain bins were not fixtures in that the original parties to the lease contemplated their removal. The defendant argued that the eviction was a breach of the lease to which the plaintiffs were bound. The lease was unrecorded and the plaintiffs showed that they had no knowledge of the lease before the purchase. The court held that the plaintiffs were not bound by the lease because they had no actual knowledge of the lease and the property involved did not put the plaintiffs on constructive notice that a lease existed. Garmon v. Mitchell, 918 S.W.2d 201 (Ark. Ct. App. 1996).

CITATION UPDATES
PRESCRIPTIVE EASEMENT. The parties owned neighboring farms. When the plaintiffs purchased their farm in 1969, the only road to their property was across the defendants’ property and the plaintiffs used the road for 20 years until the defendants placed a locked gate on the road. The evidence showed that the road had been in existence since the 1920s and used without question by the previous owners of the plaintiffs’ property. The defendants acquired their property in 1973 from their parents who acquired the land in 1946. The court ruled that the over 70 years of use of the road by the plaintiffs and their predecessors in interest raised a presumption of adverse use of the road. The defendants claimed that the use of the road was permissive such that no adverse use occurred sufficient to give rise to a prescriptive easement. The court held that the trial court had sufficient evidence to determine that the use of the road was not permissive. The court also held that the prescriptive easement was not severed by the sale of the property to the plaintiffs without mentioning the easement in the deed, because the easement had already been established prior to the sale and ran with the land. Phillips v. Sommers, 917 S.W.2d 636 (Mo. Ct. App. 1996).

ISSUE INDEX

Animals
Horses 102

Bankruptcy
General
Automatic stay 102
Chapter 12
Plan modification 102
Trustee fee 102
Federal taxation
Administrative expenses 103
Avoidable liens 103
Claims 103
Discharge 103
Plan 103
Tax liens 103

Federal Agricultural Programs
Crop insurance 104
Soils 104

Federal Estate and Gift Tax
Charitable deduction 104
Claims against estate 104
Disclaimers 104
Executor liability 104
Generation skipping transfers 104
IRA 104
Joint tenancy property 104
Life insurance 105
Marital deduction 105
Power of appointment 105
Trusts 105

Federal Income Taxation
Bad debts 106
Casualty losses 106
Court awards and settlements 106
Demolition 106
Hobby losses 106

Partnerships
Administrative adjustments 106
Pension plans 106
Returns 106
S corporations
Election 106
Trusts 106
Safe harbor interest rates
July 1996 107
Sale of residence 107

Negligence
Contamination of groundwater 107

Property
Fixtures 107
Prescriptive easement 108
TAX TRAPS IN SPLIT-DOLLAR LIFE INSURANCE

— by Neil E. Hart *

Split-dollar life insurance has become a popular insurance arrangement in recent years. Under a split-dollar policy, an employer and an employee agree to share the costs and benefits of a permanent life insurance contract providing both a death benefit and cash value. The employer provides the funds to pay part of the annual premium to the extent of the increase in the cash surrender value each year; the employee pays the balance of the annual premium. The employer is typically entitled to receive, out of the proceeds of the policy, an amount equal to the cash surrender value or at least the amount of the premiums paid. The employee has the right to name the beneficiary of the balance of proceeds payable at death.

As a practical matter, the employee pays a substantial part of the premiums in the early years of the policy but the employee’s share of the premium decreases rapidly and often reaches zero after a few years.

An employee is taxable on the value of the cost of the insurance protection benefit provided to the employee under the arrangement. The benefit is defined by using the tabular P.S. No. 58 term rate or the insurer’s one-year term rates available for all standard risks. That amount equals the one-year term cost of the declining life insurance protection to which the employee is entitled from year to year, less the portion provided by the employee, if any. The Internal Revenue Service has determined that a split-dollar insurance arrangement should not be treated as an interest-free loan by the employer to the employee. Originally, IRS had determined that these arrangements could be treated as interest-free loans. However, IRS later concluded that position was incorrect.

Worrisome 1995 ruling

In a 1995 technical advice memorandum, IRS determined that an employee has reportable income “...to the extent that the cash surrender values of the policies exceed the premiums paid ...” by the employer. The position of the Service was that the income was properly reportable under I.R.C. § 83. The employee must include in income each year the arrangement is in force — (1) an amount equal to the one-year term cost of declining life insurance and (2) any cash surrender buildup in the policies exceeding the amount returnable to the employer when the arrangement is discontinued. Under the facts of the 1995 ruling, the policies were owned by a trust and the employee was considered to have made a gift to the trust each year equal to the amount included in the employee’s income each year under the split-dollar arrangement.

Critique of the 1995 ruling

The storm of protest over the issuance of the 1995 ruling has focused principally upon the fact that earlier revenue rulings had not provided a basis for taxing, and did not contemplate taxing, employees on the cash surrender values in split-dollar contracts in excess of the employer's premium payments. Also, objection has been voiced on the grounds that I.R.C. § 83 only applies where substantial vesting has occurred. However, the ruling recites that “the cost of life insurance protection under a life insurance contract is taxable generally under section 61 of the Code during the period the contract remains substantially nonvested.”

Under the statute, I.R.C. § 83, if property is transferred in connection with the performance of services to any person other than the person for whom the services were performed, the excess of the fair market value of the property over the amount paid for the property is included in the service provider’s gross income in the first taxable year in which the rights of the service provider in the property are transferable or are not subject to a substantial risk of forfeiture. The ruling points out that, under the regulations, the term “property” for purposes of I.R.C. § 83 includes a beneficial interest in assets (including money) which is transferred or set aside from the claims of creditors of the transferor such as in a trust or escrow account.

In the 1995 ruling, while the employer had a collateral security interest in the policies to assure repayment of the employer’s premium payments, there had arguably not been a transfer of beneficial ownership in the property from the employer to the employee within the meaning of I.R.C. § 83.

Planning suggestions

Although there remains the possibility that the Internal Revenue Service may reconsider the position taken in the 1995 ruling, it seems prudent to review split-dollar arrangements that have progressed to the point of producing...
tax consequences under the 1995 ruling. Specifically, it may be wise to consider slowing the increase in cash value so that it accrues over a longer term. That postpones equity attainment. Also, it may be possible to avoid a taxable transfer under I.R.C. § 83 by providing for a substantial risk of forfeiture on the part of the employee. A taxable transfer does not occur if the interest has not vested.17 Vesting could be tied to attainment of performance objectives by the employee (or reaching a specified number of years’ service).

In conclusion...

The last word has clearly not been written on the tax treatment of split-dollar life insurance contracts. Further guidance from the Internal Revenue Service is to be expected. Moreover, the Service position is likely to be challenged in court.

FOOTNOTES


CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ANIMALS

HORSES. The plaintiff was a contestant in a horse show and had ridden her horse up to the arena entrance but was prevented from entering by a mass of people. The defendant was also an entrant and had stopped nearby for the same reason. A horse exiting the arena was forced to walk close to the defendant’s horse and bumped the defendant’s horse, causing it to rear and kick the plaintiff. The plaintiff sued for damages under negligence and strict liability theories. The defendant argued that La. Rev. Stat. § 9:2795.1 provided immunity from the suit. The statute provided immunity from liability for an “equine activity sponsor, an equine professional, or any other person.” The court held that the defendant was within the class of persons provided with immunity from liability. The plaintiff argued that the exception in the statute for willful or wanton disregard for the safety of others applied because the defendant should have known that the defendant’s horse would kick if bumped. The defendant testified that the horse had not kicked anyone before but that it was common knowledge that horses could become frightened if their “comfort zone” was invaded. The court held that the incident was within the range of dangers associated with equine activities and held that the defendant did not commit willful or wanton disregard for the plaintiff’s safety. Gautreau v. Washington, 672 So.2d 262 (La. Ct. App. 1996).

BANKRUPTCY

GENERAL-ALM § 13.03.*

EXEMPTIONS

HOMESTEAD. The debtors owned 78 acres of rural land. The debtors’ home was situated on 2 acres, 76 acres were contiguous woodlands, and 3.5 acres of the woodland were used as a residence by the debtors’ adult daughter and her children. The home site and woodlands were assessed together for property taxes but the 3.5 acres were assessed separately. The 3.5 acres were not included as security for a loan used to buy the entire 78 acres. The court held that the debtors were entitled to a rural homestead exemption for their home site and the woodlands but not for the 3.5 acres used as a residence by the daughter. The court noted that the woodlands qualified as rural property even though the debtors did not use the land for agricultural purposes, because the land was clearly rural in nature and the state exemption statute did not require that a rural homestead property be actively used for farming or other agricultural purposes. In re McCall, 195 B.R. 911 (Bankr. E.D. Ark. 1995).

PRIORITY. During the debtor’s Chapter 12 case, the county assessed property taxes against the debtor’s property. The debtor converted the case to Chapter 7. The county sought seventh priority status for the tax claim under Section 507(a)(7). The court held that when the taxes were assessed a lien was automatically created by Ark. Code § 26-34-101 and the taxes became a secured claim. The court held that Section 507(a)(7) allowed a priority only for unsecured governmental claims; therefore, the county’s claim would have to be paid from its security and could not receive priority. In re Wrigley, 195 B.R. 914 (Bankr. E.D. Ark. 1996).

CHAPTER 12-ALM § 13.03[8].*

VALUATION. The issue in this case was the valuation of the debtors’ farm real and personal property to determine the amount of the FmHA (now FSA) secured claim in the property. The court discredited both the FmHA in-house appraisal and the debtor’s personal appraisal of the property.

*Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.
and used values which were the average of both values. *In re Fuller*, 196 B.R. 41 (Bankr. W.D. Va. 1995).

**FEDERAL TAXATION-ALM § 13.03[7].**

**ABSOLUTE PRIORITY RULE.** The IRS filed a claim in the debtor’s Chapter 11 case for unpaid taxes for 1977 through 1985 when the debtor filed accurate income tax returns but did not pay the amounts due. The Bankruptcy Court held that the taxes were dischargeable because the debtor filed accurate returns and did nothing to prevent the IRS from collecting the taxes, such as hiding assets. The District Court reversed, holding that no fraudulent act need be committed by the debtor in order to deny discharge under Section 523. The court held that the debtor’s failure to pay the taxes was a willful attempt to evade taxes because the debtor knew the taxes were due and the debtor had the ability to pay the taxes. The appellate court reversed, holding that the knowing failure to pay taxes did not alone constitute a willful attempt to evade taxes. On remand, the debtor filed a Chapter 11 plan, providing for full payment of the secured tax claims over the life of the plan but only 2 percent on the unsecured portion of the tax claims which were determined to be dischargeable under the above ruling. During the proceedings above, the debtors paid a portion of their post-filing wages into an escrow account. The plan provided for use of those funds for payment of unsecured claims. The IRS objected to the plan and the debtors sought confirmation under Section 1129(a)(8). The IRS argued that Section 1129(a)(8) confirmation “cramdown” was not available to the debtors because they would retain an interest in estate property without providing new value to the estate. The debtors argued that the escrow funds were new value contributed to the estate and that the estate property was retained by the debtors only because the property was exempt. The court confirmed the plan. *In re Haas*, 195 B.R. 933 (Bankr. S.D. Ala. 1996), on remand from, 48 F.3d 1153 (11th Cir. 1995), rev’g, 173 B.R. 756 (S.D. Ala. 1993).

**DISCHARGE.** The debtor timely filed accurate 1986, 1987, 1988 and 1989 income tax returns but did not make any tax payments. In 1988, the debtor filed a no asset Chapter 7 case, a second Chapter 13 case was filed in 1991 and finally the current no asset Chapter 7 case was filed in 1995. The IRS argued that, under Section 108(c) and I.R.C. § 6503(h), the first two bankruptcy cases tolled the three year period of Sections 507(a)(7)(A)(i) and 523(a)(7)(B) such that the taxes were not dischargeable under those sections. The court held that the plain language of Section 108(c) and I.R.C. § 6503(h) indicates that those laws do not apply to bankruptcy provisions. The court noted a significant split in the cases on this issue. The court noted that the IRS had over 1,000 days to collect the 1986, 1987, and 1988 taxes and 343 days to collect the 1989 taxes when the debtor was not involved in a bankruptcy case; therefore, the IRS was not equitably entitled to suspension of the Section 507(a)(7) time period. *In re Turner*, 182 B.R. 317 (Bankr. N.D. Ala. 1995), aff’d on reconsideration, 96-2 U.S.Tax Cas. (CCH) ¶ 50,351 (Bankr. N.D. Ala. 1996).

**LEVY.** The debtor had filed a previous Chapter 13 case. The first case was dismissed by a court order which provided that the trustee retain an amount to cover expenses and pay the remainder of the bankruptcy estate to the debtor. The IRS filed a notice of levy against the trustee after the dismissal order and before the funds were repaid to the debtor and the trustee held the funds pending the outcome of this case. The court determined that the funds held by the trustee were subject to the levy once the first case was dismissed. *In re Schlapper*, 195 B.R. 805 (Bankr. M.D. Fla. 1996).

**CONTRACTS**

**PROMISSORY NOTE.** The defendant was a peanut farmer who had purchased one type of peanut seed for several years until a poor harvest because of disease. The defendant purchased a disease resistant variety from the plaintiff who claimed that the seed was capable of 88 percent germination. However, the actual seed purchased contained some uncertified seed. The defendant experienced reduced yields and obtained a refund of the seed price from the producer. The defendant sought a loan from a bank which refused to make the loan because of a large amount on account with the plaintiff. The plaintiff agreed to take a promissory note at reduced interest and to tell the bank that the account was satisfied. The bank made the loan but the defendant returned the money and rented out the land. The plaintiff sued to recover the amount owed on the promissory note. The defendant argued that the note was void because it was made without consideration from the plaintiff. The court held that the reduced interest rate, extended term for payment and agreement to tell the bank the account was satisfied were sufficient consideration. In addition, the court held that the defendant as the accommodation party cannot assert lack of consideration since the value the defendant received was what the defendant bargained for. The defendant also argued that the contract was void because of illegality since the plaintiff misrepresented to the bank that the account was paid. The court held that this defense was not available to the defendant because the defendant participated in the misrepresentation. *Morey v. Brown Milling*, 469 S.E.2d 387 (Ga. Ct. App. 1996).

**EMPLOYMENT**

**BREACH OF LOYALTY.** The defendant was employed as the manager of a farm supply store owned by the plaintiff. The defendant became dissatisfied with the employment and solicited another chemical company to establish a store in the same area, using the defendant’s property and the defendant as manager. When that agreement was reached, the defendant informed the other employees of the move and suggested that they follow him. All of the other employees left for the new store within a month after the defendant resigned and the plaintiff lost 70 percent of its business which followed the salesmen to the new store. The plaintiff sued for breach of employee loyalty and appropriation of trade secrets, the customer information. The plaintiff received a jury award of $75,000 but awarded the defendant $37,000 bonus compensation due under the old employment contract. None of the employees had signed any noncompetition agreement. The court upheld the award of damages for the plaintiff because
the defendant actively solicited the other employees while the defendant was still employed by the plaintiff. The court reversed the award of the bonus because the employment contract made the bonus discretionary with the plaintiff. The court held that no actionable appropriation of trade secrets occurred because the employees took no written records and the information about the customers was easily obtained from the customers. 

**Vigoro Indus., Inc. v. Crisp**, 82 F.3d 785 (8th Cir. 1996).

**FEDERAL AGRICULTURAL PROGRAMS**

**EMERGENCY LIVESTOCK ASSISTANCE.** The CCC has adopted as final regulations changing the designation of the Emergency Livestock Assistance regulations from Part 1475 to Part 1439. 61 Fed. Reg. 32643 (June 25, 1996).

**HERBICIDE.** See *Schuver v. E.I. Du Pont de Nemours & Co.*, 546 N.W.2d 610 (Iowa 1996) under Products Liability infra.

**TOBACCO.** The FSA has issued a notice of determination of penalty rates for nonquota tobacco:

<table>
<thead>
<tr>
<th>Type</th>
<th>Cents per pound</th>
</tr>
</thead>
<tbody>
<tr>
<td>Flue-cured</td>
<td>134</td>
</tr>
<tr>
<td>Burley</td>
<td>139</td>
</tr>
<tr>
<td>Fire-cured (Type 21)</td>
<td>122</td>
</tr>
<tr>
<td>Fire-cured (Types 22 &amp; 23)</td>
<td>163</td>
</tr>
<tr>
<td>Dark Air-cured</td>
<td>132</td>
</tr>
<tr>
<td>Virginia Sun-cured</td>
<td>115</td>
</tr>
<tr>
<td>Cigar Filler &amp; Binder</td>
<td>109</td>
</tr>
<tr>
<td>Puerto Rico Cigar-filler</td>
<td>57</td>
</tr>
</tbody>
</table>


The CCC has adopted as final regulations requiring a refund on a CCC loan on "nested" tobacco whether or not the producer knew the tobacco was nested. 61 Fed. Reg. 33303 (June 27, 1996).

**FEDERAL ESTATE AND GIFT TAX**

**GENERATION SKIPPING TRANSFERS-ALM § 5.04[6].** The decedent died in May 1995 and the will created an irrevocable trust funded with the residuary estate. The surviving spouse was the sole beneficiary of the trust, which was QTIP. The will provided that the trust terminated on the death of the surviving spouse and the trust corpus passed to a trust with one share for each surviving child, each surviving grandchild and for the grandchildren of a pre-deceased grandchild. The surviving spouse amended the spouse’s will to provide that any estate and death taxes imposed on property passing under the trust by reason of the spouse’s death were to be paid from the spouse’s probate estate. The will also provided for additional property from the spouse’s estate to be included in the trust shares to the extent of any unused GSTT exemption amount. The IRS ruled that the will provision for paying taxes resulting from the passing of the trust shares did not subject the trust to GSTT. The trusts would be considered as partially exempt from GSTT to the extent of corpus passing from the decedent’s original pre-September 25, 1995 trust and partially subject to GSTT to the extent of property passing to the grandchildren’s shares from the surviving spouse. *Ltr. Rul. 9627020, April 8, 1996.*

The decedent died in 1970 and the decedent’s will established an irrevocable trust for the surviving spouse with equal remainders to the decedent’s two children and final remainders to the children’s descendants. The trust was funded with stock and the corporation wanted to elect Subchapter S treatment. In order for the trusts to qualify as QSTTs, the trustee sought a construction of the trust in state court that the shares held by the children will be considered as separate trusts. The final remainder holders or their legal representatives claimed their interests in the trust which had not vested at the time of the disclaimers. The IRS ruled that only the disclaimers of the minor children would be timely made and that the disclaimers of the adult descendants of the children would constitute gifts. The gifts would constitute additions to the trust and subject a pro rata portion of the trust to GSTT. The IRS also ruled that the state court construction of the trust provisions would not itself subject the trust to GSTT. *Ltr. Rul. 9627010, April 3, 1996.*

**GIFT-ALM § 6.01.* The taxpayer established three irrevocable trusts, only two of which were at issue in this ruling. In both trusts, a child of the taxpayer was the primary beneficiary and one of three co-trustees, all of which were children of the taxpayer. The trusts granted the taxpayer’s grandchildren, their spouses and their issue the right to withdraw contributions to the trust by the end of each calendar year. The trusts did not require the taxpayer or the trustees to notify the beneficiaries with withdrawal rights that any contributions were made. In 1990, the taxpayer made contributions to the trusts on December 31 but the taxpayer’s attorney sent letters notifying the beneficiaries of the contributions on December 27. Banking rules prohibited crediting the trusts’ accounts until January 2, 1991. On December 10, 1991 the taxpayer’s attorney sent letters to the beneficiaries that contributions to the trusts were made; however, not until December 31, 1991 was a check dated December 26, 1991 deposited in the trusts’ account. The IRS ruled that the taxpayer was not entitled to a gift tax exclusion amount for contributions to the trusts because the withdrawal rights were shams since the failure of the taxpayer to make contributions within sufficient time to make the withdrawals indicated that the beneficiaries had agreed not to exercise the withdrawal rights. *Ltr. Rul. 9628004, April 1, 1996.*

**IRA.** The decedent’s will bequeathed the residuary estate to a trust for the surviving spouse with remainders to the decedent’s children. The residuary estate included three IRAs owned by the decedent. The surviving spouse disclaimed an interest in the trust equal to the value of the IRAs and the children disclaimed any remainder interest in the disclaimed interest. Thus, an amount equal to the value of the IRAs passed by intestacy to the surviving spouse and the executor funded the intestacy bequest with the amounts in the IRAs. The surviving spouse deposited the funds in an IRA in the spouse’s name. The IRS ruled that the disclaimers were effective, the IRA funds were treated as passing directly to the surviving spouse and the surviving

*Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.*
spouse did not need to include the IRA funds in gross income. Ltr. Rul. 9626049, April 2, 1996.

MARITAL DEDUCTION—ALM § 5.04[3]. The decedent had received an interest in trust from the decedent’s pre-deceased spouse’s estate which had qualified as QTIP. The predeceased spouse’s estate claimed a marital deduction for the QTIP trust interest. The trust failed to provide that any income received by the trust during the period between the last distribution and the decedent’s death (so-called “stub” income) was to be paid to the decedent’s estate. The decedent’s estate argued that because of this, the trust was not QTIP and the trust was not includible in the decedent’s gross estate. The court noted disagreement in the courts as to whether the “stub” income must be payable to the spouse’s estate in order for a terminable interest to be QTIP and held, therefore, that the statute was ambiguous on that point. After discussing the legislative history and the practical consequences of the two interpretations, the court held that the failure of the trust to require the “stub” income to be paid to the spouse’s estate did not disqualify the trust as QTIP. Estate of Shelfer v. Comm’r, 96-2 U.S. Tax Cas. (CCH) ¶ 60,238 (11th Cir. 1996).

RETURNS. The IRS has announced that, until revised forms are published in October 1996, the current versions of the following forms are to be used: Forms 706, 706-A, 706-NA, 709, 709-A. Ann. 96-62.

VALUATION. The taxpayers, husband and wife, each owned a 50 percent tenancy in common interest in their personal residence. Each taxpayer created an irrevocable trust and contributed their 50 percent share of the house to the trust. The trusts provided that the taxpayers could use and occupy the house for 15 years, at which time the taxpayers’ children became the beneficial owners of the trusts. The trust allowed the taxpayers to lease the residence from the trusts at fair rental value after the 15 years. The trust provided that, if a taxpayer died before the 15 years passed, the taxpayer’s interest in the trust passed to the taxpayer’s estate. The taxpayers executed wills bequeathing each’s interest to the surviving taxpayer. The IRS argued that the decedent’s fee simple interests in the properties merged with the trust interests in the properties so that the decedent was not included in the decedent’s gross estate. The IRS argued that the decedent’s fee simple interests in the properties merged with the trust interests in the properties so that the decedent was not included in the decedent’s gross estate. Estate of Shelfer v. Comm’r, 96-2 U.S. Tax Cas. (CCH) ¶ 60,238 (11th Cir. 1996).

After the decedent had been diagnosed for cancer with less than a 5 percent chance of recovery, the decedent amended two family partnership agreements to allow the transfer of partnership interests and to have the decedent’s son manage the partnership at the decedent’s death. The decedent transferred remainder interests in the decedent’s partnership interests to trusts for the decedent’s children in exchange for $250,000 and annuities payable over the decedent’s life. The remainder interests were valued using the actuarial tables of Treas. Reg. § 25.2512-5(f) (Table A) for a person of the decedent’s age. The annuity agreement had a provision that the remainder interest purchasers agreed to increase the amount to be paid if the remainder interests were revalued by the IRS or Tax Court. The Tax Court originally held that the remainder interests could not be valued using the actuarial table because of the limited life expectancy of the decedent. The savings clause was not effective to change the fact that the purchasers had paid less than fair market value for the remainder interests and that, therefore, the transfers were includible in the decedent’s estate as gifts under I.R.C. § 2036 but offset by the $250,000 actually paid. The appellate court remanded the case to determine whether the holding was consistent with Rev. Rul. 80-80, 1980-1 C.B. 194, which required that death be “clearly imminent” before the actuarial table could not be used. On remand the Tax Court reiterated its belief that the case precedents established a clearer standard but held the decedent’s death at the time of the transfer was clearly imminent since testimony demonstrated that the decedent’s chance of surviving for more than one year was less than 10 percent. Est. of McLendon v. Comm’r, T.C. Memo. 1996-307, on remand from, 77 F.3d 477 (5th Cir. 1995), rev’g without op., T.C. Memo. 1993-459.

The decedent owned undivided partial interests in a ranch, other real property and a pleasure boat. The other undivided interests were owned by a QTIP trust established for the decedent by the decedent’s predeceased spouse. The trust assets were includible in the decedent’s estate. The estate claimed that the value of the undivided interests should have been discounted for the partial interests owned by the decedent. The IRS argued that the decedent’s fee simple interests in the properties merged with the trust interests in the properties so that the decedent would be treated as owning the entire interest in each asset for valuation purposes. The court held that the undiscounted interests held by the decedent could be valued at a discount because the decedent had no control over the trust assets at death and the trust assets were not subject to estate tax until after the decedent’s death. Bonner v. United States, 84 F.3d 196 (5th Cir. 1996). An article on this case by Neil Harl will appear in a future issue of Agric. Law Digest.

FEDERAL INCOME TAXATION

BUSINESS EXPENSES. The taxpayer was a shareholder in several corporations which owned and managed commercial properties. The taxpayer did not receive any wages from the corporations. The taxpayer incurred travel and other expenses in overseeing the corporations’ businesses but did not seek reimbursement from the corporations for these expenses. The court held that the taxpayer could not claim the expenses as a business deduction because the expenses were incurred as an employee. Cavalaris v. Comm’r, T.C. Memo. 1996-308.

ENVIRONMENTAL CLEANUP COSTS. The taxpayer’s parent corporation acquired clean farm land which became contaminated with pesticides and chemicals when the land was used as an industrial waste site. The taxpayer, a subsidiary, donated the land to the county which attempted to convert the land to recreational use until the contamination was found and then the county resold the land back to the taxpayer for nominal consideration. The taxpayer was responsible for the cleanup of the land and sought to deduct the costs of legal fees for negotiating with the EPA, consulting fees for determining the amount of waste, and consulting fees for determining...
S CORPORATIONS

TRUSTS. The decedent died in 1970 and the decedent’s will established an irrevocable trust for the surviving spouse with equal remainders to the decedent’s two children and final remainders to the children’s descendants. The trust was funded with stock and the corporation wanted to elect Subchapter S treatment. The trustee sought a construction of the trust in state court that the shares held by the children would be considered as separate trusts in order for the trusts to qualify as QSSTs. The final remainder holders or their legal representatives disclaimed their interests in the trust which had not vested at the time of the disclaimer. The IRS ruled that the trust was a QSST while the surviving spouse was the beneficiary and the equal shares held by the children would be QSSTs if the proposed state court construction was obtained. Ltr. Rul. 9627010, April 3, 1996.

TIMBER. The sole issue in this case was the age at which pine timber becomes merchantable. The taxpayer presented testimony of two independent appraisers and three employees as to the merchantability of pine timber at 10 years of age. The IRS did not provide any rebuttal evidence or attempt to discredit the taxpayer’s witnesses. The court held that pine timber becomes merchantable at 10 years of age. MHC Properties, Inc. v. U.S., 96-2 U.S. Tax Cas. (CCH) ¶ 50,347 (W.D. La. 1996).

LANDLORD AND TENANT

CONVERSION. The plaintiff owned land leased to a tenant on a grazing lease. The tenant, however, sold native grass seed on the land to the defendant. The plaintiff sued the defendant for conversion of the grass seed. The trial court awarded the plaintiff damages for the loss of value of the land after the conversion and damages for bringing the suit to recover the property. The defendant argued that the damages in the first part were limited to the sales price of the seed. The court held that, under 23 Okla. Stat. § 64, the plaintiff was entitled to damages equal to the loss of land value because the plaintiff sought recovery with due diligence. The court reversed the second damage award, however, because the plaintiff’s counsel failed to provide specific evidence of the legal fees incurred by the plaintiff in pursuit of the property, excluding legal fees incurred to prosecute the action, which were not allowed by the statute. Ross v. Kan-Tex Seed Co., 914 P.2d 1085 (Okla. Ct. App. 1996).

MORTGAGES

REDEMPTION PERIOD. The defendant had borrowed money from the plaintiff and granted a mortgage on some of the defendant’s farm land. The defendant defaulted on the loan and the plaintiff brought a foreclosure action. The land was sold and the plaintiff purchased the land at the sale and brought an action for the deficiency amount. The plaintiff obtained a deficiency judgment and three other parcels of the defendant’s land were sold in satisfaction of the judgment. The trial court granted the defendant only a six month redemption period on the first sale because the defendant had paid less than one-third of the loan amount before the foreclosure. The redemption
period was amended to three months before the second sale and the trial court allowed only a three month redemption period for the second sale. The defendant argued that the second sale was not governed by the shorter period in the redemption statute because no mortgage remained and the first sale proceeds paid more than one-third of the loan amount. The court held that the normal 12 month redemption period applied to the second foreclosure sale because no mortgage existed at the time of the sale and no default occurred because the deficiency judgment was executed upon three days after it was entered. *Farm Credit Bank of Wichita v. Zerr*, 915 P.2d 137 (Kan. Ct. App. 1996).

**NEGLIGENCE**

**OBSTRUCTION OF CREEK.** The plaintiff was a soybean farmer through whose land ran a creek. The creek flooded through the defendant’s property. The defendant placed an obstruction across the creek on the defendant’s property causing the flooding of the plaintiff’s land to increase from five to 15 acres. The plaintiff sued for negligence for the loss of the additional 10 acres of soybeans lost from a heavy rain while the creek was blocked. The plaintiff provided unrefuted evidence of the amount of normal flooding, the average yield of the flooded acres, the price the lost soybeans would have been sold at (using the average price of the sale of the harvested beans), and the cost of production of the lost soybeans which was not incurred because of the flooding. The trial court found that the defendant caused the blockage of the creek and that the blockage caused the additional flooding. The court awarded damages based on the yield of the 10 acres times the average market price for beans less the costs of production saved. The state District Court reversed, holding that the damages were too speculative and not based on expert testimony. The appellate court reinstated the trial court’s judgment, holding that the trial court had discretion to accept the plaintiff’s testimony as sufficient to prove the elements of damages, especially where the defendant failed to provide any refutation of the evidence. *Bristol v. Rasmussen*, 547 N.W.2d 120 (Neb. 1996).

**PARTNERSHIPS**

**FIDUCIARY DUTY.** The defendant was a corporation formed for the purpose of acquiring and operating an orchard. The orchard chosen for the purchase included four parcels, one of which was 56 acres. The defendant signed a contract to purchase the orchard land, paid earnest money on the agreement and agreed to make a downpayment at closing. Before the closing, the defendant approached the plaintiffs for the sale of the 56 acres but the plaintiffs wanted to purchase the land with the defendant in a partnership. The plaintiffs agreed to contribute an amount equal to the agreed purchase price to the partnership with the intent that the partnership make the purchase of the 56 acres. The defendant used the contributed funds to make the downpayment on the entire orchard purchase but did not inform the plaintiffs that the money would be used this way or that the defendant would be making a profit on the transactions. The plaintiffs sought an accounting and a share of the profits made on their part of the purchase and the entire land purchase. The court held that because the partnership was formed before the orchard land was acquired by the defendant, the defendant owed a fiduciary duty to the plaintiffs as partners to inform them of the true nature of the transactions; therefore, the entire orchard land became a partnership asset and the plaintiffs were entitled to an accounting of all profits. *Chang v. Century Orchards, Inc.*, 915 P.2d 425 (Or. Ct. App. 1996).

**PRODUCT LIABILITY**

**HERBICIDE.** The plaintiff purchased the herbicide Preview, manufactured by the defendant, for application on the plaintiff’s soybean fields with the belief that the herbicide would not carry over to the next year’s corn crop. However, the next year’s and the following year’s corn crops showed herbicide carry over damage. The plaintiff sued the manufacturer in negligence and strict liability and the defendant claimed preemption of the suit by FIFRA. The plaintiff provided evidence that the carryover effect was caused by a high pH of the soil in the area. The plaintiff’s negligence claims alleged that the defendant was negligent in marketing in an area inappropriate for the herbicide and in failing to withdraw the product once the high pH of the area soil was known, in testing the product to determine whether it was compatible with the area’s soil, and in failing to warn the area farmers of the problem. Similar allegations were used to support the strict liability claim. The court held that the action was preempted by FIFRA because the plaintiff’s claims were merely another way of stating that the defendant failed to warn on the label of the carryover effects in areas with high pH soil. *Schuver v. E.I. Du Pont de Nemours & Co.*, 546 N.W.2d 610 (Iowa 1996).

**PROPERTY**

**UNLAWFUL DETAINER.** The defendant had granted a mortgage on a farm to a bank. When the defendant defaulted on the loan the bank began foreclosure proceedings which, after several bankruptcy filings by the defendant, finally ended in the sale of the property to the bank. After the sale, the parties had several discussions about the defendant repurchasing the farm or leasing the farm. The evidence was contradictory as to whether any agreement was reached. The jury found that no oral lease was entered into by the parties and reached a verdict for the bank to eject the defendant for unlawful detainer. The defendant also challenged the jury instruction on the elements of unlawful detainer because the instruction did not require a finding that the defendant’s continued possession was willful and unlawful. The court acknowledged that the jury instruction was incomplete but held that the defendant was not prejudiced by the defect because another jury instruction gave the jury an opportunity to determine whether the defendant’s holding over was pursuant to an oral lease agreement. In addition, the court noted that the closing arguments made the requirement of unlawful and willful holding over necessary for a verdict of unlawful detainer. *Agribank FCB v. Cross Timbers Ranch, Inc.*, 919 S.W.2d 256 (Mo. Ct. App. 1996).
SECURED TRANSACTIONS

PURCHASE MONEY SECURITY INTEREST. The debtor borrowed money from a bank in order to purchase a farm tractor. The bank claimed to have mailed a UCC-1 form with the filing fee to the county recorder. The bank provided no evidence that the form or check was received by the recorder’s office or that the recorder’s office mishandled the filing. The bank argued that the mere mailing of the form and fee was sufficient filing to perfect the security interest in the tractor. The court acknowledged that there is some precedent for allowing perfection where the recorder received but did not correctly file the security interest, but the court held that the creditor must provide evidence of receipt of the filing before that rule could be applied. The court refused to hold that the mailing of the form and fee was sufficient presumption of filing to perfect the security interest. The court also rejected the bank’s request to allow perfection of the security interest under the theory of unjust enrichment to the other secured creditors who will now receive a priority interest in the tractor. The court held that the doctrine of unjust enrichment did not apply where the bank’s failure to properly perform a perfection resulted in the benefit to other creditors who were not aware of the benefit until the bankruptcy of the debtor. For the same reason, the court refused to apply equitable subordination to give the bank a priority security interest in the tractor. *In re Wright*, 196 B.R. 97 (Bankr. W.D. Wis. 1995).

AGRICULTURAL LAW MANUAL
by Neil E. Harl

This comprehensive, annotated looseleaf manual is an ideal deskbook for attorneys, tax consultants, lenders and other professionals who advise agricultural clients. The book contains over 900 pages and an index.

As a special offer to Digest subscribers, the Manual is offered to new subscribers at $115, including at no extra charge updates published within five months after purchase. Updates are published every four months to keep the Manual current with the latest developments. After the first free update, additional updates will be billed at $100 per year or $35 each.

For your copy, send a check for $115 to Agricultural Law Press, P.O. Box 50703, Eugene, OR 97405.

Satisfaction guaranteed. 30 day return privilege.

ISSUE INDEX

<table>
<thead>
<tr>
<th>Animals</th>
<th>Tobacco 112</th>
</tr>
</thead>
<tbody>
<tr>
<td>Horses 110</td>
<td>Federal Estate and Gift Tax</td>
</tr>
<tr>
<td>Bankruptcy</td>
<td>Generation skipping transfers 112</td>
</tr>
<tr>
<td>General</td>
<td>Gift 112</td>
</tr>
<tr>
<td>Exemptions</td>
<td>IRA 112</td>
</tr>
<tr>
<td>Homestead 110</td>
<td>Marital deduction 113</td>
</tr>
<tr>
<td>Priority 110</td>
<td>Returns 113</td>
</tr>
<tr>
<td>Chapter 12</td>
<td>Valuation 113</td>
</tr>
<tr>
<td>Valuation 110</td>
<td>Federal Income Taxation</td>
</tr>
<tr>
<td>Federal taxation</td>
<td>Business expenses 113</td>
</tr>
<tr>
<td>Absolute priority rule 111</td>
<td>Environmental cleanup costs 113</td>
</tr>
<tr>
<td>Discharge 111</td>
<td>Installment reporting 114</td>
</tr>
<tr>
<td>Levy 111</td>
<td>Involuntary conversion 114</td>
</tr>
<tr>
<td>Contracts</td>
<td>Sale of residence 114</td>
</tr>
<tr>
<td>Promissory note 111</td>
<td>S corporations</td>
</tr>
<tr>
<td>Employment</td>
<td>Trusts 114</td>
</tr>
<tr>
<td>Breach of loyalty 111</td>
<td>Timber 114</td>
</tr>
<tr>
<td>Federal Agricultural Programs</td>
<td>Landlord and Tenant</td>
</tr>
<tr>
<td>Emergency livestock assistance 112</td>
<td>Conversion 114</td>
</tr>
<tr>
<td>Herbicide 112</td>
<td>Mortgages</td>
</tr>
<tr>
<td></td>
<td>Redemption period 114</td>
</tr>
<tr>
<td></td>
<td>Negligence</td>
</tr>
<tr>
<td></td>
<td>Obstruction of creek 115</td>
</tr>
<tr>
<td></td>
<td>Partnerships</td>
</tr>
<tr>
<td></td>
<td>Fiduciary duty 115</td>
</tr>
<tr>
<td></td>
<td>Products Liability</td>
</tr>
<tr>
<td></td>
<td>Herbicide 115</td>
</tr>
<tr>
<td></td>
<td>Property</td>
</tr>
<tr>
<td></td>
<td>Unlawful detainer 115</td>
</tr>
<tr>
<td></td>
<td>Secured Transactions</td>
</tr>
<tr>
<td></td>
<td>Purchase money security interest 116</td>
</tr>
</tbody>
</table>
CONSEQUENCES OF A BUSINESS LOSS
— by Neil E. Harl

A business loss is not exactly welcomed but at least a net operating loss deduction may be available.¹ Net operating losses can be carried back three years (unless the election is made to carry the NOL forward only)² and forward 15 years.³

However, a net operating loss may have several subtle effects, most of which tend to be negative in nature.⁴ As a matter of planning, these consequences should be figured into any effort before year end to avoid a net operating loss by delaying deductions or accelerating income.

Home office deduction

One notable consequence of a business loss is that the home office deduction⁵ may not be available.⁶ The home office deduction is limited to the excess of the gross income generated from the business activity conducted in the office less all other deductible expenses attributable to the activity which are not allocable to the use of the home office.⁷ Thus, the home office expense deduction may not create or increase a net operating loss from the business activity to which it relates.⁸ For example, personal interest income is not considered business income for a sole proprietorship even though the interest income is used to finance business operations.⁹

However, the gross income taken into account is not merely the gross income reported on Schedules F or C; it may also include income from property leasing, sales and management carried on in the home office and reported on other schedules.¹⁰

Health insurance costs

In recent years, self-employed individuals have been entitled to deduct 30 percent of the amount paid (25 percent before 1995) during the year for insurance which constitutes medical care for the self-employed individual, a spouse and dependents.¹¹ The deduction is limited to the self-employed taxpayer’s “earned income”¹² “derived from...the trade or business with respect to which the plan providing the medical care coverage is established.”¹³ The term “earned income” is defined as the “net earnings from self-employment”¹⁴ but “only with respect to a trade or business in which personal services of the taxpayer are a material income-producing factor.”¹⁵ The term “net earnings from self-employment” is defined as gross income earned by a taxpayer from a business carried on by the taxpayer less deductions allowed which are attributable to the business.¹⁶ Therefore, a net loss for a farm or ranch business means that there may be no net earnings from self-employment.¹⁷

However, in the case of a trade or business carried on by an individual or a partnership, and in which, if the trade or business were carried on by employees, a “major portion” of the services would constitute agricultural labor¹⁸—

• For an individual, if the gross income from the trade or business is not more than $2,400, the net earnings from self-employment from the trade or business may, at the taxpayer’s option, be deemed to be two-thirds of the gross income.¹⁹ or

• For an individual whose gross income from the trade or business is more than $2,400 and the net earnings from self-employment from the trade or business are less than $1,600, the net earnings from self-employment from the trade or business may, at the taxpayer’s option, be deemed to be $1,600.²⁰

Similar rules apply to partnerships.²¹

For trades or businesses where a “major portion” of the services would not constitute agricultural labor, a special rule (for not more than five taxable years) applies if net earnings from self-employment are less than $1600 and less than two-thirds of the individual’s gross income from all trades or businesses carried on by the individual.²² In no event may net earnings from self-employment under this provision exceed $1,600.²³

IRA contribution

A taxpayer may be eligible to claim a deduction for a contribution to an individual retirement account.²⁴ In general, the deduction may not exceed the lesser of $2,000 or an amount equal to the compensation includible in the taxpayer’s gross income for the taxable year.²⁵ The term “compensation” is defined as earned income²⁶ which in turn is defined as net earnings from self-employment.²⁷ Therefore, the deductibility of an IRA contribution is subject to the same rules as for health insurance as discussed above.²⁸

In conclusion...

In addition to the usual consequences of a net operating loss of losing personal and dependency exemptions,²⁹ any net operating loss carryback or carryforward,³⁰ nonbusiness

---

¹ Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
deductions (except to the extent of nonbusiness income)\textsuperscript{31} and nonbusiness capital losses (except to the extent of nonbusiness capital gains),\textsuperscript{32} taxpayers run the risk of losing the home office deduction,\textsuperscript{33} losing part or all of the deduction for an IRA contribution,\textsuperscript{34} and the deduction for health insurance costs.\textsuperscript{35} This would suggest careful attention to net income calculations before year end when there is still time to influence the level of income and deductions for the year.

**FOOTNOTES**

2. I.R.C. § 172(b)(3).
5. I.R.C. § 280A(a).
8. Id.
10. See Grinalds v. Comm’, T.C. Memo. 1993-66 (depreciation on home office claimable even though Schedule C showed loss because taxpayer acquired, constructed, improved, leased, managed and sold commercial real property from home office which was reported on Schedules B, D and E; court held that, given taxpayer’s leasing and sales activity, these amounts constituted business income).
12. See I.R.C. § 401(c)(1).
18. See I.R.C. § 3121(g).
23. Id. This point seems not to have been considered in the recent case of King v. Comm’, T.C. Memo. 1996-231.
27. See I.R.C. § 1402(a).
32. I.R.C. § 172(d)(2).
33. I.R.C. § 280A.
34. I.R.C. § 219(a).
35. I.R.C. § 162(l).

**CASES, REGULATIONS AND STATUTES**

by Robert P. Achenbach, Jr.

**BANKRUPTCY**

**GENERAL-ALM § 13.03.**

**DISCHARGE.** The debtor was a logger who contracted with a third party to log trees under a 50/50 contract. The debtor checked the county records and discovered a right of way to the third party’s land over the plaintiff’s land. The debtor notified the plaintiff about the right of way and testified that the plaintiff allowed the use of a road for the logging operation because the right of way was over swampy land. The debtor also testified that the plaintiff agreed to the removal of trees on the plaintiff’s land under the same 50/50 arrangement, although no written contract was executed. The plaintiff inspected the operation and complained about the damage to the road and, at a later inspection, discovered a large number of trees had been removed from the plaintiff’s land. The plaintiff informed the debtor of the findings and forbid any future use of the road. The debtor complied with the request. The plaintiff claimed that the debtor received payment for the trees cut from the plaintiff’s land but converted the payments to the debtor’s personal use. After the debtor filed for bankruptcy, the plaintiff filed claims for the lost trees and damage to the road. The plaintiff then filed a motion to have the debts declared nondischargeable under Sections 523(a)(4) (larceny or embezzlement) or (a)(6) (malicious and willful injury). The court held that the debts were dischargeable because the plaintiff did not demonstrate any malicious actions by the debtor in removing the trees, damaging the road or failing to make payments under the contract. The court characterized the relationship of the parties as contractual with the plaintiff’s damages as within the normal course of business between contract parties. *In re Hrim*, 196 B.R. 237 (Bankr. N.D. N.Y. 1993).

**PREFERENTIAL TRANSFERS.** The debtors had owed money to the SBA. After that debt was due, the debtors contracted with the ASCS (now FSA) for conservation programs under which the debtors would receive annual deficiency payments. The SBA instituted an administrative setoff which was properly approved by the ASCS. Some payments were made within 90 days before the debtors filed for bankruptcy and the trustee sought recovery of these setoff payments as preferential transfers. The Appellate Panel held that the ASCS and SBA lacked mutuality so that the setoff was not binding in the bankruptcy case and ordered recovery of the payments. However, the court *en banc* reversed, holding that the United States was a unitary creditor for bankruptcy purposes. The case was remanded to the panel for determinations as to whether the setoff was allowed under
the bankruptcy rules. In re Turner, 84 F.3d 1299 (10th Cir. 1996), rev’g and rem’g, 59 F.3d 1041 (10th Cir. 1995).

REOPENING OF CASE. The debtor was a dairy farmer who was forced into bankruptcy because of an alleged infection of the debtor’s herd by cows purchased from a corporation. The debtor filed a lawsuit against the corporation which was pending at the time the debtor filed for Chapter 7. The debtor did not include the lawsuit on the schedule of assets and did not file any information on the lawsuit until the day the discharge was granted in the case. The lawsuit proceeded to a large jury award for the debtor four years later but the verdict was overturned by the trial court and was on appeal. The U.S. trustee filed a motion three months later to reopen the Chapter 7 case to include the lawsuit and its potential award. The award was large enough to leave the debtor with millions of dollars after full payment of all creditors; however, the debtor argued that the doctrine of laches prohibited the reopening of the case. The court held that the reopening was not prohibited by the doctrine of laches because the debtor failed to prove that the trustee knew about the lawsuit during the Chapter 7 case, that the trustee unreasonably delayed in bringing the reopening motion after learning about the lawsuit and that the debtor was prejudiced by the reopening. The court held that the equity of the case favored reopening the bankruptcy case to prevent the debtor from reaping a windfall far in excess of creditors’ claims. In re Windburn, 196 B.R. 894 (Bankr. N.D. Fla. 1996).

