• 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).
2 112 S. Ct. 1039, 1043 (1992).
3 Ltr. Rul. 9240004, June 29, 1992; Ltr. Rul. 9315004, Dec. 17, 1992; Ltr. Rul. 9411002, Nov. 19, 1993. See generally 4 Harl, *Agricultural Law* § 28.05[21][d] (1996). See also Harl, "Environmental Cleanup Costs," 4 *Agric. L. Dig.* 117 (1993); Harl, "Handling Environmental Cleanup Costs," 5 *Agric. L. Dig.* 113 (1994).
4 1994-1 C.B. 35.
5 Ltr. Rul. 9541005, Sept. 27, 1995.
6 Ltr. Rul. 9627002, Jan. 17, 1996.
7 1994-1 C.B. 35.
8 *Id.*
9 1994-1 C.B. 35.
10 Ltr. Rul. 9541005, Sept. 27, 1995.
11 1994-1 C.B. 35.
12 *Id.*
13 *Id.*
14 1994-1 C.B. 35.
15 *Id.*
16 Ltr. Rul. 9627002, Jan. 17, 1996.
17 Ltr. Rul. 9541005, Sept. 27, 1995.
18 *Id.*
19 1994-1 C.B. 35.

# 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)**.

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

**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(i)(2) 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'g*, 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 grandchildren 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. 1996-434**.

**VALUATION**. On the decedent's death, the decedent owned a 20 percent interest in a partnership which operated a turpentine and lumber business which included timberland in its assets. The decedent had actively participated in the partnership business. The decedent's will bequeathed the partnership interest in trust and allowed the executor and trustee to continue as partners in the business during the administration of the estate and trust. The estate valued the interest in the partnership as a "going concern" but the IRS valued the interest using the values of the partnership property and allowing a discount for a minority interest and lack of marketability. The estate moved for summary judgment on the valuation method issue, but the court held that sufficient issues of fact remained as to the valuation to deny summary judgment. **McFarland v. Comm'r, T.C. Memo. 1996-424**.

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. The taxpayer filed a motion for reconsideration, arguing that the court failed to apply the factors of *Mandelbaum v. Comm'r, T.C. Memo. 1995-255, aff'd, 91 F.3d 124 (3d Cir. 1996)*. The court denied the motion, holding that the failure to apply the *Mandelbaum* factors resulted from the taxpayer's own failure to provide sufficient evidence. **Scanlan v. Comm'r, T.C. Memo. 1996-414, denying reconsid. of T.C. Memo. 1996-331**.

# FEDERAL INCOME TAXATION

**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 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 acre farm in Oklahoma inherited from the taxpayer's parents, although title to the farm remained in the deceased mother's name. The taxpayer planted crops on the land during the tax years involved. The taxpayer did not keep a separate checking account for the farm and claimed that all of the farm suppliers required cash payments and all of the crop purchasers paid in cash. The taxpayer claimed that the cash income was not deposited in any personal accounts but was used to make the cash payments to suppliers and for other farm expenses. The taxpayer did not produce any records to substantiate any of the expenses or income from the farm. 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**.

**CASUALTY LOSS**. 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**.

**DEPRECIATION-*ALM* § 4.03[4].*** 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 deprecation in 1984. **Jack Kent Cooke, Inc. v. United States, 96-2 U.S. Tax Cas. (CCH) ¶ 50,483 (E.D. Va. 1996)**.

**GROSS INCOME**. 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)**.

**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**.

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. 1996-430**.

**HOME OFFICE-*ALM* § 4.03[13].*** 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 warehouse as the business address. The court held that the taxpayer was not entitled to deductions relating to the home office because the primary business activity occurred at the 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**.

**LOSSES-*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 permissable range) and 6.22 to 7.60 percent (90 to 110 percent permissable 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**
**October 1996**

| | Annual | Semi-annual | Quarterly | Monthly |
|---|---|---|---|---|
| | | **Short-term** | | |
| AFR | 6.07 | 5.98 | 5.94 | 5.91 |
| 110% AFR | 6.69 | 6.58 | 6.53 | 6.49 |
| 120% AFR | 7.31 | 7.18 | 7.12 | 7.07 |
| | | **Mid-term** | | |
| AFR | 6.72 | 6.61 | 6.56 | 6.52 |
| 110% AFR | 7.40 | 7.27 | 7.21 | 7.16 |
| 120% AFR | 8.09 | 7.93 | 7.85 | 7.80 |
| | | **Long-term** | | |
| AFR | 7.13 | 7.01 | 6.95 | 6.91 |
| 110% AFR | 7.86 | 7.71 | 7.64 | 7.59 |
| 120% AFR | 8.59 | 8.41 | 8.32 | 8.27 |

**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 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)**.

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# 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*.



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