CHAPTER 12-ALM § 13.03[8].

CONVERSION. The debtors were farmers who originally filed under Chapter 12. In previous rulings in their case, the debtors were found to have made fraudulent transfers of property during their case and the case was converted to Chapter 7. Although the issues had been litigated in early decisions and appeals, the debtors again argued that their case could not be converted to Chapter 7 involuntarily because an involuntary case could not be filed against a family farmer. The court reiterated its prior rulings that the debtors had made fraudulent transfers and that a Chapter 12 case could be involuntarily converted to Chapter 7. In re Graven, 196 B.R. 506 (Bankr. W.D. Mo. 1996). See also In re Graven, 138 B.R. 587 (Bankr. W.D. Mo. 1992), aff’d by unrep. D. Ct. dec., aff’d, 64 F.3d 453 (8th Cir. 1995).

PLAN. The debtors’ Chapter 12 plan provided for payment of a secured claim owed to a Farm Credit Bank over the life of the plan at 7.5 percent. The original loan had an interest rate of 8.75 percent. The Bankruptcy Court did not confirm the plan because the interest rate was less than the prime rate plus 1.5 percent for the risk factor. The appellate court affirmed the Bankruptcy Court decision. The court rejected the debtors’ argument that the interest rate could not exceed the contract rate. Koopmans v. Farm Credit Services, 196 B.R. 425 (N.D. Ind. 1996).

FEDERAL TAXATION-ALM § 13.03[7].

DISCHARGE. The debtor, an attorney, failed to file income tax returns for several years. The debtor had filed returns while in the military and during school. The IRS filed a motion to have the tax for the non-return years declared nondischargeable. The court held that under Matter of Bruner, 55 F.3d 195 (5th Cir. 1995), the debtor’s failure to file income tax returns was sufficient to make the taxes nondischargeable under Section 523(a)(1). In re Parker, 196 B.R. 338 (Bankr. W.D. La. 1996).

ESTATE PROPERTY. The IRS filed a Notice of Levy on the debtor’s IRA, consisting of mutual funds, one day before the debtor filed for Chapter 13. The debtor sought to avoid the levy as made postpetition and to include the IRA in estate property. The court held that the evidence showed that the levy was filed before the bankruptcy case was filed; therefore, the levy did not violate the automatic stay. The court also held that, because the IRA consisted of intangible property, the debtor retained sufficient rights in the IRA at the time of the bankruptcy filing to include the IRA in estate property subject to administration in the case. In re Boutilier, 196 B.R. 323 (Bankr. W.D. Va. 1996).

PASSIVE ACTIVITY LOSSES. The taxpayers were debtors in Chapter 11 and owned several interests in partnerships and corporations which passed to the bankruptcy estate. The debtors’ interests were passive activities for income tax purposes and the debtors had unused passive activity losses incurred pre-petition. The partnerships and corporation incurred additional unused passive activity losses during the bankruptcy case. The bankruptcy plan provided for transfer of the partnership interests and stock back to the debtors on the effective date of the plan. The bankruptcy estate was created in August 1991; therefore, Treas. Reg. § 1.1398-1(c) did not apply unless the estate made an election to have the regulation apply. The estate did not make the election. The IRS ruled that upon the transfer of the partnership and corporation interests back to the debtors, the passive activity losses also transferred to the debtors. Ltr. Rul. 9611028, Dec. 14, 1995.

SETOFF. The debtors owed income taxes for pre-petition tax years and filed for Chapter 7 on April 15, 1994. On May 6, 1994, the IRS set off the debtors’ 1993 federal income tax refund against the pre-petition 1992 taxes. The parties agreed that both the refund and tax liability were pre-petition items and that if the IRS had timely applied for relief from the automatic stay, the setoff would be allowed. The debtors’ sole assets were federal and state tax refunds which were significantly small in comparison to the debtors’ debts. The trustee sought recovery of the refund, arguing that Section 724 required application of the refund for the payment of administrative expenses before recovery by the IRS. The court held that the IRS would be allowed retroactive relief from the automatic stay because the amount set off would not have a significant impact on the bankruptcy case and the IRS should not have to be penalized for failing to timely file for relief from the automatic stay in this case. In re Morgan, 196 B.R. 758 (E.D. Ky. 1996).

FEDERAL AGRICULTURAL PROGRAMS

FARM LOANS. The FSA has issued interim regulations implementing the statutory provisions governing loans assessments, market placements, and the graduation of seasoned direct borrowers to the guaranteed loan program. 61 Fed. Reg. 36916 (July 9, 1996).
PEANUTS. The FSA has issued interim regulations implementing the Agricultural Market Transition Act of 1996 by (1) eliminating the national poundage quota floor, (2) eliminating the undermarketing carryover provisions, (3) establishing temporary seed quota allocations, (4) establishing the ineligibility of certain farms for quota allocation, (5) authorizing inter-county transfer of farm poundage quotas, (6) eliminating the special allocations of increased quotas for certain Texas counties, and (7) establishing new provisions for “considered produced” credit for transferred quotas. 61 Fed. Reg. 36997 (July 16, 1996).

WAREHOUSES. The plaintiffs were grain producers who stored grain in a federally licensed warehouse and lost grain because the warehouse failed to maintain sufficient stocks to cover liabilities. The plaintiffs sued the United States under the Federal Tort Claims Act for failure of the Warehouse Division of the USDA (WD/USDA) to properly inspect and monitor the grain in the licensed warehouse. The United States argued that the suit was barred by the discretionary function exception and by the misrepresentation exception, 28 U.S.C. §§ 2680(a), (h). The facts at trial showed that the WD/USDA had discovered several violations at the warehouse over several years, including shortages and improper storage conditions but that the warehouse usually corrected the problems within a short time. However, in one instance, the storage problems were solved by the warehouse removing the grain from the storage area and the WD/USDA failed to determine where that grain was placed. That removal of grain substantially contributed to the final shortage that caused the warehouse to lose its license and the plaintiffs to lose their grain which was stored with the warehouse. The court found that the WD/USDA generally complied with its regulations and internal procedures in that nothing in the history of the warehouse warranted any special inspections or monitoring, until the removal of the grain from the improper storage area. Therefore, the court held that the earlier inspections were within the discretionery function exception but that the exception did not apply to the inspections required for determining the status of the grain removed from the improper storage area. The court held that the failure to properly determine the status of the removed grain violated a common law duty to exercise due care and was the proximate cause of the losses suffered by the plaintiffs. Appley Bros. V. United States, 924 F. Supp. 944 (D. S.D. 1996).

FEDERAL ESTATE AND GIFT TAX

CHARITABLE DEDUCTION. The taxpayer established a 34 year irrevocable unitrust. The trust had two Section 501(c)(3) foundations as unitrust beneficiaries which were to receive annually a total of 6 percent of the fair market value of the trust principal, payable from trust income, tax-exempt income, net capital gains or principal in that order. Any undistributed income was accumulated. If one of the unitrust beneficiaries failed to qualify as a Section 501(c)(3) foundation, the remaining beneficiary was to receive all of the unitrust distribution. If both beneficiaries failed to qualify under Section 501(c)(3), the trustees were to select a new unitrust beneficiary. The taxpayer served on the board of one of the trustees and the trust provided that if a new beneficiary was to be selected, a national bank was to be named as a replacement co-trustee for the purpose of selecting the new charitable beneficiary. At the end of 34 years, the trust principal passed to the taxpayer’s grandchildren. The IRS ruled that the trust qualified for the charitable deduction. Ltr. Rul. 9629009, April 17, 1996.

DISCLAIMERS—ALM § 5.02[6].* The decedent’s will bequeathed $600,000 to the surviving spouse in trust for the benefit of the decedent’s minor grandchildren. The trust provided that if the grandchildren died before complete distribution of the trust, the remainder passed to the decedent’s child, with final remainders to the decedent’s heirs. The residue of the estate passed to the decedent’s child with the provision that if the child predeceased the decedent, the residue passed to the trust for the grandchildren. Within nine months after the death of the decedent, the child executed a disclaimer of any interest in the residue of the estate passing by the will or intestate succession. The child did not disclaim the remainder interest in the trust for the grandchildren. A guardian was appointed by the state court and the guardian filed a disclaimer on the behalf of the grandchildren and any unborn grandchildren of any interest in the residuary estate of the decedent passing by will or intestate succession. The effect of the disclaimers was to cause the residuary estate to pass to the surviving spouse. The IRS ruled that the disclaimers were effective and the amount passing to the surviving spouse because of the disclaimers was eligible for the marital deduction. Ltr. Rul. 9629023, April 23, 1996.

The decedent’s will bequeathed the entire estate to the surviving spouse but provided that if any portion of the estate was disclaimed by the spouse, the disclaimed portion passed to the spouse as trustee and beneficiary of a trust. The trust provided for distributions to the spouse for the spouse’s health, education, maintenance and support. The decedent’s estate included an IRA which was community property. The spouse disclaimed a fraction of the IRA sufficient to minimize the federal estate tax on the decedent’s estate. The disclaimed portion of the IRA was segregated until a separate IRA was established. The IRS ruled that the disclaimer was effective and that the trust would not be included in the spouse’s gross estate because the spouse did not have a general power of appointment over trust principal. The IRS ruled that the trust would recognize the income from the distributions to the trust resulting from the disclaimed portion of the IRA. The IRS also ruled that the undisclaimed portion of the IRA which was rolled over to the spouse’s own IRA qualified as a tax-free custodian-to-custodian transfer. Ltr. Rul. 9630034, April 30, 1996.

GENERATION SKIPPING TRANSFERS—ALM § 5.04[6].* The decedent’s will provided for a residuary trust divided into two parts. The first part was to receive an amount equal to the decedent’s available GSTT exemption, with the other part to receive the balance of the residuary estate. The surviving spouse was the income beneficiary of both parts of the trust. The estate claimed a marital deduction for both parts of the trust and filed a Schedule R but failed to check the box to signify the reverse QTIP
election for the first part of the trust. However, the Schedule R was filled out consistent with a reverse QTIP election and $405,000 of the GSTT exemption was allocated to the first part of the trust. The IRS ruled that an extension of time for filing an amended Schedule R to make the reverse QTIP election was granted but that the GSTT allocation could not be changed on the amended schedule. Ltr. Rul. 9629014, April 19, 1996.

In 1966, the decedent’s predeceased spouse’s will provided for a trust for the decedent. The trust gave the decedent a testamentary general power of appointment over trust corpus. If the power of appointment was not exercised, the trust corpus passed to the predeceased spouse’s issue. The decedent died in 1993 and the will exercised the power of appointment by distributing the trust corpus in equal shares to eight grandchildren, seven of which received outright distributions and some of which received a distribution in trust. The estate argued that the distributions were not subject to GSTT because the original trust was established before September 25, 1985 and no additions were made to the trust. The IRS cited Peterson Marital Trust v. Comm’r, 102 T.C. 790 (1994), aff’d, 78 F.3d 795 (2d Cir. 1996) in support of its ruling that the exercise of the power of appointment caused the distributions to be subject to GSTT because the exercise was considered a constructive addition to the trust occurring after 1985. The existence of the general power of appointment made the trust includible in the decedent’s gross estate and the decedent was considered the transferor of the trust corpus. The IRS ruled that there was no distinguishable difference between the situation in Peterson where the trust corpus was distributed in trust to skip persons and this case where distributions were made directly to skip persons, because the focus was on the ability of the transferor, the decedent, to change the distributions of the original pre-1985 trust. The IRS also cited Treas. Reg. § 26.2601-1(b)(1)(v)(D), Example 1. Ltr. Rul. 9630003, April 16, 1996.

VALUATION. The decedent died in July 1991 and the estate included an undivided 50 percent community interest in 37 percent of the stock of a corporation. The stock was not publicly traded and was held by the members of three families. The decedent had participated in a split gift of stock owned by the decedent’s spouse in April 1991 and the issue in the case was the value of the stock on the date of the gift and the date of death. A little over a year after the death of the decedent, all of the stock in the corporation was redeemed by the corporation for $75 per share and the corporation was sold to a third party at that price per share. The estate argued that the redemption and sale price was irrelevant for determining the date of death value but the court held that the sale price was relevant because the sale was at arm’s length with an unrelated party. The court adjusted the sales price by 30 percent for the time period elapsing after the date of death and for the decedent’s minority interest to determine the date of gift and date of death value of $50 per share. The ruling is silent as to how the 30 percent discount figure was reached, except to base it on the court’s “common sense, knowledge and experience” because the record did not provide any basis for the court’s determination. Scanlan v. Comm’r, T.C. Memo. 1996-331.

The taxpayers owned stock in a closely-held family corporation. The stock was subject to transfer restrictions which restricted the transfer of stock outside the family or gave the corporation a right of first refusal if any stock was to be sold outside the family. Although the court acknowledged that the transfer restriction decreased the value of the stock for gift tax purposes, the financial strength of the corporation offset that factor. The court held that a 30 percent discount for decreased marketability would be applied to the fair market value of the stock. Mandelbaum v. Comm’r, 96-2 U.S. Tax Cas. (CCH) ¶ 60,240 (3d Cir. 1996), aff’g, T.C. Memo. 1995-255.

FEDERAL INCOME TAXATION

COST OF GOODS SOLD. The taxpayer operated a small farm which raised livestock and crops. The taxpayer’s returns for several years listed the costs of goods sold for the purchase and sale of livestock. The taxpayer did not keep permanent records and failed to substantiate many of the purchases and sales of livestock. The court held that the cost of goods sold could not include the costs of livestock not sold during a taxable year. The taxpayer also valued the livestock at an estimated fair market value which the court disallowed because of lack of proof that the fair market value was less than the taxpayer’s cost in the animals and because the taxpayer indicated on the return that inventory was valued at cost. Schroeder v. Comm’r, T.C. Memo. 1996-336.

INvoluntary CONVERSIONS. The taxpayers purchased 59.7 acres of rural land in 1988 for the purpose of developing the land as a residential subdivision. The taxpayers had a wetlands assessment made under the 1987 Wetlands Manual published by the U.S. Army Corps of Engineers which concluded that the land could be developed under existing rules. The taxpayers did not file for a permit to develop the land under the 1988 rules. In 1989, the wetlands manual was changed to the extent that the taxpayers were advised that the land was protected from development under the new rules. The taxpayers claimed a deduction under I.R.C. §§ 169, 1231 for the taking of the land by the effect of the new regulations. The taxpayers did not apply for a development permit until 1991. The court held that the taxpayers were not entitled to an involuntary conversion loss because no attempt to obtain a permit was made until well after the new rules were effective. Moore v. United States, ___ F. Supp. ___ (E.D. Va. 1996).

The taxpayer was a corporation owned, in part, by another corporation and by individuals. A manufacturing facility owned by the taxpayer was destroyed by Hurricane Andrew and the taxpayer received insurance proceeds in excess of the income tax basis of the destroyed facility. The taxpayer elected to defer gain under I.R.C. § 1033. The corporate stockholder purchased a replacement facility and planned to purchase the individual’s stock in the taxpayer and liquidate the taxpayer. The IRS ruled that the new facility did not qualify as replacement property because it was not purchased by the taxpayer. The IRS ruled that the reorganization of the taxpayer into the corporate stockholder did not affect the result because the
reorganization occurred after the purchase of the new facility. Ltr. Rul. 9630010, April 23, 1996.

LIMITED LIABILITY COMPANIES. A general partnership registered as a limited liability company (LLC) in another state. Under the state LLC law, the death or bankruptcy of a member dissolved the LLC. The IRS ruled that the LLC lacked the corporate characteristic of continuity. The LLC agreement provided that no new members may be admitted without the consent of at least two-thirds of the existing members. The IRS ruled that the LLC lacked the corporate characteristic of free transferability of interests; therefore, the LLC would be taxed as a partnership for federal income tax purposes. Ltr. Rul. 9630012, April 25, 1996.

PENSION PLANS. For plans beginning in July 1996, the weighted average is 6.92 percent with the permissible range of 6.23 to 7.47 percent (90 to 109 percent permissible range) and 6.23 to 7.61 percent (90 to 110 percent permissible range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). Notice 96-38, I.R.B. 1996-31, 29.

REPAIRS. The taxpayer purchased two farm properties which the taxpayer used for raising livestock and crops on a small scale. Several of the buildings on the properties were in such disrepair that the taxpayer had them demolished. The taxpayer refurbished a barn on one property by prepping, treating and repainting the wood; repouding nails; replacing a few tin sheets on the roof; sealing nail holes; and painting the roof. The taxpayer also replaced two support beams in the barn and built a dividing wall to create stall space for horses. The IRS argued that all of these expenses were capital as part of a general plan of rehabilitation. The court held that the support beams and new dividing wall were capital expenses but that the other expenses were currently deductible as repairs. The cost of demolishing the buildings was to be capitalized. The court held that the rule of requiring capitalization of all costs of a general plan of rehabilitation applied only where the costs were substantial. Here, the only substantial cost was from demolishing one larger building, a capital cost. Schroeder v. Comm’r, T.C. Memo. 1996-336.

RESEARCH AND DEVELOPMENT EXPENSES. The taxpayer purchased five racehorses through a corporation which purchased racehorses for the purposes of selling interests in the horses to investors. The sole shareholder of the corporation was the taxpayer’s accountant. The taxpayer was a medical doctor who also was in the business of developing champion racehorses. The taxpayer testified that the five horses were purchased as part of research into the taxpayer’s theories about developing racehorses based on bloodlines. The taxpayer’s accountant advised the taxpayer that the horses were eligible for the research and development expense deduction and the taxpayer so claimed the horses on income tax returns. The court held that the cost of the horses was not a research cost and disallowed the deduction. The court, however, held that the taxpayer had reasonably relied on the advice of the accountant and was not liable for the accuracy-related penalty of I.R.C. § 6662(a). Sheehy v. Comm’r, T.C. Memo. 1996-334.

SAFE HARBOR INTEREST RATES

<table>
<thead>
<tr>
<th></th>
<th>August 1996</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Annual</td>
</tr>
<tr>
<td><strong>Short-term</strong></td>
<td></td>
</tr>
<tr>
<td>AFR</td>
<td>6.15</td>
</tr>
<tr>
<td>110% AFR</td>
<td>6.78</td>
</tr>
<tr>
<td>120% AFR</td>
<td>7.40</td>
</tr>
<tr>
<td><strong>Mid-term</strong></td>
<td></td>
</tr>
<tr>
<td>AFR</td>
<td>6.84</td>
</tr>
<tr>
<td>110% AFR</td>
<td>7.54</td>
</tr>
<tr>
<td>120% AFR</td>
<td>8.24</td>
</tr>
<tr>
<td><strong>Long-term</strong></td>
<td></td>
</tr>
<tr>
<td>AFR</td>
<td>7.21</td>
</tr>
<tr>
<td>110% AFR</td>
<td>7.94</td>
</tr>
<tr>
<td>120% AFR</td>
<td>8.68</td>
</tr>
</tbody>
</table>

DISCHARGE OF INDEBTEDNESS. An S corporation was a debtor in bankruptcy and as part of the reorganization plan, the corporation reorganized as a new C corporation in an I.R.C. § 368(a)(1)(G) reorganization. The holders of senior subordinated notes of the S corporation received stock in the new corporation with a fair market value less than the amount of the notes. The IRS ruled that the S corporation realized discharge of indebtedness income from the exchange of notes for stock but that the income was not recognized because the corporation was in bankruptcy at the time of the exchange. Instead, the corporation reduced its tax attributes to the extent of the discharged indebtedness. Ltr. Rul. 9629016, April 22, 1996.

PASSIVE INVESTMENT INCOME. The taxpayer owned 51 percent of two corporations. The taxpayer performed services for these corporations and 30 other family owned corporations but did not keep any written log of the hours worked for each corporation or the type of work performed. The taxpayer provided only general testimony as to the taxpayer’s recollections of how many hours were worked for the corporations. The court held that the testimony was insufficient to substantiate the hours worked or the type of work performed for the corporations; therefore, the taxpayer failed to demonstrate that the taxpayer performed more than 100 hours of work for the corporation in which the taxpayer owned 51 percent of the stock. The corporate losses were held to be passive activity losses. Speer v. Comm’r, T.C. Memo. 1996-323.

The taxpayer leased construction equipment and a radio tower. The taxpayer’s employees negotiated, provided and monitored the leases, provided security for the tower, provided maintenance and repairs for the construction

*Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.*
equipment, and provided general maintenance of the tower. The taxpayer provided insurance for the equipment and tower. The IRS ruled that the rental income from the leases was not passive investment income. *Ltr. Rul. 9630007*, April 19, 1996.

**TAXPAYER RIGHTS.** The Congress has passed and the President has signed a bill amending the Taxpayer’s Bill of Rights. The amendments include (1) an increase to $100,000 in the amount of recovery allowed for lawsuits against the IRS for reckless collection; (2) an increase in the ability of the Office of Taxpayer Advocate to intercede on behalf of taxpayers; (3) a requirement that the IRS notify a taxpayer of actions against the taxpayer’s spouse or former spouse for joint liabilities; (4) an increase in the hourly legal fees recoverable; (5) a requirement that the IRS annually notify taxpayers of the amount of tax, penalty and interest currently due; and (6) a requirement that the IRS give 30 days notice before terminating a tax installment payment agreement. *HR 2337*, signed July 30, 1996.

**GIFTS**

**COMPLETED GIFT.** The father of the debtor owned a farm consisting of two parcels, 100 acres which included the residence and a separate 40 acres. The debtor and his two sons lived on the farm with the father and helped operate the farm. The father’s will bequeathed the entire estate to the debtor and the debtor’s brother and the probate schedules included the entire farm in the estate. The estate sold the smaller parcel to one of the debtor’s sons but the probate proceedings were dismissed before the remainder of the estate was administered. A portion of the 100 acre parcel was placed in the Conservation Reserve Program and a portion was leased to a third party, with the rent payments made to the debtor under both contracts. After a judgment was recorded against the debtor, the probate proceeding was reopened and the debtor recorded a deed from the father which conveyed the 100 acres to the debtor’s brother 32 days before the father’s death. When the debtor filed for bankruptcy, the 100 acres was not included in the estate. The deed was signed by the father and the evidence indicated that the deed was in the brother’s possession soon after the deed was signed. The court found that the deed was signed by the father and that delivery of the deed was completed. The court noted that the activities of the parties were consistent with transfer of ownership in that the 100 acres were not administered in the first probate proceedings and that the brother paid the real estate taxes on the property. The court also noted that, although the CRP and lease payments were made to the debtor, the brother most likely allowed these payments to be made to the debtor because of the debtor’s financial needs. Therefore, the court held that the deed was sufficient to transfer title to the property to the debtor’s brother and was not included in the debtor’s bankruptcy estate. *In re Neiderer*, 196 B.R. 417 (Bankr. C.D. Ill. 1996).

**SECURED TRANSACTIONS**

**ARTISAN’S LIEN.** The debtor had purchased a farm tractor which was subject to security interests granted to creditors. The debtor contracted with a repair shop for an engine overhaul of the tractor. The repair shop repaired the tractor and returned the tractor to the debtor even though the repair bill was not paid. The debtor later returned the tractor to the repair shop for warranty maintenance which the repair shop performed. This time the repair shop retained the tractor for nonpayment of the first repair bill and retained the tractor until ordered by the Bankruptcy Court to release it to the estate. The repair shop asserted a priority statutory artisan’s lien for both repair bills, under Mich. Comp. Laws §§ 570.186, .187. The court held that the statute creates and continues the lien so long as the artisan retains possession of the item on which the work was performed; therefore, because the repair shop released the tractor after the first repair, the first repair bill was no longer secured under the artisan’s lien provision. Because the repair shop retained possession of the tractor after the second repair, the second repair bill was secured under the artisan’s lien. The court also held that the lien was not avoidable because it did not arise as a result of the bankruptcy filing. *In re Lott*, 196 B.R. 768 (Bankr. W.D. Mich. 1996).

**ZONING**

**AGRICULTURAL USE.** The defendants owned 24 acres of land in an area zoned residential/agricultural under a township ordinance. The ordinance prohibited retail sales in the area. The defendants used the property as their residence and for farming but also conducted a retail business of selling horses, tack, feed and wood shavings. The defendants applied for a special use permit but the permit was never issued. The defendants stored some of the inventory in two commercially licensed trailers parked on the property, although the defendants knew that external storing and parking of commercial trailers were also prohibited under the zoning ordinance for the area. Also in violation of the ordinance, the defendants stored various pieces of equipment, supplies and storage tanks within view of the public. The township and defendants attempted to solve the problem by issuance of a Planned Unit Development Permit but the defendants failed to comply with the application requirements and the PUD permit was not issued. The township then sought to enforce the zoning requirements. The defendants argued that the township was estopped from enforcing the zoning restriction because of the delay in seeking enforcement. The court held that the township was not estopped because the defendants failed to show any wrongful conduct by the township and because the delay was partially caused by the defendants’ failure to complete the PUD application process. The court also held that the storage of inventory and the retail sale of horses, tack, feed and wood shavings were not an agricultural use of the land because the storage and sales were not part of livestock or crop production. *Stillwater Township v. Rivard*, 547 N.W.2d 906 (Minn. Ct. App. 1996).
SEMINAR IN PARADISE
FARM ESTATE AND BUSINESS PLANNING by Dr. Neil E. Harl
January 6-10, 1997

Spend a week in Hawai‘i in January 1997! Balmy trade winds, 70-80 degrees, palm trees, white sand beaches and the rest of paradise can be yours; plus a world-class seminar on Farm Estate and Business Planning by Dr. Neil E. Harl. The seminar is scheduled for January 6-10, 1997 at the beautiful ocean-front Royal Waikoloan Resort on the Big Island, Hawai‘i.

Seminar sessions run from 8:30 a.m. to 12:30 p.m. each day, Monday through Friday, with a continental breakfast and break refreshments included in the registration fee. Each participant will receive a copy of Dr. Harl's 400 page seminar manual, Farm Estate and Business Planning: Annotated Materials which will be updated just prior to the seminar.

Here are the major topics to be covered:
- Introduction to estate and business planning.
- Liquidity planning with emphasis on 15-year installment payment of federal estate tax.
- Co-ownership of property, including discounts, taxation and special problems.
- Federal estate tax, including alternate valuation date, special use valuation, handling life insurance, marital deduction planning, disclaimers, planning to minimize tax over deaths of both spouses, and generation skipping transfer tax.
- Gifts and federal gift tax, including problems with future interests, handling estate freezes, and "hidden" gifts.
- 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.
- Using trusts, including funding of revocable living trusts.
- Organizing the farm business--one entity or two, corporations, general and limited partnerships and limited liability companies.

The Agricultural Law Press has made arrangements for discount air fares on United Airlines and discounts on hotel rooms at the Royal Waikoloan, the site of the seminar.

The seminar registration fee is $645 for current subscribers to the Agricultural Law Digest or the Agricultural Law Manual. The registration fee for nonsubscribers is $695.

Watch your mail for more details or call Robert Achenbach at 1-541-302-1958.

ISSUE INDEX

Bankruptcy
General
Discharge 118
Preferential transfers 118
Reopening of case 119
Chapter 12
Conversion 119
Plan 119
Federal taxation
Discharge 119
Estate property 119
Passive activity losses 119
Setoff 119

Federal Agricultural Programs
Farm loans 120
Peanuts 120

Federal Estate and Gift Tax
Charitable deduction 120
Disclaimers 120
Generation skipping transfers 120
Valuation 121

Federal Income Taxation
Cost of goods sold 121
Involuntary conversions 121
Partnerships
- Limited liability companies 122
Pension plans 122
Repairs 122
Research and development expenses 122

Safe harbor interest rates
August 1996 122
Sale of residence 122
S corporations
Discharge of indebtedness 122
Passive investment income 122
Taxpayers’ rights 123

Gifts
Completed gift 123

Secured Transactions
Artisan’s lien 123

Zoning
Agricultural use 123
FUNDING MARITAL AND NON-MARITAL DEDUCTION PORTIONS: THE POSSIBILITY OF A DISCOUNT

— by Neil E. Harl*

Funding the marital and non-marital shares in a farm or ranch estate is always an important decision if a spouse survives unless all property is left outright to the surviving spouse.1 Planning attention needs to be given to - (1) the type of clause used to create and fund the marital deduction,2 (2) whether gain is triggered on funding the marital share,3 (3) how to assure compliance with Rev. Proc. 64-19,4 (4) how to fund the shares with land under special use valuation,5 (5) planning for sale of property after the death of the surviving spouse with a minimum amount of gain6 and how to use the generation skipping transfer tax $1 million exemption for maximum advantage.7 In addition, a recent Fifth Circuit Court of Appeals case has opened up another possible funding consideration—obtaining a discount for co-ownership of the property involved at the death of the surviving spouse.8

Availability of a discount

Discounts in valuing minority interests and discounts for non-marketability have become almost routine in recent years in valuing farm and ranch real property for federal gift tax and federal estate tax purposes.9 Since 1989,10 the courts have generally approved discounts ranging up to 40 percent11 even though the Internal Revenue Service continues to assert that discounts should be limited to the cost of partitioning the property.12

Discounts related to marital share ownership

The case of Estate of Bonner v. United States13 has opened up the possibility of a discount for property interests held by the marital share even though the non-marital share ownership interest is held by family members.

In Bonner,14 individual interests in ranchland, other real property and a boat were left at the first spouse's death in a qualified terminable interest property (QTIP) arrangement (eligible for the federal estate tax marital deduction)15 with the surviving spouse as the life beneficiary. At the surviving spouse's death, which was the focus of the case,16 the undivided interests in the property in question held in the QTIP were included in the surviving spouse's estate.17 with the remainder interest presumably held by unidentified beneficiaries. The other undivided interests in the property were also held by the surviving spouse and were included in the surviving spouse's estate.18 Thus, the entire ownership interest in the property ended up being included in the surviving spouse's estate.

The estate claimed a 45 percent discount on the value of the ranchland and also claimed a discount on the other real property and the boat. The Internal Revenue Service objected on the grounds that the property ownership merged at the time of the surviving spouse's death, extinguishing the fractional undivided interest and resulting in 100 percent fee simple ownership of assets by the estate.19 The IRS position was consistent with published rulings in similar fact situations.20

The court was unimpressed by the IRS argument, reversed the district court decision and took the position that the case was controlled by Estate of Bright v. United States.21 In that case, the surviving spouse held a 27 1/2 percent interest in an asset as executor of his wife's estate and an additional 27 1/2 percent interest in the same asset in his individual capacity.22 The court rejected the argument that the interests should be treated as one 55 percent interest in the asset.23

The Bright decision has been followed by the Ninth Circuit Court of Appeal24 but criticized by the Seventh Circuit.25

The court in Bonner26 concluded that, for federal estate tax purposes, the determination of tax liability is made as of the moment of death, not before death and not after death. The Fifth Circuit remanded the case to the lower court to calculate the appropriate discount.

Implications for planning

One lesson from Bonner27 is that funding marital and non-marital shares with undivided interests such as with a fractional share clause28 positions the estate to claim a discount in valuation at death. That assumes, of course, that the Bonner result will be possible outside the Fifth Circuit Court of Appeal area. Bonner arose in a community property state but the same argument can be made with tenancy in common ownership in other jurisdictions.

---

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
The potential disadvantage of undivided interests is that IRS may take the position that, on later sale by individuals receiving undivided interests through both the marital and non-marital shares, it may not be possible to maintain the different (usually higher) income tax basis for the interest passing through the marital share with the result that a sale of an undivided interest involves a proportionate part of each basis amount. Thus, the basis amounts for the two interests may merge after death.

**FOOTNOTES**

2. See 5 Harl, supra n. 1, § 44.02[4]; Harl, supra n. 1, § 5.04[3][c][ii].
3. See 5 Harl, supra n. 1, § 44.02[5][a]; Harl, supra n. 1, § 5.04[3][c].
5. See 5 Harl, supra n. 1, § 44.02[5][b]; Harl, supra n. 1, § 5.04[3][d][ii].
7. See 5 Harl, supra n. 1, § 44.08[3]; Harl, supra n. 1, § 5.04[6][d].
8. Estate of Bonner v. United States 84 F.3d 196 (5th Cir. 1996) (ranched and other property).

**CASES, REGULATIONS AND STATUTES**

**BANKRUPTCY**

**GENERAL-ALM § 13.03.*

PLAN. The debtor's plan provided for satisfaction of a secured claim by transferring a portion of the farm land collateral to the creditor. The creditor objected to the plan as not providing payment of the value of its claim. The court valued the farm land on the basis of the land's development potential because much of the land in the area was held for investment. However, because only a portion of the collateral land was being transferred the court required that the plan provide for an "indubitable equivalent" of the debtor's claim to be paid to the creditor. The court noted that, because the valuation of the land was uncertain and any sale would not be feasible for at least two years, any valuation established by the court could lead to the creditor receiving less than the value of the claim when the land was sold. Although the court did not require any specific remedy for approval of the plan, the discussion suggests that the creditor receive a lien on any collateral retained by the debtor until the land is sold so that the creditor can seek any deficiency against the remaining collateral. In re Arnold & Baker Farms, 85 F.3d 1415 (9th Cir. 1996), aff'g, 177 B.R. 648 (Bankr. 9th Cir. 1994).

**CHAPTER 12-ALM § 13.03[8].**

ELIGIBILITY. Prior to filing for Chapter 12, the debtors operated a hog farm. The debtors suffered losses in their herd from disease which precipitated the bankruptcy filing. Prior to filing a plan, the debtors turned over all remaining livestock to the secured creditor. The plan provided for full payment on an installment contract for the purchase of the farm land. The land was owned by the debtors and one debtor's mother, who was not a co-debtor in bankruptcy. One effect of the plan payments was to pay the mother's share of the obligation on the farm without any contribution from the mother. During the life of the plan, the debtors' primary income would be from nonfarm employment and the debtors expressed the intent to use

---

*Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.
whatever extra income remained to rebuild the livestock herd for the farm; however, this time the animals would be sheep. The debtors did not provide any specific estimates about the number of sheep to be purchased or the costs of or income from raising the sheep. During the plan, the debtors intended to lease some of the farm land for pasture and one debtor planned to provide horse breaking services for a neighbor. However, again, the debtors did not provide specific details as to the amount of income reasonably expected from these activities. The court held that the debtors were not entitled to be Chapter 12 debtors and dismissed the case for bad faith filing in that the plan provided for payment of a nondebtor’s obligations, the debtors had little chance to successfully reestablish farming during the plan and the debtors had caused several delays in prosecuting their case. In re Buckingham, 197 B.R. 97 (Bankr. D. Mont. 1996).

TRUSTEE FEES. The debtor’s Chapter 12 plan provided for a trustee’s fee of 10 percent of the payments to be made to the creditors. The trustee objected to the plan, arguing that the fee was to be applied to the payments made to the trustee, resulting in a 11.11 percent charge against the payments to be made to the creditors. The court held that the statutory fee of 10 percent was unambiguous and was limited to 10 percent of the property to be paid to the creditors. The court reasoned that, because the statute assessed the fee against “the payments made under the plan” and because only the trustee makes the plan payments, the fee could not be assessed to payments made to the trustee by the debtor. In re Wallace, 197 B.R. 82 (E.D. Mo. 1996), aff’d, 167 B.R. 531 (Bankr. E.D. Mo. 1994).

The debtor’s Chapter 12 plan provided for payment of the only three creditors, two governmental units and the FmHA (now FSA). The plan provided for direct payments of the secured claims and payments of unsecured claims from disposable income through the trustee. The trustee objected to direct payments. The court held that, because the creditors were sophisticated creditors, the debtor could make direct payments without payment of the trustee fee. Matter of Cross, 197 B.R. 321 (D. Neb. 1996), aff’d, 182 B.R. 42 (Bankr. D. Neb. 1995).

CHAPTER 13-ALM § 13.03.*

PLAN. The debtors’ Chapter 13 estate included a residence with $1,700 of nonexempt equity and personal property with $5,199 of nonexempt equity. The Chapter 13 plan proposed to pay unsecured creditors $1,795. In determining the amount creditors would receive in a Chapter 7 liquidation, the costs of sale of the residence plus the costs from capital gains from the sale of the residence would leave nothing for payment to creditors from the residence. If the residence was not sold by the hypothetical Chapter 7 trustee, the sale of the personal property would net $3,400 for unsecured creditors. The Chapter 13 trustee argued that, in determining whether a Chapter 13 plan is fair to creditors under Section 1325(a)(4), the second scenario should be followed because a Chapter 7 trustee would not administer an asset which would not bring any benefit to the estate. The court agreed and held that the debtors’ Chapter 13 plan could not be confirmed because it did not provide payments at least equal to the $3,400 that would be available from the sale of the personal nonexempt assets. In re Gayton, 197 B.R. 331 (Bankr. D. Colo. 1996).

FEDERAL TAXATION-ALM § 13.03[7].*

ALLOCATION OF TAX PAYMENTS. The debtors previously filed Chapter 7 case. The Chapter 7 trustee obtained funds in settlement of a preferential transfer action and applied the funds to payment of the debtors’ federal tax claims. The trustee directed that the payments be made for 1982 taxes owed by the debtors, taxes which were dischargeable in the present Chapter 13 case. The debtors filed a motion in the Chapter 13 case to have the trustee’s payments in the Chapter 7 case reallocated by the IRS to nondischargeable taxes. The court held that debtors in Chapter 7 are not entitled to allocate tax payments made in the case; therefore, the payment could not be reallocated in the Chapter 13 case. In re Ferguson, 197 B.R. 161 (Bankr. S.D. Fla. 1996).

DISMISSAL. In a prior Chapter 13 case, the debtor and IRS entered into a consent agreement which established the amount of the IRS claim and the amount of the secured portion of the claim. That case was dismissed before any distributions were made to the IRS. The debtors filed a second Chapter 13 case and sought to limit the IRS claim to the amount in the consent agreement in the first case. The IRS sought to include additional penalties and interest which accrued during the interim between filings. The court held that the dismissal of the first case vacated the consent agreement. United States v. Hampton, 197 B.R. 297 (E.D. Ark. 1996).

CONTRACTS

GUARANTEE. The defendant originally was a partner in a farming partnership with one other partner. The partnership applied for an open line of credit with the plaintiff but the plaintiff required both partners to personally guarantee the obligations of the partnership. The guarantee agreement required any revocation of the guarantee to be made in writing. The defendant signed the agreement but claimed to have not read it nor to have received a copy. The partnership was eventually dissolved and the defendant sold all interest in the concern to a corporation formed by the other former partner. The defendant orally made a request to an officer of the plaintiff to revoke the defendant’s guarantee of the corporation’s obligations with the plaintiff. At that time, no balance remained on the account. The officer of the plaintiff informed the defendant a week later that the guarantee was released. However, the corporation later defaulted on the line of credit and the plaintiff sought payment from the defendant under the guarantee. The defendant argued that the plaintiff was estopped from enforcing the guarantee. The court held that the doctrine of estoppel was not available to the defendant because the defendant had, or should have had, the same knowledge as the plaintiff that any revocation of the guarantee was to be in writing to be effective. In addition, the defendant did not claim to have given any consideration for the revocation to support an oral modification of the guarantee contract. Farmland Industries, Inc. v. Bittner, 920 S.W.2d 581 (Mo. Ct. App. 1996).
FEDERAL AGRICULTURAL PROGRAMS

CROP INSURANCE. The FCIC has issued interim regulations which remove the restriction that precluded eligibility for crop insurance for producers who produce crops on predominately highly erodible land or on converted wetlands. 61 Fed. Reg. 38057 (July 23, 1996).

FARM LOANS. The FSA has issued proposed regulations which provide that a Notice of the Availability of Loan Service and Debt Settlement Programs for Delinquent Farm Borrowers will be sent after a borrower is dismissed from bankruptcy if the borrower was not previously notified and the account was not accelerated. 61 Fed. Reg. 37405 (July 18, 1996).

TOBACCO. The CCC has adopted as final the 1996 marketing quota for flue-cured tobacco at 873.6 million pounds and a 1996 price support level of 106.1 cents per pound. 61 Fed. Reg. 37672 (July 19, 1996).

FEDERAL ESTATE AND GIFT TAX

GROSS ESTATE. The decedent had owned stock with the decedent’s predeceased spouse as tenants by the entirety. The stock was received when the corporation, owned in part by the spouse, transferred the stock to the decedent’s spouse and the decedent who took ownership with the decedent as tenants by the entirety. In October 1986, the decedent and spouse transferred $140,000 of stock to their two children for life with remainders to their grandchildren. The decedent and spouse elected to treat the gift as a split gift with each claiming a gift of $70,000 less two $10,000 exclusions. The spouse died within three years after the gift and the estate included the taxable gift of $50,000 in the gross estate. Under I.R.C. § 2001(e), if a joint gift was entirely includible in the spouse’s estate under I.R.C. § 2035, then none of the gift was included in the decedent’s estate. The court held that the gift was not included in the spouse’s estate under I.R.C. § 2035 but was included in the spouse’s estate under I.R.C. § 2001(b) as a taxable gift. The estate argued that the decedent received the stock for no consideration, the full amount of the gifted stock should have been included in the spouse’s gross estate under I.R.C. § 2040. The court held that I.R.C. § 2040 did not apply because the gifted stock was not owned by the spouse and decedent at the time of the spouse’s death. The court acknowledged that, under I.R.C. § 2035(a), property transferred within three years of death is treated as owned by the decedent; however, the court held that I.R.C. § 2035 did not apply because the stock was included in the spouse’s estate by virtue of I.R.C. § 2001(b). Estate of Greco v. Comm’r, T.C. Memo. 1996-373.

INTEREST DEDUCTION. The decedent’s estate included substantial stock holdings in a family owned corporation. The decedent’s will provided for authority for the executor to elect the 15-year installment payment of estate tax. The stock was also subject to sale restrictions which included provisions for repurchase of the decedent’s stock in order to make the installment payments. However, at the death of the decedent, the payment of estate taxes, even with deferral by installment payment, would have required the repurchase of a large number of shares at a time when the corporation could not afford the repurchase. The executor decided to borrow the funds for payment of the full estate tax and incurred interest payments which the executor claimed as a deduction on the estate’s initial and amended returns. The IRS argued that the decedent’s will required the election of installment payment of estate tax and disallowed the interest deduction. The court held that under the decedent’s will and state law, the executor had the discretion to elect how to pay the estate tax, and because, under the circumstances, the executor’s election to borrow the funds was advantageous to the estate and the corporation, the interest deductions were allowed. Estate of McKeel v. Comm’r, T.C. Memo. 1996-351.

FEDERAL INCOME TAXATION

C CORPORATIONS-ALM § 7.02.*

STOCK REDEMPTION. The taxpayers each owned one-half of the stock of a corporation. The taxpayer each had been annually transferring stock to their children who had been actively involved in the management of the corporation for several years. The taxpayers sold some of the remaining shares to the children for cash and had the corporation redeem the remaining shares for a note at fair market value. The note was for less than 15 years, the payment of the note was not dependent upon corporate profits, the taxpayers had no rights under the note or other agreement to receive shares in the corporation in the event of a default of the note, the taxpayer had no interests in the corporation after the redemption and the taxpayers executed an I.R.C. § 302(c)(2)(A)(iii) agreement prohibiting the reacquisition of any interest in the corporation for at least 10

* Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.
years. The IRS ruled that the redemption was not entered into for the purpose of avoiding payment of taxes, the redemption would be treated as a distribution in full payment of stock, the taxpayers recognized gain based on the difference between their adjusted basis in the stock and the redemption price, the taxpayers could recognize gain on the note on the installment method, no loss was recognizable in the transaction, and the corporation did not recognize any gain or loss on the transaction. Ltr. Rul. 9632008, May 10, 1996; Ltr. Rul. 9632009, May 10, 1996.

CASUALTY LOSSES-ALM § 4.05[1]. The taxpayer corporation operated several timberlands which were infected with southern pine beetles. Although the beetles were always present in the timberlands, in several tax years, the beetles caused major damage to the taxpayer’s timber. The court held that because an infestation of beetles can kill a tree within days, the infestation at epidemic proportions was a deductible casualty loss. The court held, however, that the taxpayer was not entitled to any deduction because the taxpayer’s records were insufficient to prove the amount of loss. The taxpayer also had several forests destroyed by fires and one tract destroyed by the eruption of Mount St. Helens. The court held that the fires and eruption were casualty events allowing the taxpayer a deduction for the loss of trees. The appellate court affirmed on these issues. The taxpayer had used the depletion block method of determining the loss from the casualties. The IRS argued that the “tree stand” method should have been used. The trial court had overruled precedent and ruled that the tree stand method should have been used. The appellate court reversed on this issue, holding that the precedent should have been followed, allowing the depletion block method for determining the amount of loss. The taxpayer began salvage logging of the affected areas and recognized gain from the income from these activities. The IRS had allowed the taxpayer to recognize these gains under I.R.C. § 1033. The trial court held that the taxpayer was not required to offset these gains against the losses. The appellate court affirmed this holding because the salvage operation were considered separate activities from the casualties. Weierhaeuser Co. v. U.S., 96-2 U.S. Tax Cas. (CCH) ¶ 50,420 (Fed. Cir. 1996), aff’d in part and rev’d in part, 32 Fed. Cl. 80 (1994).

CONSERVATION EASEMENT. The taxpayers owned ranch land which included developed and undeveloped land. The taxpayers transferred a conservation easement to a charitable organization for the purpose of maintaining the natural, scenic and open space conditions of the land. The land had been determined to have important wildlife preservation qualities. The easement, in general, prohibited the further development of the area which adversely impacted the scenic views, the agricultural use and the wildlife on the land. The easement gave the organization the authority to prohibit the taxpayers from further development of the land which adversely impacted the goals of the easement, although the taxpayers were allowed to build a second residence on the land and to add additional improvements to the existing homestead ranch. The subsurface mining rights were retained in part by previous owners but the taxpayers presented evidence by mineral experts that no significant amounts of minerals existed under the surface. The taxpayers retained rights to the surface mining but the easement granted the organization the right to prohibit such mining if it adversely impacted the goals of the easement. The IRS ruled that the transfer of the easement qualified for the charitable deduction. Ltr. Rul. 9632003, May 7, 1996.

DEPRECIATION-ALM § 4.03[4]. The taxpayer corporation made improvements to its buildings used in its restaurant business and claimed depreciation under the Asset Depreciation Range for buildings placed in service before January 1, 1981 and ACRS for improvements to buildings placed in service after December 31, 1980. The taxpayer argued that the improvements were included in the ADR Class 57.0 as improvements that were part of the structural shell of the buildings. The Tax Court held that I.R.C. § 1250 property was not included in the ADR Class 57.0 by statute unless the IRS explicitly includes the property in the class. Because the IRS has not included the property in the class, the improvements had to be depreciated using the 15-year recovery period for real property. The appellate court reversed, holding that the property classified under Class 65.0 could be depreciated based on a 10-year useful life. On remand, the Tax Court noted that the parties agreed that assets which could be included under both categories would be classified as Class 57.0 property. The Tax Court held that items such as interior partitions, ceiling systems, electrical lighting, and floor finishes could fit under both categories; therefore, these items were Class 57.0. Other items, such as decor finishes and decorative canopies were only included as Class 65.0 property because these items were more closely related to the operation of a restaurant and not to the building structure. Walgreen Co. v. Comm’r, T.C. Memo. 1996-374, on rem. from, 68 F.3d 1006 (7th Cir. 1995), rev’d, 103 T.C. 582 (1994).

HOBBY LOSSES-ALM § 4.05[1]. The taxpayer was a doctor who operated a horse farm. The court held that losses incurred by the horse farm activity were not allowed because the farm was not operated for profit where the farm had suffered substantial continuing losses without much chance of future profits. The appellate decision is designated as not for publication. Borsody v. Comm’r, T.C. Memo. 1993-534, aff’d, 96-2 U.S. Tax Cas. (CCH) ¶ 50,415 (4th Cir. 1996).

LOSSES. The taxpayer’s employment was terminated and the taxpayer sued the employer for wrongful termination, seeking $200,000 in damages for lost wages. The parties settled for $27,000. The taxpayer claimed the difference as a loss. The court held that the mere expectation of payment was insufficient to support the deduction. Kukes v. Comm’r, T.C. Memo. 1996-363.

PENSION PLANS. The taxpayer suffered a downturn in business and had to make premature withdrawals from SEP and Keogh plans to pay debts. The taxpayer included the payments in gross income but did not pay the 10 percent additional tax of I.R.C. § 72(t). The taxpayer argued that, although not provided in the statute, there should be an exception to the additional tax for withdrawals necessitated by financial hardship. The Tax Court refused to recognize any exception not specifically provided in the statute and
held that the taxpayer was liable for the 10 percent additional tax. Pulliam v. Comm’r, T.C. Memo. 1996-354.

The taxpayer owned an interest in a qualified retirement plan through the taxpayer’s employer. The taxpayer was 36 when the taxpayer withdrew $50,000 from the plan and used the funds to purchase a family residence. The court held that the use of the funds to purchase a home was not a transfer to an eligible retirement plan and caused the funds to be included in the taxpayer’s gross income, plus a 10 percent penalty for early withdrawal. Coffield v. Comm’r, T.C. Memo. 1996-365.

PREPRODUCTION EXPENSES. In 1985, the taxpayer purchased a corporation which owned farm land and intended to use the land for the production of ornamental trees. In 1985, the taxpayers cleared the land, bought seedlings and planted the trees. In 1986, the taxpayers’ expenses were substantially preproductive expenses for the maintenance of the trees. The court acknowledged that for 1985 and 1986, the taxpayers had the election to deduct or capitalize these expenses. The taxpayers incurred similar expenses in 1987 through 1990 because the trees were still not ready for sale, although the trees should have been ready within three years of planting. The taxpayers claimed the 1985-1990 expenses as business deductions and the court held that this constituted an election by the taxpayers not to capitalize the expenses. The taxpayers sought to file amended returns for 1987-1990 to revoke the election. The court held that the taxpayers could not revoke the election without the consent of the IRS. Hodel v. Comm’r, T.C. Memo. 1996-348.

SALE OF RESIDENCE. The taxpayer had been married to and lived with a former spouse at one residence. The couple were divorced and as part of the divorce settlement, the former spouse was allowed to live at the marital residence with the provision that when the residence was sold, each would receive one-half of the proceeds. The taxpayer went to live with another person and eventually married that person. The former residence was sold with the provision that when the residence was sold, each would receive one-half of the proceeds. The court acknowledged some split in authority on the issue but followed the more recent precedents and held that the lien became effective only after the NFTL was filed. Sandclay Trucking, Inc., 96-2 U.S. Tax Cas. (CCH) ¶ 50,394 (M.D. Fla. 1996).

LANDLORD AND TENANT

EMBLEMENTS. The plaintiff purchased farm land from an estate. The decedent had leased the land to the defendant who grew Christmas trees on the property. The lease allowed termination by the decedent or successors in interest by at least 30 days’ notice prior to December 30 of each year. During the sale negotiations, the plaintiffs expressed concern about the lease and the defendant was approached for a release of the lease. The defendant signed a quitclaim deed releasing all rights in the real property. The sale was completed but the defendant continued to care for the trees on the property and removed 190 of them several months after the sale. The plaintiffs sued for timber trespass. The defendant argued that the doctrine of emblements allowed the removal of the trees because the lease was for an uncertain period and the trees were planted by the defendant before the termination of the lease. The defendant also claimed that the quitclaim deed was not voluntarily entered into because the defendant had defaulted on rent payments and was under the threat of termination of the lease. The court held that the defendant voluntarily executed the quitclaim deed because the default resulted from the defendant’s own actions. The court also held that the quitclaim deed also released the defendant’s emblements rights because the defendant’s rights in the trees passed under the deed as part of the realty. Taggart v. Battablia, 915 P.2d 1001 (Or. Ct. App. 1996).

TERMINATION NOTICE. In March 1994, the plaintiffs purchased farmland which was leased to the defendants by the sellers. (See case summary of issue of validity of the lease under Trusts, infra.) In May of 1994, the plaintiffs sent a notice of the termination of the lease, effective June 1, 1994, and demanded possession of the land by that date. The lease was found to be a year-to-year lease because the plaintiffs did accept some rent payments and was found to run with the calendar year. The defendants continued to retain possession until after the 1995 crop was planted and the defendant also sought rights to the planted crop. The defendants argued that the notice was ineffective to terminate the lease, under Mo. Stat. § 441.050, because the notice was not given 60 days before the end of the year. The court held that the statute required notice “not less than 60 days” prior to the end of the lease year; therefore, a notice of termination given seven months before the end of the year was effective to terminate the lease at the end of the year. The trial court had awarded the 1995 crop to the defendants with the right to harvest the crop and sell it, subject to payment of one-third to the plaintiffs less the costs of harvest. The appellate court remanded on this issue because the trial court failed to give any authority or findings of facts to support this ruling and because the holding summarized here reversed the trial court on the termination issue. Jansen v. Pobst, 922 S.W.2d 43 (Mo. Ct. App. 1996).

*Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.
NEGLIGENCE

SAFE WORKPLACE. The plaintiff was an employee of the defendant which operated a dairy farm. The plaintiff was injured while attempting to remove frozen feed from a conveyer in the milking barn. The plaintiff testified as to the dangers of working in the barn in cold weather when the high humidity in the barn and the cold winter air would often produce slippery conditions in all parts of the barn. However, the plaintiff had prepared testimony from experts that the method chosen by the plaintiff to clear the conveyer was the only reasonable method available. The plaintiff charged that the lack of alternative methods created an unsafe workplace. The defendant argued that the plaintiff realized and assumed the risk of using the method to clean the conveyer. The trial court had granted the defendant a summary judgment, but the appellate court reversed, holding that the plaintiff’s intended expert testimony was sufficient to raise a jury question as to whether the plaintiff had a choice in method of cleaning the conveyer. Mack v. Kranz Farms, Inc., 548 N.W.2d 812 (S.D. 1996).

PRODUCTS LIABILITY

TRACTOR. The plaintiff’s decedent was killed when the decedent’s tractor turned over while the decedent was operating it in a farm field. The plaintiff sued the manufacturer of the tractor in strict liability, claiming that the tractor was unreasonably dangerous because it did not have a Roll Over Protection System (ROPS ) installed. The defendant argued that the tractor was not dangerous because the lack of a ROPS was an obvious condition of the tractor. The court held that the open and obvious defense did not apply in Missouri because of the availability of the comparative fault rule. Because the jury award included a finding that the plaintiff’s decedent was 10 percent at fault, the jury award accounted for the decedent’s assumption of risk in operating the tractor without a ROPS. Miller v. Varity Corp., 922 S.W.2d 821 (Mo. Ct. App. 1996).

STATE REGULATION OF AGRICULTURE

AERIAL CROP SPRAYING. The appellant was fined $1,500 under Tex. Agric. Code § 76.116(a)(1) for the aerial spraying of a pesticide on an automobile on a public highway near cotton fields the appellant was spraying. The appellant argued that the evidence was insufficient to prove that the appellant sprayed the field on the day claimed. The evidence presented was the testimony of the occupants of the car and state inspectors who inspected the car and the field the day after the alleged spraying. The appellant’s major argument was that the description of the plane by the car occupants was incorrect. However, the occupants’ description of the plane’s colors was close, although not completely accurate, and the inspectors’ tests on the pesticide residue were consistent with the break down of the pesticide over one day. The court held that the fine was supported by substantial evidence. Lauderdale v. Texas Dept. Of Agric., 923 S.W.2d 834 (Tex. Ct. App. 1996).

APPLES. The plaintiffs were apple growers who had contracted with the defendant commission merchant to process, package, market and sell the plaintiffs’ apples on consignment. The contracts authorized the defendant to sell the apples to affiliated companies and to commingle the apples with other growers’ apples. The defendant sold some of the apples, commingled with other apples, to affiliated companies and the plaintiffs charged that these sales violated Wash. Rev. Code § 20.01.330(4) in that the defendant failed to give notice of the sales to affiliates. The defendant argued that the statute was not violated because the contracts allowed the sales of apples to affiliates. The court held that the contractual authority to make the sales was not equivalent to notice to the growers and held that the sales violated the statute. The defendant also argued that, because the apples were commingled as allowed by the contract, notice was not possible since the identity of the producer was lost. The court held that the statute provided no exception from the notice requirement for difficulty in making the notice. The jury had awarded the plaintiffs $38,000 in damages, representing the gross profits of the defendant from the affiliate sales. The court found that the defendant had not breached any fiduciary duties in the sales because the sales were authorized by the contracts, the defendant fully reported the sales to the plaintiffs and exercised prudent business judgment in making the sales. Therefore, the court held that the plaintiffs’ recovery would be limited to the net profits gained by the affiliates from the sales. St. Hilare v. Food Services of America, 917 P.2d 1114 (Wash. Ct. App. 1996).

TRUSTS

APPARENT AUTHORITY. The decedent had owned farm land with a predeceased spouse for several years and continued to own the land alone for several years but rented the land to the defendants. The decedent transferred the farm to a trust for the decedent’s children with the decedent retaining a life estate in the trust income. Although the lease payments were to be made to the trustees, the children, the decedent continued to personally collect the rent. The testimony of the trustees was that both trustees informed the defendants that the decedent no longer had the authority to sign contracts concerning the land. However, the defendants entered into two more long term leases with the decedent. After the decedent died, the land was sold to the plaintiff who informed the defendants that the lease was terminated and that the defendants should vacate the property in 60 days. (See summary of the issue of the termination of the lease under Landlord and Tenant, supra.) The plaintiffs argued that the lease was invalid in that the decedent had no authority to make the lease. The defendants argued that the trustees had ratified the lease by not objecting to it or by the practice of payment of the rent to the decedent. The court upheld the jury verdict that the lease was invalid, holding that there was sufficient evidence that the decedent did not have apparent authority to make the lease or that the defendants reasonably relied on the decedent’s conduct, since the defendants had notice of the trust. Jansen v. Pobst, 922 S.W.2d 43 (Mo. Ct. App. 1996).
ZONING

EXCEPTIONS. The petitioner owned farm land neighboring the respondents. The respondent had petitioned the county land use board (LUBA) for construction of a second residence on the respondent’s land. The respondent’s land had been zoned agricultural but had been rezoned for residential use which allowed the construction of only one residence on the property. Under Policy 8 of the county’s comprehensive zoning plan, protection of agricultural activities was to be of primary importance in zoning matters. The hearing officer and, on appeal, LUBA determined that Policy 8 did not apply because the respondent’s land was not used or zoned for agricultural activities. The court held that the hearing officer should have applied Policy 8 because the zoning change would impact neighboring farm land. Gutoski v. Lane County, 917 P.2d 1048 (Or. Ct. App. 1996).

CITATION UPDATES

Estate of Shelfer v. Comm’r, 86 F.3d 1045 (11th Cir. 1996) (marital deduction) see p. 113 supra.

ISSUE INDEX

Bankruptcy
General
Plan 126
Chapter 12
Eligibility 126
Trustee fees 127
Chapter 13
Plan 127
Federal taxation
Allocation of tax payments 127
Dismissal 127
Contracts
Guarantee 127
Federal Agricultural Programs
Crop insurance 128
Farm loans 128
Tobacco 128
Federal Estate and Gift Tax
Gross estate 128
Interest deduction 128
Returns 128
Federal Income Taxation
C corporations
Stock redemption 128
Casualty loss 129
Conservation easement 129
Depreciation 129
Hobby losses 129
Losses 129
Pension plans 129
Preproduction expenses 130
Sale of residence 130
Tax liens 130
Landlord and Tenant
Emblems 130
Termination notice 130
Negligence
Safe workplace 131
Products Liability
Tractor 131
State Regulation of Agriculture
Aerial crop spraying 131
Apples 131
Trusts
Apparent authority 131
Zoning
Exceptions 132
SUMMARY OF SELECTED PROVISIONS OF THE SMALL BUSINESS JOB PROTECTION ACT
(Pub. L. 104-188, signed August 20, 1996)
— by Neil E. Harl*

Expense Method Depreciation
The amount of expense method depreciation has been increased from its 1996 level of $17,500 as follows:

- 1997 $18,000
- 1998 18,500
- 1999 19,000
- 2000 20,000
- 2001 and 2002 24,000
- After 2002 25,000

Act § 1111(a), amending I.R.C. § 179(b)

The legislation does not alter what is eligible for expense method depreciation except as noted in the next item.

Expensing Denied
The legislation denies expense method depreciation for property used outside the United States, property used in connection with furnishing lodging, property used by tax-exempt organizations, property used by governments and foreign persons and air conditioning and heating units. Act § 1702(h)(19), amending I.R.C. § 179(d)(l).

The provision is effective for property placed in service after December 31, 1990. Act § 1702.

"Aggie" Bonds
The legislation has eased the eligibility requirements for tax-exempt First-Time Farmer Industrial Development Bonds issued by state and local governments. Funds from the bonds may be used to finance a “first-time farmer’s” purchase of land and personal property used in farming operations. The amount of farmland that an individual may own and still be considered a first-time farmer has been doubled from 15 percent to 30 percent of the median size farm in the county in which the land is located. Also, proceeds from the tax-exempt bonds may now be used to finance farm purchases (land or personal property) from related parties. Related party acquisitions must be for fair market value and, after the acquisition, the related person must not have a financial interest in the farming operation with respect to which the bond proceeds are to be used. The change will allow children to buy land from parents or other close relatives and still be eligible for financing under the beginning farmer loan program.

The Conference Committee report states that a seller will not be treated as having a financial interest in the farming operation if the seller--

"(a) has no more than a ten-percent interest in the capital or profits in a partnership comprising the farm;
(b) has no more than a ten-percent stock interest in a corporation comprising the farm;
(c) has no more ten-percent [sic] of the beneficial interest in a trust comprising the farm;
(d) is not a principal user of the farm; or
(e) has no other direct or indirect ownership or use of the farm which has as a principal purposes [sic] the avoidance of this provision.”

Act § 1117(a), amending I.R.C. § 147(c)(2).

The provision is effective after the date of enactment of the act.

Dues For Agricultural or Horticultural Organizations
Dues paid up to $100 per year are not to be considered unrelated business income for agricultural or horticultural organizations. Act § 1115, adding I.R.C. § 512(d).

The provision is effective for taxable years beginning after December 31, 1986. Act § 1115(b).

Involuntary Conversions
If property held for productive use in a trade or business or for investment is involuntarily converted as a result of a Presidential-declared disaster after 1994, the proceeds can be reinvested in any tangible property held for productive use in a trade or business. Act § 1119, amending I.R.C. § 1033(h).

The provision is effective for disasters for which a Presidential declaration is made after December 31, 1994, in tax years ending after that date. Act § 1119.

Lease Improvements
The legislation clarifies that the lessor's unrecovered cost for leasehold improvements made by the lessor for the lessee and disposed of or abandoned upon the expiration of the lease is to be treated as though the property was disposed of by the lessor. Thus, the remaining basis may be recovered even if there is no actual disposition of the underlying property. Act § 1121(a), amending I.R.C. § 168(i).

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
The Conference Committee report specifies that the provision does not apply to the extent the present-law demolition rules apply under I.R.C. § 280B.

The provision is effective for leasehold improvements disposed of or abandoned after June 12, 1996. Act § 1121(b).

S Corporations

Number of shareholders. For tax years beginning after December 31, 1996, the maximum number of shareholders in an S corporation is increased from 35 to 75. Act § 1301, amending I.R.C. § 1361(b)(1)(A).

New category of trust. The legislation creates a new category of trust eligible to hold stock in S corporations, known as a "small business trust." In such trusts, each potential current beneficiary is treated as a shareholder.

To be a small business trust, only individuals, estates and certain charitable organizations which hold a contingent interest and are not a potential current beneficiary can be beneficiaries; no interest in the trust can be acquired by purchase (interests in small business trusts must be acquired by gift, bequest or other non-purchase acquisition); and an election must be made. Qualified Subchapter S trusts and tax exempt trusts are not eligible to be small business trusts. Each potential current beneficiary is treated as a shareholder for purposes of the 75-shareholder limitation.

The portion of the trust consisting of stock in one or more S corporations is treated as a separate trust for purposes of computing the income tax attributable to the S corporation stock held by the trust. This portion of the trust’s income is taxed at the highest rates imposed on estates and trusts. The taxable income that is attributed to the trust as an S corporation shareholder includes (1) gain or loss from the sale of the S corporation stock; (2) items of income, loss or deduction allocated to the trust as an S corporation shareholder under the subchapter S rules; and (3) any state or local taxes and administrative expenses of the trust allocable to the S corporation stock. Act § 1302, amending I.R.C. § 1361(c)(2)(A).

The provision is effective for taxable years beginning after December 31, 1996.

Trust ownership of stock after death. The legislation changes the 60 day post-death holding period, for trusts holding S corporation stock, to two years, effective for taxable years beginning after December 31, 1996. The two-year holding period begins on the date of the grantor’s death. A trust becoming an S corporation shareholder under a will is also permitted to be an S corporation shareholder for two years beginning on the date the stock is transferred to the trust. Act § 1303, amending I.R.C. § 1361(c)(2).

Financial institutions able to hold safe harbor debt. The bill allows financial institutions (“a person which is actively and regularly engaged in the business of lending money”) to hold safe harbor debt (“straight debt”), effective for taxable years beginning after December 31, 1996. Act § 1304, amending I.R.C. § 1361(c)(5)(B).

S corporation terminations and elections. The legislation broadens the authority to treat S corporation election terminations as inadvertent and provides authority to treat late elections as timely when there was reasonable cause for the failure to make the election in a timely manner. IRS may waive the effects of an invalid election caused by inadvertent failure to qualify as an S corporation or to obtain shareholder consent or both. Act § 1305, amending I.R.C. §§ 1362(b), 1362(f).

The provision is effective for taxable years beginning after December 31, 1992.

Election to terminate year. The legislation clarifies the election to terminate the taxable year. If a shareholder terminates the shareholder's interest in an S corporation, for “affected shareholders” the taxable year may be treated as two taxable years the first of which ends on the date of termination. The term “affected shareholder” includes all shareholders to whom the terminating shareholder had transferred shares during the year. Act § 1306, amending I.R.C. § 1377(a)(2).

The provision applies to taxable years beginning after December 31, 1996.

Ownership of subsidiaries. The legislation allows an S corporation to elect to hold stock in wholly-owned subsidiaries provided the subsidiary is a "domestic corporation." The subsidiary is not considered a separate corporation. Act § 1308(b), amending I.R.C. § 1361(b)(2).

The provision is effective for taxable years beginning after December 31, 1996. Act § 1317(a).

Distributions during loss years. The legislation clarifies that, in the case of distributions in loss years, the stock basis is to be determined by including the adjustments from the loss before the loss limitation is applied for the year. Consequently, distributions reduce the basis for determining the allowable loss for the year. However, that loss does not reduce the basis for purposes of determining the tax status of the distributions. Act § 1309(a), amending I.R.C. § 1366(d)(1).

The provision is effective for taxable years beginning after December 31, 1996.

Accumulated adjustments account. The act clarifies that the amount in the accumulated adjustments account as of the close of the taxable year is to be determined without regard to any "net negative adjustment" for the year. That term is defined as the reductions in the account for the taxable year (other than for distributions) over the increases in the account for the taxable year. Net negative adjustments are disregarded. Act § 1309(b), amending I.R.C. § 1368(e)(1).

The provision is effective for taxable years beginning after December 31, 1996.

Subchapter C rules applicable. The legislation makes it clear that C corporation rules apply to an S corporation (including liquidation) except to the extent inconsistent with Subchapter S. Act § 1310, amending I.R.C. § 1371(a).

This provision applies to taxable years beginning after December 31, 1996.

Elimination of earnings and profits. The act provides that S corporations with elections for taxable years beginning before January 1, 1983, that are S corporations after December 31, 1996, are to have their accumulated earnings and profits reduced by accumulated earnings and
profits in any tax year before 1983 for which the corporation was an S corporation. The result is that an S corporation’s accumulated earnings and profits are solely attributable to tax years for which its S corporation election was not in effect. Act § 1311(b), amending I.R.C. §§ 1042(c)(4)(A)(i), 1362(d)(3), 1375(a),(b).

Adjustment to basis of inherited stock. The legislation specifies that for stock in an S corporation acquired by reason of death or by bequest, devise or inheritance, the income-in-respect-of-decedent rules are to be applied as if the decedent had held the IRD item directly. The basis of stock in an S corporation at death is to be reduced by the portion of the value of IRD items attributable to the decedent. A deduction under I.R.C. § 691(c) is allowed for the estate tax attributable to an item of income in respect of decedent.

The adjusted basis of the stock acquired from a decedent is reduced to the extent to which the value of the stock is attributable to IRD items. Act § 1313(a), amending I.R.C. § 1367(b).

The amendment applies to decedents dying after the date of enactment. Act § 1313(b).

Real estate subdivided for sale. S corporations are made eligible for the special rules applicable to real property subdivided for sale (I.R.C. § 1237) that are available to noncorporate taxpayers. Act § 1314(a), amending I.R.C. § 1237(a).

Exempt organizations as shareholders. The legislation allows certain exempt organizations to be shareholders in S corporations with each to count as one shareholder. Act § 1316, amending I.R.C. § 1361(b)(1).

The amendment is effective for taxable years beginning after December 31, 1997. Act § 1316(f).

Basis Adjustment

If a taxpayer satisfies the replacement property requirement for involuntarily converted property by acquiring stock in a corporation, the corporation must generally reduce its adjusted basis in its assets by the amount by which the taxpayer is required to reduce its basis in the stock. If more than one piece of property is acquired, the basis is allocated in proportion to the respective costs. The taxpayer’s basis in the corporation’s stock is reduced by the amount of any gain from the involuntary conversion that was not recognized. Act § 1610, amending I.R.C. § 1033(b).

The amendment is effective for involuntary conversions occurring after the date of enactment. Act § 1610(b).

Spousal IRAs

Spouses without earned income are allowed to contribute and deduct up to $2,000 per year to an IRA. Previously, if one spouse had no earned income, a married couple was allowed a maximum annual IRA contribution deduction of $2250.

The spousal IRA rules apply if a joint return is filed and the amount of compensation (if any) includible in the individual’s gross income is less than the compensation includible in the spouse’s gross income. If the working spouse is an active participant in an employer-sponsored retirement plan and earns over $40,000, the maximum amount of the deduction for the spousal IRA is reduced proportionately as under prior law.

The deduction for health insurance expenses (at the 30 percent level for 1996) applies to long-term care insurance premiums.

Employer-provided long term care insurance premiums are not excludable from an employee’s income if provided under a cafeteria or other flexible spending arrangement. Act § 321(a), adding I.R.C. § 7702B.

The provision is effective for contracts issued after December 31, 1996. Act § 321(f).

Terminally Ill Individuals

Individuals who are terminally and chronically ill are allowed to exclude from gross income life insurance benefits paid out prior to death. A “terminally ill individual” is an individual who has been certified by a physician as having an illness or physical condition which can reasonably be expected to result in death in 24 months or less after the date of certification. Act § 331(a), adding I.R.C. § 101(g).

The provision is effective for amounts received after December 31, 1996. Act § 331(b).

IRA Withdrawals

Effective for distributions after December 31, 1996, the legislation allows penalty free withdrawals from individual retirement accounts for qualified medical expenses that exceed 7.5 percent of adjusted gross income, the floor for deducting medical expenses. Likewise, the 10 percent additional tax does not apply to IRA distributions for payment of health insurance premiums after separation from
employment. To avoid the 10 percent tax, the individual must have received unemployment compensation for 12 or more consecutive weeks under federal or state law. A self-employed individual meets the requirements for unemployment compensation if the individual would have received the compensation except for the fact that the individual had been self-employed. Act § 361, amending I.R.C. § 72(t).

Corporate-Owned Life Insurance

The legislation phases out the interest deduction for corporate-owned life insurance over a transitional period. The interest incurred during the transitional period is deductible to the extent that the rate of interest does not exceed the lesser of (1) the rate specified in the contract as of October 13, 1995, or (2) the applicable percentage of Moody’s Corporate Bond Yield Average--Monthly Average Corporates for each month the interest is paid or accrues. The applicable percentage of Moody’s rate is 100 percent in 1996, 90 percent in 1997, 80 percent in 1998 and zero thereafter.

An exception is provided for key persons for insurance contracts not to exceed $50,000. Act § 501(b), amending I.R.C. § 264.

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

BANKRUPTCY

CHAPTER 13-ALM § 13.03.∗

PLAN. The debtors, husband and wife, owned a 136 acre farm which was used to feed cattle on contract. The husband had income from an army pension and the wife was employed as a school teacher. The debtors failed to list any livestock, feed or supplies on their asset schedules, failed to list the army pension as income and failed to list an account receivable of $4,000. The husband had borrowed the downpayment for the farm and failed to repay the loan, although the debtors often had the resources to make the payments. The debtors’ plan proposed to pay the largest unsecured creditor 100 percent of the claim but the rest of the unsecured creditors only 4 percent of their claims. At the time of the plan confirmation, the husband was not actively employed, either on the farm or elsewhere, even though the husband was in good health and had marketable skills. The court denied confirmation of the plan as not proposed in good faith, primarily because the husband had no plans to seek gainful employment during the plan. The court noted that the husband was well able to secure employment on or off the farm sufficient to pay all creditors 100 percent of their claims over the plan period. In re Jobe, 197 B.R. 823 (Bankr. W.D. Tex. 1996).

FEDERAL TAXATION-ALM § 13.03[7].∗

DISCHARGE. The debtor was assessed a penalty, under I.R.C. § 6698, for failure to file a partnership return. The Bankruptcy Court had allowed the discharge of the penalty, under Section 523(a)(7)(A), because the penalty did not relate to any tax. The District court reversed, holding that because the penalty did not relate to a dischargeable tax, the penalty was nondischargeable. United States v. Amici, 197 B.R. 696 (M.D. Fla. 1996), rev’g, 177 B.R. 386 (Bankr. M.D. Fla. 1995).

The debtors, husband and wife, filed for Chapter 7 in 1990 and sought to have income taxes for 1977 through 1983 declared dischargeable. For the 1974 tax return, the husband claimed income based upon the dollar’s “gold value” and a notice of deficiency was upheld in the courts. In 1975, the husband transferred the debtors’ assets and assigned income to a family estate trust without consideration and without relinquishing possession or control to the trust. The trust was also declared invalid by the courts. The debtors failed to file any returns for 1980 through 1983 and the husband was found guilty of failure to file income tax returns and was ordered to pay a penalty, court costs, and the taxes owed and was placed on probation. The probation was revoked when the husband failed to pay any taxes owed for 1980 through 1983. The court held that the 1974 and 1975, as well as the 1980 through 1983, actions of the husband were relevant to show the husband’s willful failure to pay taxes and denied the husband’s discharge as to the 1977 through 1983 taxes. The court held, however, that, although the wife signed all joint returns, the IRS had failed to show that she committed any actions which amounted to willful attempt to evade payment of taxes. Matter of Birkenstock, 87 F.3d 947 (7th Cir. 1996).

The debtor admitted to filing false W-4 forms with excessive claimed exemptions for dependents in order to maximize disposable wage income during the tax year. The debtor filed accurate federal income tax returns but failed to fully pay the taxes owed. The IRS filed a claim for those taxes and sought to have the taxes declared nondischargeable under Section 523(a)(1)(C) for willful attempt to evade payment of taxes. The Bankruptcy Court found that the debtor had intended to file accurate income tax returns and pay the full amount due; therefore, the Bankruptcy Court held that the taxes were dischargeable. The District Court reversed, holding that the Bankruptcy Court applied the wrong legal test for “willful” as a bad purpose or evil motive. The court held that a willful act required only a voluntary, conscious and intentional violation of a known legal duty; therefore, the debtor’s intentional falsification of the W-4 forms was sufficient to make the actions willful under Section 523(a)(1)(C). Smith v. United States, 96-2 U.S. Tax Cas. (CCH) ¶ 50,426 (S.D. Ind. 1996).

FEDERAL AGRICULTURAL PROGRAMS

PERISHABLE AGRICULTURAL COMMODITIES ACT. The plaintiff sold produce to the defendants who later filed for bankruptcy. The plaintiff sought payment for the

∗Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.
produce from the PACA trust fund. The defendants were a corporation which developed, owned and operated restaurants and a subsidiary corporation which operated its own restaurants. Both defendants argued that they were not dealers in produce, under 7 U.S.C. § 499a(b)(6), subject to PACA. The court noted that the statute was unambiguous and included retailers with purchases of commodities over $230,000 per year. The facts demonstrated that the defendants purchased the produce from a wholesaler, the plaintiff, for use in the restaurants and both defendants had annual purchases of commodities exceeding $230,000. The defendants argued that they were not retailers but were consumers of the produce. The court held that the defendants were subject to PACA as retailers because the defendants enhanced the produce by cooking and other preparation for serving to customers. Matter of Magic Restaurants, Inc., 197 B.R. 455 (Bankr. D. Del. 1996).

FEDERAL ESTATE AND GIFT TAX

CHARITABLE DEDUCTION. The decedent’s will established two trusts for the benefit of the decedent’s son who was disabled. Both trusts had charities as remainder holders. The first trust provided for annual payments equal to a percentage of the fair market value of the trust assets, but also provided for payment of the son’s funeral and burial expenses and any debts or obligations at the son’s death. The trust allowed the trustees to amend the trust so that the trust qualified as a charitable remainder annuity trust. The trustees petitioned a state court to remove the provision for payment of the funeral and burial expenses and the son’s obligations. The son’s guardian also petitioned a state court for permission to file a written disclaimer of the son’s right to payment for these expenses. The second trust provided for payments to the son if the first trust’s payments were insufficient for the son’s care and support. The trustees petitioned a state court to amend the second trust to provide for payments equal to the lesser of the net trust income or a unitrust amount plus deficiencies from prior trust years when the net income was less than the unitrust amount. The IRS ruled that both trusts were reformable and that the amendments to the trusts qualified them for the charitable deduction. Ltr. Rul. 9633004, May 6, 1996.

The decedent’s inter vivos trust provided for testamentary distribution of the trust corpus. The trustee was required to distribute 80 percent to Roman Catholic charities, 10 percent to Protestant charities, and 10 percent to Jewish charities, with the specific charities to be selected at the trustee’s discretion. The IRS ruled that, under New York law, the trustee was required to distribute the trust corpus to charities as defined by the IRC; therefore, the bequests would qualify for the charitable deduction. Ltr. Rul. 9634025, May 25, 1996.

CLAIMS AGAINST THE ESTATE. The decedent’s will provided for bequests to a charitable foundation established by the decedent. The decedent’s heirs hired attorneys to prepare litigation against the decedent, the foundation and the foundation trustee for tortious interference with inheritance. The parties entered into negotiations after the decedent’s death and reached a settlement which included additional payments to the heirs from the foundation bequest. The foundation stated that the settlement was reached in order to avoid the legal costs of litigation. The decedent’s estate claimed the settlement payments as a deduction as either a claim against the estate or administrative expenses. The court denied the deduction, holding that the settlement was a nondeductible distribution to heirs because the cause of action for interference with inheritance could not have been brought against the decedent but was a liability of the foundation or its trustee. The court held that the settlement was not a deductible administrative expense because the estate was not benefited or diminished by the action. Lindberg v. United States, 927 F. Supp. 1401 (D. Colo. 1996).

DISCLAIMERS-ALM § 5.02[6]. The IRS has issued proposed regulations concerning the requirement that a qualified disclaimer occur within nine months after creation of the interest disclaimed. The IRS noted in the comments, that in United States v. Irvine, 981 F.2d 991 (8th Cir. 1992), rev’d on another point, 114 S. Ct. 1473 (1994), a disclaimer of a pre-gift tax transfer was not subject to the nine-month rule because no taxable transfer had occurred. The proposed regulations provide that the nine-month rule applies to inter vivos or testamentary transfers, whether or not any gift or estate tax is imposed on the transfer. The same applies to interests passing as a result of an exercise, release or lapse of a general power of appointment, whether or not the event is subject to gift or estate tax. The proposed regulations clarify this rule by changing the prior regulations use of the term “taxable transfer” to the statutory term “transfer creating the interest.” Prop. Treas. Reg. §§ 20.2041-3(d)(6); 20.2046-1(a); 20.2056(d)-2(a),(b); 25.2511-1(c); 25.2514-3(c); 25.2518-1; 25.2518-2(c)(3).

The IRS also noted that the regulations governing the disclaimer of a survivorship interest in joint tenancy property held invalid in several cases (see, e.g., Kennedy v. Commissioner, 804 F.2d 1332 (7th Cir. 1986)). The proposed amendments would revise the regulations to provide that, if a joint tenancy may be unilaterally severed by either party, a surviving joint tenant may disclaim the one-half survivorship interest in property held in joint tenancy with right of survivorship within 9 months of the death of the first joint tenant to die, even if the surviving joint tenant provided some or all of the consideration for the creation of the tenancy. Thus, the new rule does not apply to unseverable tenancies (tenancies by the entirety). Prop. Treas. Reg. § 25.2518-2(c)(4).

The proposed regulations provide that the 9-month period for making the qualified disclaimer commences on the death of the first joint tenant of a joint bank account. The proposed regulations also clarify that a surviving joint tenant cannot disclaim any portion of the account attributable to that survivor’s contribution to the account. Further, the proposed regulations clarify that this rule applies even if only one-half of the property is included in the decedent’s gross estate under I.R.C. § 2040(b) because the joint tenants are married. Prop. Treas. Reg. § 25.2518-2(c)(4)(iv).

The proposed regulations also clarify the estate tax treatment of a disclaimer interest in a joint bank account. State law generally deems a disclaimant to have
predeceased the decedent with respect to the disclaimer interest. The disclaimed interest in a joint bank account (the creation of which is treated as an incomplete gift under the gift tax regulations), would lose its character as joint property and pass through the decedent's probate estate. Accordingly, under such circumstances, the interest disclaimed is subject to inclusion in the decedent's gross estate under I.R.C. § 2033, rather than I.R.C. § 2040(a) (providing for inclusion based on the contribution of each tenant) or I.R.C. § 2040(b) (providing for inclusion of one-half the property in the case of certain joint tenancies between spouses). The balance of the account not subject to the disclaimer retains its character as joint property and is includible in the decedent's gross estate under either I.R.C. § 2040(a) or I.R.C. § 2040(b). Prop. Treas. Reg. § 25.2518-2(c)(5), Examples 13, 14, 15. 61 Fed. Reg. 43197 (Aug. 21, 1996).

GENERATION SKIPPING TRANSFERS—ALM § 5.04[6]. The decedent's will bequeathed property in trust from an inter vivos trust to several grandchildren. The will provided that, if a grandchild died “before receipt” of the trust corpus, the share passed to that grandchild’s issue, or if no issue survived, to the other surviving grandchildren or their issue. The IRS interpreted the “before receipt” language as requiring that a grandchild survive until actual receipt of the bequeathed property in order for the grandchild’s interest to have vested; therefore, the property would not be included in his grandchild’s gross estate unless actually delivered before the grandchild’s death. Under Section 1433 of Pub. L. No 99-514, as amended by Pub. L. No. 100-647, a transfer of property in trust to a grandchild is eligible for the GSTT exemption only if the property was includible in the grandchild’s gross estate. The case argued that the language was ambiguous; therefore, the Michigan law favoring vesting applied where the language is ambiguous. The court agreed with the estate that the language was ambiguous, citing language elsewhere in the will which referred to the vested interests and required an accounting to the beneficiaries during the administration of estate. The court applied the Michigan rule in favor of vesting and held that the bequest qualified for the GSTT exemption. Comerica Bank, N.A. v. United States, 96-2 U.S. Tax Cas. (CCH) ¶ 60,242 (6th Cir. 1996).

INSTALLMENT PAYMENT OF ESTATE TAX—ALM § 5.05[1]. The decedent owned interests in several corporations, two of which were the subject of this ruling. The first corporation developed and constructed rental real estate. The second corporation provided management services for rental properties owned by the corporation and other entities owned by members of the decedent’s family. The IRS ruled that both corporations were considered to be operating a trade or business for purposes of installment payment of estate tax. Ltr. Rul. 9634006, May 14, 1996.

MARITAL DEDUCTION—ALM § 5.04[3]. The decedent’s will established a trust for the surviving spouse. The trust provided for payment of $2,500 per month for ten years with the remainder of the trust to be paid to the spouse, if the spouse was alive at the end of ten years, or to the spouse’s estate if the spouse died before the end of ten years. The IRS ruled that the trust qualified for the marital deduction. Ltr. Rul. 9634020, May 24, 1996.

POWER OF ATTORNEY. The decedent had granted a daughter a power of attorney which included broad powers to manage the decedent’s affairs, to convey and sell property, and otherwise do with the property as if the daughter was the decedent. The power of attorney listed a significant number of specific powers granted except nowhere did the instrument convey authority to make gifts of the decedent’s property. The daughter made several gifts during the decedent’s lifetime. The IRS ruled that the gifted property was included in the decedent’s estate because the daughter did not have the authority to make the gifts and the gifts were revocable on the decedent’s date of death. Ltr. Rul. 9634004, May 2, 1996.

FEDERAL INCOME TAXATION

APPEALS. The taxpayers sent a Form 2848, Power of Attorney and Declaration of Representative, to the IRS after an audit was begun on the taxpayers’ 1992 return. The form listed the address of the taxpayer’s attorney as the address for all notices and communications to the taxpayers from the IRS. A Notice of Deficiency, dated December 14, 1995, was sent to the taxpayers and a copy was sent to the taxpayers’ attorney. The attorney twice contacted the IRS about the final due date for any appeal of the deficiency notice and was told each time, and confirmed once by letter, that the final appeal date was March 14, 1996. The correct final date was March 13, 1996, 90 days after the date of the deficiency notice. The appeal was sent by certified mail, postmarked March 14, 1996 and the IRS moved to dismiss the appeal for lack of jurisdiction because the appeal was not timely filed. The taxpayers argued that the deficiency notice appeal period did not begin until it was received at the address listed on the Form 2848 and not from the date sent to the taxpayers. The taxpayers also argued that the IRS should be bound by the advice of its agents, even though incorrect. The court held that the IRS failure to send the original notice to the taxpayers’ representative did not affect the effective date of the notice where the original notice was received by the taxpayers and a copy was sent to the representative, both giving the taxpayers adequate time to make a timely appeal. The court also held that the errors of IRS employees could not waive jurisdictional requirements and that the taxpayers had the responsibility to calculate correctly the appeal limitations period. There is no discussion of why the taxpayers waited so long to file the appeal. Elgart v. Comm’r, T.C. Memo. 1996-379.

BUSINESS EXPENSES. The taxpayer was the sole shareholder of a corporation. The taxpayer retained over $120,000 which was paid to the corporation and the issue was how much of that amount was paid to the taxpayer in reimbursement for corporate expenses paid by the taxpayer. The taxpayer claimed automobile expenses incurred for the corporation but the court disallowed most of the expenses for lack of any record by the taxpayer that the expenses were for business purposes. The court also disallowed most meal expenses because the taxpayer provided no evidence to substantiate a business purpose for the meals. The taxpayer was not allowed to deduct payments made to a former spouse because the income was chargeable to the taxpayer as the sole shareholder and officer and the payments would...
be an impermissible assignment of income. The court also held that the taxpayer was the sole shareholder because the taxpayer filed corporate tax returns declaring the taxpayer as the sole shareholder. \textit{Ellabban v. Comm’r}, T.C. Memo. 1996-382.

\textbf{LEGAL FEES.} The taxpayers’ principal residence was destroyed in a fire and the taxpayers filed a claim with their insurance company. The taxpayers incurred legal fees in negotiating a settlement with the insurance company and claimed the payment of those fees as a miscellaneous deduction. The house was not used in any trade or business and any gain from the insurance proceeds was eligible for deferment upon the rebuilding of the house. The court held that the legal fees were not currently deductible because they were incurred as part of a recovery of a capital asset. \textit{Jasko v. Comm’r}, 107 T.C. No. 3 (1996).

\textbf{LIKE-KIND EXCHANGES.} The taxpayers, all siblings, shared ownership of two contiguous parcels of land which had a total of three residences. The parcels were originally owned by one ancestor who devised the property to several heirs. The parcels eventually were devised to the three taxpayers as tenants in common with the taxpayers receiving ownership to the two parcels at different times. The taxpayers divided the total land into four parcels, three with one residence and one undeveloped property. Each taxpayer received full title to one residential parcel and an undivided interest in the undeveloped parcel. The interests in the undeveloped parcel were determined so as to equalize the value of the property received by each taxpayer with the initial one-third interest in the total property. The IRS ruled that, because the parcels were contiguous, the parcels would be treated as one property; therefore, Rev. Rul. 56-437, 1956-2 C.B. 507 applied to allow tax-free exchange treatment of the transaction. The taxpayers were all equally liable for a mortgage on the properties incurred to make improvements. The exchange agreement provided for each taxpayer to receive full title to one residential parcel and an undivided interest in the undeveloped parcel. The IRS ruled that this agreement did not affect the equal division of the property. \textit{Ltr. Rul. 9633028, May 20, 1996; Ltr. Rul. 9633033, May 20, 1996; Ltr. Rul. 9633034, May 20, 1996}.

\textbf{RETURNS.} The IRS has announced that under the Taxpayer Bill of Rights, Pub. L. No. 104-168, Forms W-2G, 1098, 1099-A, 1099-B, 1099-DIV, 1099-G, 1099-INT, 1099-Misc, 1099-OID, 1099-PATR and 1099-S for 1996 will require inclusion of a telephone number of a person to contact about statements on the form. Because the 1996 versions of these forms have already been printed, the IRS has waived any penalty for failure to include the phone number on the 1996 forms only. The IRS recommends, however, that the phone numbers be included in the box for the flier’s name and address or anywhere else on the form. \textit{Ann. 96-88}.

\textbf{SALE OF RESIDENCE.} During a previous marriage in Seattle, the taxpayer owned a principal residence. After the divorce, the taxpayer lived in the house for about one year and then moved to San Diego. The house was rented to unrelated parties for seven years before it was sold by the taxpayer at a gain. The taxpayer remarried and obtained a residence by having friends purchase a house, with the taxpayer agreeing to renovate the house in exchange for the right to live in the house and an equity interest after completion of the work. The court held that the taxpayer was not entitled to defer the gain on the sale of the first residence because a second residence was not purchased within two years after the sale. \textit{Edmondson v. Comm’r}, T.C. Memo. 1996-393.

\textbf{SAFE HARBOR INTEREST RATES}

<table>
<thead>
<tr>
<th></th>
<th>September 1996</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Annual</td>
</tr>
<tr>
<td>Short-term</td>
<td></td>
</tr>
<tr>
<td>AFR</td>
<td>6.02</td>
</tr>
<tr>
<td>110% AFR</td>
<td>6.63</td>
</tr>
<tr>
<td>120% AFR</td>
<td>7.25</td>
</tr>
<tr>
<td>Mid-term</td>
<td></td>
</tr>
<tr>
<td>AFR</td>
<td>6.64</td>
</tr>
<tr>
<td>110% AFR</td>
<td>7.31</td>
</tr>
<tr>
<td>120% AFR</td>
<td>7.99</td>
</tr>
<tr>
<td>Long-term</td>
<td></td>
</tr>
<tr>
<td>AFR</td>
<td>7.03</td>
</tr>
<tr>
<td>110% AFR</td>
<td>7.74</td>
</tr>
<tr>
<td>120% AFR</td>
<td>8.46</td>
</tr>
</tbody>
</table>

\textbf{SECURED TRANSACTIONS}

\textbf{PRODUCER’S LIEN.} The bankruptcy debtor was a processor of walnuts who had purchased “combination” walnuts from a California producer/processor (the creditor). The creditor filed a secured claim for unpaid walnuts, based on the California Producer’s Lien Statute, Cal. Food & Agric. Code § 55631. The trustee sought to avoid the lien under Section 545(2) as a bona fide purchaser. The court reluctantly followed Ninth Circuit Court of Appeals precedent holding that the lien was not avoidable because the lien was unenforceable against a bona fide purchaser only if the purchaser took possession; therefore, the lien was unenforceable against the trustee as hypothetical bone fide purchaser because the trustee did not take possession of the walnuts. The court also held that there was an issue of fact as to whether the walnuts involved were produced by the creditor and were not produced by other parties and processed by the creditor prior to sale to the debtor. The debtor argued that the lien was released by the creditor because the creditor sold the walnuts on a “Net 30” basis. The court held that, under Cal. Food & Agric. Code § 55639, the allowance of time to make payment for produce was not a waiver of the lien. \textit{In re S.N.A. Nut Co., 197 B.R. 642 (Bankr. N.D. Ill. 1996)}.

\textbf{AMERICAN AGRICULTURAL LAW ASSOCIATION ANNUAL CONFERENCE}

The AALA is meeting October 3-5, 1996 at the Westin Hotel in Seattle, WA. The theme for this year’s conference is “Legal Service to Agriculture in the 21st Century.” Speakers include Secretary of Agriculture Dan Glickman, Jake Looney, Bill Oemichen, Neil Hamilton, Roger McEowen, Phil Harris, Nels Ackerson, Gordon Tanner and Terry Centner.

Seattle is a friendly and fascinating city, full of the charm and beauty of the Pacific Northwest. The Agricultural Law Press will be there and we hope you will too.
CITATION UPDATES

Buchanan v. United States, 87 F.3d 197 (7th Cir. 1996) (bad debt) see p. 106 supra.

STATE TAXATION

VALUATION. The taxpayer’s ranch included land in two counties, with the land in one county either not suitable for crops or isolated and inaccessible to farm machinery. The assessment of the ranch land was different for the parcels in each county and the inaccessible land was discounted $2.00 an acre to adjust for the inaccessibility. The taxpayer argued that the different values for portions of the same ranch were improper; however, the taxpayer did not provide any case or statutory authority for this issue. The court held that this issue was waived for failure to provide authority. The taxpayer also argued that the valuation of the inaccessible land was improper because the county assessor did not use any comparative sales to determine the value. The county assessor admitted that there were no sales of inaccessible land in the county. The court held that the valuation was improper because the statute, S.D. Code § 10-6-23, required valuation to be based on comparative sales. The court stated that the assessor should have looked for sales in neighboring counties or sales farther back in time. West Rivers Ranch v. Pennington Co., 549 N.W.2d 683 (S.D. 1996).

AGRICULTURAL LAW PRESS
ON THE WEB

http://members.aol.com/aglaw/agpub
Check out our internet site for information about:
• Agricultural Law Manual, by Neil E. Harl, a comprehensive, annotated looseleaf deskbook.
• Principles of Agricultural Law, a college textbook, by Roger A. McEowen and Neil E. Harl, due for publication in December 1996.
• Direct internet links to legal resources on the internet.
• Direct email link to the Agricultural Law Press.
We welcome any suggestions for improving our web site.

ISSUE INDEX

Bankruptcy
   Chapter 13
   Plan 136
   Federal taxation
   Discharge 136
Federal Agricultural Programs
   PACA 137
Federal Estate and Gift Tax
   Charitable deduction 137
   Claims against the estate 137
   Disclaimers 137
   Generation skipping transfers 138
   Installment payment of estate tax 138
   Marital deduction 138
   Power of attorney 138
Federal Income Taxation
   Appeals 138
   Business expense 138
   Legal fees 139
   Like-kind exchanges 139
   Returns 139
   Sale of residence 139
   Safe harbor interest rates
      September 1996 139
Secured Transactions
   Producer’s lien 139
State Taxation
   Valuation 140
SUMMARY OF SELECTED PROVISIONS OF THE SMALL BUSINESS JOB PROTECTION ACT

(Part 2)

(Pub. L. 104-188, signed August 20, 1996)

— by Neil E. Harl*

Retail Motor Fuel Outlets

The legislation clarifies that retail motor fuel outlets (whether or not food or other convenience items are sold at the outlet) may be depreciated over 15-years rather than as depreciable real property over 39 years. IRS had taken the position that 15-year depreciation could only be used if 50 percent or more of the gross revenues are from petroleum sales and 50 percent or more of the space is dedicated to petroleum sales. Act § 1120(a), amending I.R.C. § 168(e)(3)(E).

The provision is effective for property placed in service after the date of enactment. A taxpayer can elect to treat property placed in service earlier as subject to the provision. Act § 1120(c).

Employee or Independent Contractor

The legislation makes several clarifications in the present law safe harbor for establishing independent contractor status including shifting the burden of proof to the Internal Revenue Service after the taxpayer establishes a prima facie case that it was reasonable not to treat an individual as an employee. Act § 1122, amending Section 530 of the Revenue Act of 1978.

The provision is generally effective after December 31, 1996. Act § 1122(b).

Work Opportunity Tax Credit

The legislation replaces the expired Targeted Jobs Credit with a new Work Opportunity Tax Credit (WOTC). Beginning October 1, 1996, employers are eligible to claim a 35 percent credit on the first $6,000 of first year wages paid to a qualifying individual (a maximum credit of $2100). For summer youth, for services performed during any 90-day period between May 1 and September 15, employers may claim a 35 percent credit on $3,000 of wages (a maximum credit of $1050). Employers are required to complete a prescreening notice before the date of hiring, unless the individual has been pre-certified by a state or local employment agency. A credit is not allowed unless the employee works at least 180 days (or 400 hours) or, in the case of summer youth, 20 days (or 120 hours).

Generally, qualifying individuals include long-term "Aid to Families With Dependent Children" recipients (and their family members); certain veterans and disabled workers; economically-disadvantaged ex-felons; certain food stamp recipients; and high risk youth living in empowerment zones and enterprise communities. The WOTC program terminates for those beginning work after September 30, 1997. Act § 1201, amending I.R.C. § 51(a).

Employer-Provided Educational Assistance

The exclusion for up to $5250 for employer-provided educational assistance for undergraduates has been extended and is available for courses beginning before July 1, 1997. Note: the Committee Report states the expiration date is May 31, 1997. The exclusion for graduate expenses ended for courses beginning after June 30, 1996. Act § 1202, amending I.R.C. § 127(d).

The IRS has announced procedures for employees and employers to obtain refunds for employer-provided education assistance plans in 1995 and 1996. IR-96-36.

FUTA Exemption for Alien Agricultural Workers

The Federal Unemployment Tax Act (FUTA) exemption for alien agricultural workers admitted to the United States to perform agricultural labor has been made permanent. Act § 1203, amending I.R.C. § 3306(c)(1).

Exclusion for Punitive Damages and for Damages Not Attributable to Physical Injury or Sickness

The legislation addresses the much-litigated area of whether punitive damages and damages not attributable to physical injury or sickness are taxable. The legislation specifies that the exclusion for personal injury or "tort-like" damages does not include punitive damages or damages not attributable to physical injury or physical sickness. Emotional distress is not considered a physical injury or physical sickness except payments for medical care attributable to emotional distress. Act § 1605, amending I.R.C. § 104(a)(2).

The provision is effective on enactment with several transitional provisions. The limitations on punitive damages do not apply to punitive damages awarded in a wrongful death action if applicable state law in effect on September 20, 1996.

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
13, 1995, provides (by judicial decision or state statute) that only punitive damages may be awarded. In that case, the award is excludable to the extent it was received on account of personal injury or sickness. Act § 1605(d).

Luxury Automobiles
The act decreases the excise tax on luxury automobiles by one percentage point per year for sales after June 30, 1996. Thus, the rate will be 9 percent for 1996, 8 percent for 1997, 7 percent for 1998, 6 percent for 1999, 5 percent for 2000, 4 percent for 2001 and 3 percent for 2002. The tax is scheduled to expire for years after 2002. Act § 1607, amending I.R.C. § 4001.

The amendment is effective for sales occurring seven days or more after the date of enactment. Act § 1607(c).

Use of Employer Vehicles
The act specifies that "the use of an employer's vehicle for travel by an employee and activities performed by an employee which are incidental to the use of such vehicle for commuting, shall not be considered part of the employee's principal activities if the use of such vehicle for travel is within the normal commuting area for the employer's business or establishment and the use of the employer's vehicle is subject to an agreement on the part of the employer and the employee or representative of such employee." Act § 2102.

The provision is effective on the date of enactment and applies in determining the application of Section 4 of the Portal-to-Portal Act of 1947 in any civil action brought before the date of enactment and pending. Act § 2103.

Disposition of Passive Activities
If a passive activity is disposed of in a taxable transaction, any net passive loss arising from the activity must first be applied against income (or gain) from the taxpayer's other passive activities. Any loss remaining from the activity is then classified as nonpassive and may be used to offset income from nonpassive activities such as wage income. Act § 1704(e)(i), amending I.R.C. § 469(g)(i)(A).

The provision is effective for taxable years beginning after December 31, 1986.

Adoption Credit
The legislation provides a credit for adoption expenses incurred for adopting a child up to $5,000 ($6,000 for a child with special needs, except for foreign adoptions). The credit phases out above $75,000 of adjusted gross income and completely phases out at $115,000 of adjusted gross income. Act § 1807, adding I.R.C. § 23.

The provision applies to taxable years beginning after December 31, 1996. The credit is not available, other than for special needs adoptions, for expenses paid or incurred after 2001. Act § 1807(e).

SIMPLE Retirement Plans
The legislation creates a Savings Incentive Match Plan for Employees (SIMPLE) for employers with 100 or fewer employees who received at least $5,000 in compensation in the preceding year from the employer provided the employer does not maintain another qualified plan. Employees may make elective contributions expressed as a percentage of compensation up to $6,000 per year (indexed for inflation) and requires employers to make matching contributions. Self-employed individuals may also participate in SIMPLE plans.

Employers are required to satisfy one of two contribution formulas:

(1) With the "matching contribution" formula, employers are generally required to match employee contributions on a dollar-for-dollar basis up to three percent of an employee's compensation for the year. An employer may elect, however, to match all eligible employees for a particular year at a rate lower than three percent (but not below one percent) of each employee's compensation.

(2) Under an alternative formula, an employer may choose to make a nonelective contribution of two percent of compensation for each eligible employee earning at least $5,000 in compensation from the employer during the year. The $150,000 compensation limit applies to this formula.

Earnings in the account are not taxed until distributed to the employee. Employers may generally deduct contributions (including pre-tax employee contributions) to employees' accounts for the year in which made. Matching contributions are deductible only if the contributions are made by the due date of the employer's tax return. Contributions to a SIMPLE account are excludable from an employee's income.

The plans are not subject to the nondiscrimination rules including the top-heavy provisions.

SIMPLE plans may be set up as an IRA or as a 401(k) qualified cash or deferred arrangement. All contributions are considered fully vested.

Distributions from a SIMPLE account are generally taxed as distributions from an IRA and are taxed when income is withdrawn from the account.

In addition to the usual 10 percent penalty for early withdrawals, contributions withdrawn during the two year period beginning on the date of first participation in the plan are assessed a 25 percent penalty. Act § 1421, adding I.R.C. §§ 219(b)(4), 402(k), 404(m), 408(p).

Death Benefit Exclusion ($5,000)
The employer-provided death benefit exclusion of up to $5,000 paid to the beneficiary or estate of a deceased employee has been repealed, effective for decedents dying after the date of enactment. Act § 1402, repealing I.R.C. § 101(b).

Lump-Sum Distributions
Five-year forward averaging for lump sum distributions has been repealed effective for tax years beginning after December 31, 1999. Act § 1401, amending I.R.C. §§ 55(e)(i), 401(a)(28)(B),(k)(10)(B)(ii), 402(c),(d),(e)(4)(D), (e)(f), 691(c), 871(b)(l), 877(b), 4980A(c)(4).

Minimum Wage
The legislation increases the minimum wage from $4.25 to $5.15. The increase comes in two stages -- 50 cents per hour on October 1 (and an additional 40 cents on September 1, 1997). Act § 2104.
ANIMALS

COWS. The plaintiff was injured when the plaintiff’s truck struck a cow owned by the defendant. The evidence showed that the defendant had learned on the day of the accident that the cow had escaped from the defendant’s land to a pasture 12 miles away. However, the defendant did not look for the cow until the next day, the day after the accident. The defendant testified that it was highly unusual for a cow to escape and travel so far to another fenced pasture. The evidence also showed that the defendant’s fences were in good repair before and after the escape. The trial court ruled that the defendant was not negligent as a matter of law. The defendant argued that the ruling was correct because the fences were in good repair and the defendant had no reason to believe that the cow would escape the neighbor’s fenced pasture. The appellate court reversed, holding that the defendant should have known that a cow which escaped the defendant’s fences and traveled 12 miles would probably escape other fences and travel a sufficient distance to be on a public highway. Therefore, an issue of fact remained as to whether the defendant exercised sufficient reasonable care in not immediately seeking to capture the cow. Hand v. Starr, 550 N.W.2d 646 (Neb. 1996).

BANKRUPTCY

GENERAL ALM § 13.03.

AVOIDABLE TRANSFERS. During the year before filing for bankruptcy, the debtor corporation was insolvent. The corporation was owned by one individual, and the shareholder’s spouse served as president, managing the corporation business, a livestock feedlot. The same shareholder also owned a real estate title company which was also managed by the spouse. The debtor received eight short term loans from the title company during the year before the bankruptcy filing, each loan made only after the prior loan was paid. The loans were made to allow the debtor to meet cash flow needs from buying and selling livestock. The trustee sought to have the transfers avoided as preferential transfers to an insider of the debtor. The court agreed that the transfers were preferential but held that the transfers were not avoidable because the transfers were made in the ordinary course of business for consideration. The court noted, however, that some of the payments exceeded the subsequent loans; therefore, the new value exception did not apply to the extent that the payments exceeded the value of the subsequent loans. In re Liberty Livestock Co., 198 B.R. 365 (Bankr. D. Kan. 1996).

DISCHARGE. The debtor owned land neighboring the land of a claimant in a Chapter 7 case. During development of the debtor’s land, a workcrew cut down trees and removed soil from the claimant’s land. A state court trial for trespass was held and a jury verdict was entered against the debtor for treble damages to the trees. The jury verdict specifically found that the debtor had knowledge of the trespass and failed to take any action to stop it. The claimant sought to have the judgment debt declared nondischargeable for willful and malicious damage to the claimant’s property. The court held that the actions of the debtor were clearly willful since the actions were done with knowledge of the trespass. The court also found that the debtor’s actions were malicious in that the trespass continued for several months after the debtor was informed by the claimant that the trespassing was occurring. The court held that the fact that the damage was done by agents of the debtor did not affect the ruling because the agents were working under the control of the debtor. In re Sullivan, 198 B.R. 417 (Bankr. D. Minn. 1996).

The debtor operated a grain buying, trucking and selling business and had purchased, but not paid for, substantial amounts of grain from one creditor. The debtor’s business records consisted primarily of canceled checks and bank deposit slips. The debtor maintained no written records of the specifics of any grain sales or purchases or trucking expenses. The Bankruptcy Court held that the records were sufficient to deny a motion by the creditor to deny discharge to the debtor because an accountant could reconstruct the necessary information with the help of testimony from the debtor and because there was no evidence that the debtor concealed or destroyed any records. The appellate court reversed, holding that the burden was on the debtor to produce records sufficient to determine the debtor’s business affairs, the testimony of the debtor could not be used to substitute for adequate written records, and the lack of any destruction or concealment of records was irrelevant to the issue of whether the records were sufficient. Matter of Juzwik, 89 F.3d 424 (7th Cir. 1996).

EXEMPTIONS

AVOIDABLE LIENS. The debtor originally filed for Chapter 12 prior to the 1994 amendment of Section 522. The case was converted to Chapter 7 after the amendment. A creditor had a judgment lien against the debtors’ real property which included several separate parcels of farm land, one of which included the residence. The debtors had no equity in any of the property and claimed a homestead exemption for the residence parcel and the wildcard exemption for the other parcels. The debtors sought to avoid the judgment lien on all of the parcels as impairing the claimed exemptions. Under the Ohio exemption statute and prior Ohio bankruptcy cases, a judgment lien against exempt property was not avoidable unless the judgment creditor had begun foreclosure proceedings. The 1994 amendments to Section 522 removed that obstacle, but the creditor argued that the amendment did not apply to this case because the original Chapter 12 case was filed prior to the amendments. The court examined the legislative history of the amendments and held that the amendments were intended to
clarify the existing law as intended by Congress and to overturn the Ohio rulings; therefore, the amendments could be applied to this case. The creditor also argued that the wildcard exemption could not be applied to several separate parcels of real estate. The court held that the wildcard exemption had no limitation as to the number or types of properties which could be exempted and that the judgment lien could be avoided on the basis of the wildcard exemption for property in which the debtor had no equity. In re Miller, 198 B.R. 500 (Bankr. N.D. Ohio 1996).

CHAPTER 13-ALM § 13.03.*

ELIGIBILITY. The IRS had assessed the debtor for $297,000 in owed taxes, penalties and interest, based, in part, on allegations of tax fraud. The debtor brought an action in the Tax Court challenging the assessment but filed for Chapter 13 before the case was tried. The IRS moved to dismiss the Chapter 13 case for lack of jurisdiction because the debtor had more than $100,000 in unsecured debts. (The post-1994 limit is $250,000.) The debtor argued that because the tax liability was subject to a Tax Court challenge, the debt was unliquidated and not included in the debtor’s debts for purposes of Chapter 13 eligibility. The debtor argued that the debt was unliquidated because the exact amount was not determinable, the amount was in dispute, and the debt was based on an allegation of fraud which the IRS was required to prove. The court held that (1) the amount of the claim was determinable under statutes and regulations; (2) the issue of the debtor’s liability is not a factor in determining the liquidated status of a claim; and (3) disputed claims are considered debt for purposes of Chapter 13 eligibility. United States v. Verdunn, 89 F.3d 799 (11th Cir. 1996).

FEDERAL TAXATION-ALM § 13.03[7].*

ALLOCATION OF PLAN PAYMENT OF TAXES.
The debtor was a small corporation with three employees, the sole shareholder who was the uncompensated president, the shareholder’s spouse who was the paid bookkeeper, and an unrelated employee. The debtor filed for Chapter 11 and the plan provided that payments made to the IRS were to be applied to employment tax trust fund obligations first, interest on the taxes second and penalties third. The effect of the allocation was to have nondischargeable taxes paid first with dischargeable taxes paid last, an advantage for the debtor should the plan fail. The IRS objected to the plan provision in that the debtor had not shown that the allocation was necessary for a successful reorganization. The debtor provided only testimony of the shareholder that the provision would be an incentive to work hard to make the reorganization a success. The court held that the plan could not be confirmed in that the debtor failed to show that the reorganization could not succeed without the plan provision. In re Classic Chemical & Supply Co., 198 B.R. 112 (Bankr. E.D. Pa. 1996).

CLAIMS. The IRS filed a claim for taxes in the debtor’s Chapter 13 case. The debtor challenged the claim, under Bankr. Rule 3001 on the basis that (1) the claim did not include any supporting facts, (2) the claim was not based on a writing, and (3) the agent who filed the claim did not have personal knowledge of the claim. The court held that the claim was sufficient because (1) a properly filed claim had a presumption of validity, (2) the claim was based upon the IRS statutory authority to assess taxes, and (3) Rule 3001 did not require personal knowledge for claimant’s agents. The court also held that the debtor failed to provide any evidence to rebut the claim. In re Hollars, 198 B.R. 270 (Bankr. S.D. Ohio 1996).

DISCHARGE. The debtors were audited in 1984 for tax deficiencies for 1975 through 1982 which were eventually determined by a Tax Court to exceed $2 million. Soon after the audit, the debtors began a series of asset transfers to their children, friends and new corporations in attempts to remove the assets from the reach of IRS liens and assessments. For example, the debtors had themselves removed from the payroll of one corporation after the IRS attempted to attach the wages. The debtors even went to the extreme of selling their residence to friends and renting the friends’ house as their new residence. The debtors also paid off all debts other than the tax debt. The trial court held that the taxes were nondischargeable, under Section 523(a)(1)(C), for willfully attempting to evade the taxes. The debtors argued that all of the transfers were bona fide and made for personal and family reasons. The appellate court upheld the Bankruptcy Court’s finding that the debtors’ stated intentions were not credible. The appellate court also upheld the Bankruptcy Court’s holding that the debtors’ actions demonstrated in whole a willful attempt to evade payment of taxes, even though any one particular action could have been bona fide and for reasons independent of the tax debt. Matter of Zuhone, 88 F.3d 469 (7th Cir. 1996).

The debtors failed for several years to make estimated tax payments or pay taxes when they filed their income tax returns. Several of the returns were also filed late. Although the debtors made some attempts to negotiate installment payment of the taxes, agreements were never reached. The debtors then joined a tax avoidance organization and removed assets to the organization in an attempt to avoid payment of the taxes. The debtors used letters and forms provided by the organization to mislead the IRS and to make frivolous arguments about their tax status. Only when the IRS began to attach the debtors’ property with tax liens did the debtors give up on the tax avoidance organization and seek payment negotiations with the IRS. The court held that, although the non-payment of taxes was insufficient evidence of intent to evade payment of taxes, the debtors’ actions went beyond mere nonpayment and included attempts to hide assets and mislead the IRS; therefore, the taxes were nondischargeable under Section 523(a)(1)(C). In re Spirito, 198 B.R. 624 (Bankr. M.D. Fla. 1996).

The taxpayer was a beneficiary of a one-fourth interest in a trust. In May 1992, the taxpayer, spouse and the IRS reached an agreement in a Tax Court case determining the taxpayer’s tax deficiencies for 1985 through 1987. The taxpayer claimed to have assigned the taxpayer’s interest in the trust to the taxpayer’s spouse in April 1992, but the taxpayer continued to receive distributions from the trust. In addition, the trustee did not receive any notice of the assignment until June 1993. The IRS issued notices of levy on the trust interest and the taxpayer filed for bankruptcy the next day. The court held that the taxes were

*Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.
nondischargeable because the trust assignment was a willful attempt to evade payment of taxes. In re Ward, 96-2 U.S. Tax Cas. (CCH) ¶ 50,450 (Bankr. D. Colo. 1996).

REFUND. The debtors did not file income tax returns for 1986 and 1987 until 1993. The IRS had filed an assessment for the 1986 and 1987 taxes in 1990 but agreed in this case that no taxes were due for those years. The debtors’ 1986 and 1987 returns requested a refund which the IRS denied as untimely. The court held that the limitation period for refund requests is, under I.R.C. § 6402(a), three years from the due date of the return, with extensions, for which the refund was claimed; therefore, the debtors’ refund requests were untimely and the refunds could not be required to be offset against the IRS claims in the bankruptcy case. Willis v. United States, 198 B.R. 201 (S.D. Tex. 1996).

SETOFF. The debtor filed a Chapter 13 case on January 12, 1996, and filed the debtor’s 1995 income tax return on January 22, 1996, claiming a refund. The IRS refused to pay the refund, holding the refund as a setoff against prior taxes owed by the debtor. The debtor argued that the refund was a post-petition obligation of the IRS which was not subject to setoff against pre-petition obligations of the debtor. The IRS argued that the refund effective date should be the last date of the tax year for which the refund was sought. The court cited I.R.C. § 6407 which provided that the allowance date of a refund was the date the IRS first authorizes the refund, holding the refund as a setoff against prior taxes owed by the debtor. The debtor argued that the refund was a setoff against prior taxes owed by the debtor. The IRS argued that the refund effective date should be the last date of the tax year for which the refund was sought. The court noted that the debtor would have this power even with the IRS’s refund date because the debtor could have filed the case prior to December 31, 1995 and achieved the same result. The court held that the IRS could not set off the refund because the refund was a post-petition obligation. In re Glenn, 198 B.R. 106 (Bankr. E.D. Penn. 1996).

FEDERAL AGRICULTURAL PROGRAMS

APPEALS. The petitioners appealed an adverse ruling of the FmHA (now FSA) to the National Appeals Division (NAD) and obtained a reversal, allowing a loan restructuring. The petitioners applied for legal fees under the Equal Access to Justice Act (EAJA) which were denied. The court held that the NAD appeal was an adjudication under the Administrative Procedures Act which allowed recovery of fees under the EAJA. The court specifically held that the appeal procedures were based, in part, on the APA because the statutes and regulations concerning the NAD appeal procedures did not supplant the APA procedures but only added to them. Although the NAD decision did not make a finding that the original agency determination was not substantially justified, the appellate court reviewed the NAD decision and found that the agency determination was based on numerous errors and inadequate recordkeeping; therefore, the court held that the agency determination was not substantially justified and the petitioners were entitled to recover legal fees under the EAJA. Lane v. USDA, 929 F. Supp. 1290 (D. N.D. 1996).


The CCC has issued a request for proposals from states, tribes, and local governments for cooperation in the acquisition of conservation easements or other interests in prime, unique or other productive soil for the purposes of limiting non-agricultural use of that land. 61 Fed. Reg. 43226 (Aug. 21, 1996).


The FCIC has issued proposed regulations providing specific provisions for the insurance of walnut crops in conjunction with the Common Crop Insurance Policy Basic Provisions. 61 Fed. Reg. 41527 (Aug. 9, 1996).

The FCIC has issued proposed regulations providing specific provisions for the insurance of almond crops in conjunction with the Common Crop Insurance Policy Basic Provisions. 61 Fed. Reg. 41531 (Aug. 9, 1996).


FARM LOANS. The FSA has adopted as final regulations establishing new policies and procedures for the release from liability of guaranteed loan borrowers and cosigners. 61 Fed. Reg. 43147 (Aug. 21, 1996).

FEDERAL ESTATE AND GIFT TAX

INSTALLMENT PAYMENT OF ESTATE TAX-ALM § 5.05[1]. The decedent owned and operated a cattle ranch with the decedent’s son. The decedent owned land used in the ranch. The son owned other property used in the business. The decedent operated the ranch in part by a partnership with the son and in part as a sole proprietor. The son contributed part of the son’s property to the partnership with the remainder of the son’s property used by the partnership but owned by the son. The decedent also allowed the partnership to use the decedent’s land and retained separate ownership of the land. The decedent was actively involved in the management of the partnership and proprietorship businesses. The partnership paid the real estate taxes, casualty and liability insurance and fencing costs for the property used by the partnership but the partnership did not pay rent for the use of the separately owned property. The IRS ruled that (1) the decedent was carrying on the cattle business both as a partner and as a sole proprietor, (2) the decedent’s land was essential to the operation as a partnership and sole proprietorship, and (3) the fact that the decedent owned the land separately from the partnership did not affect the decedent’s eligibility for installment payment of estate tax because the income from
the land was derived from the cattle business and not from rent of the land. *Ltr. Rul. 9635004, May 15, 1996.*

**LIFE INSURANCE.** The taxpayer established an irrevocable trust for the benefit of the taxpayer’s children. The taxpayer’s brother was named as trustee and the taxpayer and spouse were prohibited from becoming the trustee. The trustee had the discretion, during the taxpayer’s lifetime, to distribute trust income to the taxpayer’s issue. The trust terminated at the earlier of the taxpayer’s death or the passing of 25 years. The trust was funded with a cash gift which was used to purchase a life insurance policy on the taxpayer’s life. The trustee then entered into a split-dollar arrangement with the taxpayer’s spouse under which the trust paid a portion of the policy premiums equal to the lesser of (1) the applicable amount in the P.S. 58 tables in Rev. Rul. 55-747, 1955-2 C.B. 228 and (2) the published premium rate for individual one-year term life insurance available to all standard risks of the insurance company issuing the policy. The spouse paid the rest of the premium from the spouse’s separate property. The agreement terminated at the death or bankruptcy of the spouse or failure of either party to perform under the agreement. If the agreement terminated prior to the death of the taxpayer, the spouse would receive the net cash value of the policy. Upon the death of the taxpayer, the spouse would receive the greater of the net cash value or the amount of premiums paid by the spouse. The spouse’s interests in the policy were secured by a promissory note and collateral assignment agreement. The IRS ruled that the spouse’s payments of a portion of the premiums would not be gifts to the trust from the spouse or a deemed gift from the taxpayer. The IRS also ruled that the insurance proceeds would not be included in the taxpayer’s gross estate. *Ltr. Rul. 9636033, March, 12, 1996.*

**FEDERAL INCOME TAXATION**

**BUSINESS EXPENSES.** The taxpayer owned and operated a tax preparation and consulting business. The taxpayer had claimed deductions for office rent, equipment rental and utility expenses; however, the taxpayer was unable to substantiate many of the payments allegedly made for these expenses and several records were found to be not credible by the court. The court held that the taxpayer was unable to substantiate many of the payments allegedly made for these expenses and claimed the expenses for the taxpayer’s issue. The taxpayer was not reimbursed by the firm for these expenses and claimed the expenses on the taxpayer’s individual tax return. The taxpayer maintained a log of which clients were visited each day. The log did not contain information about the location of the meetings or what was discussed. The taxpayer had been audited for a prior tax year and only 82 percent of the automobile expenses were allowed. The taxpayer argued that 82 percent of the claimed expenses should also be allowed for the tax year involved in this case. The court held that the expenses were properly disallowed for lack of substantiation and that the IRS was not required to use an estimate from a previous year. *Thomas v. Comm’r, T.C. Memo. 1996-403.*

**PENSION PLANS.** For plans beginning in August 1996, the weighted average is 6.92 percent with the permissible range of 6.22 to 7.47 percent (90 to 109 percent permissible range) and 6.22 to 7.61 percent (90 to 110 percent permissible range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). *Notice 96-43, I.R.B. 1996—.*

**PARTNERSHIPS-ALM § 7.03.**

**ADMINISTRATIVE ADJUSTMENTS.** Three years after the period for assessments against the partnership lapsed, the IRS sent a Notice of Final Partnership Administrative Adjustment to the “Tax Matters Partner” at the partnership address. Several partners received the generic FPAA, including the partner with the largest share of partnership profits. The FPAA was mailed within the limitation period for the notice. The partnership argued that the notice was untimely filed because it was mailed after the period for assessments had lapsed. The court held that the limitation period for FPAAAs was independent of the assessment limitation period. The court also held that the failure of the FPAA to specifically name the tax matters partner did not invalidate the notice. *Wayne Caldwell Escrow Partnership v. Comm’r, T.C. Memo. 1996-401.*

An S corporation was a pass-through partner of a general partnership. The S corporation had two individuals as shareholders who were considered indirect partners of the general partnership under I.R.C. § 6231(a)(10). The S corporation was also the tax matters partner in the partnership but lost that status when it filed for bankruptcy. The IRS filed a FPAA with the general partnership and notified the S corporation that, as a result of the bankruptcy filing, the corporation’s partnership items were converted to nonpartnership items and no longer subject to the FPAA or reviewable in FPAA proceedings. The two shareholders timely filed a petition for readjustment and the IRS argued that the petition was not allowed because the corporation’s partnership items were converted to nonpartnership items. The court held that, because the shareholders were not debtors in the bankruptcy case, the bankruptcy filing did not

*AGRICULTURAL LAW DIGEST: For information about ordering the Manual, see the last page of this issue.*
The taxpayer was a shareholder in a family farm corporation. The taxpayer built a residence on corporate land using the taxpayer’s separate funds, although the taxpayer did not pay real estate taxes on the land nor rent to the corporation for the use of the land. The taxpayer owed taxes for unreported drug sales and the IRS filed a tax lien against the residence. The IRS sought to foreclose on the lien by selling the taxpayer’s stock in the corporation and the four acre residential parcel of the farm. Title to the four acres was in the name of the corporation. The IRS argued that the corporation was merely the alter ego of the taxpayer but the court held that the corporate form could not be disregarded because the taxpayer did not exercise control over corporate affairs. The court also ruled that the payment of real estate taxes and the failure to charge rent did not indicate that the corporation was the alter ego of the taxpayer, because the corporation was responsible for the taxes as title holder and the title to the land and improvements was not transferred to the taxpayer; thus, the benefits of the residence inured to the corporation. The court also rejected the IRS argument that the corporation held title to the four-acre parcel as the taxpayer’s nominee, because the corporation acquired title to the land long before any residence was constructed. The IRS also sought to foreclose on the taxpayer’s interest in the corporation by seeking sale of the taxpayer’s interest in all of the corporation’s assets. The court held that the lien attached only to the taxpayer’s shares of stock. United States v. Miller, 96-2 U.S. Tax Cas. (CCH) ¶ 50,445 (N.D. Ohio 1996).

PRODUCTS LIABILITY

HAY BALER. The plaintiff was injured while loading hay by hand into a hay baler manufactured by the defendant. The plaintiff presented evidence of similar accidents with the same model of hay baler and claimed that the defendant had knowledge that the hay baler was dangerous in that it could grab hay faster than an operator could release the hay, thus pulling hands and arms into the machinery. The plaintiff requested a jury instruction on the defendant continuing duty to warn but was refused. The appellate court reviewed Illinois law on the duty to warn and held that the case law indicated that there was no continuing duty of a manufacturer to warn purchasers of the manufacturer’s products. The court distinguished the case of Seegers Grain Co., Inc. v. United States, 577 N.E.2d 1364 (Ill. Ct. App. 1991), which held that a steel manufacturer had a duty to warn a customer about a similar accident which occurred within a month prior to the accident in the case, where the products were specifically designed for the injured party and the manufacturer had specific knowledge of the intended use and the inappropriateness of the manufacturer’s product for the intended use. The court noted that, in this case, the hay baler was a generic product sold over-the-counter to a buyer unknown to the manufacturer; therefore, the Seeger special rule did not apply. Birchler v. Gehl Co., 88 F.3d 518 (7th Cir. 1996).
TRACTOR. The plaintiff was injured while employed on a sugarcane farm. The plaintiff was helping to remove a tractor and cutter implement from some muddy ground by pulling on the implement with a chain attached to another tractor. The driver of the stuck tractor left the driver’s seat with the tractor still running in order to help the plaintiff. The stuck tractor went into reverse gear and backed the cutter over the plaintiff. The plaintiff alleged that the tractor was defectively design in that the tractor could be in gear when the shift lever was placed in the neutral position. The defendant tractor manufacturer claimed that the driver of the stuck tractor merely failed to properly place the tractor in neutral before leaving the cab. The plaintiff appealed a jury verdict for the defendant and argued that hearsay evidence was impermissibly admitted at the trial. The appellate court held that the evidence, testimony of the employer as to what the plaintiff said that the tractor driver said, was inadmissible hearsay. The appellate court then went on to a de novo review of the evidence and held that the defendant’s experts’ testimony was more credible that the tractor was not negligently designed and that any defect in the shift mechanism was caused by normal wear from use. Clay v. International Harvestor Co., 674 So.2d 398 (La. Ct. App. 1996).
FURTHER WAFFLING ON DEDUCTING ENVIRONMENTAL CLEANUP COSTS

— by Neil E. Harl*

Although it was generally believed for many years that environmental cleanup costs were currently deductible for federal income tax purposes,1 the issuance of a series of private letter rulings beginning in 1992 confirmed that the Internal Revenue Service was convinced that INDOPCO, Inc. v. Commissioner2 required that such expenditures be capitalized and amortized over some time period.3

In 1994, IRS issued Rev. Rul. 94-384 which many thought would resolve the contentious issue of deductibility of cleanup costs. That, however, proved not to be the case. A 1995 technical advice memorandum5 confirmed that fact, setting off more controversy. Now, IRS has revoked the 1995 TAM,6 leaving some uncertainty as to the IRS position.

The 1994 revenue ruling

In Rev. Rul. 94-38,7 IRS indicated that costs incurred to clean up land contaminated by a business could be deducted as ordinary and necessary business expenses. In the facts of the ruling, soil remediation activities included excavating the contaminated soil, transporting the soil to a waste disposal facility and backfilling with uncontaminated soil. The ruling, in addition to allowing deductibility for soil remediation expenses, held that costs attributable to groundwater treatment facilities (wells, pipes, pumps and other equipment to extract, treat and monitor groundwater) were capital expenditures to be depreciated.8

IRS warned, informally, that Rev. Rul. 94-389 applied only to situations where the taxpayer was responsible for the pollution.

The 1995 TAM

The technical advice memorandum issued in 199510 confirmed that the informal IRS warning as to the scope of Rev. Rul. 94-3811 should be taken seriously. In the facts of the 1995 ruling, a company had acquired uncontaminated farm land which was later used as a site for the disposal of industrial waste.12 Later, a subsidiary of the firm acquiring the land contributed the land to the county for a recreational park and claimed a charitable deduction.13 Some time later, the county discovered that the land was contaminated and conveyed the land back to the subsidiary for $1.

Eventually, the state environmental agency designated the land as a superfund site with remediation costs assessed to the subsidiary.

IRS declared that Rev. Rul. 94-3814 did not apply inasmuch as the taxpayer (the subsidiary) acquired contaminated property. The TAM explained that Rev. Rul. 94-3815 only applied if a taxpayer acquired clean property and then contaminated the property through business operations.

The policy implications from the TAM were somewhat unusual if not perverse: a taxpayer acquiring clean property who contaminates it is entitled to a deduction; those who acquire contaminated property and clean it up are denied a deduction.

The 1996 TAM

The latest IRS pronouncement, in the form of another technical advice memorandum,16 revoked the 1995 TAM17 and allowed deductibility of consulting fees, legal expenses and environmental impact study costs. No actual work on site remediation had been done.

The TAM reached that conclusion by holding that "the interim break in ownership should not, in and of itself, operate to disallow a deduction under the general principles of section 162 of the Code."18 Thus, the subsidiary was treated as though the land were still owned by the parent company. That is hardly earthshaking in light of (1) the obviously close relationship between subsidiary and parent and (2) the "purchase price" of $1 paid by the subsidiary to reacquire the land from the county.

Conclusions

So where does all of this leave the issue of deductibility? That is not entirely clear but some tentative conclusions can be drawn -

• A basic premise of Rev. Rul. 94-3819 that deductibility is allowed if the taxpayer acquires clean land and contaminates it seems to have survived the TAMs.
• Those acquiring contaminated land and wanting to (or forced to) clean it up apparently must capitalize remediation costs.

• Transfers of ownership in less than arm's length transactions, particularly where the consideration is nominal, are unlikely to affect deductibility.

FOOTNOTES
1 I.R.C. § 162(a).

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

BANKRUPTCY
GENERAL-ALM § 13.03.*

CLAIMS. The debtor had granted to a lender a security interest in a tractor truck used in the debtor’s business. The debtor filed for Chapter 13 and the plan provided for the debtor’s retention of the truck for use in the business and for payment of the loan secured by the truck in the amount equal to the wholesale value of the truck on the date of the petition, using the cramdown provision of Section 1325(a)(5)(B). The lender argued that, under Section 506(a), the secured amount of the claim was equal to the replacement value of the truck at its full retail value. The debtor presented credible expert testimony as to the wholesale value of the truck and the lender provided weak expert testimony as to the retail value of the truck. The Court held that the amount of the secured portion of the claim was limited to the wholesale value of the truck as determined by the debtor’s expert testimony. Matter of Rash, 90 F.3d 1036 (5th Cir. 1996).

FEDERAL TAXATION-ALM § 13.03[7].*

AUTOMATIC STAY. The IRS filed a claim for unpaid income taxes, penalties and interest and unpaid employment taxes, penalties and interest. Prior to the filing for bankruptcy, the IRS had filed a notice of levy against the debtors’ real property which was subject to an Illinois land trust. The notice was not filed with the trustee. After the bankruptcy filing, the IRS erroneously filed a duplicate notice of levy and sent the debtors a notice of audit of employment taxes for pre-bankruptcy tax years. The IRS later rescinded the duplicate notice of levy. The debtors first argued that the duplicate levy notice and audit notice violated the automatic stay, but the court held that the rescission of the duplicate notice removed any violation and that an audit notice was not a violation of the automatic stay. The debtors also argued that the rescission of the duplicate notice caused the initial levy to be rescinded because the second notice merged with the first. The court held that this argument failed because the debtors failed to provide any support for the merger theory in statute or case law. The debtors also argued that the assessed penalties and interest should have been abated because the debtors’ failure to pay the taxes resulted from the high medical bills for their disabled child. The court held that the debtors had sufficient means to either pay the taxes from income or by borrowing the money against their substantial equity in the debtors’ home. Carlson v. U.S., 198 B.R. 949 (N.D. Ill. 1996).

DISCHARGE. The IRS filed a claim for 1986, 1987 and 1988 taxes owed by the debtors. The taxes were due more than three years before the bankruptcy petition was filed. The 1986 and 1987 taxes were assessed more than 240 days before the petition but the 1988 taxes were assessed 151 days before the petition. The debtors received a discharge in the case but, after the discharge, the IRS continued to seek payment of the taxes through levies, even after letters from the debtors were sent reminding the IRS of the discharge. The IRS argued that the three year period should have been equitably waived by the court but did not provide any reason for the equitable waiver. The court held that the IRS’s failure to seek the equitable waiver before violating the automatic stay of the discharge prohibited applying equitable principles to the IRS’s claims. Therefore, the court ruled that the IRS could continue assessments and collection only as to the 1988 taxes which were not discharged. In re Gilmore, 198 B.R. 686 (Bankr. E.D. Tex. 1996).

DISMISSAL. The debtor filed for Chapter 11 with primarily federal income tax debts as claims in the case. The court found that the debtor failed to file the Chapter 11 operating reports in contravention of court orders, filed incorrect and misleading information with the court, and failed to file and pay post-petition income taxes. The court held that the debtor’s actions demonstrated bad faith sufficient to warrant dismissal of the case. Matter of Whitehurst, 198 B.R. 981 (Bankr. N.D. Ala. 1996).
EARNED INCOME TAX CREDIT. The debtors filed for Chapter 7 on December 19, 1995. During the bankruptcy case, the debtors received an income tax refund for 1995 which resulted from an earned income tax credit. The court held that the refund was estate property. The debtors claimed the refund as an exemption under the Oklahoma exemption for “alimony, support, separate maintenance or child support payments.” Okla. Stat. tit. 31, § 1(19). The court held that the refund was eligible for the exemption because the earned income tax credit was intended to provide support for low income workers with children. In re George, 199 B.R. 60 (Bankr. N.D. Okla. 1996).

NET OPERATING LOSSES. The debtors had filed for Chapter 7 in 1982. The bankruptcy trustee filed bankruptcy estate income tax returns, and the 1989 return showed a final net operating loss resulting from losses in 1981 through 1984. After the bankruptcy case ended in 1991, the debtors filed amended individual returns for 1986 through 1989 claiming deductions for the net operating losses remaining from the bankruptcy estate. The IRS denied the requested refunds for 1986 and 1987 as untimely filed. The debtors acknowledged that, under I.R.C. § 6511(a), the refund claims were not timely filed because the refund claims were filed more than two years after the taxes was paid. The debtors argued that 11 U.S.C. § 346(a) allowed use of any remaining tax attributes as though any time limitations were suspended during the bankruptcy case. The court held that Section 346(a) made Section 346(i)(2) subject to the Internal Revenue Code of 1986; therefore, the two year limitation period for filing a refund was not suspended by the bankruptcy filing. The IRS denied the refund claims for 1988 and 1989 because the remaining net operating losses were not reduced by the amount of indebtedness discharged in the bankruptcy case as required by I.R.C. § 108. Apparently, the bankruptcy trustee failed to offset the net operating losses against the discharged indebtedness on the final return. The debtors argued that the final return was entitled to a presumption of correctness because the IRS did not object to the return. The court held that the failure of the trustee to properly complete the return did not excuse the debtors from complying with I.R.C. § 108; therefore, because the amount of discharged indebtedness exceeded the net operating losses, the debtors were not entitled to any refund. Firsdon v. United States, 96-2 U.S. Tax Cas. (CCH) ¶ 50,475 (6th Cir. 1996), aff’d, 95-1 U.S. Tax Cas. (CCH) ¶ 50,040 (N.D. Ohio 1995).

FEDERAL AGRICULTURAL PROGRAMS

CONSERVATION. The USDA has issued interim final regulations (effective immediately but may be amended later after public comments) implementing changes to the Highly Erodible Land and Wetland Conservation program. The amendments include: (1) adding factors for allowing a variance for weather, pest or disease problems; (2) providing that highly erodible land which is combined with another parcel must retain its highly erodible character; (3) requiring that a conservation system be evaluated according to the NRCS field office technical guide; (4) requiring that conservation field trials have prior approval from the NRCS and be documented in the conservation plan; (5) adding factors for use by the FSA state committee for granting relief based on economic hardship in implementing a conservation system; (6) adding additional, more precise definitions of wetlands; and (7) providing that in making a determination of good faith compliance, the USDA may consider any other violations of federal, state or local conservation provisions. The USDA noted that the new regulations do not affect the Memorandum of Agreement reached between the EPA, USDA, Department of the Army and the Department of the Interior but that agreement will be reviewed by the four agencies. 61 Fed. Reg. 47019 (Sept. 6, 1996), amending 7 C.F.R. Part 12.

CROP INSURANCE. The FCIC has issued proposed regulations amending the cotton crop insurance provisions to require additional information necessary for determining producer eligibility and the amounts to be paid for claims. 61 Fed. Reg. 46401 (Sept. 3, 1996).

FARM LOANS. The FSA has issued proposed regulations governing administrative offset to collect delinquent debts due under programs formerly administered by the FmHA. 61 Fed. Reg. 45907 (Aug. 30, 1996).

PERISHABLE AGRICULTURAL COMMODITIES ACT-ALM § 10.05[2]. The petitioner was a licensed wholesale produce dealer subject to PACA. The petitioner purchased a shipment of berries which was inspected upon delivery by the USDA which issued inspection certificates. The petitioner thought that the berries were in poor condition and sought a price reduction through the seller’s agent. The agent requested copies of the inspection certificates. The petitioner altered the temperature reading on the certificates and faxed the altered certificates to the agent who, based on the altered certificates, allowed a price reduction. The ALJ imposed a 90 day suspension of the petitioner’s license for willful, flagrant and repeated violations of 7 U.S.C. § 499(b)(4). The petitioner argued on appeal that PACA did not apply to this shipment of berries because the berries were intended only for intrastate commerce. The court upheld the ALJ ruling that PACA did apply to the berries because the berries were part of the petitioner’s interstate commerce business and some of berries were sold to an interstate hotel chain. The petitioner also argued that the altering was not a knowing misrepresentation because the petitioner altered the temperature reading because the petitioner believed that the inspection method produced a false temperature. The appellate court also upheld the ALJ’s ruling that the altering of the certificate was a fraudulent action which the petitioner willing and knowingly committed. Produce Place v. U.S.D.A., 91 F.3d 173 (D.C. Cir. 1996).

SHEEP. The APHIS has adopted as final regulations removing the scrapie indemnification program which provided financial compensation for owners of sheep destroyed because of an infection of scrapie. 61 Fed. Reg. 47669 (Sept. 10, 1996).

FEDERAL ESTATE AND GIFT TAX

DISCLAIMERS-ALM § 5.02[6]. The decedent’s will bequeathed the residuary estate in trust to the decedent’s children for life with remainders to the grandchildren and
further remainders to the great-grandchildren. The children executed written disclaimers of any interest in the trust. The grandchild executed disclaimers of any interest in the trust beyond $500,000. The great-grandchildren, through court appointed guardians, executed disclaimers of any interest in the trust. Because the trust did not provide for any remainders after the great-grandchildren, the trust interests in excess of $500,000 passed by the law of intestacy, $50,000 to the surviving spouse and the remainder to the children in fee. The IRS ruled that the disclaimers were effective to pass the trust interests above $500,000 to the children and surviving spouse. Ltr. Rul. 9638014, June 12, 1996.

GROSS ESTATE-ALM § 5.02.* The decedent had been the subject of an action by the United States under CERCLA. The decedent reached a settlement under which the decedent’s residence was transferred to one trust which provided the decedent with the use of the residence during the decedent’s life, and the remainder of the decedent’s property was transferred to a trust which provided for a monthly annuity for the decedent plus so much of the principal as necessary for the decedent’s maintenance, property expenses and tax payments. The IRS ruled that the trust property in both trusts was included in the decedent’s estate with a deduction for the amount that passed to the United States. Ltr. Rul. 9638036, June 24, 1996.

TRUSTEE LIABILITY FOR TAX. The taxpayer was the trustee of a marital trust for the decedent. The decedent exercised by will a power of appointment over the trust corpus and appointed the trust corpus to the taxpayer’s brother. The taxpayer received nothing from the decedent’s estate. Although the brother was the estate executor, no federal estate tax return was filed until the taxpayer filed the return. An estate tax deficiency was assessed against the estate and the taxpayer was assessed for that deficiency under I.R.C. § 6324 as a trustee of the property in the estate. The court held that the taxpayer had sufficient control over the trust at the time of the decedent’s death to make the estate tax payments; therefore, the taxpayer was liable for the estate tax, even though the taxpayer received none of the estate property. I.H. Govern Estate v. Comm’r, T.C. Memo. 1996-414, denying reconsider. of T.C. Memo. 1996-331.

ACCOUNTING METHOD-ALM § 4.01.* The taxpayer was a farm partnership which grew wine grapes. The owners of the partnership also established another company which produced wine from grapes purchased from the partnership and other unrelated parties. The partnership also sold grapes to other unrelated companies. The partnership used the cash method of accounting but the IRS argued that the partnership should be required to use the accrual method because the winery company often was allowed up to five years to make payments for grapes from the partnership, thus causing a material distortion of income for the partnership. The taxpayer argued that the deferral of payments was in the ordinary course of business in that the winery company often needed a stable, long-term relationship with a grape supplier. The evidence also demonstrated that the winery deferred payment primarily because of cash flow needs and borrowing needs while the winery was expanding. The court held that the deferral of payments for such long periods was not a standard industry practice, especially where the grape supplier was not given any extra consideration for the deferrals. The shared ownership of the companies by the same persons also indicated that the deferrals were part of a strategy to develop the winery at the expense of the partnership. The court held that the deferral of payments for the grapes was a material distortion of income and not made in the ordinary course of business; therefore, the partnership was required to use the accrual method of accounting for income tax purposes. Oakcross Vineyards, Ltd. v. United States, T.C. Memo. 1996-433.

BUSINESS EXPENSES. The taxpayer was employed as a computer specialist in Florida and also owned a 300
The taxpayer purchased three paint employed as a pipe fitter for a railroad and owned a carpet worth of trees had been cut.

The contract was to determine the value of the trees after they were cut. The court held that the sale was completed when the $207,000 was paid in income, arguing that the sale was not a completed transaction because the actual timber to be cut was not determined when the payment was made. The court held that the deductions disallowed by the IRS were properly disallowed for lack of substantiation by the taxpayer. Haigh v. Comm'r, T.C. Memo. 1996-409.

The taxpayer suffered the loss of an automobile caused by insufficient anti-freeze in the engine. The court held that the loss was not a deductible casualty loss but was a personal expense resulting from personal neglect. Mohiuddin v. Comm'r, T.C. Memo. 1996-422.

The taxpayer was a corporation which operated a horse racing and breeding activity. On December 28, 1984, the taxpayer purchased the assets of a decedent’s estate which included the stock of another corporation and the personal assets of the estate. The taxpayer continued the purchased corporation as a subsidiary. On January 15, 1985, the taxpayer transferred the estate personal property, which included 353 horses, to the subsidiary retroactively, effective on the date the property was purchased from the estate, December 28, 1984. The taxpayer claimed a full year of depreciation for the horses, arguing that the temporary ownership of the horses gave the taxpayer a sufficient ownership interest to claim depreciation. The court held that the true ownership of the horses, as established by the taxpayer’s own actions, was that the horses were owned by the subsidiary which was entitled to only one month of depreciation in 1984. Jack Kent Cooke, Inc. v. United States, 96-2 U.S. Tax Cas. (CCH) ¶ 50,483 (E.D. Va. 1996).

The taxpayer owned timberland and signed an agreement with an unrelated party to log the land. The other party paid the taxpayer $207,000 under the contract before any logging commenced. The payment was in the form of satisfaction of mortgages on the property. The parties disputed the contract rights and the other party eventually won a judgment in court which required the taxpayer to repay the other party for loss of the timber harvesting rights. The taxpayer did not include the $207,000 payment in income, arguing that the sale was not a completed transaction because the actual timber to be cut was not determined when the payment was made. The court held that the sale was completed when the $207,000 was paid because the actual trees to be cut was not an essential element of the contract. The only remaining task under the contract was to determine the value of the trees after they were cut so that the parties would know when $207,000 worth of trees had been cut. In re Apsel, 96-2 U.S. Tax Cas. (CCH) ¶ 50,490 (Bankr. D. Or. 1996).

The taxpayers, husband and wife, were both employed full time. The taxpayers purchased a vacation cottage three blocks from the ocean and later purchased a lot across the street which contained an uninhabitable house and a barn. The taxpayers visited the properties nearly every weekend, traveling 160 miles from their home in the city where they worked. The taxpayers started a small flower and tree nursery on the second property. Because the taxpayer could commit only weekend efforts to the nursery, the nursery was unable to generate sufficient income to cover all expenses eligible for a deduction. The taxpayers claimed all expenses associated with both properties as business expenses. Although the taxpayers kept a journal of expenses associated with the nursery, the taxpayers failed to provide evidence of allocation of expenses common to both properties, such as insurance and utility expenses. The court noted that the taxpayers had no expertise as plant growers or as retail business people and that the nursery had no prospect of ever operating on a profit for tax purposes. The court held that the taxpayers could not take deductions in excess of the nursery income. Gagnon v. Comm’r, T.C. Memo. 1996-417.

The taxpayer operated a scrap metal business which consisted primarily of a rented warehouse. Scrap metal was delivered to the warehouse where the taxpayer’s employees sorted the metal and prepared it for resale. Because the warehouse did not have suitable office space, the taxpayer used a portion of the taxpayer’s living and dining rooms in the residence for regular office work. The office was not used to see customers or clients. The taxpayer’s stationery gave the home office because the primary business activity occurred at the

Hobby Losses-ALM § 4.05[1]. The taxpayer was employed as a pipe fitter for a railroad and owned a carpet cleaning business. The taxpayer purchased three paint horses with the intent to train the horses for competition and to offer the horses for stud fees once the horses were successful at the competitions. The taxpayer hired a professional trainer and at least one horse was successful at some competitions. However, in the second year of the activity no horses were entered into competitions and no breeding ever occurred. Records were kept for the horse training and showing activities. The court held that the horse training and breeding activity was operated with the intent to make a profit, allowing deductions in excess of income because (1) the taxpayer maintained separate records and a separate checking account for the activity; (2) the taxpayer’s lack of profit/loss analysis was not necessary given the limited nature of the activity; (3) the taxpayer hired a professional trainer who devoted a substantial amount of time to the activity; (4) the taxpayer had a reasonable expectation that the horses would appreciate in value after they won competitions; (5) the taxpayer did not have substantial income from other sources which was offset by the horse activity; (6) the taxpayer had a reasonable expectation of profits from the activity; (7) the losses were incurred primarily during the start-up period when the horses were being trained; (8) the taxpayer, or any member of the taxpayer’s family, did not use the horses for personal pleasure; and (9) the taxpayer’s lack of success in this and another similar activity was outweighed by the other factors. Dawson v. Comm’r, T.C. Memo. 1996-417.
warehouse and the taxpayer did not exclusively use the office space for business uses. Miller v. Comm'r, T.C. Memo. 1996-432.

INvoluntary conversions. The taxpayers owned business property which was condemned by the state for highway construction. The state placed a deposit with the court on June 5, 1980 and the condemnation occurred on June 16, 1980. The taxpayers withdrew the deposit on June 24, 1980 but did not include the funds in income on their 1980 income tax returns. The court held that the failure to include the funds in income constituted an election to have I.R.C. § 1033 apply to the transaction. The taxpayers entered into negotiations with the state over the final amount to be paid for the condemned land and final payment was made in 1989, after which the taxpayers purchased replacement property. The court held that the three year period for purchasing replacement property commenced on June 16, 1980, the date of the condemnation and when the taxpayers first had the right to withdraw the funds. Because the taxpayers did not purchase replacement property until more than three years after the condemnation date, the entire gain was reportable as realized. Thus, the deposit was recognized as income in 1980 and the remainder recognized in 1989. The entire condemnation award was gain because the taxpayers failed to demonstrate any basis in the condemned property. Wilson v. Comm'r, T.C. Memo. 1996-418.

Loses-ALM § 4.03.* The taxpayer was an avid horse rider and trained in the sport of equine dressage. The taxpayer decided to breed a mare which the taxpayer had trained in dressage. The foal was sold at 22 months of age, long before any normal training would occur. The foal was originally intended to be trained by the taxpayer but the taxpayer determined that the taxpayer did not have sufficient time to devote to the training. The taxpayer claimed a long-term capital loss on the sale of the foal. The court found that the taxpayer did not obtain the foal with an intent to make a profit in that the taxpayer’s interest in training the foal was primarily for personal pleasure. The taxpayer had other employment and failed to develop a plan by which the foal would be trained and eventually sold at a profit. The court held that the loss from the sale of the foal was not entitled to capital loss treatment. Cotner v. Comm'r, T.C. Memo. 1996-428.

PenSion plans. For plans beginning in September 1996, the weighted average is 6.91 percent with the permissible range of 6.22 to 7.46 percent (90 to 109 percent permissible range) and 6.22 to 7.60 percent (90 to 110 percent permissible range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). Notice 96-45, I.R.B. 1996-__.

The IRS has ruled that a defined contribution plan does not satisfy the consent requirements of I.R.C. § 411(a)(11) if (1) participants who have not terminated employment are allowed to direct the investment of their accounts, (2) the plan offers a broad range of investment choices, and (3) the accounts of former employees who do not consent to an immediate distribution of their account balances are required to be invested in a money market fund. The IRS ruled that the loss of the right to choose among a broad range of investment alternatives is a significant detriment, as defined by Treas. Reg. § 1.411(a)-11(c)(2)(i), for participants who choose not to have immediate distributions; therefore, such a plan permits an immediate distribution without a valid consent. Rev. Rul. 96-47, I.R.B. 1996-__.

This ruling involved a qualified retirement plan which permitted employees who have not satisfied the minimum age and service requirements for participation to make rollover contributions to the plan’s trust. The IRS ruled that (1) the plan was not precluded from treating as excludible, under I.R.C. § 410(b), all employees who have not completed one year of service; (2) employees who are eligible to make rollover contributions but who have not met the one-year service requirements are not taken into account under I.R.C. § 401(k)(3) or 401(m)(2); and (3) the plan must separately satisfy the nondiscriminatory availability requirement of Treas. Reg. § 1.401(a)(4)-1(b)(3) with respect to the right of employees who have not satisfied the minimum one-year of service requirement. The IRS also ruled that, for the purposes of the minimum contribution and benefit requirements of I.R.C. § 416(c), employees are not plan participants for a plan year merely because the employees are eligible for or make rollover contributions. Rev. Rul. 96-48, I.R.B. 1996-__.

Safe harbor interest rates

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Annual</td>
<td>Semi-annual</td>
<td>Quarterly</td>
<td>Monthly</td>
</tr>
<tr>
<td>AFR</td>
<td>6.07</td>
<td>5.98</td>
<td>5.94</td>
<td>5.91</td>
</tr>
<tr>
<td>110% AFR</td>
<td>6.69</td>
<td>6.58</td>
<td>6.53</td>
<td>6.48</td>
</tr>
<tr>
<td>120% AFR</td>
<td>7.31</td>
<td>7.18</td>
<td>7.12</td>
<td>7.07</td>
</tr>
<tr>
<td>AFR</td>
<td>6.72</td>
<td>6.61</td>
<td>6.56</td>
<td>6.52</td>
</tr>
<tr>
<td>110% AFR</td>
<td>7.40</td>
<td>7.27</td>
<td>7.21</td>
<td>7.16</td>
</tr>
<tr>
<td>120% AFR</td>
<td>8.09</td>
<td>7.93</td>
<td>7.85</td>
<td>7.80</td>
</tr>
<tr>
<td>AFR</td>
<td>7.13</td>
<td>7.01</td>
<td>6.95</td>
<td>6.91</td>
</tr>
<tr>
<td>110% AFR</td>
<td>7.86</td>
<td>7.71</td>
<td>7.64</td>
<td>7.59</td>
</tr>
<tr>
<td>120% AFR</td>
<td>8.59</td>
<td>8.41</td>
<td>8.32</td>
<td>8.27</td>
</tr>
</tbody>
</table>

Self-employment income-ALM § 4.06.* The taxpayer held a real estate license but primarily operated a business as a photographer’s agent. In 1981, the taxpayer purchased a single family residence with the intent to remodel it and resell it at a profit, but the house was merely rented after three months. In 1984, the taxpayer purchased a second residential property, a duplex, with the intention of renting one-half of the property until it could be sold at a profit. The taxpayer lived in the other half. The taxpayer sold the duplex and purchased another duplex under the same arrangement. The taxpayer also married and the couple continued to own the spouse’s pre-marital residence which was rented. The taxpayer claimed losses from these properties as business losses which decreased the taxpayer’s self-employment income. The court held that the taxpayer held the properties for investment and not as a dealer in real estate; therefore, the losses from the properties were not part of the calculation of self-employment income under I.R.C. § 1402(a)(1). Nadeau v. Comm'r, T.C. Memo. 1996-427.

The taxpayers, husband and wife, owned and operated a ranch as sole proprietors. The taxpayers transferred the livestock and the farmstead to a new wholly-owned ranch corporation which cash rented the remaining land from the taxpayers. The corporation constructed a new house on the farmstead in which the taxpayers lived. The taxpayers also

* Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.
rented the farm machinery to the corporation at a fixed annual rental rate. The land not rented to the corporation was enrolled in the federal Conservation Reserve Program by the taxpayers. Both taxpayers were employees of the corporation and operated the ranch business as before the transfer. The taxpayers admitted that the wife’s duties corresponded to the normal duties of a farm wife, including bookkeeping, meal preparation and general assistance as needed in the ranch operation. The husband was named as president of the corporation, a member of the board of directors and manager of the ranch operation in the corporation bylaws and employment contracts. The IRS ruled that the husband materially participated in the tenant’s business activities. The IRS also ruled that the wife also materially participated in the tenant’s business through her position as secretary and treasurer, as member of the board of directors and through involvement in the ranch operation. The IRS ruled that both taxpayers actually participated in the ranch operation of the corporation. The IRS ruled, therefore, that the rental income from the corporation was included in the taxpayers’ self-employment income under I.R.C. § 1402(a)(1). The IRS noted that the fact that the taxpayers also received salaries from the corporation and that the rental payments were fixed did not affect the status of the rental payments as self-employment income. The IRS also held that, under Rev. Rul. 60-32, 1960-1 C.B. 23, the CRP payments were included in self-employment income because the taxpayers materially participated in the business use of the land. Ltr. Rul. 9637004, May 1, 1996. The next issue of the Digest will include an article by Neil Harl on this ruling.

The taxpayers, husband and wife, operated a crop and livestock farm. The taxpayers purchased an additional 1,022 acres of land in 1987 and 1989 which had previously been placed in the federal Conservation Reserve Program. The CRP contract required the maintenance of a ground cover and prohibited the commercial use of the land for crops or grazing. The taxpayer claimed the expenses of maintaining the land, taxes, depreciation and other expenses as business deductions and claimed the CRP payments as farm income not subject to self-employment tax. The court held that because the taxpayers were already engaged in the business of farming and the CRP payments were contingent upon the land being suitable for farming, the CRP payments were included in self-employment income. The court cited Rev. Rul. 60-32, 1960-1 C.B. 23 in support of its holding that sufficient nexus existed between the CRP payments and the taxpayers’ business of farming. Ray v. Comm’r, T.C. Memo. 1996-436. An article by Neil Harl on this case will be included in an upcoming issue of the Digest.

MEDICAID

ASSET TRANSFERS. Under the Health Insurance Portability and Accountability Act of 1996, it is a criminal offense punishable by a year in prison or a $10,000 fine to transfer assets in order to qualify for Medicaid if done “knowingly and willfully” to become eligible for assistance if disposition of the assets results in a period of ineligibility. Pub. L. No. 104-191, Sec. 217, amending 42 U.S.C. § 1320(a)-7b(a).

SECURED TRANSACTIONS

ATTACHMENT. The debtors had granted a bank a security interest in all crops growing or to be grown by the debtors. The debtors had cash leased land to a corporation owned by the debtors. The debtors lost the leased land by foreclosure and the land was sold soon after the tenant corporation planted a new wheat crop. The buyers of the land harvested the crop and held the proceeds in escrow pending the determination of the priority security interest in the crop. The bank argued that its security interest in the crops had priority because it was perfected first. The court agreed as to the prior time of filing but held that the crops were not covered by the security interest because the debtor’s only interest was the rent charged for the land. Janitell v. State Bank of Wiley, 919 P.2d 921 (Colo. App. 1996).

PERFECTION BY POSSESSION. The debtor had granted a bank a security interest in all present and after-acquired inventory. The debtor had subsequently purchased an interest in cattle held by a feedlot business. The agreement provided that the feedlot retained a security interest in the cattle to secure the cost of purchasing the cattle. The feedlot did not file a financing statement but the cattle never left the feedlot. After the debtor filed for bankruptcy, the trustee sought a determination as to the priority of the security interests as to the cattle in the possession of the feedlot. Under Kan. U.C.C. § 9-312(3), a purchase money security interest has priority over prior security interests if the purchase money security interest is perfected when the debtor receives possession of the collateral and the holder of the purchase money security interest notifies the other security interest holder within five years before the debtor receives possession of the collateral. The court held that because the debtor never had possession of the collateral and the purchase money security interest was perfected by possession of the purchase money security interest holder, notification of the other security interest holder was not necessary to perfect the purchase money security interest. The bank also argued that the cattle were not in the possession of the feedlot for perfection purposes but to feed and care for the cattle; therefore the possession exception did not apply. The court held that the cattle were held under the agreement which stated that the cattle were security for the price of the cattle; therefore, one of the purposes of the possession was for security for the cost of the cattle. The court noted that the facts also indicated that the debtor may not have acquired enough rights in the cattle for the bank’s security interest to attach, since the debtor did not have sufficient control over the care or selling of the cattle. Kunkel v. Sprague Nat’l Bank, 198 B.R. 734 (D. Minn. 1996).
TRESPASS

ENVIRONMENTAL POLLUTION. The plaintiff sought to sell several parcels of farm land but the sale fell through when the potential buyer learned that a gasoline spill had occurred on neighboring land and there was a chance some of the plaintiff’s land was contaminated. The plaintiff did not test the land and one report issued to the neighboring land owner found that the contamination spread away from the plaintiff’s land. The plaintiff filed suit against the neighboring landowner and business which caused the spill under theories of trespass and nuisance. However, the petition contained no allegations that the plaintiff’s land was contaminated but used only hypothetical allegations. The court held that, although hypothetical pleadings were allowed in certain circumstances, the plaintiff’s petition should be dismissed because the plaintiff had the power and time to test for contamination. Sprague Farms, Inc. v. Providian Corp., 929 F. Supp. 1125 (C.D. Ill. 1996).

CITATION UPDATES

Perry v. Comm’r, 91 F.3d 82 (9th Cir. 1996) (sale of residence) see p. 130 supra.

**ISSUE INDEX**

<table>
<thead>
<tr>
<th>Bankruptcy</th>
<th>Federal Income Taxation</th>
<th>Medicaid</th>
</tr>
</thead>
<tbody>
<tr>
<td>General</td>
<td>Accounting method</td>
<td>Asset transfers</td>
</tr>
<tr>
<td>Claims</td>
<td>Business expenses</td>
<td>155</td>
</tr>
<tr>
<td>Federal taxation</td>
<td>Casualty loss</td>
<td>Involuntary conversions</td>
</tr>
<tr>
<td>Automatic stay</td>
<td>Depreciation</td>
<td>154</td>
</tr>
<tr>
<td>Discharge</td>
<td>Gross income</td>
<td>Losses</td>
</tr>
<tr>
<td>Dismissal</td>
<td>Hobby losses</td>
<td>Pension plans</td>
</tr>
<tr>
<td></td>
<td>Home office</td>
<td>Safe harbor interest rates</td>
</tr>
<tr>
<td>Earned income tax credit</td>
<td>Involuntary conversions</td>
<td>October 1996</td>
</tr>
<tr>
<td>Net operating loss</td>
<td>Losses</td>
<td>154</td>
</tr>
<tr>
<td>Federal Agricultural Programs</td>
<td></td>
<td>Self-employment income</td>
</tr>
<tr>
<td>Conservation</td>
<td></td>
<td>154</td>
</tr>
<tr>
<td>Crop insurance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Farm loans</td>
<td></td>
<td></td>
</tr>
<tr>
<td>PACA</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sheep</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Federal Estate and Gift Tax</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Disclaimers</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross estate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trustee liability for tax</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Valuation</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**AGRICULTURAL LAW PRESS ON THE WEB**

http://members.aol.com/aglaw/agpub

Check out our internet site for information about:
- Direct internet links to legal resources on the internet.
- Direct email link to the Agricultural Law Press.
- We welcome any suggestions for improving our web site.
RENTERING LAND TO FAMILY ENTITY

by Neil E. Harl

In late 1995, the U.S. Tax Court shocked farmers and their tax advisors with the startling news that a non-material participation crop share lease of 731 acres of land to a family partnership (in which the Arkansas landowner was a 25 percent partner) produced self-employment tax liability on the share rents paid to the landowner. Now, an IRS private letter ruling has reached the same conclusion under a different factual situation. The growing body of authority supporting the IRS position has fueled an already burgeoning level of audit activity in the area and promises to produce a pronounced shift in estate and business planning strategies for farmers and ranchers.

The latest ruling, dated May 1, 1996, involved a husband and wife as officers and directors of a family ranch corporation. Formerly, the taxpayers had operated the ranch as sole proprietors. They incorporated the ranch with the livestock and farmstead transferred to the newly formed corporation. The taxpayers rented the land to the corporation under a cash rent lease. The machinery was also rented to the corporation. Both the taxpayers were employees of the corporation. IRS ruled that both the husband and wife were materially participating in the ranch operation. The taxpayers were held liable for self-employment tax on the cash rental received from the corporation. The ruling cited the late 1995 case, Lee Mizell, with approval and reached the same conclusion as the Tax Court reached in the Mizell case. The IRS ruling, however, involved a cash rent lease rather than the crop share lease in Mizell.

Reasoning employed

In both the Mizell case and the 1996 ruling, the focus was on the language in I.R.C. § 1402. That section provides, in part --

"(1) The term 'net earnings from self-employment' means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member; except that in computing such gross income and deductions and such distributive share of partnership ordinary income or loss --

“(a) There shall be excluded rentals from real estate and from personal property leased with the real estate (including such rentals paid in crop shares) together with the deductions attributable thereto, unless such rentals are received in the course of a trade or business as a real estate dealer, except that the preceding provisions of this paragraph shall not apply to any income derived by the owner or tenant of land if (1) such income is derived under an arrangement, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities... on such land, and there shall be material participation by the owner or tenant... and there is material participation by the owner or tenant... with respect to any such agricultural or horticultural commodity..."(Emphasis added).

The Tax Court and the IRS in the letter ruling interpreted the term "under an arrangement" to include the activities of the landowner as a partner or corporate officer and director as well as the activities of the landowner as lessor under the lease. Both the Tax Court and the IRS found the material participation requirement to have been met even though the activities of the landowner as lessor alone were insufficient for material participation. The combining of activities of a landowner as lessor and as an active member of the production entity (partner or employee) has been criticized.

Planning options

The position taken successfully by IRS in the Tax Court case and in the letter ruling suggests several planning strategies for farmers and ranchers --

• One possibility is to revert to greater use of the single entity approach to farm business planning as was the case in the 1970s and early 1980s when investment tax credit eligibility for non-corporate lessors and the potential for investment tax credit recapture on formation of multiple entities discouraged use of the multiple entity approach to planning. The advantages of keeping the land separate from the production entity, however, are viewed as sufficiently advantageous to suggest that this planning option is expected to be an unpopular choice.

Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
• Another possibility is to shift landownership to the spouse (using the 100 percent federal gift tax marital deduction)\(^\text{12}\) with the spouse renting the land to the production entity under a non-material participation crop share, livestock share\(^\text{13}\) or cash rent lease. For this strategy to succeed, it would be necessary for the land owning spouse not to be involved in the production entity as partner, employee or otherwise to the extent that the combined level of involvement constitutes material participation. No attribution rules exist to treat spousal ownership of land in this type of setting as land ownership by the non-land owning spouse.

• Another possible strategy would be to convey the land to another entity (other than a grantor trust) with the land owning entity then entering into a lease with the production entity. Although a successful outcome (in terms of avoiding self-employment tax) is not assured, it is believed that income from self-employment would not be imputed to the entity owners.

• Finally, some may prefer to simply pay the additional self-employment tax, particularly if the amount of earned income otherwise is approaching the covered amount for OASDI purposes ($62,700 for 1996). It is important to note that HI tax now continues to apply to all self-employment income.\(^\text{14}\)

FOOTNOTES
\(^{2}\) Ltr. Rul. 9637004, May 1, 1996.
\(^{3}\) Id.
\(^{4}\) Id.
\(^{5}\) T.C. Memo. 1995-571.
\(^{6}\) Id.
\(^{7}\) Id.
\(^{8}\) Ltr. Rul. 9637004, May 1, 1996.
\(^{9}\) I.R.C. § 1402(a)(1).
\(^{10}\) See Harl, “Renting Land to a Family Partnership, Corporation or LLC,” 7 Agric. L. Dig. 49 (1996).
\(^{11}\) See 6 Harl, supra n. 1, §§ 50.03, 50.04. See also Harl, supra n. 1, § 7.01.
\(^{12}\) I.R.C. § 2523.
\(^{13}\) See Dugan v. Comm’r, T.C. Memo. 1995-578 (taxpayer did not physically work on ranch, did not make decisions regarding operations and seldom inspected animals; held to be non-material participation livestock share lease).
\(^{14}\) Pub. L. 103-66, Sec. 13207(a), (b), (e), 107 Stat. 467 (1993).

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

ANIMALS

BULL. The plaintiff was injured when the plaintiff’s vehicle on a public highway struck a bull owned by the defendant. The bull had escaped from the defendant’s feedlot by pushing against and jumping a five foot non-electrified fence. The evidence presented by the testimony of the defendant showed that the bull had escaped from pastures twice before, the bull had a gentle nature, hay was stored just outside the feedlot fence and the bull was usually kept within pastures with electrified fences. The defendant moved for a directed verdict after the plaintiff’s case was presented and the trial court granted the motion because the plaintiff failed to show that the defendant had not exercised due care in the restraining of the bull. The appellate court reversed, holding that the plaintiff, through the defendant’s own testimony, had presented sufficient issues of fact concerning the defendant’s exercise of due care to require the defendant to demonstrate that due care was exercised. Nevious v. Bauer, 667 N.E.2d 1074 (Ill. Ct. App. 1996).

HORSES. The plaintiff owned nine horses which were boarded in Wisconsin. The horses were seized by the county humane society after the horses were found to be neglected by the stable. The humane society notified the plaintiff in Alaska that the plaintiff had to redeem the horses within five days by paying for their maintenance by the county and moving the horses to other quarters. After five days, the county declared the horses to be strays, under Wis. Stat. 951.15(3), and placed the horses for adoption with members of the society, their families and friends for nominal amounts. The plaintiff sued for recovery of the horses, arguing that the seizure and adoption of the horses deprived the plaintiff of property rights in the horses without due process. The court held that the seizure of the horses without allowing the plaintiff an opportunity for a hearing on the seizure was a violation of the plaintiff’s constitutional property rights. The court also held that the random or unauthorized actions of the society members did not excuse the state from liability for the constitutional violation. Porter v. DiBlasio, 93 F.3d 301 (7th Cir. 1996).

BANKRUPTCY
CHAPTER 13-ALM § 13.03.*

DISPOSABLE INCOME. The debtors had claimed $15,000 of equity in their homestead as an exemption. The exemption was allowed and the plan confirmed. During the plan, the house was sold with $2,654.07 in proceeds left after all expenses. The trustee argued that the proceeds were includible in the debtors’ disposable income and should be applied to the plan payments. The court held that, because
the homestead exemption applied to the proceeds of the sale of the homestead, the proceeds were not included in post-petition disposable income. *In re Kerr*, 199 B.R. 370 (Bankr. N.D. Ill. 1996).

**FEDERAL TAXATION—ALM § 13.03[7].**

**DISCHARGE.** The IRS filed a claim for unpaid income taxes due more than three years before the debtor filed for Chapter 13. The debtor had failed to report income in these tax years from a prisoner food program business due to an error by the debtor’s tax accountant. The IRS argued that the taxes were nondischARGEABLE under Section 523(a)(1)(C) because the debtor failed to file accurate returns and failed to fully pay the taxes owed. The court held that mere failure to file an accurate return or mere failure to pay taxes was insufficient to deny discharge of the taxes and, in addition, the IRS failed to demonstrate that the debtor should be held responsible for the errors of the tax accountant. *Matter of Burgess*, 199 B.R. 201 (Bankr. N.D. Ala. 1996).

**DISMISSAL.** The debtor had filed a previous Chapter 7 case in which a federal tax claim was held to be nondischARGEABLE because of the debtor’s willful failure to pay taxes. The IRS had a tax lien on the debtor’s property and had levied against the debtor’s only asset, monthly social security payments. The debtor filed for Chapter 13 when the eligibility requirements were increased and the IRS moved to dismiss the case and objected to the plan, both on the grounds of bad faith. The IRS argued that, because the tax debt was the only debt involved in the case and because the debt was nondischARGEABLE, the filing of the Chapter 13 case was in bad faith. The Bankruptcy Court held that, under its holding in *In re Gathright*, 67 B.R. 384 (Bankr. E.D. Pa. 1986), app. dismissed, 71 B.R. 343 (E.D. Pa. 1987), there was no good faith filing requirement for Chapter 13 cases. The District Court reversed on this point, holding that the debtor’s pre-bankruptcy actions to evade payment of the taxes were “cause” for dismissal of the case. The Bankruptcy Court also held that only debtor misconduct or fraud in the bankruptcy proceeding can give rise to bad faith sufficient to deny confirmation of a plan or discharge in Chapter 13. Because the debtor had accurately filed all schedules and met all Chapter 13 requirements, confirmation could not be denied for bad faith. The District Court affirmed on this point but dismissed the case based on its first holding. The appellate court held that the debtor’s pre-bankruptcy tax actions could not be used as a basis for dismissal of the bankruptcy case. The appellate court, however, held that a Chapter 13 case could be dismissed for cause because of the debtor’s bad faith. *In re Lilley*, 91 F.3d 491 (3d Cir. 1996), aff’d *in part and rev’d in part*, 185 B.R. 489 (E.D. Pa. 1995), rev’d *and aff’d*, 181 B.R. 809 (Bankr. E.D. Pa. 1995).

**EARNED INCOME TAX CREDIT.** The debtor filed for Chapter 7 and claimed a portion of the debtor’s 1995 refund claim attributable to an earned income tax credit as exempt under Ohio Rev. Code § 2329.66(A)(9)(e) as a disability assistance payment. The court held that the refund was not eligible for the exemption because the earned income tax credit was not intended to provide support for disabled taxpayers. *In re Kurlich*, 199 B.R. 161 (Bankr. N.D. Ohio 1996).

**INNOCENT SPOUSE.** The IRS filed a claim for taxes resulting from disallowed charitable deductions claimed on joint returns filed for the debtor by the debtor’s former spouse. The debtor claimed that the debtor’s signature on the returns was forged and that the debtor had no knowledge of the claimed deductions; therefore, the debtor was entitled to the innocent spouse defense available under I.R.C. § 6013(e)(1). The court found that (1) the debtor’s former spouse controlled the couple’s finances and prepared the returns, (2) the debtor always intended to file joint returns with the former spouse, (3) the debtor had no knowledge of the false charitable deductions either through knowledge of the returns or from indirect knowledge, and (4) the debtor did not receive significant benefits from the improper deduction. The court held that the debtor was not liable for the taxes resulting from the disallowed charitable deduction. *In re Michaud*, 199 B.R. 248 (Bankr. D. N.H. 1996).

**FEDERAL AGRICULTURAL PROGRAMS**

**BRUCELLOSIS.** The APHIS has issued proposed regulations adding the rapid automated presumptive test to the list of official tests for determining the brucellosis disease status of test-eligible cattle, bison and swine. 61 Fed. Reg. 48430 (Sept. 13, 1996).

**CONSERVATION.** The CCC has issued proposed regulations revising the CRP regulations, including the consolidation of all CRP regulations in 7 C.F.R. Part 1410. The new provisions include (1) inclusion of wetlands and acreage enrolled in the Water Bank Program as eligible CRP acres; (2) expansion of the conservation priority areas to include CRP acres, the Wetlands Reserve Program and the Environmental Quality Incentives Program; (3) restriction of the total CRP acres in a state to 10 percent of the total crop land; (4) provisions for an incentive of up to 25 percent of the costs of restoring wetlands; and (5) provisions for incentives to enroll filter strips, riparian buffers, field windbreaks, grass waterways, and EPA acres designated as wellhead protection acres. 61 Fed. Reg. 49697 (Sept. 23, 1996).

**CROP INSURANCE.** The FCIC has issued proposed regulations providing specific provisions for crop insurance for grapes as a grape endorsement to the Common Crop Insurance Policy. 61 Fed. Reg. 49982 (Sept. 24, 1996).

The FCIC has issued proposed regulations providing specific provisions for crop insurance for forage crops as a forage endorsement to the Common Crop Insurance Policy. 61 Fed. Reg. 48416 (Sept. 13, 1996).

The FCIC has issued proposed regulations providing specific provisions for crop insurance for cranberries as a cranberries crop endorsement to the Common Crop Insurance Policy. 61 Fed. Reg. 48420 (Sept. 13, 1996).

The FCIC has issued proposed regulations providing specific provisions for crop insurance for fresh market tomatoes as a fresh market tomatoes crop endorsement to the Common Crop Insurance Policy. 61 Fed. Reg. 48423 (Sept. 13, 1996).

**MILK.** Vermont passed a labeling law which required milk and milk product retailers to identify through
signs and stickers (i.e., no product label changes were required) the milk and milk products which were produced from cows which had been injected with recombinant bovine growth hormone (rBST). The plaintiffs were various trade associations representing retailers and milk producers. The plaintiffs alleged that the labeling law violated the First Amendment and the Commerce Clause of the U.S. Constitution and sought a preliminary injunction. The defendant, Vermont, stated that the purpose of the labeling law was to inform consumers so that the consumers could make purchases based on their concerns about rBST treatment of cows and the economic and health concerns from such treatment. The District Court denied the injunction because the plaintiffs failed to show irreparable harm or likelihood of success on the merits. The court found that the costs of such labeling were minimal and easily recouped from a minimal increase in the cost of milk products. The District Court noted that the increase of production from rBST-treated cows could decrease the cost of such milk products, thus increasing the sales and profits of retailers. The plaintiffs also alleged that even the minimal loss of First Amendment freedoms was sufficient harm to support an injunction. The District Court held that the labeling law does not curtail any speech but only requires truthful statements about the milk products. The District Court also held that the plaintiffs were not likely to succeed on the merits because the labeling law did not discriminate against out-of-state producers by favoring in-state producers, since all producers are subject to the same labeling requirements and both in-state and out-of-state producers produce both kinds of milk products. The District Court also noted that the state had a legitimate interest in providing its consumers with full information about retail products and that the labeling law was passed in response to a variety of public concerns over milk products from rBST treated cows. The District Court held that the labeling law did not violate the First Amendment because the speech involved here was commercial speech which could be restricted by a substantial governmental interest, such as truthfully informing consumers. The appellate court reversed, holding that the potential infringement of First Amendment free speech right was sufficient to allow a preliminary injunction. The appellate court also held that the milk retailers had also shown a likelihood of success on the merits in that Vermont had failed to demonstrate a substantial interest in the labeling of milk, because the only identified interest was the interest of consumers and the public’s right to know. The appellate court noted that no public safety issue was involved because the FDA had determined that rBST was not a health hazard to humans. International Dairy Foods Ass’n v. Amestoy, 92 F.3d 67 (2d Cir. 1996), rev’d, 898 F. Supp. 246 (D. Vt. 1995).

PERISHABLE AGRICULTURAL COMMODITIES ACT-ALM § 10.05[2]. The petitioner was a PACA-licensed produce handler. The petitioner was asked by a customer to relabel shipments of New Zealand apples so that the apples appeared to be Washington state apples. The petitioner knew that the apples would be sold to third parties in the mislabeled state. The petitioner eventually shipped 7,554 mislabeled cartons to the customer. The USDA revoked the petitioner’s PACA license for flagrant, repeated and willful violations of PACA, 7 U.S.C. § 499b(5). The appellate court upheld the Judicial Officer’s holding that the petitioner’s conduct was intentional, deliberate and knowing and thus constituted a flagrant violation of PACA. The court noted that although the number of cases shipment mislabeled was not sufficient by itself to demonstrate flagrant conduct, the large number of cases helped support that ruling. The petitioner also argued that the conduct was not willful because the buyer was not misled by the mislabeling since the customer requested the mislabeling. The court held that the mislabeling was willful because the petitioner received a special commission for the act, provided a demonstration of how well the mislabeling would work, expressed doubts to the customer about the propriety of the act and shipped more than 7,000 cases of mislabeled apples. The petitioner also argued that the full revocation of the license was too strong a sanction and the JO had failed to consider mitigating circumstances such the fact that the petitioner was no longer in business because of the violations. The appellate court upheld the revocation as supported by the evidence. Potato Sales Co., Inc. v. Dept. of Agriculture, 92 F.3d 800 (9th Cir. 1996).

WETLANDS. The plaintiff owned wetlands which the plaintiff wanted to drain for crop production. The plaintiff started the draining in 1984 and filed in 1986 for a commenced-conversion determination under the Swampbuster provisions to allow the draining to continue. The conversion plan was approved but did not include any alteration to culverts under a road bordering the wetlands. The plaintiff found that the draining would not occur unless these culverts were lowered. The plaintiff had the culverts lowered and the ASCS ruled that existing work would be considered as part of the previous commenced-conversion determination but the plaintiff could not do any more conversion work on the wetlands. The plaintiff argued that without the lowering of the culverts, the original conversion plan could not have been realized and that the road was a man-made barrier which could be altered without violation of the conversion plan. The District Court held that the road was not shown to be a cause of the wetlands; therefore, the altering of the culverts was part of the conversion and was subject to the Swampbuster provisions. The District Court also held that the conversion exception was strictly construed and did not provide any provision for the converter’s intent in commencing the conversion to allow additional work to meet the conversion exception without prior approval of the ASCS. Finally, the District Court held that the plaintiff failed to show any financial hardship from denial of the further conversion work since the plaintiff had not contracted to have the additional work done or otherwise expended money to have the work done. The appellate court affirmed, finding that the ASCS and the District Court decisions were not arbitrary. Von Eye v. U.S., 92 F.3d 681 (8th Cir. 1996), aff’d, 887 F. Supp. 1287 (D. S.D. 1995).

FEDERAL ESTATE AND GIFT TAX DISCLAIMERS-ALM § 5.02[6]. The decedent died in 1994 and had been the executor of the estate of a predeceased spouse. The predeceased spouse’s will
provided that if the decedent disclaimed any bequest, the disclaimed property passed to a family trust for the benefit of the couple’s child. The decedent had prepared a ledger of estate accounts and activity occurring during estate administration. The decedent also prepared an inventory of estate property. The couple’s attorney had sent a letter to a couple when the predeceased spouse’s will was drawn up and the letter indicated that the will made provisions for post-death planning by use of disclaimers. The IRS ruled that none of the documents, alone or together, qualified as a disclaimer for estate tax purposes because the documents did not contain any language which could be construed as the decedent’s unequivocal renunciation of property bequeathed to the decedent. Ltr. Rul. 9640005, June 14, 1996.

In 1989, the taxpayer had established a 10-year grantor retained annuity trust (GRIT). In October 1989, pursuant to IRS Notice 89-99, the taxpayer disclaimed any interest in the reversionary interest in the GRIT and a power of appointment provided by the GRIT. A gift tax return was filed for the gift tax effects of the disclaimer. In 1990, I.R.C. § 2036(c) was retroactively applied. The taxpayer then obtained a state court order retroactively disregarding the disclaimer. The taxpayer argued that the repeal of I.R.C. § 2036(c) and the state court order removed the gift tax liability for the disclaimer. The court held that, under Van Den Wymelenberg v. United States, 397 F.2d 443 (7th Cir. 1968), a retroactive reformulation of a disclaimer was not effective to change the original consequences of the disclaimer. Lange v. United States, 96-2 U.S. Tax Cas. (CCH) ¶ 60,244 (N.D. Ind. 1996).

GROSS ESTATE-ALM § 5.02.* The decedent had been a beneficiary of a testamentary trust created by the will of the decedent’s pre-deceased mother. The trust provided the decedent with the power to “use the income and so much of the principal as in her sole discretion shall be necessary and desirable.” The court held that the trust granted the decedent a general power of appointment over the trust corpus and that the trust corpus was included in the decedent’s gross estate. The court found no state law to interpret the trust language and found that the language allowed distribution of trust corpus for uses beyond the decedent’s health, education, and/or support or maintenance. Hyde v. United States, 96-2 U.S. Tax Cas. (CCH) ¶ 60,243 (D. N.H. 1996).

TRUSTS. The taxpayer was a beneficiary of a testamentary trust. The trust was funded with stock, and the trustee borrowed funds on margin from a brokerage account and loaned the money to the decedent’s estate and corporations owned by the estate. The loans were not evidenced by repayment schedules, fixed maturity dates or notes but the loans were ratified by the estate representatives and the boards of directors of the corporations. The estate did not have any distributable net income (DNI) for the tax years involved but paid the trust interest on the loans. The taxpayer argued that because the estate had no DNI, the trust did not have any DNI from the interest payments. The court held that the taxpayer had to include distributions from the trust in gross income because the interest payments were DNI to the trust. Gefman v. Comm’r, T.C. Memo. 1996-447.

VALUATION. The taxpayer transferred a personal residence and 43 contiguous acres to a three year personal residence trust. The property also has a swimming pool, pool house, greenhouse, tool shed, barn with attached corral and quarters for a caretaker. The entire parcel had been used as a personal residence property for over 100 years and the neighboring properties are of similar size and use. The IRS ruled that the trust was a qualified personal residence trust under I.R.C. § 2702(a)(5)(A)(ii). Ltr. Rul. 9639064, June 27, 1996.

FEDERAL INCOME TAXATION

ALTERNATIVE MINIMUM TAX-ALM § 4.01.* A husband and wife operated a potato farm and sold potatoes to various buyers under agreements which deferred some portion of the selling price until the following tax year. The IRS examining agent did not object to the deferral for regular income tax purposes but took the position that the arrangement was subject to the alternative minimum tax rules applicable to “the installment method under [I.R.C.] section 453.” The Service agreed with the agent, relying on Warren Jones Co. v. Comm’r, 524 F.2d 788 (9th Cir. 1975), rev’g. 60 T.C. 663 (1973), in concluding that the tax treatment of a deferred payment obligation depended upon whether the fair market value of property received in exchange can be ascertained. In addition, the Service ruled in the TAM that the outcome of the ruling involves a change of accounting method. Further, IRS indicated that I.R.C. § 481 applies in determining the farmers’ tax for the year of change. This ruling is discussed in an article by Neil Harl in 7 Agric. Law Digest, p. 93 supra. Ltr. Rul. 9640003, Dec. 21, 1995.

BIOMASS FUELS CREDIT. The taxpayer was a lumber and veneer company which used scrap wood in a gasifier to produce heat used in the veneering process. The taxpayer leased a portion of its facility to another company. The leased area was to be used for making veneer with the second company’s equipment. The lease required the taxpayer to furnish utilities for the leased area. The taxpayer claimed a biomass fuels credit for the heat provided to the leased area from the gasifier. The court held that the taxpayer was not eligible for the credit because biomass fuel was not sold to the second company; instead, the taxpayer sold only heat. In addition, the court held that no sale occurred because the utility costs were included in the rent for the space. Norstam Veneers, Inc. v. Comm’r, T.C. Memo. 1996-443.

CHARITABLE DEDUCTION. Under an agreement with a charity, the taxpayer purchased a house and leased the house to the charitable organization for one dollar per year. The house was purchased and leased to the organization for the purpose of having the organization renovate the house for use by the organization in its charitable work. Once the renovations were completed, the taxpayer intended to donate the house to the organization. The organization used other donations and volunteer help to substantially improve the property and the taxpayer donated the house to the organization. The taxpayer argued that the amount of the charitable deduction should equal the fair
market value of the house at the time of the final donation. The IRS ruled that the charitable deduction was limited to the taxpayer’s basis in the property, the original purchase price, because the taxpayer did not own the renovations or pay for them. Ltr. Rul. 9639009, June 13, 1996.

C CORPORATIONS-ALM § 7.02.*

COMPENSATION OF OFFICERS. The taxpayers were brothers who shared the ownership of a corporation which operated a scrap metal business. An IRS audit in two tax years found that the corporation failed to report income from the sale of scrap metal in each year. The corporation admitted to the errors but claimed an offsetting deduction, claiming that the income was paid to the taxpayers as compensation. The corporation did not list the payments as compensation in the corporate records nor did the corporation include the payments in the taxpayers’ W-2 forms. The only evidence that the payments were intended as compensation was the personal income tax returns of the taxpayers for the second tax year. The court held that the corporation was not allowed a deduction for the payments as compensation because the corporation had no contemporaneous records of any intent to make the payments as compensation. Tool Producers, Inc. v. Comm’r, 96-2 U.S. Tax Cas. (CCH) ¶ 50,495 (6th Cir. 1996).

CONSTRUCTIVE RECEIPT. A state’s lottery laws were amended to allow lottery winners to assign future installment payments of lottery winnings. The IRS ruled that the assignment of future installment lottery payments did not amount to constructive receipt of the future payments by the assignor, because the assignment did not affect the dates of the payments by the state lottery commission. Ltr. Rul. 9639016, June 17, 1996.

EMPLOYEES. The taxpayer operated a sod laying and landscape business which employed 16 people. The workers consisted of a bookkeeper/secretary, graders, sodlayers, truck drivers and one landscaper. The taxpayer treated all of the workers as independent contractors and the workers all signed agreements of understanding which included an agreement to pay their own self-employment taxes. The bookkeeper and main company truck driver were held to not be independent contractors because the taxpayer exercised sufficient control over their work and these employees worked only for the taxpayer. The Bankruptcy Court, however, had ruled that the taxpayer was not liable for the employment taxes for these employees, under I.R.C. § 3401, because the taxpayer had a reasonable basis for treating them as independent contractors. The appellate court reversed on this issue, holding that treating these employees as independent contractors was not reasonable under any judicial precedent. IRS audit or long-standing industry practice. As to the other workers, the court held that they were properly classified as independent contractors because (1) the taxpayer did not provide instruction to these workers, (2) the workers had the authority to hire other workers, (3) the work hours were not set by the taxpayer, (4) the workers were not paid at set intervals, (5) the workers made their services available to other sodlaying and landscaping companies, and (6) the industry practice was to treat these workers as independent contractors. In re Arndt, 96-2 U.S. Tax Cas. (CCH) ¶ 50,505 (M.D. Fla. 1996).

INTEREST. The taxpayers owned several businesses operated as partnerships and S corporations. The taxpayers made pre-1986 payments of tax deficiencies and interest in order to take advantage of the pre-1986 interest deductions. The taxpayers, however, claimed the interest payments as business interest deductions, whereas the IRS allowed the deductions only as personal interest deductions. The taxpayers argued that the interest resulted from the income generated by the businesses; therefore, the interest payments were business expenses. The court held that, because partnerships and S corporations do not pay taxes, the interest on taxes was not related to the businesses and was eligible only for a personal interest deduction. The IRS had also argued that interest on taxes was never a business expense because normal business activity should include timely payment of taxes. The court did not discuss this issue. True v. United States, 96-2 U.S. Tax Cas. (CCH) ¶ 50,502 (10th Cir. 1996).

LIFE INSURANCE. A grantor trust was a general partner in a partnership. The trust purchased a life insurance policy on the grantor/trustee’s life. The trust, partnership and grantor/trustee entered into an agreement under which the trust owned the policy and the partnership paid the premiums but would be reimbursed in part by the trust. The policy was assigned to the partnership as security for the trust’s promise to pay the premiums. The partnership had the right to collect from the policy proceeds (either the death benefit or cash surrender value) the amounts paid in premiums, with the remainder paid to the trust. This is a split-dollar insurance arrangement. The IRS ruled that neither the trust nor grantor/trustee would be deemed to have received a distribution from the partnership. Ltr. Rul. 9639053, June 20, 1996.

RETURNS. The IRS has issued new guidelines for ordering Audit Technique Guides produced by the IRS Market Segment Specialization Program. Purchasers may now use credit cards for the purchases by phone (202-512-1800), fax (202-512-2250), mail (Superintendent of Documents, P.O. Box 371954, Pittsburgh, PA 15250-7954), or the internet (http://www.access.gpo.gov).

S CORPORATIONS-ALM § 7.02[3][a].*

REORGANIZATION. The taxpayer was an S corporation which formed a second shell corporation for the purposes of merging the two corporations with the new corporation as the surviving corporation. The reorganization was intended to qualify as an I.R.C. § 368(a)(1)(F) (type F) reorganization. The IRS ruled that the merger would not change the S corporation status of the old corporation and the new corporation would qualify as an S corporation. The IRS also ruled that Rev. Rul. 57-276, 1957-2 C.B. 126 provided guidance for determining the effect of the reorganization on the taxable year of the corporations, and Rev. Rul. 73-526, 1973-2 C.B. 40 provided for transfer of the taxpayer identification number of the old corporation to the new corporation. Ltr. Rul. 9639059, June 26, 1996.

SHAREHOLDER BASIS. The taxpayer owned 98 percent of an S corporation with one other shareholder. The taxpayer and corporation each obtained loans from a bank and entered into a cross-collaterization and cross-default agreement which secured the loans with all the property of
the shareholder and corporation, including subsequent improvements. The shareholder constructed a building and first leased it to the corporation before transferring the building to the corporation in exchange for 400 shares of stock in an I.R.C. § 351 transaction. The parties’ loan obligations were not affected by the transaction. The taxpayer argued that the basis of the 400 shares of stock was equal to the shareholder’s basis in the building before the transfer. The IRS ruled that because the building was subject to liabilities in excess of the shareholder’s basis in the building, the shareholder’s basis in the stock was zero plus any gain recognized by the transaction. Ltr. Rul. 9640001, Nov. 29, 1994.

TRAVEL EXPENSES. The taxpayer was employed as a college physics professor and self-published a book on physics. The taxpayer also presented public seminars at an airport within walking distance of the taxpayer’s college office. The taxpayer made several trips to popular cities and visited the tourist attractions there. While in each city, the taxpayer would visit book stores without prior notice and would attempt to make some book sales. The taxpayer claimed deductions for automobile expenses in driving to the seminars and travel expenses for the visits to the cities. The court held that the travel expenses for the visits to the cities were not deductible business expenses because the primary purpose of the visits was for personal pleasure. The court also held that the automobile expenses for driving to the seminars was not deductible because the trips were primarily for commuting to the taxpayer’s place of employment. Shelton v. Comm’r, T.C. Memo. 1996-444.

NEGLIGENCE

LICENSEE/INVITEE. In a case involving a slip and fall at a hospital, the Nebraska Supreme Court held that the common-law classification of licensee and invitee would be abolished in favor of a duty of reasonable care for all nontrespassers on property. Heins v. Webster County, 552 N.W.2d 51 (Neb. 1996).
AGRICULTURAL LAW PRESS
P.O. BOX 50703
EUGENE, OR 97405

AGRICULTURAL LAW PRESS ON THE WEB
http://members.aol.com/aglaw/agpub
Check out our internet site for information about:
• Agricultural Law Manual, by Neil E. Harl, a comprehensive, annotated looseleaf deskbook.
• Principles of Agricultural Law, a college textbook, by Roger A. McEowen and Neil E. Harl, due for publication in December 1996.
• Direct internet links to legal resources on the internet.
• Direct email link to the Agricultural Law Press.
We welcome any suggestions for improving our web site.

AGRICULTURAL LAW MANUAL
by Neil E. Harl
This comprehensive, annotated looseleaf manual is an ideal deskbook for attorneys, tax consultants, lenders and other professionals who advise agricultural clients. The book contains over 900 pages and an index.
As a special offer to Digest subscribers, the Manual is offered to new subscribers at $115, including at no extra charge updates published within five months after purchase. Updates are published every four months to keep the Manual current with the latest developments. After the first free update, additional updates will be billed at $100 per year or $35 each.
For your copy, send a check for $115 to Agricultural Law Press, P.O. Box 50703, Eugene, OR 97405.
Satisfaction guaranteed. 30 day return privilege.

ISSUE INDEX

Animals
Bull 158
Horses 158

Bankruptcy
Chapter 13
• Disposition income 158
Federal taxation
• Discharge 159
• Dismissal 159
• Earned income tax credit 159
• Innocent spouse 159

Federal Agricultural Programs
Brucellosis 159
Conservation 159
Crop insurance 159
Milk 159
PACA 160
Wetlands 160

Federal Estate and Gift Tax
• Disclaimers 160
• Gross estate 161
• Trust 161
• Valuation 161

Federal Income Taxation
• Alternate minimum tax 161
• Biomass Fuels credit 161
• Charitable deduction 161
• C corporations
• Compensation of officers 162
• Constructive receipt 162
• Employees 162
• Interest 162
• Life insurance 162
• Returns 162
• S corporations
• Reorganization 162

Shareholder basis 162
• Tax liens 163
• Travel expenses 163

Negligence
• Licensee/inviter 163

State Regulation of Agriculture
• Kiwifruit 163

State Taxation
• Farmer 163
REPORTING CRP PAYMENTS

— by Neil E. Hart

The Conservation Reserve Program, the 10-year program for idling erodible lands, was enacted as part of the 1985 farm bill in an effort to reduce soil erosion and to aid in balancing demand and supply of program crops. From the time of the first sign-up in early 1986, questions have been raised about the reporting of CRP payments for self-employment tax purposes. A recent IRS ruling and a U.S. Tax Court decision have added to the sparse authority on how CRP payments are to be reported.

Retired taxpayers

A 1988 letter ruling provided helpful guidance on how retired landowners should report CRP payments. In that ruling, IRS indicated that, for a retired taxpayer who is not materially participating under a lease, payments received under the Conservation Reserve Program would not be considered net income from self-employment. In the ruling, the landowner had terminated the lease several months before bidding the land into the CRP program so no tenant was sharing in the CRP payments and contributing to maintenance of the land as required by the CRP rules. The landowner’s activities did not constitute material participation. This ruling was particularly notable because of the position that had been taken by some I.R.S. agents that someone must necessarily be materially participating and if there was no tenant involved, the landowner must be materially participating. The 1988 ruling signaled disapproval of that position.

Landowners not retired

For landowners biding their land into CRP who were not retired, and did not retire during the 10-year period, the Associate Chief Counsel, Technical, at an early date stated that where the farm operator or owner is materially participating in the operation, the CRP payments constitute receipts from farm operations includable as earnings from self-employment. The Commissioner of Social Security indicated agreement with that position.

In a 1996 private letter ruling, a husband and wife as directors and officers of a family ranch corporation were determined to be materially participating in the overall operation through their corporation. Therefore, the CRP payments received by them as owners of land previously bid into CRP were to be reported as self-employment income.

A 1996 Tax Court case held that a materially participating landowner was required to report CRP payments as earnings from self-employment. The taxpayer in that case had reported CRP payments for 1989, 1991, and 1992 on Schedule F with the payments subject to self-employment tax. However, the payment for 1990 was not reported on Schedule F even though the expenses on the CRP land were included on Schedule F. The court stated that the CRP payments had a "direct nexus" with the farming operation and thus were considered earnings from self-employment subject to self-employment tax.

Landowners retiring during the CRP term

To date, no rulings or cases have focused on the situation posed by a landowner who retires during the CRP term. The issue is whether the reporting of CRP payments for self-employment tax purposes should change at the time of retirement. Authority from other settings is divided on the issue.

The guidance provided on the whole-herd dairy buy out program conducted in 1987 indicated that the focus should be on the landowner’s status at the time the agreement was entered into. If the landowner was a materially participating taxpayer at that time, the payments should be reported as earned income for self-employment purposes throughout the term of payment. It should be noted that the CRP is distinguishable from the dairy termination program in that the contribution of the taxpayer in the latter program was completely fixed at the time of the agreement. With CRP, the taxpayer makes a continuing contribution to the program by idling the land each successive year of the CRP bid.

A similar position to the authority issued for the dairy termination program was taken in a 1960 revenue ruling issued to provide guidance under the soil bank program of the late 1950s.

Dictum in a 1967 social security ruling indicated that it is the taxpayer’s status at the time payments are received that determines liability for self-employment tax.

Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
Land held for investment

Thus far, no guidance has been provided on handling CRP payments where the land is held solely for investment with no trade or business involved and with the landowner not materially participating under the CRP contract. Arguably, CRP payments received on land held for investment and not in any way involved in or related to a farming operation would not be considered earnings from self-employment. In the recent case of Connie D. Ray, the Tax Court stressed the necessity for "a connection or nexus between the payments received by the taxpayer and some trade or business from which they were derived." If that nexus is absent, the activity is in the nature of an investment, payments should not be subject to self-employment tax. As noted, however, authority is lacking in this situation.

IRS could, conceivably, take the position that CRP payments are self-employment income if the taxpayer materially participates in any trade or business, but that argument seems unlikely to prevail absent clear statutory authority to that effect.

FOOTNOTES
2 See 4 Harl, Agricultural Law § 37.03[3][b](1996).
3 Ltr. Rul. 9637004, May 1, 1996.
6 See I.R.C. § 1402(a)(1).
7 Id.
8 See I.R.C. § 1402(a)(1).
11 See 4 Harl, supra n. 1, § 37.03[3][b].
12 Ltr. Rul. 9637004, May 1, 1996.
13 Id.
14 Id.
15 T.C. Memo. 1996-436.
16 Id.
17 Notice 87-26, 1987-1 C.B. 470.
18 Id.
22 T.C. Memo. 1996-436.
23 Id.

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

ADVERSE POSSESSION

POSSESSION. The disputed land was surrounded by land owned by the plaintiff. The plaintiff had repaired and maintained a perimeter fence around the plaintiff’s land and had grazed sheep or cattle on the entire property for more than 18 years. The only action taken by the defendant’s predecessor in interest was to seek an appraisal of the disputed parcel in one year. The effect of the appraisal was reversed, holding that, where the disputed land was within the boundaries of a perimeter fence and the plaintiff used all of the land uniformly, no fencing of the disputed land was required to achieve adverse possession. Palmer Ranch Ltd. v. Suwansawasdi, 920 P.2d 870 (Colo. Ct. App. 1996).

PUBLIC EASEMENT. The plaintiff owned farm land which abutted a natural lake. The plaintiff had granted the county the right to build a road over a portion of the plaintiff’s land and the road ran to within three feet of the high water mark of the lake on the plaintiff’s land. The public used the road as an access point to the lake but neither the county nor the state improved the area bordering the lake to improve public access or use of the lake. The state sought jurisdiction over the disputed land under a theory of prescriptive easement. The court held that the state had not given any express notice of its easement claim to the plaintiffs until the suit was filed and the state’s failure to take any actions consistent with an easement claim, such as building docks or clearing shoreline trees, prevented a claim of prescriptive easement. Larman v. State, 552 N.W.2d 158 (Iowa 1996).

BANKRUPTCY

GENERAL-ALM § 13.03.*

AUTOMATIC STAY. The debtors had defaulted on a loan and the creditor obtained a state court judgment and a judgment lien against soybeans stored on the debtors’ farm. The creditor executed against the storage bin and removed most of the soybeans, retaining possession of the bin and beans. Just before the execution, the debtors made two deliveries of soybeans to other parties. The debtors then filed for Chapter 12 and sought turnover of the execution proceeds and remaining soybeans. The creditor retained possession of the soybeans until the Bankruptcy Court ordered transfer to the trustee. The debtors sought sanctions against the creditor for violating the automatic stay by retaining the soybeans after the filing of the bankruptcy petition. The Bankruptcy Court held that the creditor only technically violated the automatic stay in order to protect the creditor’s interests in the soybeans and denied the claim for actual and punitive damages because the court found no

*Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.
willful or egregious actions by the creditor. The debtors also argued that some soybeans were missing and that the creditor was responsible for the missing soybeans. The Bankruptcy Court found that the debtors' own actions demonstrated that the bin was not full when the creditor executed against it; therefore, there was insufficient evidence that any soybeans were missing. The appellate court affirmed. In re Kolberg, 199 B.R. 929 (W.D. Mich. 1996).

AVOIDABLE LIENS. The debtor was a grain storage and marketing facility which accepted grain from producers on delayed pricing contracts. The debtor's license was revoked when the facility showed a large short fall of grain in storage as compared to the amount of grain owed on the delayed price contracts. Under Ohio Rev. Code § 926.021, grain producers were provided with a lien for grain stored in grain elevators and terminals. The bankruptcy trustee sought to avoid the producers' liens on the grain stored in the debtor's facilities at the date of the petition, arguing that the statutory liens were avoidable under Section 547 because the liens arose when the debtor became insolvent and the license was revoked. The court held that the statutory lien arose when the grain was delivered, making the producers secured creditors. The trustee argued that the liens were not perfected on the date of the petition and were avoidable under Section 545(2) since the trustee acted as a bona fide purchaser as of the date of the bankruptcy petition. The court also denied this argument on the same basis that the statute created and perfected the liens as of the date of delivery. The trustee also argued that the liens were avoidable under Section 545(1). The court held that Section 545(1) applied only to avoid the fixing of a lien and could not be used where the liens were fixed long before the debtor filed for bankruptcy. Matter of Merchants Grain, 93 F.3d 1347 (7th Cir. 1996).

PREFERENTIAL TRANSFERS. The debtor operated a grain storage facility in Ohio. The debtor had entered into delayed pricing contracts with several grain producers who stored grain at the facility. The debtor failed to meet Ohio statutory net worth requirements and its license was suspended. Under Ohio law, grain producers have a statutory lien for grain stored in a licensed facility which continues until the producer receives compensation for the grain. The debtor was allowed to continue in business to liquidate the grain inventory and to disburse payments to the producers. Some of these payments occurred within 90 days before the debtor filed for bankruptcy and the bankruptcy trustee sought to recover the payments as preferential transfers. The trustee argued that the statutory lien was voidable by the trustee under Section 547 because it arose only when the facility became insolvent. The court held that the Ohio statutory lien arose when the grain was deposited in the facility. The trustee also argued that the lien was voidable under Section 545(2). The court held that Section 545(2) did not apply because no lien existed at the time of the petition since the producers' liens were extinguished upon payment. Thus, the court held that the producers were secured creditors and that the payments received pre-petition were no more than the producers would have received in the bankruptcy case and the transfers were not avoidable. Merchants Grain, Inc. v. Adkins, 93 F.3d 1347 (7th Cir. 1996), aff'g, 184 B.R. 52 (S.D. Ind. 1995).

PRIORITY. The debtor was a purchaser and processor of fryer chickens. Under a process enacted by the Oregon legislature, the members of the fryer chicken industry in Oregon voted to establish a fryer commission to make assessments against purchasers of fryer chickens and to use the proceeds to promote the Oregon fryer chicken industry. The debtor had failed to pay assessments and the Oregon Fryer Commission filed a claim in the debtor's bankruptcy case and argued that the claim was entitled to priority, under Section 507(a)(8)(C) as a tax claim. The court used the four factors determined in In re Lorber Industries of California, 675 F.2d 1062 (5th Cir. 1982) to determine whether the assessments were taxes. The court held that the assessments were fees and not taxes because (1) the assessments were not imposed under the state police or taxing authority, and (2) the assessments were not a close issue and decided not to rule on that element since the remaining elements favored holding that the assessments were fees not entitled to priority under Section 507(a)(8)(C). In re Belozer Farms, Inc., 199 B.R. 720 (Bankr. 9th Cir. 1996).

FEDERAL TAXATION-ALM § 13.03[7].

DISCHARGE. The debtors filed a previous Chapter 13 case which was filed 179 days after the IRS assessed the taxes which were a claim made in that case. The debtors made some payments on the tax claim but did not receive a discharge. After 754 days, the case was dismissed before the plan was completed. The IRS filed a notice to levy after the case was dismissed and 15 days later the debtors filed the instant case, arguing that the taxes were now dischargeable because the taxes were assessed more than 240 days before the filing of the second petition. The court held that there was no statutory authority for a tolling of the 240 day period during the first bankruptcy case but held that the court had equitable power to order the tolling of the 240 day period. The court found that the tax claim arose because the debtors underreported the amount of tax due, made an initial partial payment with an insufficient funds check, and filed the second case primarily to prevent the IRS from executing on the levy. The court held that under those circumstances, the court would exercise its equitable authority to toll the 240 day period for the time of the first bankruptcy filing. In re Miller, 199 B.R. 631 (Bankr. S.D. Tex. 1996).

NET OPERATING LOSSES. The debtor had net operating losses in 1975 which the debtor carried forward to tax years through 1993 when the bankruptcy case was closed. The law in 1975 was that NOLs could only be carried forward five years. The debtor filed for bankruptcy in late 1979, prior to the effective date of the Bankruptcy Act of 1978 and was not affected by I.R.C. § 1398. The court held that the debtor was limited to the five year carryforward period for the NOLs and the carryover period
was not affected by later I.R.C. amendments or bankruptcy law. Beery v. Comm'r, T.C. Memo. 1996-464.

**FEDERAL AGRICULTURAL PROGRAMS**

**CONSERVATION.** The NRCS and FSA have announced that they will conduct 54 public forums where interested individuals can provide comments and ideas on the implementation of the conservation provisions of the Federal Agriculture Improvement and Reform Act of 1996, which includes: Highly Erodible Land Compliance, Wetlands Conservation, Conservation Reserve Program, and the Environmental Quality Incentives Program. The announcement contains the addresses and dates of the forums. 61 Fed. Reg. 52663 (Oct. 7, 1996).


**CROP INSURANCE.** The FCIC has issued proposed regulations providing for a Group Risk Plan of Insurance. The plan provides insurance against the widespread loss of certain crops in a county. The GRP pays only when the average yield of the entire county drops below the expected county yield as determined by FCIC. The payment is determined on the basis of the difference between the expected area yield and the actual average yield for the whole designated area. Thus, an insured can have no loss yet receive payments if the area wide losses reduce the area yield to a below-expected level and an insured may experience a loss and yet receive no payment because the average yield for the area was higher or as high as the expected average yield. 61 Fed. Reg. 52717 (Oct. 8, 1996).

**FARM LOANS.** The plaintiff had obtained an FmHA (now FSA) loan but was in default on the loan for over four years. The plaintiff was offered loan restructuring but failed to file the application within the time allowed. The court held that the FmHA did not abuse its discretion in servicing the loan and did not act in a capricious manner in applying the law to the plaintiff. The court also rejected the plaintiff’s equal protection argument because the plaintiff failed to provide any evidence that the plaintiff was treated any differently from other persons similarly situated. Daniel Farms v. Espy, 932 F. Supp. 1173 (E.D. Mo. 1996).

**IMPORTS.** The APHIS has issued proposed regulations establishing a new domestic quarantine notice. The domestic quarantine notice would provide that, subsequent to their importation, plants and plant parts prohibited under foreign quarantine notices from being imported into certain states or areas are also prohibited from being moved interstate into those states or areas. 61 Fed. Reg. 51376 (Oct. 2, 1996).

**PAYMENT LIMITATIONS-ALM § 10.03[4].** The plaintiffs were farmers who had various relationships with a large family farm corporation. The corporation was owned by the parents and the children participated in farming some of the land owned by the corporation. One son was determined by ASCS (now FSA) to not be a separate person for payment limitation purposes because the son failed to demonstrate the source of the son’s financing for the son’s farming operation. The court noted that the son provided no bank records to support claims that the son’s operation was funded by either a bank loan or personal savings. The parents argued that the ASCS determination that they were involved in a scheme or device to evade the payment limitations was not supported by the administrative record because no evidence of the parents’ activites was cited in support of the administrative ruling. The court, however, held that the ASCS determination that the corporation was involved in a scheme or device was supported by the record and the actions of the corporation carried over to the parents as sole owners. Huntsman Farms, Inc. v. Espy, 928 F. Supp. 1451 (E.D. Ark. 1996).

**PERISHABLE AGRICULTURAL COMMODITIES ACT-ALM § 10.05[2].** The debtor had purchased dried prunes and dried apricots from a seller and had not paid for the fruit. The debtor had previously granted a blanket security interest to a lender which covered all inventory. The seller sought to claim a priority interest in the proceeds of the dried fruit under the PACA trust provisions. The lender argued that the drying process converted the fruit into a product not covered by PACA. The issue involved the definition of fresh fruit, in 7 C.F.R. § 46.2(u), covered by PACA, which included fruit from which the surface moisture had been removed. The seller argued that the sun drying of the fruit was primarily for the removal of surface moisture. The court found that the drying of the prunes and apricots involved removal of a substantial amount of water from the whole fruit and altered the nature, taste and shape of the fruit so as to produce a food of a different character from the original fruit; therefore, the dried fruit was not a fresh fruit and the PACA trust rules did not apply to the proceeds of the dried fruit. *In re L. Natural Foods Corp.*, 199 B.R. 882 (Bankr. E.D. Pa. 1996).

**PESTICIDES.** See Bruce v. ICI Americas, Inc., 933 F. Supp. 781 (S.D. Iowa 1996) under Products Liability infra.

**SEEDS.** The APHIS has issued proposed regulations amending the imported seed regulations to (1) move the regulations to a new part, 7 C.F.R. Part 361; (2) establish a seed analysis program with Canada; and (3) provide compliance agreements with companies which import seed for cleaning or screening. 61 Fed. Reg. 51791 (Oct. 4, 1996).

**TOBACCO.** The CCC has adopted as final the determination that the marketing quota for 1996 burley tobacco is 633.6 pounds and the price support level is 173.7 cents per pound. 61 Fed. Reg. 50423 (Sept. 26, 1996).

**FEDERAL ESTATE AND GIFT TAX**

**CAPITAL GAINS.** A trust was formed by a decedent’s will and the trust was funded with estate property. The executor, a bank, made an I.R.C. § 643(e)(3) election on the estate’s income tax return to treat any gain from the funding

---

* *Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.*
of the trust as capital gain. The executor consulted with its accountants and received erroneous advice that gain would be recognized from the transfer and that a Section 643(e) election was necessary to minimize the tax on the transaction. When the executor learned that no gain was recognized by the estate in funding the trust, the executor petitioned for revocation of the Section 643(e)(3) election. The IRS noted that the election would have caused recognition of the gain. The IRS ruled that the revocation would be allowed because the executor exercised due diligence in seeking and relying on the tax advice of the accountants. Ltr. Rul. 9641018, July 3, 1996.

**GENERATION SKIPPING TRANSFERS-ALM § 5.04[6].** The taxpayer requested an extension of time to file an inter vivos QTIP election under I.R.C. § 2523(f). The IRS ruled that it had no authority to grant an extension under Treas. Reg. § 301.9100-1 because the time for filing the election was established by statute, I.R.C. § 2523(f)(4). Ltr. Rul. 9641023, July 10, 1996.

**GIFT-ALM § 6.01.** The decedent died in 1991 and had made taxable gifts in 1976, 1987 and 1988. The tax on the 1987 gift was calculated by first applying the unified rate schedule to the total of the 1976 and 1987 gifts. The tax attributable to the 1976 gift was subtracted from the above total tax to determine the 1987 tax. The same procedure was used for the 1988 gift, i.e., the tax attributable to the 1976 and 1987 gifts was subtracted from the tax calculated on all three gifts. The IRS ruled that this was the proper method of calculating the gift tax for these gifts for purposes of determining the tentative estate tax under I.R.C. § 2001(b). Ltr. Rul. 9642001, Nov. 30, 1994.

**POWER OF APPOINTMENT.** The decedent owned a beneficial interest in a trust established by the decedent’s predeceased spouse. The trust provided for trustee discretion to make payments to the decedent from trust income and principal for the decedent’s “care, support and maintenance, hospital and medical needs and expenses of invalidism.” The trust also provided the decedent with a noncumulative right to withdraw the greater of 5 percent of the trust principal or $5,000 annually. The decedent never made any withdrawals from the trust. The trustee was not allowed to consider any withdrawals by the decedent in making discretionary distributions from trust income or principal. The court characterized the decedent’s annual noncumulative power to withdraw 5 percent of the trust principal as a general power of appointment over 5 percent of the trust and the failure to exercise that power each year as a lapse of the power. The estate argued that the power had lapsed with the decedent’s death and I.R.C. § 2041(b)(2) allowed exclusion of the 5 percent from the decedent’s gross estate. The court held that the exception in Section 2041(b)(2) applied only to lapsed powers of appointment and was not available to the decedent’s estate because the decedent still held the power to withdraw 5 percent of the trust on the date of death. The court noted that this interpretation was consistent with an example in Treas. Reg. § 20.2041-3(d)(3) which was drawn from the legislative history of I.R.C. § 2041. See also Estate of Kurz v. Comm’r, 101 T.C. 44 (1993). Estate of Dietz v. Comm’r, T.C. Memo. 1996-471.

**SPECIAL USE VALUATION-ALM § 5.03[2].** An estate elected special use valuation of farm land which was devised to three children of the decedent. Within ten years after the death of the decedent, one of the children sold that child’s entire interest in the farm to two siblings. The IRS ruled that the sale was not a disposition causing recapture of special use valuation benefits; however, the purchasing siblings must execute an amendment to the agreement consenting to personal liability for recaptured special use valuation benefits. The amended agreement should reflect the new ownership status of the parties. Ltr. Rul. 9642055, July 24, 1996.

**FEDERAL INCOME TAXATION**

**ASSESSMENTS.** The taxpayer timely filed an income tax return for 1990. The taxpayer subsequently moved and filed other federal tax forms which indicated a new address but did not file a change of address form with the IRS. The IRS sent a notice of deficiency for 1990 to the address on the taxpayer’s 1990 return, but the notice was returned as undeliverable because the taxpayer had moved. The IRS sent another notice of deficiency to the same address without any attempt to determine the taxpayer’s new address. The court held that the second notice was invalid in that the IRS failed to exercise due diligence in determining the taxpayer’s new address once the IRS learned that the taxpayer had moved. Crawford v. Comm’r, T.C. Memo. 1996-460.

**FARM CREDIT SYSTEM.** The taxpayer was an Agricultural Credit Association formed from the merger of a Production Credit Association and a Federal Land Bank Association. The enabling legislation provided that ACAs have the same powers as FLBs including the making of long term loans. FLBs were exempt from income tax on the income from long-term loans and the taxpayer argued that this exemption carried over to the ACA long-term loans. The IRS ruled that because no explicit exemption for ACAs was included in the enabling legislation, the ACA was not entitled to the exemption available to FLBs. Ltr. Rul. 9641006, July 18, 1996.

**INTEREST.** The taxpayer worked as a furniture lumper and claimed withholdings of social security taxes on the taxpayer’s income tax returns. The taxpayer made such claims without receiving W-2 forms from the employer. After an audit, the IRS determined that the taxpayer was an independent contractor and owed for the underpaid social security taxes on the income. The taxpayer paid the tax deficiency and $42,000 in interest and claimed the interest paid as a business deduction for the tax years involved. The IRS disallowed the deduction. The court held that the interest payment was not an ordinary and necessary business expense because the taxpayer was on notice that social security taxes were owed from the lack of W-2 forms. Michael v. Comm’r, T.C. Memo. 1996-466.

**IRA.** The decedent had owned an interest in a pension plan and an IRA with the surviving spouse as the designated beneficiary. The surviving spouse was over the age of 70 1/2 years and transferred the interests in the plan and IRA to
a new IRA in the surviving spouse’s name. No other amounts were contributed to the IRA. Payments from the surviving spouse’s IRA were based on the joint life expectancy of the surviving spouse and the designated beneficiary. The IRS ruled that distributions to the surviving spouse from the IRA were excluded in determining the amount of excess distributions subject to the 15 percent tax imposed by I.R.C. § 4980A. The IRS also ruled that any amounts in the IRA at the surviving spouse’s death would be excluded in determining excess accumulations for purposes of calculating the 15 percent increase in estate tax under I.R.C. § 4980A(d). Ltr. Rul. 9642059, July 24, 1996.

LIKE-KIND EXCHANGES-ALM § 4.02[16].* This ruling involved six taxpayers who owned, as tenants in common, undivided one-sixth interests in 23 separate parcels of farm land. The parcels were cropshare leased and the leases were managed by one of the taxpayers as agent for the others. The taxpayers exchanged their partial interests in the several properties for entire fee interests in a few of the properties. By agreement of the parties, no further disposition of the properties was to occur, except upon the death of a party, for at least two years after the transfers. The exchanged property interests were of equal value with no boot or assumption of liabilities by any party. The IRS ruled that the exchanges would qualify for like-kind exchange treatment without recognition of gain so long as the values of the exchanged interests were approximately equal. Ltr. Rul. 9642029, July 16, 1996; Ltr. Rul. 9642032, July 16, 1996; Ltr. Rul. 9642033, July 16, 1996; Ltr. Rul. 9642034, July 16, 1996; Ltr. Rul. 9642035, July 16, 1996.

LODGING EXPENSES. The taxpayer operated gaming resorts and offered discounted and free lodging, meals and travel to its customers in accord with industry marketing practices. The benefits were available to the general public and were usable at the taxpayer’s facilities. The taxpayer also provided similar benefits to selected customers for use at unrelated facilities. The IRS ruled that the benefits offered to the general public were exempted from the disallowance provisions of I.R.C. § 274 and were deductible under I.R.C. § 162. However, the IRS ruled that the benefits offered to selected customers and used at unrelated facilities were not deductible under I.R.C. § 274. Ltr. Rul. 9641005, June 27, 1996.

REFUNDS. The taxpayer filed for an automatic extension to file the 1986 return and included a check for $25,000. The taxpayer did not file a return for 1986 until 1993 and the return showed a tax liability of only $14,900. The taxpayer requested a refund which was denied by the IRS. The court held that the $25,000 check was a payment and not a deposit; therefore, the refund request was barred by the limitations period of I.R.C. § 6511. Ott v. United States, 96-2 U.S. Tax Cas. (CCH) ¶ 50,526 (W.D. Wash. 1996).

S CORPORATIONS

NATURAL RESOURCE RECAPTURE PROPERTY. The IRS has adopted as final regulations governing the treatment of gain, under I.R.C. § 1254, from disposition of natural resource recapture property by S corporations and from disposition of S corporation stock to the extent of Section 1254 costs allocable to the stock. Disposition of natural resource recapture property by an S corporation requires calculation at the shareholder level of the income recaptured. Section 1254 costs must be recaptured in like-kind exchanges and involuntary conversions where any gain is recognized in the transaction and where the replacement property is not Section 1254 property. 61 Fed. Reg. 53062 (Oct. 10, 1996).

SAFE HARBOR INTEREST RATES

<table>
<thead>
<tr>
<th>November 1996</th>
<th>Annual</th>
<th>Semi-annual</th>
<th>Quarterly</th>
<th>Monthly</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-term</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AFR</td>
<td>5.96</td>
<td>5.87</td>
<td>5.83</td>
<td>5.80</td>
</tr>
<tr>
<td>110% AFR</td>
<td>6.56</td>
<td>6.46</td>
<td>6.41</td>
<td>6.37</td>
</tr>
<tr>
<td>120% AFR</td>
<td>7.16</td>
<td>7.04</td>
<td>6.98</td>
<td>6.94</td>
</tr>
<tr>
<td>Mid-term</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AFR</td>
<td>6.60</td>
<td>6.49</td>
<td>6.44</td>
<td>6.40</td>
</tr>
<tr>
<td>110% AFR</td>
<td>7.27</td>
<td>7.14</td>
<td>7.08</td>
<td>7.04</td>
</tr>
<tr>
<td>120% AFR</td>
<td>7.94</td>
<td>7.79</td>
<td>7.72</td>
<td>7.67</td>
</tr>
<tr>
<td>Long-term</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AFR</td>
<td>7.02</td>
<td>6.90</td>
<td>6.84</td>
<td>6.80</td>
</tr>
<tr>
<td>110% AFR</td>
<td>7.73</td>
<td>7.59</td>
<td>7.52</td>
<td>7.47</td>
</tr>
<tr>
<td>120% AFR</td>
<td>8.45</td>
<td>8.28</td>
<td>8.20</td>
<td>8.14</td>
</tr>
</tbody>
</table>

SOCIAL SECURITY TAX-ALM § 4.06.* Beginning with the January 2, 1997 payment, the monthly social security benefit payments will increase to a maximum of $484 for an individual and $726 for a couple. The maximum amount of annual wages subject to Old Age Survivors and Disability Insurance for 1997 is $65,400, with all wages and self-employment income subject to the medicare portion of the tax. For 1997, the maximum amount of annual earnings before reduction of benefits is $13,500 for persons aged 65 through 69 and $8,640 for persons under age 65. The amount of wages necessary for one quarter of coverage is $650. Social Security Admin. News Release, October 17, 1996.

NUISANCE

HOGS-ALM § 13.08.* The parties were two sons of one parent who devised the family farm in two parcels, one to each son. The parcels were divided by a stream and a road along the stream. At a point near the plaintiff’s residence, the defendant’s parcel included a narrow strip of land between the road and the plaintiff’s land. The strip was crossed by a driveway which the plaintiff constructed in order to reach a new residence built on the plaintiff’s parcel. Although no agreement was entered into by the parties allowing the driveway, the defendant never objected to the driveway. The defendant used a portion of the defendant’s parcel for raising hogs and the defendant moved a part of the hog lot to the narrow strip of land in front of the plaintiff’s residence. The plaintiff sued for an injunction, arguing that the use of the narrow strip constituted a private nuisance because of the sight, odor and insect problems caused by the hogs. The trial master denied the injunction, ruling that the odor and insect problems were no worse before the hogs were moved. The appellate court reversed, holding that the testimony clearly indicated that the use of the strip for raising and feeding hogs interfered with the plaintiff’s use of the residence and lowered the value of the

*Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.
residence. The court affirmed the trial master’s ruling that the defendant had acquiesced to the building of the driveway so as to create a prescriptive easement for the driveway. O’Cain v. O’Cain, 473 S.E.2d 460 (S.C. Ct. App. 1996).

PRODUCTS LIABILITY

PESTICIDES. The plaintiffs owned and operated a large family grain farm. The plaintiffs applied to their corn crop a rootworm pesticide manufactured by the defendant. After the pesticide failed to control rootworm, the plaintiffs sued for breach of implied warranty of fitness for a particular purpose, breach of warranty of merchantability, and in strict liability. The defendant argued that the claims were all barred by pre-emption of FIFRA and that the disclaimers of implied and express warranties barred the claims. The court found that a portion of the plaintiff’s claims on both the breach of warranty claims was based on representations made by the defendant in advertising, sales literature and a trade name. The court held that to the extent the claims were not label based, the claims were not preempted by FIFRA. However, the court held that the disclaimers were conspicuous and barred the nonpre-empted claims. The strict liability claim was also dismissed because the plaintiffs sought economic damages for their losses, which were not allowed under state law. In addition, the manufacturer was not in privity with the plaintiffs because the pesticide was sold by independent dealers. Bruce v. ICI Americas, Inc., 933 F. Supp. 781 (S.D. Iowa 1996).

SECURED TRANSACTIONS

PRIORITY. The debtor was a cotton grower who had granted a security interest in the cotton crop to the lessor of the land on which the crop was grown. The lessor executed a financing statement in April 1993. The lessor then sold the property under an agreement which allocated the rent between the lessor and the new buyer. The debtor also borrowed money from a commercial lender to finance the production of the cotton crop and granted the lender a security interest in the same crop. The lender filed a financing statement in May 1993. The debtor hired another company to harvest the cotton and granted that company a security interest in the cotton. The harvesting company filed a financing statement in July 1993. The proceeds of the cotton were insufficient to pay all of the debts and the issue was the priority of the three security interests. Under La. Rev. Stat. § 3:2651 a statutory priority was available first to laborers and second to lessors who could assert a lessor’s privilege. An initial issue was whether the statute applied to the proceeds of the cotton. The court held that the priority statute applied to harvested and unharvested cotton so long as the security interest arose while the cotton was unharvested. The parties argued that the harvesting company was not a laborer entitled to the top priority under the statute. The court held that the harvesting company was not entitled to the top priority as a laborer because the company hired other workers to actually harvest the cotton. The court also held that the lessor could not assert statutory priority because the lessor did not assert its lessor’s priority within 15 days after the cotton was harvested. The court also held that the buyer of the land did not have a perfected security interest in the cotton crop because no assignment of the security interest was included in the sale agreement and the buyer failed to properly perfect a security interest in the cotton crop. Thus, the priority of the security interests was based on the date of perfection as to the original lessor, the lender and the harvesting company. Bayou Pierre Farms v. BAT Farms Partners, III, 676 So.2d 643 (La. Ct. App. 1996).

STATE TAXATION

AGRICULTURAL USE. The defendants owned ranch land which received special valuation for property tax purposes based on the earnings capability of the land. The land was used for grazing, but the defendants leased several parcels to third parties for use as pasture. In several tax years several of the parcels were not actually used for grazing because of unavailability of water and other reasons. The Board of Adjustment allowed the valuation of the land as pasture because the board held that the statute did not require actual use of the land for grazing but only that the land was pasture land and that the possessor intended to use the land for grazing. The court held that the statute required actual grazing on land for each year the land received the special valuation, except where the grazing was not done in order to carry out conservation practices. The court also held that the Board of Adjustment should have determined whether any of the parcels were separate tax units or part of larger units on which some grazing had occurred, because the statute did not require grazing on all of a parcel which received special valuation. The court remanded the case back to the Board of Adjustment for determinations as to whether grazing did not occur because of conservation practices and whether any of the parcels could be joined with other land on which grazing did occur. Douglas County Bd. of Equalization v. Clarke, 921 P.2d 717 (Colo. 1996).

VETERINARIANS

BAILMENT. The plaintiff delivered a pet dog to the care of the defendant veterinarian for a surgical procedure. The dog died after the procedure was performed and the plaintiff sued the defendant for breach of a bailment agreement. Plaintiff’s petition did not allege any negligence and sought damages only for the fair market value of the dog. The court held that, because the dog was delivered to the veterinarian for performance of professional medical procedures, an action in bailment may not be brought. The court noted that only an action in negligence is allowed and because the plaintiff did not allege any negligence, the case was properly dismissed. Price v. Brown, 680 A.2d 1149 (Pa. 1996).
**AGRICULTURAL LAW PRESS ON THE WEB**

[http://members.aol.com/aglaw/agpub](http://members.aol.com/aglaw/agpub)

Check out our internet site for information about:

- Direct internet links to legal resources on the internet.
- Direct email link to the Agricultural Law Press.

We welcome any suggestions for improving our web site.

---

**AGRICULTURAL LAW MANUAL**

by Neil E. Harl

This comprehensive, annotated looseleaf manual is an ideal deskbook for attorneys, tax consultants, lenders and other professionals who advise agricultural clients. The book contains over 900 pages and an index.

As a special offer to Digest subscribers, the Manual is offered to new subscribers at $115, **including at no extra charge updates published within five months after purchase**. Updates are published every four months to keep the Manual current with the latest developments. After the first free update, additional updates will be billed at $100 per year or $35 each.

For your copy, send a check for $115 to Agricultural Law Press, P.O. Box 50703, Eugene, OR 97405.

Satisfaction guaranteed. 30 day return privilege.

---

**ISSUE INDEX**

<table>
<thead>
<tr>
<th>Adverse Possession</th>
<th>Pesticides 168</th>
</tr>
</thead>
<tbody>
<tr>
<td>Possession 166</td>
<td>Seeds 168</td>
</tr>
<tr>
<td>Public easement 166</td>
<td>Tobacco 168</td>
</tr>
<tr>
<td><strong>Bankruptcy</strong></td>
<td><strong>Federal Income Taxation</strong></td>
</tr>
<tr>
<td>General</td>
<td><strong>Assessments 169</strong></td>
</tr>
<tr>
<td>Automatic stay 166</td>
<td><strong>Farm Credit System 169</strong></td>
</tr>
<tr>
<td>Avoidable liens 167</td>
<td><strong>Interest 169</strong></td>
</tr>
<tr>
<td>Preferential transfers 167</td>
<td><strong>IRA 169</strong></td>
</tr>
<tr>
<td>Priority 167</td>
<td><strong>Like-kind exchanges 170</strong></td>
</tr>
<tr>
<td>Federal taxation</td>
<td><strong>Lodging expenses 170</strong></td>
</tr>
<tr>
<td>Discharge 167</td>
<td><strong>Refunds 170</strong></td>
</tr>
<tr>
<td>Net operating losses 167</td>
<td><strong>S corporations</strong></td>
</tr>
<tr>
<td><strong>Federal Agricultural Programs</strong></td>
<td>Natural resource recapture property 170</td>
</tr>
<tr>
<td>Conservation 168</td>
<td>Safe harbor interest rates November 1996 170</td>
</tr>
<tr>
<td>Crop insurance 168</td>
<td>Social security tax 170</td>
</tr>
<tr>
<td>Farm loans 168</td>
<td><strong>Nuisance</strong></td>
</tr>
<tr>
<td>Imports 168</td>
<td>Hogs 170</td>
</tr>
<tr>
<td>Payment limitations 168</td>
<td><strong>Products Liability</strong></td>
</tr>
<tr>
<td>PACA 168</td>
<td>Pesticides 171</td>
</tr>
<tr>
<td><strong>Secured Transactions</strong></td>
<td><strong>Priority 171</strong></td>
</tr>
<tr>
<td></td>
<td><strong>State Taxation</strong></td>
</tr>
<tr>
<td></td>
<td>Agricultural use 171</td>
</tr>
<tr>
<td></td>
<td><strong>Veterinarians</strong></td>
</tr>
<tr>
<td></td>
<td>Bailment 171</td>
</tr>
</tbody>
</table>
MORE ON INSTALLMENT SALES OF COMMODITIES AND AMT

— by Neil E. Harl

In the June 21, 1996, issue of the Digest we discussed in detail a technical advice memorandum which imposed alternative minimum tax on the sale of potatoes on a deferred basis. That TAM has now been formally released by the Internal Revenue Service. In addition, a U.S. District Court case has upheld IRS in a deferred commodity sale.

Authority of the TAM

IRS may impose a 20 percent accuracy-related penalty where there is a "substantial understatement of tax." A substantial understatement exists when the understatement for the year exceeds the greater of (1) 10 percent of the tax required to be shown on the return (including self-employment tax) or (2) $5,000 ($10,000 for corporations other than S corporations or personal holding companies). In general, taxpayers can avoid the penalty by showing - (1) that they acted in good faith and there was reasonable cause for the understatement, (2) that the understatement was based on substantial authority and (3) if there was a reasonable basis for the tax treatment of an item, the relevant facts affecting the item's tax treatment were adequately disclosed on Form 8275 (Form 8275-R for positions taken contrary to regulations).

Technical advice memoranda issued after October 31, 1976, are considered "substantial authority." Therefore, such authority should not be ignored.

Coohey v. United States

In late October, 1996, a U.S. District Court in Iowa decided a case involving deferred payment contracts for hogs. The farmer had sold $915,967 of hogs on a deferred payment basis in late 1990 with payment to be made in early 1991. IRS said the amount had to be reported in 1990 for AMT purposes, producing $151,791 of additional tax liability.

The court stated that the taxpayer did not elect out of installment reporting so installment reporting applied automatically. That meant AMT applied to the transaction.

Ironically, had the taxpayer elected out of installment reporting, the regulations note that no other method of deferred reporting would have been available to the taxpayer.

Another interesting feature of Coohey v. United States is that the taxpayer argued for a characterization of the transaction as a deferred payment arrangement. Yet the Internal Revenue Service has consistently ruled that a sale of livestock to a buyer subject to the Packers and Stockyards Act is ineligible for deferral of income tax liability. A U.S. District Court has disagreed, however, and has held that a cash basis farmer should be taxed in the year payment was received, which was the year following delivery of livestock to a market corporation that sold the livestock through an auction market.

Proposed Legislation

Two bills have been introduced to eliminate the AMT problem on installment sales and deferred payment sales of commodities. S.368, which was introduced in 1995, and H.R. 4072, which was introduced in 1996, would address the problem. However, the 104th Congress adjourned without taking action on either bill. Thus, possible Congressional action was delayed until 1997.

Any remaining distinction?

An important issue, since the decision in Coohey v. United States, is whether any meaningful distinction remains between installment sales of commodities and deferred payment sales. The Coohey case, blurred the line between the two marketing concepts. The 1995 TAM (issued in October of 1996), with different reasoning, implied that both types of arrangements were subject to AMT. If Coohey is upheld on appeal, and is followed in later cases, the two approaches to commodity sales may be indistinguishable for AMT purposes. However, the two types of contracts are fundamentally different for other purposes.
• Deferred payment contracts must be reported into income at year end unless made non-assignable and non-transferable.  

• IRS has resisted the use of deferred payment contracts for sales of livestock where the purchaser was subject to the Packers and Stockyards Act.  

• Installment sale treatment is not available to taxpayers who maintain inventories under their method of accounting.

Therefore, it is important to maintain an awareness of both types of transactions and to characterize particular transactions as one or the other, even though the two may be treated the same for AMT purposes.

FOOTNOTES
1 Harl, "Installment Sales of Commodities and AMT," 7 Agric. L. Dig. 93 (1996).
3 See generally 4 Harl, Agricultural Law § 25.03[2](1996); Harl, Agricultural Law Manual § 4.01[1][b][ii](1996). See also Harl, "Deferred Payment Sales: AMT Liability," 4 Agric. L. Dig. 17 (1993).
4 TAM 9640003, Dec. 21, 1996.

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

ADVERSE POSSESSION

FENCE. In 1964, the plaintiff purchased property from a third party and the seller represented that a fence delineated the northern boundary of the property. The plaintiff continually maintained and mowed the land within the fence. The defendant purchased land north of the fence by sheriff’s deed. The previous owner had purchased the land from the same third party who sold the southern portion to the plaintiff. The defendant ordered a survey of the property eight years after the purchase and discovered that the fence was located 10 feet onto the defendant’s property. The defendant argued that the sheriff’s deed conveyed title in preference to the title gained by the plaintiff by adverse possession. The court held that the defendant could acquire only the title held by the previous owner and because the plaintiff had acquired title by adverse possession before the sheriff’s sale, the sheriff’s deed was incapable of transferring title to the disputed strip. The defendant also argued that the failure of the plaintiff to pay property taxes on the disputed land prevented acquisition of the strip by adverse possession. The court held that because title by adverse possession provides no notice to the county tax assessor or to the adverse title holder, the failure to pay taxes on the strip does not affect acquisition by adverse possession. Graham v. Lambeth, 921 P.2d 850 (Kan. Ct. App. 1996).

ANIMALS

COW. A cow belonging to the plaintiff broke through a fence and wandered onto the defendant’s property. The plaintiff went to the defendant’s house and asked for permission to retrieve the cow; however, the plaintiff did not identify the cow or ask for return of the cow. Instead, the plaintiff filed suit for conversion and sought damages. The plaintiff argued that, under Ga. Code § 44-12-150, proof of conversion was not required because the defendant committed no unlawful act in acquiring possession of the cow. The court held that the statute did not apply because the defendant committed no unlawful act in acquiring possession of the cow. Therefore, because the plaintiff failed to provide any evidence that the defendant converted the cow or that the plaintiff had made a demand for the cow which was rejected, judgment for the defendant was proper. Simmons v. Bearden, 474 S.E.2d 250 (Ga. Ct. App. 1996).

BANKRUPTCY

FEDERAL TAXATION-ALM § 13.03[7].*

DISCHARGE. The debtor timely filed the 1991 income tax return. In March 1994, the IRS discovered an error in the 1991 return and sent a notice to this effect to the debtor. The debtor did not respond to the letter. In December 1994 the IRS recorded the lack of response...
from the debtor and in February 1995, within 180 days before the debtor filed for Chapter 7, the IRS sent an assessment notice for the amount owing for 1991. The debtor filed the Chapter 7 petition 455 days after the first notice of the error. The debtor argued that the first notice was an assessment, allowing the discharge of the taxes under Section 523(a)(1)(B). The court held that only the second qualified as an assessment because only that notice requested payment. The court noted that the first notice provided the debtor with the option of agreeing to an immediate assessment by responding to the notice but that the debtor chose not to respond, leaving the assessment to occur on the later date. **Schweizer v. United States, 96-2 U.S. Tax Cas. (CCH) ¶ 50,545 (C.D. Ill. 1996).**

The debtors timely filed their 1982 and 1983 income tax returns and filed for Chapter 13 in April 1988. The IRS filed a claim for tax deficiencies for 1982 and 1983. The plan was confirmed and the case was dismissed on August 13, 1992. The debtors refiled for Chapter 13 on August 19, 1992 and claimed the 1982 and 1983 taxes as dischargeable. The IRS argued that the three year period of Sections 523(a)(1)(A), 507(a)(8)(A) was tolled during the first Chapter 13 case. The court held that no statutory authority existed for tolling of the three year period by a bankruptcy case. The court also held that the Bankruptcy Court’s ruling that the taxes were dischargeable was not proper under use of equitable powers because the IRS failed to show any fraud or bad faith by the debtors in filing the second case. **Borsage v. United States, 96-2 U.S. Tax Cas. (CCH) ¶ 50,566 (S.D. Ala. 1996).**

The debtor filed returns for 1987 through 1990 together but late for all years. The returns were sent to the IRS by delivering the returns to a private courier on November 22, 1991. The IRS received the returns on November 25, 1991. The debtor filed for Chapter 7 on November 23, 1993. The debtor argued that the taxes were dischargeable, under Section 523(a)(1)(B)(ii) as filed more than two years before the bankruptcy filing because the effective date of the filing was the date the returns were delivered to the courier. The court held that the “mailbox rule” (effective date of filing was postmark date) applied only for timely filed returns delivered to the U.S. Postal Service; therefore, the effective filing date for the returns was November 25, 1991, the date received by the IRS. **In re Smith, 96-2 U.S. Tax Cas. (CCH) ¶ 50,560 (6th Cir. 1996).**

**DISMISSAL.** The debtor filed for Chapter 13 and the plan was confirmed. During the plan period, the debtor incurred additional post-petition employment and income tax liabilities which were not paid. The court dismissed the Chapter 13 case for bad faith in that the failure to pay the post-petition taxes was a prejudicial and unreasonable delay of payment of the IRS claims. **In re Bennett, 200 B.R. 252 (Bankr. M.D. Fla. 1996).**

**RETURNS.** The debtor had failed to timely file returns for 1981 through 1984 for the debtor’s business. The IRS constructed substitute returns and sent the debtor a 90-day determination letter which required a response by the debtor within 90 days in order for the debtor to challenge the determination in the Tax Court. The debtor filed the returns after the 90-day period had passed, thus allowing the debtor only an appeal to the District Court. The IRS argued that the returns were a nullity for purposes of Section 523(a)(1)(B) such that the taxes owed were not dischargeable because no return was filed. The court held that the returns were valid, under I.R.C. § 6501(a), for purposes of commencing the three-year period for assessments; therefore, the returns were not a nullity under the I.R.C. and would qualify as returns under Section 523(a)(1)(B) and allow discharge of the taxes owed. **In re Sullivan, 200 B.R. 327 (Bankr. N.D. Ohio 1996).**

The debtors filed for Chapter 13 and the court had ordered the debtors to file all pre-petition income tax returns which had not been filed. The debtors were granted one extension but failed to file returns for two tax years, although the debtors filed affidavits titled “Actual and Constructive Notice of Declaration” containing some statements of income and tax liability. The court dismissed the case for bad faith filing because the debtors failed to comply with the court’s order to file all pre-petition income tax returns. **In re Tobias, 200 B.R. 412 (Bankr. M.D. Fla. 1996).**

The debtor filed for Chapter 13 and the court had ordered the debtor to file a pre-petition income tax return which had not been filed. The debtor failed to file the return, although the debtor filed information in the bankruptcy schedules containing some statements of income and tax liability. The court dismissed the case for bad faith filing because the debtor failed to comply with the court’s order to file the pre-petition income tax return. **In re MacClean, 200 B.R. 417 (Bankr. M.D. Fla. 1996).**

**CONTRACTS**

**HEDGE-TO-AARRIVE CONTRACTS.** The plaintiff was an agricultural cooperative which entered into several hedge-to-arrive contracts with the defendant grain farmer. Under the contracts, the defendant was to deliver grain over several years, although the contracts contemplated rolling over the contracts in future years. The defendant repudiated the contracts and the plaintiff sued in state court for breach of contract. The defendant pled as an affirmative defense that the contracts were illegal under the Commodity Exchange Act and removed the case to federal court, arguing that the case essentially involved a federal question in an affirmative defense. **Farmers Co-operative Elevator v. Doden, No. C 96-3144-MWB (N.D. Iowa 1996).**
FEDERAL AGRICULTURAL PROGRAMS

BRUCELLOSIS. The APHIS has issued interim regulations amending the brucellosis regulations concerning the interstate movement of cattle by changing the classification of Louisiana from Class A to Class Free. 61 Fed. Reg. 56116 (Oct. 31, 1996).

CROP INSURANCE. The FCIC has issued proposed regulations providing specific provisions for crop insurance for raisins as an endorsement to the Common Crop Insurance Policy. 61 Fed. Reg. 55928 (Oct. 30, 1996).

The FCIC has issued proposed regulations establishing procedures for determining eligibility for program participation in any program administered under the Federal Crop Insurance Act and administering and maintaining an ineligible tracking system. The proposed regulations also set out the criteria for reinstatement of program eligibility. 61 Fed. Reg. 56151 (Oct. 31, 1996).

The FCIC has adopted as final regulations providing specific provisions for crop insurance for pears as a pear endorsement to the Common Crop Insurance Policy. 61 Fed. Reg. 57578 (Nov. 7, 1996).

HORSES. The APHIS has adopted as final regulations removing the regulations governing the interstate movement of horses affected with or exposed to contagious equine metritis and adding this disease to a list of diseases not known to exist in the United States. 61 Fed. Reg. 56116 (Oct. 31, 1996).

LIVESTOCK. The APHIS has issued proposed regulations amending the regulations regarding the interstate movement of livestock by combining the provisions for the approval of livestock markets for cattle and bison, horses, and swine into a single section. The proposed regulations also remove the regulations that restrict the movement of swine and swine products from areas quarantined for hog cholera and that provide for the payment of compensation to the owners of swine destroyed because of hog cholera. 61 Fed. Reg. 56155 (Oct. 31, 1996).

PACKERS AND STOCKYARDS ACT-ALM § 9.05.* The respondent corporation operated a livestock auction which was a stockyard posted under the P&SA. The respondent was found to have a negative balance in the custodial account on four occasions during a 90 day period. The respondent was also found to have failed to reimburse the custodial account for withdrawals and to properly designate the custodial account. The ALJ also determined that the violations were aggravated by the respondent’s receiving prior notice that the custodial account had a negative balance and occurrence of the above violations after that notice. The respondent argued that the negative balance violations were caused by a bank’s refusal to honor an overdraft agreement, a bad check from a purchaser, and a delay in receipt of several receivables. The ALJ rejected these factors as mitigating the violations because it was the respondent’s duty to insure that the custodial account was solvent. The ALJ issued a cease and desist order and fined the respondent $7,000. In re Smithfield Livestock Auction, Inc., 55 Agric. Dec. 430 (1995).

The respondent corporation operated a registered stockyard. A routine audit showed that the respondent had a negative balance in its custodial account. The respondent argued that it had an open line of credit with a bank which would cover any overdraft drawn on the account and that no insufficient funds checks were ever issued by the respondent. The ALJ ruled that a line of credit was insufficient to meet the requirements of the P&SA that the custodial account have a positive balance at all times. The ALJ issued a cease and desist order and fined the respondent $4,000. In re Greencastle Livestock Market, Inc., 55 Agric. Dec. 458 (1996).

PEANUTS. The AMS has adopted as final regulations which reduce the indemnification payment coverage to certain costs involved with appeal and product claims. The regulations reduce the Peanut Administrative Committee’s indemnification payments for losses incurred by signatory handlers in not being able to ship unwholesome peanuts for edible purposes from a ceiling of $7 million for each of the last two years, to about $300,000. The reduction in indemnification claim payments would provide the Committee with adequate funds in its indemnification reserve to cover costs. 61 Fed. Reg. 55547 (Oct. 28, 1996).

PERISHABLE AGRICULTURAL COMMODITIES ACT-ALM § 10.05[2].* The respondent was a PACA licensed produce dealer whose license had lapsed for nonpayment of the license fee. The PACA had received several PACA trust notices and reparation complaints and instituted an audit of the respondent. The audit revealed 24 unpaid sellers involving 166 lots of produce received through interstate commerce. The respondent claimed that the failures to pay resulted from errors made by salesmen hired by the respondent and from accounting errors. The ALJ ruled that the reasons for the nonpayments were insufficient and that the respondent had committed repeated and flagrant violations of PACA. The ALJ imposed the sanction of publication that the respondent had made repeated and flagrant violations of PACA. In re N. Pugach, Inc., 55 Agric. Dec. 581 (1995).

The respondent was a PACA licensed produce dealer. A person (the employee) who worked for the respondent had been a 50 percent owner of another licensed produce dealer which was ruled to have committed repeated and flagrant violations of PACA. The ALJ in that case found that the employee had been responsibly connected with the other dealer and was prohibited from employment by another licensed dealer for one year. The respondent argued that the employee did not have any substantial duties with the respondent and was not paid for the work done. The ALJ found, however, that the employee took and delivered orders and participated in sales of produce. The ALJ also found that the respondent continued to

* Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.
employ the employee after being notified that employment was a violation of PACA. The ALJ imposed the sanction of revocation of the respondent’s license. In re County Produce, Inc., 55 Agric. Dec. 596 (1996).

The respondent was a produce dealer formerly licensed under PACA but which had lost its license for failure to pay the license fee. The respondent was found to have purchased 27 lots of produce without making timely payments for the produce. The ALJ ruled that the respondent had committed repeated and flagrant violations of PACA and ordered publication of that ruling. In re Coastal Tomato & Banana Co., 55 Agric. Dec. 617 (1996).

POULTRY. The APHIS has adopted as final regulations generally revising the regulations concerning exotic Newcastle disease in birds and poultry, and psittacosis or ornithosis in poultry. 61 Fed. Reg. 56877 (Nov. 5, 1996).

FEDERAL ESTATE AND GIFT TAX

GENERATION SKIPPING TRANSFERS-ALM § 5.04[6]. The decedent died in October 1982. The residue of the decedent’s estate passed to a marital trust for which a QTIP election was made by the estate. The trust provided that, upon the death of the surviving spouse, the trust principal passed to six trusts, one for each of the decedent’s children. Each child was entitled to the income from the trust and to trust principal at the discretion of the trustees. Each child had a special testamentary power over trust principal. The decedent’s will made no provision for payment of estate taxes imposed on the surviving spouse’s estate from inclusion of the trust in the spouse’s estate. The surviving spouse executed a will which provided for payment of estate and inheritance taxes, except for GST taxes and limited to a maximum amount, attributable to the marital trust included in the spouse’s estate and which passed in trust to the decedent’s children. The spouse’s will also waived any right of recovery of taxes attributable to the children’s trusts. The IRS ruled that (1) the trust was treated as if a reverse QTIP election was made so that the decedent would continue to be considered the transferor of the children’s trust; (2) the waiver of the right of recovery was not considered a constructive addition to the trust so as to subject the trust to GSTT; and (3) the payment of estate and inheritance taxes did not subject the trust to GSTT. Ltr. Rul. 9644048, Aug. 1, 1996.

JOINT TENANCY PROPERTY. The decedent’s predeceased spouse had executed a will which provided for either outright distribution of estate property to three unrelated persons or, at the discretion of the decedent, to execute promissory notes for the amounts to be distributed. The decedent did not make the outright distributions but created a joint bank account which included one of the legatees as a joint tenant and deposited the bequest amount in the account. The decedent executed promissory notes for the other bequests. The decedent’s estate included one-half of the bank account in the decedent’s estate. Under I.R.C. § 2053(c)(1)(A) the entire account was includible in the decedent’s estate except for the portion contributed by the other joint tenant which was the tenant’s separate property or was acquired for full consideration. The estate argued that the joint tenant’s half of the account was received from the predeceased spouse’s estate. The court held that the decedent’s estate failed to provide sufficient evidence that the predeceased spouse’s estate had sufficient property to fund the joint tenant’s share of the account; therefore, no deduction was allowed for the joint tenant’s share of the account. The estate excluded the amount owed on the note to the other legatees under I.R.C. § 2053(c)(1)(A). Again, the court held that the deduction for the note was not allowed because the decedent’s estate did not provide sufficient evidence that the predeceased spouse’s estate had sufficient property to pay the note. Estate of Harden v. Comm’, T.C. Memo. 1996-488.

MARITAL DEDUCTION-ALM § 5.04[3]. The decedent and surviving spouse had created a revocable trust for their benefit with the decedent and spouse as co-trustees. The trust provided that, at the death of the decedent, the trust was to be split into two trusts with the marital trust funded with $600,000. The surviving spouse was the trustee of this trust but could be replaced if necessary. The marital trust would terminate at the incompetency of the surviving spouse. The marital trust provided that the trustee had the discretion to distribute all trust income at least quarterly and to distribute all trust corpus for the surviving spouse’s care, comfort, maintenance and welfare. The trust granted the surviving spouse the power to withdraw all trust principal. The surviving spouse had a general testamentary power of appointment over the trust corpus. The IRS ruled that the marital trust was not eligible for the marital deduction because the surviving spouse was not entitled in all events to the income from the trust, since the trustee had the discretionary power to accumulate income and the trust could terminate before the death of the surviving spouse. Although the surviving spouse retained the right to revoke the trust, this power lapsed at the incompetency of the surviving spouse; therefore, the IRS ruled that the surviving spouse’s power to withdraw all trust principal was not exercisable in all events. Ltr. Rul. 9644001, July 3, 1996.

SPECIAL USE VALUATION-ALM § 5.03[2]. The decedent died on December 15, 1995 owning farm property. The decedent’s estate attempted to make a special use valuation election on the estate’s timely filed estate tax return. However, the executor failed to fill in the “yes” box after the question on the form asking if a special use valuation was elected and the return failed to include the recapture agreement of the qualified heirs. The IRS notified the estate that the election was incomplete and the estate supplied the recapture agreement within 90 days after the IRS notification. The IRS denied the election because the initial return did not substantially comply with the election requirements. The
court held that the recapture agreement was an essential element of the election and the estate return did not substantially comply with the election; therefore, the estate was not entitled, under I.R.C. § 2032A(d)(3) to perfect the election. The estate also argued that Section 1421 of the Tax Reform Act of 1986 allowed the perfection of the election because the original estate tax return provided “substantially all the information” for the election. The court held that the recapture agreement was an essential part of the “information” required by Section 1421 and the failure to provide the agreement prevented the estate from perfection of the election after notice by the IRS. Estate of Lucas v. United States, 96-2 U.S. Tax Cas. (CCH) ¶ 60,247 (11th Cir. 1996).

FEDERAL INCOME TAXATION

CORPORATIONS-ALM § 7.02.*

SECTION 1244 STOCK. The taxpayer was an attorney who initially invested $15,000 in a small business corporation as a silent partner. The taxpayer later guaranteed loans obtained by the corporation. When the corporation defaulted on the loans, the taxpayer started working for the corporation and invested additional funds in the corporation. The court held that the taxpayer was entitled to I.R.C. § 1244 stock treatment for losses only to the extent of the original $15,000 investment, with the remainder of the investment entitled to capital loss treatment. The court also disallowed a business bad debt deduction for the guaranteed loans because the guarantee was made primarily to protect the taxpayer’s investment and not employment with the corporation. Zuravin v. United States, 96-2 U.S. Tax Cas. (CCH) ¶ 50,543 (D. Md. 1996).

EMPLOYMENT TAXES. The taxpayer provided its new employees with an election to participate in a group health insurance plan. If the employee decided to participate, the taxpayer reduced the wages of the employee but not by an amount which totally covered the cost to the taxpayer of the coverage for the employee. The IRS assessed FICA and FUTA employment taxes on the amount of reduced wages. The court held that the reduced wage amounts were not subject to FICA or FUTA taxes. Express Oil Change, Inc. v. United States, 96-2 U.S. Tax Cas. (CCH) ¶ 50,553 (N.D. Ala. 1996).

The IRS has issued “Independent Contractor of Employee?” explaining the three relief requirements provided by Section 530 of the Revenue Act of 1978: (1) have a reasonable basis for not treating workers as employees, (2) consistent treatment of similar workers as independent contractors, and (3) consistent filing of information returns with the IRS. IR-96-44.

PENSION PLANS. For plans beginning in October 1996, the weighted average is 6.91 percent with the permissible range of 6.22 to 7.47 percent (90 to 109 percent permissible range) and 6.22 to 7.61 percent (90 to 110 percent permissible range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). Notice 96-54, I.R.B. 1996-44, 13.

RESPONSIBLE PERSON. The taxpayer was the spouse of the owner of a book store. The taxpayer and spouse had invested their lifec savings in the store and the taxpayer worked in the store as executive manager and purchaser. The spouse maintained management control over the staff and financial affairs of the store and checks were written by others only with the spouse’s approval. The IRS argued that the taxpayer was a responsible person liable, under I.R.C. § 6672, for employment taxes owned by the business. The court held that the taxpayer’s substantial financial and personal investment in the store and status as executive manager made the taxpayer liable as a responsible person in the business. In re Pond, 200 B.R. 267 (Bankr. S.D. Fla. 1996).

RETURNS. The taxpayer purchased wood for third parties. The taxpayer contracted with independent timber harvesters who contracted with timber owners for the cutting of trees. The independent contractors delivered the cut trees to lumber mills and the lumber mills paid for the trees by paying the taxpayer. The taxpayer then paid the independent contractors. Some of the contractors had their payments made out in the form of two checks, one to themselves and one to the timber owners. The IRS ruled that the taxpayer had to report payments in excess of $600 per year for the payments made to the independent contractors (unless the contractor was a corporation) but did not have to make additional reports for the payments made by separate checks to the timber owners. Ltr. Rul. 9643004, July 12, 1996.

S CORPORATION-ALM § 7.03(2)[c].*

PASSIVE INVESTMENT INCOME. The taxpayer was a corporation which owned rental properties. The corporation provided services to the tenants through full- and part-time employees. The corporation provided maintenance and construction services, a parking lot for the tenants and the tenants’ customers, inspections, and subletting services. The corporation paid for the insurance, utilities and repairs for the properties. The IRS ruled that the rental income was not passive investment income for purposes of eligibility for S corporation status. Ltr. Rul. 9643017, July 22, 1996.

SOIL AND WATER CONSERVATION EXPENSES. The IRS has announced that Form 8645, Soil and Water Conservation Plan Certificate is obsolete for tax years after 1995. The information required by the former form is to be reported on Schedule F; Form 4835, Farm Rental Income and Expenses; Form 1040-SS, U.S. Self-Employment Tax Return (Virgin Islands, Guam, American Samoa, Northern Mariana Islands); and Form 1040-PR, Planilla Para La Declaracion De La Contribucion Federal Sobre El Trabajo Por Propia-Puerto Rico. Ann. 96-42, I.R.B. 1996-20, 18.

THEFT LOSS. The taxpayers loaned money to their son-in-law to assist the son-in-law in financing several business opportunities. The son-in-law used the money, however, to invest in the stock market and lost all of the...
borrowed funds. The taxpayers claimed the unrecoverable loans as a theft loss. The court disallowed the theft loss deduction because the taxpayers made the loans with no expectation of profit or interest on the loans and the taxpayers knew the loans were not repayable in the tax year prior to the year the deduction was claimed. **Leonard v. Comm’r, T.C. Memo. 1996-473.**

**NUISANCE**

**HOG CONFINEMENT OPERATION.** The plaintiffs purchased their rural home and farmland in 1977. The defendants purchased their land, directly south of the plaintiffs, in 1974 and operated a commercial hog feeding operation on the land since 1990. The plaintiffs suffered from the strong odors from the waste treatment lagoon maintained for the hog operation and presented testimony of several rural residents as to the strength and distasteful nature of the odors. The trial court ruled that the operation was a nuisance but only a temporary nuisance and awarded damages but no injunction. The trial court reasoned that technological advances in odor control would eventually solve the problem. The appellate court upheld the holding that the hog operation was a nuisance but held that the nuisance was permanent because no evidence was presented that any odor control technology was available or was soon to be available. The second issue was whether Iowa Code § 351.11 provided a defense against a nuisance action. The defendants’ land was approved as an agricultural area on October 8, 1991 and, as an agricultural area, was protected from nuisance suits after that date. The court held that, because the nuisance action was brought before the land was approved as an agricultural area, the plaintiffs action was not barred and the plaintiffs could recover past, present and future damages caused by the nuisance. The trial court had awarded $45,000 in special damages for past and present injuries from the nuisance. Although the appellate court held that future damages were allowable, the court held that the $45,000 award was sufficient to cover the future damages as well. Note: A future issue of the Digest will publish an article by Neil E. Harl on this case. **Weinhold v. Wolff, No. 157/94-1589, ___ N.W.2d ___ (Iowa 1996).**

**STATE REGULATION OF AGRICULTURE**

**ENVIRONMENT.** The plaintiffs owned a 55 acre tree covered parcel in the flood plain of a river. The plaintiffs wanted to clear cut the trees in order to develop the land as farmland. Under Conn. Gen. Stat. § 22a-342, the plaintiffs were required to obtain a permit from the county commissioner because the land was in a flood plain and adjacent to a river. The plaintiffs argued that they were exempt, under Conn. Gen. Stat. § 22a-349, from the permit requirement because the land was intended for farming. The court held that the exemption was available only for actions which were either farming in themselves or incidental to farming. Because the clear cutting was a one time event and not part of a timber operation, the land did not qualify for the farming exemption. **Cannata v. Dept. of Environmental Protection, 680 A.2d 1329 (Conn. 1996).**

**CITATION UPDATES**

**Firsdon v. United States, 95 F.3d 444 (6th Cir. 1996), aff’g, 95-1 U.S. Tax Cas. (CCH) ¶ 50,040 (N.D. Ohio 1995) (net operating losses) see p. 151 supra.**

---

**AGRICULTURAL LAW PRESS ON THE WEB**

http://members.aol.com/aglaw/agpub

Check out our internet site for information about:

- **Agricultural Law Manual,** by Neil E. Harl, a comprehensive, annotated looseleaf deskbook.
- **Principles of Agricultural Law,** a college textbook, by Roger A. McEowen and Neil E. Harl, due for publication in December 1996.
- Direct internet links to legal resources on the internet.
- Direct email link to the Agricultural Law Press.

We welcome any suggestions for improving our web site.

**AGRICULTURAL LAW MANUAL by Neil E. Harl**

This comprehensive, annotated looseleaf manual is an ideal deskbook for attorneys, tax consultants, lenders and other professionals who advise agricultural clients. The book contains over 900 pages and an index.

As a special offer to Digest subscribers, the Manual is offered to new subscribers at $115, including at no extra charge updates published within five months after purchase. Updates are published every four months to keep the Manual current with the latest developments. After the first free update, additional updates will be billed at $100 per year or $35 each.

For your copy, send a check for $115 to Agricultural Law Press, P.O. Box 50703, Eugene, OR 97405.

Satisfaction guaranteed. 30 day return privilege.
Time is running out to take advantage of this special seminar, register now to insure your reservation

SEMINAR IN PARADISE
FARM ESTATE AND BUSINESS PLANNING by Dr. Neil E. Harl
January 6-10, 1997

Spend a week in Hawai‘i in January 1997! Balmy trade winds, 70-80 degrees, palm trees, white sand beaches and the rest of paradise can be yours; plus a world-class seminar on Farm Estate and Business Planning by Dr. Neil E. Harl. The seminar is scheduled for January 6-10, 1997 at the beautiful ocean-front Royal Waikoloa Resort on the Big Island, Hawai‘i.

Seminar sessions run from 8:30 a.m. to 12:30 p.m. each day, Monday through Friday, with a continental breakfast and break refreshments included in the registration fee. Each participant will receive a copy of Dr. Harl’s 400 page seminar manual, Farm Estate and Business Planning: Annotated Materials which will be updated just prior to the seminar.

Here are the major topics to be covered:
- Introduction to estate and business planning.
- Liquidity planning with emphasis on 15-year installment payment of federal estate tax.
- Co-ownership of property, including discounts, taxation and special problems.
- Federal estate tax, including alternate valuation date, special use valuation, handling life insurance, marital deduction planning, disclaimers, planning to minimize tax over deaths of both spouses, and generation skipping transfer tax.
- Gifts and federal gift tax, including problems with future interests, handling estate freezes, and "hidden" gifts.
- 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.
- Using trusts, including funding of revocable living trusts.
- Organizing the farm business--one entity or two, corporations, general and limited partnerships and limited liability companies.

The Agricultural Law Press has made arrangements for discount air fares on United Airlines and discounts on hotel rooms at the Royal Waikoloa, the site of the seminar.

The seminar registration fee is $645 for current subscribers to the Agricultural Law Digest or the Agricultural Law Manual. The registration fee for nonsubscribers is $695.

For a registration packet, please call Robert Achenbach at 1-541-302-1958.

ISSUE INDEX

Adverse Possession
- Fence 174

Animals
- Cow 174

Bankruptcy
- Federal taxation 174
- Discharge 174
- Dismissal 175
- Returns 175

Contracts
- Hedge-to-arrive contracts 175

Federal Agricultural Programs
- Brucellosis 176
- Crop insurance 176
- Horses 176
- Livestock 176
- Packers and Stockyards Act 176
- Peanuts 176
- PACA 176
- Poultry 177

Federal Estate and Gift Tax
- Generation skipping transfers 177
- Joint tenancy 177
- Marital deduction 177
- Special use valuation 177

Federal Income Taxation
- Corporations
- Section 1244 stock 178

Employment taxes 178
- Pension plans 178
- Responsible person 178
- Returns 178
- S Corporation
- Passive investment income 178
- Soil and water conservation expenses 178
- Theft loss 178

Nuisance
- Hog confinement operation 179

State Regulation of Agriculture
- Environment 179
REPORTING HTA LOSSES

— by Neil E. Harl

Hedge-to-arrive contracts, which in recent years had spread throughout Midwestern agriculture like a virus,1 pose important but difficult issues on how the losses are reported for federal income tax purposes. Some guidelines are well known2 and are relevant in determining whether losses are from hedges and thus are ordinary3 or are capital in nature.4 Ordinary losses offsets ordinary gains but long term capital losses can only affect long-term capital gains and, for individuals, up to $3,000 per year of ordinary income.5 Excess capital losses can be carried forward indefinitely for individuals6 and for up to five years for corporate taxpayers.7

Calculating gains and losses from hedges

In some instances, hedge contracts are closed out at the time the actual commodities are sold. In that case, the calculation of gains or losses on the hedging contract and on the actual commodities is straightforward with the gains and losses reported on Schedule F (or the appropriate business schedule for non sole proprietors).

But in other instances, the factual circumstances surrounding the close out of the hedge is less clear. The regulations8 provide guidance on how the transactions should be handled.

As a general proposition, the accounting approach used by the taxpayer where hedges are involved must clearly reflect income.9 To clearly reflect income, the method used must reasonably match the timing of income, deductions, gains or losses from the hedging transactions with the timing of income, deductions, gains or losses from the items being hedged.10 Taking gains and losses into account in the period in which they are realized generally reflects income clearly for hedging transactions.11 For hedges of inventory, gains or losses on the hedge may be taken into account in the same period that it would be taken into account if the gains or losses were treated as related to inventory.12 The records are to contain a description of the accounting approach used.13

The regulations provide considerable latitude in adopting an approach to handling hedges. But once adopted, the method must be used consistently.14

Taxpayers on cash accounting with less than $5,000,000 of gross receipts for all taxable years after September 30, 1993, are not required to use these rules.15 Most farm taxpayers fall into that category. However, the regulations point out that those taxpayers may, nonetheless, use an approach consistent with these rules.16

In the event a taxpayer hedges an item and then disposes of or terminates its interest in the item but does not dispose of or terminate the hedge, the taxpayer must "appropriately" match the built-in gain or loss on the hedging transaction to the gain or loss on the disposed item.17 Thus, hedges may be "marked-to-market" on the date the actuals are disposed.18

For "recycled" hedges, with the hedge later used to serve as a hedge of a different item, the taxpayer must match the built-in gain or loss at the time of the recycling to the gain or loss on the original hedged items. Gains or losses attributable to the period after recycling must be matched to the new hedged item.19

Such recycling has been common with hedge-to-arrive contracts. In numerous instances, 1995 crop in storage was hedged. However, the crop in storage was sold on the cash market as prices rose with the hedge "rolled over" to the 1996 crop -- even beyond. It appears that the gain or loss on a hedge contract is calculated at the time the actual commodities are sold. This creates a basis for the hedging contract for purposes of calculating gain or loss at the time the actual commodities are sold. This creates a basis for the hedging contract for purposes of calculating gain or loss at the time the new hedged item is sold.

Failure to identify hedges

To receive ordinary loss treatment, taxpayers must identify hedges when entered into along with the item or items hedged.20 Hedging transactions entered into on or after January 1, 1994, must be identified as such before the close of the day on which the taxpayer enters into the hedge.21

The regulations impose a stern set of penalties for failure properly to identify hedges.

---

1 Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
- If a taxpayer identifies a transaction as a hedging transaction, and it is not a hedge, gains from the transaction are ordinary but losses are capital losses.²²
- In the event a transaction meets the definitions of a hedge but it is not identified as a hedge, gains from the transaction are nonetheless ordinary and losses are capital losses.²³

Thus, compliance with the regulations has been made the exclusive way to receive treatment as a hedge. That result has been criticized.²⁴

**Treatment as a "regulated futures contract"**

Positions in "regulated" futures contracts are subject to the "marked-to-market" rules and are treated as if sold on the last day of the year.²⁵ Gains or losses arising from those calculations are treated as if they were 60 percent long-term and 40 percent short-term without regard to the actual holding period.²⁶ Hedging transactions are exempt from these rules.²⁷

It would appear that hedge-to-arrive contracts are not "regulated futures contracts."²⁸ A regulated futures contract must be "traded on or subject to the rules of a qualified board or exchange."²⁹ Hedge-to-arrive contracts appear to have been outside the ambit of regulated futures activity.³⁰

**FOOTNOTES**


2. See 4 Harl, supra n. 1, § 27.03(8)[d]; Harl supra n. 1, § 4.02[6].

3. See Treas. Reg. § 1.1221-2(b) (defines hedges which produce ordinary losses). See also I.R.C. §§ 1092(e), 1256(e)(i).

5. I.R.C. § 1211(b).
10. Id.
11. Id.
16. Id.
18. Id.
21. Treas. Reg. § 1.1221-2(e)(1). The identification must be made “substantially contemporaneously” with entering into the hedge. An identification does not meet that test if made more than 35 days after entering into the hedging transaction. Treas. Reg. § 1.1221-2(e)(2)(ii).
27. I.R.C. § 1256(e)(1).
29. Id.

**CASES, REGULATIONS AND STATUTES**

by Robert P. Achenbach, Jr.

**ANIMALS**

**CATTLE.** A veterinarian informed the state police that neglected cattle were on the plaintiff’s property. One defendant, a state trooper, accompanied the veterinarian to the plaintiff’s farm and investigated the condition of the animals. The trooper filed a report with the county prosecutor who obtained a warrant for the seizure of some of the animals. The second defendant, also a state trooper, assisted in executing the warrant under which the cattle were seized by the local humane society which eventually sold the animals to cover maintenance costs. As a result of the second visit, another warrant was issued for seizure of the remaining animals. The third defendant, a state trooper, accompanied the humane society as it seized the animals. The plaintiff was eventually exonerated of animal neglect charges but by then all of the animals had been sold. The plaintiff sued all parties, with the state troopers as the only defendants in the current case. The plaintiff alleged that the state troopers violated the plaintiff’s due process rights and brought an action under 42 U.S.C. § 1983. The court upheld the dismissal of the case against the troopers because the troopers were properly executing court orders or were too removed from the sale of the animals to have participated in deprivation of the plaintiff’s property. **Campbell v. Chappelow, 95 F.3d 576 (7th Cir. 1996).**

**BANKRUPTCY**

**GENERAL-ALM § 13.03.*

**ADMINISTRATIVE EXPENSES.** The debtor was a family farm partnership which operated a grain and dairy farm. The partners and their spouses also filed individual bankruptcy cases which were consolidated with the debtor’s case. During the pendency of the debtor’s case, a seed supplier sold on credit corn seed, fertilizer and two herbicides to the debtor for producing one year’s crop. The crop did not do well and the debtor complained to the
supplier that the seed was defective and that the application method for the fertilizer and herbicide was ineffective. The supplier filed a priority administrative expense claim for the seed and chemicals. The other creditors objected to the claim, arguing that the estate was not benefited by the seeds and chemicals because the farm was to be sold as soon as possible. The court held that the seed and chemicals benefited the estate by continuing to keep the farm operational during the time it was offered for sale. The debtor argued that the claim should not be allowed because the seed and chemicals were defective. The court held that the debtor failed to show that the seed or chemicals were defective and that other intervening causes, such as low moisture and poorly operating equipment, were not responsible for the low yield. In re Molnar Bros., 200 B.R. 555 (Bankr. D. N.J. 1996).

EXEMPTIONS

EARNED INCOME TAX CREDIT. The court held that the debtor’s earned income tax credit was not eligible for an exemption under Ohio Rev. Code § 2329.66(A)(9)(e). In re Beagle, 200 B.R. 595 (Bankr. N.D. Ohio 1996).

PREFERENTIAL TRANSFERS. The debtors had owed money to the SBA. After that debt was due, the debtors contracted with the ASCS (now CFSA) for conservation programs under which the debtors would receive annual deficiency payments. The SBA instituted an administrative setoff which was properly approved by the ASCS. Some payments were made within 90 days before the debtors filed for bankruptcy and the trustee sought recovery of the setoff payments as preferential transfers. The court held that the ASCS and SBA lacked mutuality so that the setoff was not binding in the bankruptcy case and ordered recovery of the payments. Upon reconsideration, the court held that the offset did not improve the SBA position; therefore, the setoff was not subject to recovery. In re Turner, 96 F.3d 465 (10th Cir. 1996), on remand from 59 F.3d 1041 (10th Cir. 1995).

TRUSTEE LIABILITY. The debtor had operated a manufacturing business on real property and deposited waste from the manufacturing process on the land, contaminating the land and groundwater. The debtor filed for Chapter 11 and a trustee was appointed. The trustee, acting as trustee of the bankruptcy estate, transferred the land to the plaintiff. The debtor falsely submitted a Negative Declaration Affidavit with the state department of environmental protection, stating that no areas of environmental concern existed on the property. The sale was closed but the plaintiff later learned of the contamination. The plaintiff filed suit against all parties, including the trustee. The court held that the trustee did not have a fiduciary duty to the purchaser; therefore, the public policy of protecting trustees from suits by nondebtors prevented the trustee’s personal liability for the debtor’s misconduct. Tennsc Corp. v. Estey Metal Products, Inc., 200 B.R. 542 (D. N.J. 1996).

CHAPTER 13-ALM § 13.03.*

ALLOCATION OF PLAN PAYMENTS OF TAXES. The debtors’ Chapter 13 plan provided that all priority claims were to be paid in full but that unsecured claims would receive no payments. The IRS had filed a claim for taxes which consisted of some priority taxes and some unsecured general taxes. The debtors were entitled to a tax refund from a pre-petition tax year and the IRS sought permission to offset the refund against the tax claims, first against the unsecured tax claim and then against the priority tax claim. The trustee testified that the plan would not succeed if the refund was applied first to the unsecured taxes. The court held that it had the authority to exercise its equitable powers to order the IRS to allocate the refund first to the priority tax claim. In re Moore, 200 B.R. 687 (Bankr. D. Or. 1996).

FEDERAL TAXATION-ALM § 13.03[7].*

CLAIMS. The debtors filed for Chapter 13 in September 1995. The debtors filed a claim for 1995 taxes for the IRS, arguing that the amount due for the first two estimated tax installments were pre-petition taxes. The court held that the 1995 taxes were not due until the end of the tax year, December 31, 1995; therefore, the 1995 taxes were all post-petition taxes. In re Michaelson, 200 B.R. 862 (Bankr. D. Minn. 1996).

DISMISSAL. The debtor’s Chapter 13 case was dismissed for failure of the debtor to file all income tax returns as ordered by the court. In re Vines, 96-2 U.S. Tax Cas. (CCH) ¶ 50,603 (M.D. Fla. 1996).

INTEREST. The debtor filed for Chapter 11 and the IRS filed an unsecured priority claim for employment taxes. The debtor’s plan was confirmed in August 1990, and in February 1991, the IRS assessed additional unpaid post-petition employment taxes. The debtor argued that the IRS was not entitled to post-petition interest on the filed claim and the post-petition assessment violated the automatic stay. The court held that, because the IRS claim was not discharged, post-petition interest continued to accrue. The court also held that, because the plan did not provide for the continuing of the automatic stay during the plan, the post-confirmation assessment did not violate the automatic stay. The case is designated as not for publication. In re Gehri, 96-2 U.S. Tax Cas. (CCH) ¶ 50,577 (Bankr. 9th Cir. 1996).

POST-PETITION TAXES. The debtors filed for Chapter 13 in September 1989 and the IRS filed claims for unpaid taxes for 1985 through 1988. The debtors timely filed their 1989 tax return and in June 1990 sought permission to add the 1989 taxes to the Chapter 13 plan. The IRS failed to object to this and filed amendments to its claims. The court held that post-petition claim were includible in the Chapter 13 plan only upon request of the creditor; therefore, the 1989 taxes could not have been included in the plan at the request of the debtors. Matter of Epstein, 200 B.R. 611 (Bankr. S.D. Ohio 1996).

RETURNS. The debtor filed an income tax return for the bankruptcy estate and then filed an amended return for the estate. The debtor requested a prompt determination
with only the amended return. The amended return was accurate but failed to include the amount of taxable income listed on the original return. The IRS failed to notify the debtor that the return was selected for examination within 90 days after receiving the debtor’s request. The IRS argued that an exception to that rule applied because the amended return contained a material misrepresentation from the failure to include the taxable income from the original return. The court held that the omission of the original taxable income was not a material misrepresentation; therefore, the IRS was prohibited from challenging the amended return. In re Grassgreen, 200 B.R. 696 (Bankr. M.D. Fla. 1996).

FEDERAL AGRICULTURAL PROGRAMS

BRUCELLOSIS. The APHIS has issued interim regulations changing the classification of New Mexico from a Class A to a Class Free state. 61 Fed. Reg. 58625 (Nov. 18, 1996).

CROP INSURANCE. The FCIC has adopted as final regulations which add specific provisions for sugar beets to the Common Crop Insurance Policy. 61 Fed. Reg. 58769 (Nov. 19, 1996).

The FCIC has issued proposed regulations which add specific provisions for peaches to the Common Crop Insurance Policy. 61 Fed. Reg. 58786 (Nov. 19, 1996).

The FCIC has issued proposed regulations which add specific provisions for dry beans to the Common Crop Insurance Policy. 61 Fed. Reg. 60049 (Nov. 26, 1996).

PEANUTS. The CCC has issued proposed regulations establishing the 1997 national peanut poundage quota as between 1,111,000 and 1,155,000 short tons and the additional price support level of between $125 and $140 per short ton. The minimum sales price for additional peanuts for export edible use is to be between $375 and $425 per short ton. 61 Fed. Reg. 59840 (Nov. 25, 1996).

FEDERAL ESTATE AND GIFT TAX

DISCLAIMERS-ALM § 5.02[6]. The decedent’s will bequeathed the entire estate, primarily the “home farm,” to the surviving spouse and provided that if the surviving spouse did not survive the decedent by at least 30 days, the estate passed to a trust for the decedent’s child. The surviving spouse disclaimed a portion of the estate that would be subject to the federal estate tax. The disclaimed amount passed to the surviving spouse. The IRS ruled that the disclaimer was effective. Ltr. Rul. 9645010, Aug. 12, 1996.

GIFT-ALM § 6.01. The taxpayer owed taxes from involvement in a business. The taxpayer transferred title to the taxpayer’s residence to the taxpayer’s two minor daughters under the Illinois Uniform Transfers to Minors Act, reserving the right to live in the residence. The IRS argued that the gift lacked donative intent and transferred only bare legal title; therefore, the residence remained available for attachment for payment of the taxpayer’s taxes. The taxpayer argued that the transfer was bona fide because it complied with state law. The court held that summary judgment for the taxpayer was improper at this point because the IRS provided sufficient evidence to rebut the presumption of a gift through transfer in compliance with the Illinois Uniform Transfers to Minors Act. United States v. Melcher, 96-2 U.S. Tax Cas. (CCH) ¶ 50,578 (C.D. Ill. 1996).

GROSS ESTATE. The taxpayer established an irrevocable trust which provided that the beneficiaries had the discretion to distribute or accumulate trust income. At the death of the beneficiaries, the trustor and the trustee’s spouse, the trust terminated and trust corpus, except for assets contributed by persons other than the trustor and the trustee’s spouse, were to pass to the taxpayer’s children. The trustor and spouse made contributions in 1973, the couple’s children made contributions in 1974 and 1975 and the spouse’s estate was added to the trust in 1987. The IRS ruled that the trust was includible in the trustor’s estate only as to the property contributed by the trustor, based on the ratio of the fair market value of the contribution to the fair market value of the trust corpus at the time of the contribution, adjusted by the fair market value of later contributions by others. The IRS also ruled that the trust corpus was subject to GSTT only as to post-1985 contributions. Ltr. Rul. 9646021, Aug. 20, 1996.

The taxpayers, husband and wife each established an irrevocable trust. The beneficiaries of the wife’s trust included the husband and their children. The beneficiaries of the husband’s trust included only the children. The taxpayers served as trustee of each other’s trusts but all distribution powers were given to an independent co-trustee. The children and the husband had the power to require distribution of gift contributions to the trusts but not to exceed 5 percent of the trust corpus or $5,000. The taxpayers had limited powers of appointment over trust corpus. The IRS ruled that the only portion of the trusts included in the taxpayers’ estates was the value of the husband’s corpus withdrawal rights at the time of death. Ltr. Rul. 9643013, July 19, 1996.

MARITAL DEDUCTION-ALM § 5.04[3]. The decedent’s estate included an interest in a trust which passed to the surviving children. The residue of the estate passed to the surviving spouse and the estate claimed a marital deduction for the value of the entire residue, without any reduction for the residue’s share of inheritance and estate taxes. The decedent’s will provided language in three provisions for payment of inheritance and estate taxes from the estate other than the residue portion passing to the surviving spouse. Under the Ohio apportionment statute, taxes were not to be paid from bequests for which a marital deduction was available, unless the decedent’s will expressly assigned the taxes to specific bequests. The court found that the will and trust provisions were ambiguous in that the provisions could have been interpreted to include...
the marital bequest as a source of payment of the taxes. The court held, therefore, that the decedent’s will did not expressly assign the taxes to all bequests and the apportionment statute applied to prohibit apportionment of the estate and inheritance taxes to the residue bequest which was eligible for the marital deduction. The court acknowledged rulings in the state probate court that agreed with this interpretation of the will, although the court was not bound by that ruling. 

Estate of Swallen v. Comm’r, 96-2 U.S. Tax Cas. (CCH) ¶ 60,248 (6th Cir. 1996), aff’d, T.C. Memo. 1993-149.

The decedent had established an inter vivos trust which would continue for the surviving spouse at the decedent’s death. The trust provided for distribution of all trust income to the surviving spouse, except during any period of incompetency. During the incompetency period, the trustee was to hold trust income in another trust for distribution to the spouse upon regaining competency. If the spouse died before regaining competency, the accumulated income passed to the remainder holders. The IRS ruled that the trust was not eligible for the marital deduction because the surviving spouse was not entitled to all trust income in all events. 

Ltr. Rul. 9645006, July 24, 1996.

SPECIAL USE VALUATION—ALM § 5.03[2]. On the death of the decedent in 1983, the estate made the special use valuation election for farmland and the qualified heirs signed and filed the agreement to the election and to be liable for any recapture tax. Later, the IRS discovered that some of the land was rented for cash to third parties. The IRS issued a deficiency notice for recapture of the special use valuation benefits relating to the cash rented land. The heirs argued that the initial election was invalid and that the IRS had notice of the invalidity from the date of the election because the heirs included cash rent income on the estate’s Schedule F of the income tax return. Therefore, the statute of limitations had expired as to the election. The court held that, because some of the estate’s farmland was not included in the special use valuation election, the IRS could have reasonably assumed that the cash rents came from that land and not the special use valued land. In addition, the court held that the heirs were under a duty to file consistent returns and could not now claim a prior election as invalid when the heirs had acted for several years as if the election was valid. 

LeFever v. Comm’r, 96-2 U.S. Tax Cas. (CCH) ¶ 60,250 (10th Cir. 1996), aff’d 103 T.C. 525 (1994).

TAX LIEN. The taxpayer was a decedent’s estate. The decedent had bequeathed a portion of real property to a third party. The IRS had filed a tax lien for taxes owed by the third party and the lien was a cloud on the title to the property which the estate wanted to sell. The third party disclaimed any interest in the estate and the estate argued that the disclaimer had the effect of removing any interest of the third party in the property to which a lien could attach. The court held that under Texas law, a decedent’s estate property immediately vested in the named heirs and that this vesting was sufficient interest in the property for the lien to attach. The disclaimer was not effective under federal law to remove the lien. 


VALUATION. The taxpayer owned a residence on 16.6 acres of beach property. The entire property had been used as a residence for 40 years and was not suitable for division. The taxpayer transferred the property to a six-year trust with the taxpayer as the sole income beneficiary. The trust could sell the property but was required to either purchase a replacement residence or distribute the corpus at the sooner of the trust termination or two years after the sale. The trust also provided that the trust corpus could not be sold directly or indirectly to the taxpayer or the taxpayer’s spouse. The trust also had the power to hold cash for the maintenance and improvement of the property. If the taxpayer died before the trust terminated, the trust corpus was to be distributed according to a power of appointment held by the taxpayer; otherwise, the trust corpus passed upon termination to the taxpayer’s children. The IRS ruled that the trust was a qualified personal residence trust. 


FEDERAL INCOME TAXATION

BAD DEBTS. The taxpayer had invested in real property for the purpose of developing the land for residential construction. As part of that plan, the taxpayer loaned money to a third party. The investment did not bear fruit and the third party filed for Chapter 7 bankruptcy. The taxpayer claimed the unpaid loan as a business bad debt deduction. The court held that the taxpayer’s involvement in the real estate investment was not a trade or business; therefore, the bad debt did not qualify as a business bad debt. The court also held that, because the Chapter 7 estate held assets for distribution to creditors, the taxpayer’s debt was not wholly worthless and was not entitled to a bad debt deduction. 


The taxpayers owned a roofing company and personally guaranteed a line of credit for the company in order for the company to acquire supplies for a roofing job. The company failed to receive payment for that job, however, and was liquidated. The taxpayers claimed the guaranteed debt as a business bad debt deduction. The court allowed the business bad debt deduction because the taxpayers made the guarantee in order to protect their income from the business and not to protect their investment in the company. 

Rosenberg v. United States, 96-2 U.S. Tax Cas. (CCH) ¶ 50,583 (N.D. Ill. 1996).

COURT AWARDS AND SETTLEMENTS. The taxpayers received a judgment award in a negligence action. The award included prejudgment interest equal to 39 percent of the total award. While the case was on appeal, the parties settled for a specific amount, but the settlement did not include a specific apportionment for prejudgment interest. The IRS apportioned 39 percent of the settlement to prejudgment interest and assessed income tax as to that amount. The court upheld the IRS assessment because the taxpayers failed to prove that the settlement intended a different apportionment. The prejudgment interest was taxable because it was not part of the damages awarded for personal injury. 

Delaney v. Comm’r, 96-2 U.S. Tax Cas. (CCH) ¶ 50,576 (1st Cir. 1996).

HOBBY LOSSES. The taxpayers were employed as registered nurses and also operated a medical records review service. The taxpayers purchased up to 10 Paso Fino horses
with the intent to breed them for sale to the public. The breeding business produced several years of increasing costs and tax losses which offset their substantial wages. The court looked at the nine factors of Treas. Reg. § 1.183-2(b) to determine that the breeding business was not operated with the intent to make a profit: (1) the taxpayers failed to formulate a plan to produce a profit from the business; (2) although the taxpayers had knowledge about the horses, the taxpayers failed to obtain expert advice about running a profitable breeding business; (3) the taxpayer expended sufficient time in the business; (4) the appreciation of the horses had no potential to offset the losses; (5) the taxpayer had not successfully operated a similar business before; (6) the business had a history of only losses; (7) the amount of income from the business was insubstantial in comparison to the losses; (8) the taxpayers’ other income was sufficient to maintain their standard of living while absorbing the losses; and (9) the taxpayers worked hard at the business but also received much personal pleasure from rural life and riding the horses. Thus, the taxpayer’s deductions from the business expenses were limited to the income from the business. *Yates v. Comm’r*, T.C. Memo. 1996-499.

**IN VOLUNTARY CONVERSION.** The taxpayer was a limited partnership which formed a general partnership with a corporation for the purpose of purchasing real property. The property became the subject of governmental condemnation proceedings and an agreement to sell the property to the governmental entity was reached by the general partnership. Once the sale was assured and imminent, the general partnership transferred 50 percent tenant-in-common interests to the taxpayer and the corporation. The taxpayer used the proceeds of the sale to purchase similar property and sought allowance of like-kind tax-free transfer treatment for the sale and purchase. The IRS ruled that the sale of the original property was made by the general partnership and not by the taxpayer; therefore, the purchase of other property by the taxpayer did not qualify for like-kind exchange treatment. *Ltr. Rul. 9645005*, July 23, 1996.

**LEY.** The IRS has issued a table for determining the amount of wages, salary or other income except from levy for 1997. *Notice. 96-56, I.R.B. 1996-47, 7.*

The defendant hired the taxpayer to perform subcontracting services. The taxpayer had assigned its accounts receivable to a bank as security for a loan. On July 7, 1992, the IRS filed a tax levy on the defendant for taxes owed by the taxpayer. The bank notified the defendant of the assignment on July 9, 1992. The court held that the defendant was liable for the failure to pay the amount owed on the tax levy because the levy was filed prior to notification of the assignment. *United States v. Giffels Associates, 96-2 U.S. Tax Cas. (CCH) ¶ 50,584 (E.D. Mich. 1996).*

**PENALTIES.** The taxpayers were assessed additional taxes after an audit of their 1985-1986 returns. The taxpayers operated a substantial feedlot business with annual revenues over $6 million. In the audit, the IRS imposed a FIFO inventory system because the taxpayers had inadequate inventory records. The taxpayers were also found to have improperly reported an interest expense in the tax year before the interest was actually charged. The IRS disallowed a dependent deduction for the taxpayers’ daughter for the tax year the daughter was married, because the daughter and new husband filed a joint return. Finally, the taxpayers improperly claimed a business deduction for the use of three head of cattle to feed the taxpayers and their workers. The IRS assessed a penalty for substantial underpayment of taxes and the taxpayers sought a waiver of that penalty for acting in good faith. The court held that the penalty was justified for all but the interest deduction, because the taxpayers had relied on a bank statement that the interest was charged in the year for which the deduction was claimed. *Walter v. United States*, 96-2 U.S. Tax Cas. (CCH) ¶ 50,604 (D. S.D. 1996).

The IRS has issued proposed regulations concerning the reasonable basis standard for avoiding the accuracy-related, negligence, and substantial understatement of income penalties. Under the final regulations currently in place, the reasonable basis standard is “significantly higher than the not frivolous standard applicable to preparers under 6694.” The proposed regulations provide that the reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. A return position will generally satisfy the reasonable basis standard if it is reasonably based on one or more of the authorities set forth in Treas. Reg. § 1.6662-4(d)(3)(iii). The proposed regulations also clarify that if a return position does not satisfy the reasonable basis standard, the reasonable cause and good faith exception as set forth in Treas. Reg. § 1.6664-4 may still provide relief from the penalty. *61 Fed. Reg. 58020 (Nov. 12, 1996).*

The taxpayer was a corporation which had timely paid its taxes for 1983 but had obtained the automatic extension to file. When the taxpayer finally filed the 1983 return, the taxpayer claimed a refund because the timely tax payment exceeded the actual amount due. The taxpayer elected to apply the refund amount to the 1984 tax liability. However, upon review by the IRS, the 1983 refund amount was reduced. The IRS charged the taxpayer for interest on the excess refund claimed by the taxpayer from the date of the 1983 return. The IRS argued that once the refund was applied to the 1984 tax year, any deficiency would carry back to the 1983 return. The taxpayer argued that the 1983 taxes were fully paid and that the interest could not be charged until 1984 taxes were due but unpaid. The court held that the “use of money” principle applied to determine when interest on taxes begins to accrue. Because the taxpayer had no benefit from the erroneous refund claim until taxes became due in 1984, no interest could be charged until those taxes became due. *The May Department Stores Co. v. United States*, 96-2 U.S. Tax Cas. (CCH) ¶ 50,596 (Fed. Cl. 1996).

The IRS had determined that the taxpayer corporation had overpaid its 1981 tax but owed additional taxes for 1982 and 1983. The amount of the overpayments exceeded both of the deficiencies. The IRS paid interest on the entire 1981 overpayment until the due date of the return for 1982. The IRS then paid interest on the remaining overpayment until the due date for the 1983 return. The IRS then paid interest on the remaining overpayment until the date of repayment. For 1986, the taxpayer timely filed its return and claimed an overpayment of taxes. The taxpayer elected to apply the

*Agricultural Law Manual (ALM). For information about ordering the Manual, see the next to last page of this issue.*
overpayment to the 1987 taxes but did not designate as to which estimated tax payment the overpayment was to be applied. The IRS applied the overpayment to the first estimated tax payment and assessed interest on a 1988 deficiency from the date of the first estimated payment instead of the due date of the return. Ltr. Rul. 9646001, June 20, 1996.

PENSION PLANS. For plans beginning in November 1996, the weighted average is 6.91 percent with the permissible range of 6.22 to 7.46 percent (90 to 109 percent permissible range) and 6.22 to 7.60 percent (90 percent permissible range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). Notice 96-59, I.R.B. 1996-__, __.

SAFE HARBOR INTEREST RATES

<table>
<thead>
<tr>
<th>December 1996</th>
<th>Annual</th>
<th>Semi-annual</th>
<th>Quarterly</th>
<th>Monthly</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>AFR</strong></td>
<td>5.75</td>
<td>5.67</td>
<td>5.63</td>
<td>5.60</td>
</tr>
<tr>
<td>110% AFR</td>
<td>6.34</td>
<td>6.24</td>
<td>6.19</td>
<td>6.16</td>
</tr>
<tr>
<td>120% AFR</td>
<td>6.92</td>
<td>6.80</td>
<td>6.74</td>
<td>6.71</td>
</tr>
<tr>
<td><strong>Mid-term</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AFR</td>
<td>6.31</td>
<td>6.21</td>
<td>6.16</td>
<td>6.13</td>
</tr>
<tr>
<td>110% AFR</td>
<td>6.95</td>
<td>6.83</td>
<td>6.77</td>
<td>6.73</td>
</tr>
<tr>
<td>120% AFR</td>
<td>7.59</td>
<td>7.45</td>
<td>7.38</td>
<td>7.34</td>
</tr>
<tr>
<td><strong>Long-term</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AFR</td>
<td>6.77</td>
<td>6.66</td>
<td>6.61</td>
<td>6.57</td>
</tr>
<tr>
<td>110% AFR</td>
<td>7.46</td>
<td>7.33</td>
<td>7.26</td>
<td>7.22</td>
</tr>
<tr>
<td>120% AFR</td>
<td>8.15</td>
<td>7.99</td>
<td>7.91</td>
<td>7.86</td>
</tr>
</tbody>
</table>

SALE OF ASSETS. The taxpayer was the sole shareholder, chief executive officer and director of a corporation which manufactured paint sprayers. The taxpayer owned several horses which the taxpayer wanted to sell. The taxpayer had title to the horses secretly transferred to a new subsidiary of the corporation. The purpose of the transfer was to have the corporation sell the horses and recognize any gain which would be eligible for offset by net operating loss carryforwards held by the corporation. The management of the horses did not change after the transfer and other directors and employees of the corporation were not informed about the horse transfer and sales. The court held that the taxpayer was required to recognize any gain from the sale of the horses because the corporation was merely a conduit for the sale. The court noted that the transfer of the horses to the corporation served no business purpose of the corporation and was made primarily for tax advantages. Estate of Kluener v. Comm’r, T.C. Memo. 1996-497.

TRUSTS. The taxpayer established a trust to be funded with S corporation stock. The trust provided that the trustee had the power to lend money from the trust to the taxpayer without providing security for the loan. The trustee could irrevocably release or waive this power. The taxpayer had the power to acquire trust property by substituting property of equivalent value. The IRS ruled that the trust was a grantor trust such that the taxpayer was liable for any tax on trust income. Ltr. Rul. 9645013, Aug. 9, 1996.

The taxpayer was the owner of a grantor trust which had income from the renting of safe deposit boxes. The trust filed a “1041 Supplement” showing income of $87,519 but the taxpayer reported income from the trust of only $74,955, claiming that the taxpayer was entitled to more depreciation than was claimed by the trust. The court found that the trust was a grantor trust; therefore, the income and deductions from the rental of the safe deposit boxes was treated as if the boxes were owned by the taxpayer. The additional depreciation was not allowed because the taxpayer failed to provide evidence of the basis of the boxes for determining the appropriate depreciation. Bresnahan v. Comm’r, T.C. Memo. 1996-497.
Time is running out to take advantage of this special seminar, register now to insure your reservation

**SEMINAR IN PARADISE**

**FARM ESTATE AND BUSINESS PLANNING** by Dr. Neil E. Harl

**January 6-10, 1997**

Spend a week in Hawai’i in January 1997! Balmy trade winds, 70-80 degrees, palm trees, white sand beaches and the rest of paradise can be yours; plus a world-class seminar on Farm Estate and Business Planning by Dr. Neil E. Harl. The seminar is scheduled for January 6-10, 1997 at the beautiful ocean-front Royal Waikoloa Resort on the Big Island, Hawai’i.

Seminar sessions run from 8:30 a.m. to 12:30 p.m. each day, Monday through Friday, with a continental breakfast and break refreshments included in the registration fee. Each participant will receive a copy of Dr. Harl’s 400 page seminar manual, *Farm Estate and Business Planning: Annotated Materials* which will be updated just prior to the seminar.

Here are the major topics to be covered:
- Introduction to estate and business planning.
- Liquidity planning with emphasis on 15-year installment payment of federal estate tax.
- Co-ownership of property, including discounts, taxation and special problems.
- Federal estate tax, including alternate valuation date, special use valuation, handling life insurance, marital deduction planning, disclaimers, planning to minimize tax over deaths of both spouses, and generation skipping transfer tax.
- Gifts and federal gift tax, including problems with future interests, handling estate freezes, and “hidden” gifts.
- 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.
- Using trusts, including funding of revocable living trusts.
- Organizing the farm business—one entity or two, corporations, general and limited partnerships and limited liability companies.

The Agricultural Law Press has made arrangements for **discount air fares** on United Airlines and **discounts on hotel rooms at the Royal Waikoloa**, the site of the seminar.

The seminar registration fee is $645 for current subscribers to the *Agricultural Law Digest* or the *Agricultural Law Manual*. The registration fee for nonsubscribers is $695.

For a registration packet, please call Robert Achenbach at 1-541-302-1958.

---

**ISSUE INDEX**

**Animals**
- Cattle 182

**Bankruptcy**
- General
  - Administrative expenses 182
  - Exemptions 182
  - Earned income tax credit 183
  - Preferential transfers 183
  - Trustee liability 183
- Chapter 13
  - Allocation of plan payments of taxes 183
  - Federal taxation 183
  - Claims 183
- Dismissal 183
- Interest 183
- Post-petition taxes 183
- Returns 183

**Federal Agricultural Programs**
- Brucellosis 184
- Crop insurance 184
- Peanuts 184

**Federal Estate and Gift Tax**
- Disclaimers 184
- Gift 184
- Gross estate 184
- Marital deduction 184
- Special use valuation 185

**Federal Income Taxation**
- Bad debts 185
- Court awards and settlements 185
- Hobby losses 185
- Involuntary conversion 186
- Levy 186
- Penalties 186
- Pension plans 187
- Safe harbor interest rates
  - November 1996 187
- Sale of assets 187
- Tax lien 185
- Valuation 185

---

188
ACCOUNTING ADJUSTMENTS FOR AMT WITH COMMODITY SALES

— by Neil E. Harl*

In the June 21, 1996,1 and the November 15, 1996,2 issues of the Digest, we examined in detail the potential liability for alternative minimum tax3 for installment sales4 and deferred payment sales5 of farm commodities.6 In this issue, we examine the accounting adjustments required in reporting AMT under the “substantial authority”7 that emerged in 1996.8

Calculating the AMT

The statute9 makes it clear that taxpayers are to calculate the regular tax10 and the tentative minimum tax and pay the greater amount.11 The regulations state that all Internal Revenue Code provisions applicable to the calculation of regular tax apply also in determining alternative minimum taxable income including accounting changes.12

A change in the handling of a “material item” is subject to the rules on change of accounting method.13 Change in the treatment of installment or deferred payment sales of commodities is considered a change in the method of accounting.14 Therefore, adjusting to the IRS position on AMT for commodity sales involves a change in method of accounting.15

Change of Accounting

If a change of accounting occurs, adjustments must be made to prevent items of income or expense from being duplicated or omitted.16 In calculating alternative minimum taxable income for any taxable year in which commodity sales are deferred, it is necessary to increase taxable income by the value of deferred payment or installment payment obligations received in that year and to reduce taxable income by the amounts attributable to sales in prior years but reported in the taxable year in question.17

A limitation is imposed on the tax attributable to the required adjustments if the adjustments increase the income for the year by more than $3,000.18 The tax reported is the lesser of three calculated tax amounts—

• The first calculation involves determining the increase in tax if all of the required adjustments are taken into account in the year of change.19
• The second calculation is to be made if the taxpayer used the “old” method of accounting in the two prior years.20 With this approach, the required adjustments are divided evenly among the year of change and the two immediately preceding taxable years.21 The increase in tax for each year is calculated and the three amounts are summed.
• The third approach can be used if the taxpayer can establish income using the “new” method of accounting for years prior to the year of change.22 In that event, the required adjustments are allocated to those years that consecutively precede the year of change with the balance, if any, allocated to the year of change.23 The increase in tax for the years involved is summed.24

The second of the three adjustments will, in many cases, produce the least tax. The following example is for individual taxpayers assuming $150,000 of grain was delivered to the elevator in 1996 with payment deferred to January of 1997.

In the example, the taxpayer had the following history of using deferred payment contracts—

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>-0</td>
<td>20,000</td>
<td>-0</td>
<td>12,000</td>
<td>100,000</td>
<td>8,000</td>
<td>-0</td>
<td>15,000</td>
<td>100,000</td>
<td>100,000</td>
</tr>
</tbody>
</table>

Step 1: AMT preference for 1996: 150,000 - 100,000 = 50,000

Step 2: AMT preference for three prior years—

<table>
<thead>
<tr>
<th>Year</th>
<th>1993</th>
<th>1994</th>
<th>1995</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>10,000</td>
<td>15,000</td>
<td>100,000</td>
</tr>
</tbody>
</table>

Step 3: Allocate one-third of 1996 AMT preference to current and two prior years—

---

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

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Adj. gross income</td>
<td>$40,000</td>
<td>$40,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>Add: AMT pref. (other)</td>
<td>5,000</td>
<td>5,000</td>
<td>5,000</td>
</tr>
<tr>
<td>+ 1/3 of 100,000</td>
<td>33,333</td>
<td>33,333</td>
<td>83,334</td>
</tr>
<tr>
<td>Less Exemption</td>
<td>-45,000</td>
<td>-45,000</td>
<td>-45,000</td>
</tr>
<tr>
<td>AMT tax rate</td>
<td>.26</td>
<td>.26</td>
<td>.26</td>
</tr>
<tr>
<td>8,667 + 8,667 + 21,667</td>
<td>$39,001</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Regular Tax

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Adj. gross income</td>
<td>$40,000</td>
<td>$40,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>Less standard ded.</td>
<td>-6,350</td>
<td>-6,550</td>
<td>-6,700</td>
</tr>
<tr>
<td>Less personal exemption</td>
<td>-9,800</td>
<td>-10,000</td>
<td>-10,200</td>
</tr>
<tr>
<td>23,850</td>
<td>23,450</td>
<td>23,100</td>
<td></td>
</tr>
<tr>
<td>(SE tax is not taken into account for this example</td>
<td>x .15</td>
<td>x .15</td>
<td>x .15</td>
</tr>
<tr>
<td>account for this example</td>
<td>3,578</td>
<td>3,517</td>
<td>3,465</td>
</tr>
</tbody>
</table>

Alternative Minimum Tax With Adjustment $28,441

Thus, the use of the second approach would reduce the AMT substantially under the facts of this example.

For corporate taxpayers, the exemption is $40,000 with a 20 percent AMT rate. Note that, for individuals, the AMT rate rises to 28 percent above $175,000 (over the exemption amount). The exemption phases out by 25 percent of the amount by which AMTI exceeds a specified amount ($150,000 for noncorporate taxpayers).

Filing Form 3115

The adjustment calculations are to be reported with the Form 3115, “Application for Change in Accounting Method.” It should be noted that a different allocation method can be used with agreement with I.R.S. Requests are to be addressed to the Commissioner of Internal Revenue.

Recent Developments

In response to the Coohey case and TAM 9640003, there has been congressional interest in providing a legislative remedy for the AMT issue for deferred payment crop sales. As part of that effort, the following Memorandum was sent by Neil E. Harl to Senator Tom Daschle in support of his efforts and others in discussions with the Department of the Treasury to obtain transitional relief from the IRS position:

“There have been, since 1980, two distinct methods for deferral of crop sales by farmers—


2. The installation sale of crops and livestock under I.R.C. § 453 was authorized as part of the Installment Sales Revision Act of 1980. The crucial passage is found in I.R.C. § 453(b)(2)(B).

The Senate Finance Committee recognized this distinction in the Senate Finance Committee Report on the Installment Sales Revision Act of 1980—

‘Under the bill, gain from the sale of property which is not required to be inventoried by a farmer under his method of accounting will be eligible for installment method reporting as gain from a casual sale of personal property even though such property is held for sale by the farmer. The committee also intends that deferred payment sales to farmer cooperatives are to be eligible for installment reporting as under present law (Rev. Rul. 73-210, 1973-1 C.B. 211).’ S. Rep. 96-1080, 96th Cong., 2d Sess. 8 (1980).

In 1986, Congress added an amendment to I.R.C. § 56 (which was further amended in 1987 but without making a material change in the scope of the provision) which specified that AMT applied to installment obligations involving property described in I.R.C. § 1221(1). The language found in I.R.C. § 56(a)(6), provides as follows—

‘In the case of any disposition after March 1, 1986, of any property described in section 1221(1), income from net disposition shall be determined without regard to the installment method under section 453. . . . (emphasis added)’

Thus, the use of the second approach would reduce the AMT substantially under the facts of this example.

‘There is no question that installment sales of crops and livestock have been subject to AMT since 1986.

‘It has been generally believed that deferred payment sales, as a separate concept, were not subject to AMT because deferred payment sales were never subject to ‘the installment method under section 453.’ Deferred payment sales rest upon a base comprised of Rev. Rul. 58-162, supra, and the cases decided prior thereto. The installment sale of crops and livestock was added in 1980 to address a problem created by Ltr. Rul. 8001001, September 4, 1979, which had held that deferred payment sales which were transferable had to be reported into income at the end of the taxable year.

*Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.
"The Congressional reaction was to authorize installment sale treatment as another way to sell crops (and livestock).

"My belief is that the issuance of TAM 9640003, December 21, 1995, and the decision in the case of Coohey v. United States, N.D. Iowa 1996, represent an extension of the AMT concept to deferred payment sales. I believe that transitional relief is warranted inasmuch as contracts were in place based upon an expectation that AMT did not apply."

FOOTNOTES
1 Harl, "Installment Sales of Commodities and AMT," 7 Agric. L. Dig. 93 (1996).
3 I.R.C. § 55(a).
6 See generally 4 Harl, Agricultural Law § 25.03(2)(1996); Harl, Agricultural Law Manual § 4.01 [1][b][ii][1996].
9 I.R.C. § 55(a).
10 See I.R.C. §§ 55(c)(1), 26(b) (defined as the Chapter 1 tax for the year with several specified adjustments).
11 I.R.C. § 55(a).
12 See Treas. Reg. § 1.55-1(a).
15 Id.
16 I.R.C. § 481(a).
18 I.R.C. § 481(b).
20 I.R.C. § 481(b)(1).
21 Id.
22 I.R.C. § 481(b)(2).
23 Id.
24 Id.
25 The example is drawn substantially from an example prepared by Orville Bloethe, Victor, Iowa, and David Bibler, Algona, Iowa, for the Iowa State Bar Association Tax School, December 4-6, 1996, Des Moines, Iowa.
31 The request should be directed to Attention: T.R., Washington, D.C.
33 TAM 9640003, Dec. 21, 1996.

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

BANKRUPTCY
GENERAL-ALM § 13.03.*

DISCHARGE. The debtors were three individuals who were shareholders and officers in a corporation which was a PACA-licensed produce dealer. The corporation purchased produce from a seller and failed to pay fully for the produce. The seller sued for payment in federal court and won a judgment for the unpaid amount. The District Court ruled that the judgment amount was nondischargeable in bankruptcy. The debtors then filed for bankruptcy and the seller filed a claim for the judgment amount and sought nondischargeability as to the claim for defalcation as a fiduciary, based upon the existence of the PACA trust for the unpaid amount. The court held that the debtors could be held accountable as fiduciaries as to the PACA trust amount; however, the seller failed to identify the amount of the PACA trust because the seller failed to demonstrate how much of the produce was resold and how much was lost due to spoilage. In addition, the court found that the seller failed to preserve its rights in the PACA trust by failing to serve the required timely notice of a PACA trust claim. The court refused to give res judicata effect to the District Court ruling as to dischargeability of the claim because the issue of dischargeability was not litigated in that action, nor was the action brought under the Bankruptcy Code. In re Zois, 201 B.R. 501 (Bankr. N.D. Ill. 1996).

CHAPTER 12-ALM § 13.03[8].*

PLAN. The debtors entered into a “Land Contract” with a creditor for the purchase of a farm, under which during the first two years, the debtors paid a rent of $1,150 per month. By the time of the bankruptcy petition, the lease period had expired. The contract provided that for years three through 20, the monthly payments increased and were to be applied against principal and interest due on the contract price. After the lease period, the debtors became liable for property taxes and insurance. The seller filed a claim for lease payments in default but did not specify the amount due on the lease portion of the contract. The debtors’ plan provided for reduction of the secured portion of the contract to the fair market value of the property and unsecured status for the other amounts due. The court held that the first two years of the contract created a lease and that the remaining years were a traditional mortgage contract. The court held that once the lease expired, the amounts due under the lease merged with the mortgage contract; therefore, all payments were subject to the Chapter 12 cramdown provision, Sections 1222(b)(2), 1225(a)(5)(B). The plan was not confirmed, however,
because the plan provided for only 3 percent interest on the unpaid portion of the claim. In re Wilcox, 201 B.R. 334 (Bankr. N.D. N.Y. 1996).

The debtor was 65 and had operated the farm and cattle ranch for 40 years. The operation had five years of net losses. The debtor’s plan provided for reduction of the number of acres owned by the debtor and the cash rental of the remaining acres, the growing of crops on newly rented acres, and a 40 head cow/calf operation. The plan provided for a streamlined farm operation, reducing labor and equipment expenses without explaining how those needs were to be otherwise met. The income from the wheat crop was based on the price of wheat at $5.00/bushel, although the current price was under $4.00 and testimony demonstrated that prices were not expected to go above $4.10/bushel. In addition, ranch income was based on the sale of 40 head of cattle per year which did not allow for any death or other loss of the herd. The Farm Credit Bank held a mortgage on the debtor’s real property and $7,000 of FCB stock held by the debtor as required by the loan. The debtor’s plan provided for 10 percent interest on the mortgage payments made under the plan and valued the secured portion of the claim by the fair market value of the real estate only. The debtor argued that the stock was not to be included in the secured claim because the stock could not be redeemed without the consent of the FCB. The court held that the interest rate was too low because the FCB offered 12.28 percent for similar loans. The court held that the value of the stock was included in the secured portion of the claim because the stock would be offset against the loan amount when the loan was paid off. The court also held that the plan was not confirmable because the debtor failed to provide a reasonable estimate of farm and ranch income. In re Honeyman, 201 B.R. 533 (Bankr. D. N.D. 1996).

CHAPTER 13-ALM § 13.03.*

DISCHARGE. The debtors filed for Chapter 13 and the plan was confirmed. The plan provided for monthly payments of $70 over an unspecified period for priority claims and $63 a month for a secured claim. The plan stated that all priority claims were to be paid in full. The debtors made all payments for 60 months and applied for a discharge. The payments, however, were not sufficient to pay all of the priority claims and the trustee moved for dismissal of the case. The court held that, because the plan period had expired, the plan could not be modified. Because the priority claims were not paid in full as provided in the plan, the case was dismissed. In re Goude, 201 B.R. 275 (Bankr. D. Or. 1996).

FEDERAL TAXATION-ALM § 13.03[7].*

ALLOCATION OF TAX PAYMENTS. The debtor was a corporation which filed for Chapter 11. The debtor’s plan provided that payments made on an employment tax claim be applied first to the trust fund portion of the taxes before payment of interest and penalties. The effect of the plan provision was to relieve the corporate officers of their liability for the taxes under the responsible person provisions of I.R.C. § 6672. The court held that the allocation was not enforceable against the IRS because the debtor failed to demonstrate that the allocation would increase the likelihood of the successful reorganization of the debtor. In re Oyster Bar of Pensacola, Inc., 201 B.R. 567 (Bankr. N.D. Fla. 1996).

DISCHARGE. In April 1985, the IRS mailed to the debtor a Notice of Deficiency as to the debtor’s 1978 and 1981 individual income tax liabilities. In June 1985, the debtor petitioned the Tax Court for a redetermination of the deficiency. In March 1990, the debtor transferred title to the debtor’s residence and van to the debtor’s spouse for $10.00. The debtor’s spouse was relieved of liability for the deficiencies by consent of the IRS under the innocent spouse rules. The debtor filed for Chapter 7 bankruptcy and sought discharge of the taxes. The IRS argued that the transfer of the residence and van was a willful attempt to evade payment of taxes and prohibited discharge under Sections 523(a)(1)(C) and 727. The court held that the transfer of essentially all of the debtor’s assets to the spouse was a willful attempt to evade payment of taxes which were the basis of the IRS tax claim. In re Schaeffer, 201 B.R. 282 (Bankr. D. Colo. 1996).

The debtor filed for Chapter 12 and the plan provided for full payment of all taxes owed as of the petition filing date. The debtor completed payments under the plan and sought a discharge. The IRS objected to the discharge, claiming that post-petition interest and penalties were still owed on the tax claims. The court held that the debtor was not liable for post-petition interest on tax claims which were paid in full under the plan. The court also held that the penalties on the taxes were not discharged because the failure to pay the taxes post-petition was the fault of the debtor and was not caused by operation of the bankruptcy law or rules. In re Bossert, 201 B.R. 553 (Bankr. E.D. Wash. 1996).

The taxpayer was convicted of various crimes and was sent to prison. While in prison, the IRS contacted the taxpayer about unfiled returns for 1980 and 1981. The taxpayer cooperated with the IRS and eventually signed papers determining the amount of tax owed for those years. The taxpayer continued negotiations with the IRS after release from prison but was unable to make payments on the taxes and eventually filed for Chapter 7. The taxpayer argued that the taxes were dischargeable as assessed more than 240 days before the bankruptcy petition. The IRS argued that the taxes were not dischargeable because no returns were filed. The court held that the papers signed by the taxpayer in prison were intended as substitute returns and allowed discharge of the taxes. In re Gless, 96-2 U.S. Tax Cas. (CCH) ¶ 50,639 (Bankr. D. Neb. 1996).

SOVEREIGN IMMUNITY. The debtor had received a discharge in a Chapter 13 case after paying all claims for federal income taxes, and the case was closed. However, the IRS filed liens, made levies and coerced the debtor into making post-discharge payments on the discharged taxes. The debtor brought suit to reopen the case and to recover the excess assessments and resulting costs for the suit. The IRS claimed the defense of sovereign immunity because the debtor’s suit was not a claim of the bankruptcy estate. The court held that Section 106(a) provided a waiver of sovereign immunity only as to claims which were property of the estate at the commencement of the case or arising

* Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.
before the case is closed, Sections 541, 1306; therefore, because the debtor’s case was closed and only the debtor would benefit from the suit, the IRS could not be considered to have waived its immunity under Section 106(a). The appellate court reversed, allowing the suit for nonpunitive monetary damages if the debtor could demonstrate that the IRS knew about the discharge injunction and intentionally violated the injunction. *In re Hardy*, 97 F.3d 1384 (11th Cir. 1996), *rev’d and rem’d*, 171 B.R. 912 (S.D. Ga. 1994), *aff’d*,161 B.R. 320 (Bankr. S.D. Ga. 1993).

**FEDERAL AGRICULTURAL PROGRAMS**

**PEANUTS.** The FSA has adopted as final regulations establishing the 1996 national peanut quota at 1,100,000 short tons. *61 Fed. Reg. 60509* (Nov. 29, 1996).

**TOBACCO.** The CCC has adopted as final regulations for the 1995 tobacco price support levels as follows:

<table>
<thead>
<tr>
<th>Kind and Type</th>
<th>Cents per pound</th>
</tr>
</thead>
<tbody>
<tr>
<td>Virginia fire-cured (type 21)</td>
<td>145.5</td>
</tr>
<tr>
<td>Ky-Tenn. fire-cured (types 22-23)</td>
<td>155.7</td>
</tr>
<tr>
<td>Dark air-cured (types 35-36)</td>
<td>133.9</td>
</tr>
<tr>
<td>Virginia sun-cured (type 37)</td>
<td>128.8</td>
</tr>
<tr>
<td>Cigar filler &amp; binder (types 42-44, 53-55)</td>
<td>112.0</td>
</tr>
<tr>
<td>Cigar filler (type 46)</td>
<td>88.1</td>
</tr>
</tbody>
</table>


**FEDERAL ESTATE AND GIFT TAX**

**GIFT-ALM § 6.01.** The IRS has issued a modification of Rev. Rul. 67-396, 1967-2 C.B. 351. In Situation 1 of that ruling, the donor transferred a gift check on December 25 to a noncharitable donee, but the donee held the check until January 2 of the following year when the check was cashed by the drawee bank. *Rev. Rul. 67-396* held that the gift was not complete for federal gift tax purposes. Under *Metzger v. Comm’r*, 38 F.3d 118 (4th Cir. 1994), the date of a gift by check relates back to the date of deposit by the donee so long as the check is paid by the drawee bank while the donor is alive, the donor intended to make a gift, delivery of the check was unconditional, and the donee presented the check for payment in the year gift tax treatment is sought and within a reasonable time of issuance. The IRS ruled that *Rev. Rul. 67-396* was revised to include the Metzger holding. However, the Situation 1 holding in *Rev. Rul. 67-396* remained unchanged. *Rev. Rul. 96-56, I.R.B. 1996-___.

**TRANSFERS WITH RETAINED INTERESTS-ALM § 5.02[3].** The decedent had sold the remainder interest in stock to an heir in exchange for an annuity valued at the same amount as the value of the remainder interest. The decedent retained a life estate in the stock and received more than a third of the annuity before death. The estate argued that the stock was not included in the decedent’s estate because the decedent sold the remainder interest for full and adequate consideration, thus qualifying for the exception in I.R.C. § 2036(a). The Tax Court held that the stock was not eligible for the exception and was included in the decedent’s gross estate, less the value of the annuity. The appellate court reversed, holding that the property was transferred for full and adequate consideration and was eligible for the exception. *Estate of D’Ambrosio v. Comm’r*, 96-2 U.S. Tax Cas. (CCH) ¶ 60,252 (3d Cir. 1996), *rev’g*,105 T.C. 252 (1995).

**TRUSTS.** The taxpayer had established a qualified personal residence trust with a ten-year term and the taxpayer’s grandchildren as remainder beneficiaries. The purpose of the grantor in creating the trust was to minimize estate tax liabilities; however, the taxpayer had failed to consider the GSTT liability resulting from transfer of the remainder to the grandchildren and the taxpayer sought reformation of the trust to provide that the taxpayer’s children would be the remainder holders. The court held that the reformation would be allowed under the Massachusetts rule of mistake. *Simches v. Simches*, 96-2 U.S. Tax Cas. (CCH) ¶ 60,251 (Mass. 1996).

**FEDERAL INCOME TAXATION**

**COURT AWARDS AND SETTLEMENTS-ALM § 4.02[14].** The taxpayer received a jury award of compensatory and punitive damages in a personal injury action and sought to exclude the punitive damages from taxable income. The court viewed the case law and acknowledged a split of authority and an inconclusive legislative history of I.R.C. § 104(a)(2), but held that, based on the doctrine of narrowly construing exclusions, the punitive damages were not excludible from income. *O’Gilvie v. United States*, 96-2 U.S. Tax Cas. (CCH) ¶ 50,664 (S. Ct. 1996), *aff’d*, 66 F.3d 1550 (10th Cir. 1995), *rev’d*, 92-2 U.S. Tax Cas. (CCH) ¶ 50,567 (D. Kan. 1992).

The taxpayer filed a suit against the U.S. Postal Service alleging sex, handicap discrimination under title VII of the Civil Rights Act of 1964 and the Age Discrimination in Employment Act of 1967. The taxpayer received a negotiated settlement of that suit. The court held that the settlement proceeds were included in gross income because the suit was not for tort or tort-type rights involving personal injuries or sickness. *Rutt-Hahn v. Comm’r*, T.C. Memo. 1996-536.

**HOBBY LOSSES.** The taxpayers purchased a 7.5 acre ranch after the taxpayers retired. The farm never reported any net income. The farm operation consisted of 20 to 25 sheep, some chickens and peacocks, three horses and four cattle. The farm did not advertise animals or animal products for sale and sold only one sheep and eggs. The farm had an unlisted phone number. The taxpayers attended a few courses in animal husbandry but did not have any other experience with raising animals. The court disallowed deductions for farm expenses, depreciation and credits in excess of farm income because the farm was not operated with the intent to make a profit, since (1) the taxpayers did not keep separate, accurate records for the business, (2) did not have or seek expert advice, (3) did not devote substantial effort or time to the business, (4) did not expect any appreciation of assets sufficient to offset the losses, (5) did not have any successful past farming businesses, and (6) had a history of only losses and had substantial income.
from other sources which was offset by the net losses from the farm activity. Whalley v. Comm’r, T.C. Memo. 1996-533.

INTEREST RATE. The IRS has announced that for the period January 1, 1997 through March 31, 1997, the interest rate paid on tax overpayments is 8 percent and for underpayments is 9 percent. The interest rate for underpayments by large corporations is 11 percent. The interest rate on corporate overpayments above $10,000 is 6.5 percent. Rev. Rul. 96-61, I.R.B 1996-__.

INVOLUNTARY CONVERSION. The taxpayers owned interests in a ranch held for investment because the property was leased to third parties. A neighboring city notified the taxpayers of its intent to purchase the property for use as a site to construct a sewage plant. The city entered into sale negotiations but informed the taxpayers that if a price could not be negotiated, condemnation proceedings would occur. The IRS ruled that the negotiated sale of the ranch to the city was an involuntary conversion which would make purchase of qualified replacement property eligible for a tax-free exchange. Ltr. Rul. 9649018, Sept. 3, 1996.

PARTNERSHIPS-ALM § 7.03[2].*

PARTNER’S DISTRIBUTIVE SHARE. The IRS has issued proposed regulations relating to the allocation of depreciation recapture among partners in a partnership. The proposed regulations amend existing regulations to require that any gain characterized as depreciation recapture must be allocated to each partner in an amount equal to the lesser of the partner’s share of total gain from the sale of the property or the partner’s share of depreciation from the property. 61 Fed. Reg. 65371 (Dec. 12, 1996).

RETURNS. The IRS has issued a reminder that all tax returns will be required to have valid taxpayer identification numbers for taxpayers, spouses and dependents born before December 1, 1996. Temporary, “applied for” and other substitute designations will not be accepted. Form W-7, Application for IRS Individual Taxpayer Identification Number can be obtained from the IRS web site: http://www.irs.ustreas.gov or calling the IRS toll-free number 1-800-829-3676.

CCH has reported that final regulations concerning the check-the-box entity classification are imminent. The regulations were expected to have been delivered to the Federal Register by December 13, 1996, for publishing by the end of the year. The Federal Register may be searched and viewed online at:
http://www.access.gpo.gov/su_docs/aces/aaces002.html

S CORPORATIONS-ALM § 7.02[3][c].*

TRUSTS. The taxpayer created an annuity trust for the benefit of the taxpayer. If the taxpayer survived the term of the annuity trust, the trust S corporation stock passed to one trust and other property passed to a family trust, both of which terminated at the later of the annuity term or the death of the taxpayer. The taxpayer had the power to acquire property in these trusts in exchange for property of identical value. At the termination of these two trusts, the corpus passed to the surviving spouse with remainder to separate trusts for the taxpayer’s children. The IRS ruled that the trusts were grantor trusts during the life of the taxpayer and all income and deductions inured to the taxpayer. The IRS also ruled that the trust were QSSTs. Ltr. Rul. 9648045, Sept. 3, 1996.
AGRICULTURAL LAW PRESS
P.O. BOX 50703
EUGENE, OR 97405

AGRICULTURAL LAW MANUAL
by Neil E. Harl

This comprehensive, annotated looseleaf manual is an ideal deskbook for attorneys, tax consultants, lenders and other professionals who advise agricultural clients. The book contains over 900 pages and an index.

As a special offer to Digest subscribers, the Manual is offered to new subscribers at $115, including at no extra charge updates published within five months after purchase. Updates are published every four months to keep the Manual current with the latest developments. After the first free update, additional updates will be billed at $100 per year or $35 each.

For your copy, send a check for $115 to Agricultural Law Press, P.O. Box 50703, Eugene, OR 97405.

Satisfaction guaranteed. 30 day return privilege.

ISSUE INDEX

Medicaid
   Asset transfers 155
Mortgages
   Redemption 98, 114
Negligence
   Aerial spraying 68
   Attractive nuisance 83
   Contamination of groundwater 107
   Herbicides 30
   Licensee/invitee 163
   Obstruction of creek 115
   Safe workplace 131
   Trespasser 23
Nuisance
   Hogs 170
   Hog confinement operation 179
Partnerships
   Fiduciary duty 115
Patents
   Hydroponic system 83
Product Liability
   Cultivator 83
   Damages 55
   Fixtures 107
   Hay baler 147
   Herbicide 74, 83, 91, 99, 115
   Manure handling system 74
   Pesticides 39, 171
   Prescriptive easement 108
   Tractor 131, 148
   Vaccines 91
Property
   Fences 31, 75, 99
   Hunters 31
   Unlawful detainer 115
   Usurfruct 84
Secured Transactions
   Artisan’s lien 123
   Attachment 155
   Filing 75
   Livestock lien 8
   Ownership 31
   Perfection by possession 155
   Priority 171
   Producer’s lien 8, 139
   Purchase money security interest 116
   Repossession 31
   Subordination agreement 75
State Regulation of Agriculture
   Aerial crop spraying 131
   Apples 47, 131
   Environment 179
   Import fees 55
   Kiwifruit 163
   Nonresident alien ownership of land 91
State Taxation
   Ad valorem taxes 91
   Agricultural use 31, 75, 92, 171
   Equalization valuation 75
   Farmer 163
   Sales tax 84
   Valuation 140
Trespass
   Environmental pollution 156
   Timber 40, 55
Trusts
   Apparent authority 131
Workers’ Compensation
   Statutory employee 99
Veterinarians
   Bailment 171
Zoning
   Agricultural use 99, 123
   Exceptions 132
   Hog confinement facility 24

Printed on recycled paper using soy ink.