Example: a taxpayer exchanges, in a like-kind exchange, property A, which is Section 1245 property with an adjusted basis of $100,000, for property B which has a fair market value of $90,000 and property C which has a fair market value of $35,000. Upon the exchange, $25,000 of gain is recognized since property C is not Section 1245 property. The basis of the properties received in the exchange is $125,000 (the basis of the property transferred, $100,000, plus the amount of gain recognized, $25,000), of which the amount allocated to property C is $35,000 (the fair market value) and the residue of $90,000 is allocated to property B.[16]

Section 1250 property

If any real property (other than Section 1245 property) which is of a character subject to an allowance for depreciation (such as a farm shop, machinery storage or general purpose sheds or barns)[17] is transferred in a like-kind exchange, the amount of gain taken into account as recapture income does not exceed the greater of the gain recognized on the exchange on the disposition or the excess, if any, of the gain reported as ordinary income because of additional depreciation had the property been sold over the fair market value of the Section 1250 property acquired in the transaction.[18]

In the case of Section 1250 property, the recapture of depreciation is partially or fully deferred until there is a disposition of the acquired property.[19]

As for basis adjustment, the basis of property received is the basis of the exchanged Section 1250 property—(1) decreased by the amount of any money received that was not spent acquiring similar property, (2) increased by the amount of gain recognized and (3) decreased by the amount of loss recognized.[20] If more than one item of property of each type is received, the total basis is allocated to the individual items of property.[21]

In conclusion

As part of the checklist of factors to consider in a like-kind exchange, it is important to consider the possibilities for I.R.C. § 1245 or I.R.C. § 1250 recapture. In some exchanges, the recapture amount can be significant.

FOOTNOTES

1 I.R.C. § 1031. See generally, Harl, *Agricultural Law* § 4.02[16] (2004). See also Harl, "New Limits on 'Reverse' Like-Kind Exchanges," 15 *Agric. L. Dig*. 185 (2004); Harl, "New Rules on Like-Kind Exchanges with Personal Property," 15 *Agric. L. Dig*. 129 (2004); Harl, "Is a Partition an 'Exchange'?" 14 *Agric. L. Dig*. 41 (2003).

2 See Treas. Reg. § 1.1031(a)-2(b).

3 See, e.g., Harl, "Partition and the Related Party Rule," 13 *Agric. L. Dig*. 145 (2002).

4 See Treas. Reg. §§ 1.1245-4(d)(1), 1.1250(d)(4).

5 See generally Treas. Reg. § 1.1031(a)-1(c).

6 Treas. Reg. § 1.1031(a)-1(c).

7 *Id.*

8 E.g., Ltr. Rul. 9851039, September 15, 1993.

9 Rev. Rul. 55-749, 1955-2 C.B. 295. See Ltr. Rul. 200404044, October 23, 2003 (exchange approved where water rights were limited in quantity to a specified amount per year rather than limited in quantity to a specific percentage of the overall supply of agricultural water). But see *Wiechens v. United States*, 228 F. Supp. 2d 1080 (D. Ariz. 2002) (court viewed restrictions as making exchange non-like kind).

10 See generally Harl, *Agricultural Law* § 31.02 (2004).

11 I.R.C. § 1245(a)(3)(A).

12 I.R.C. § 1245(a)(3)(B).

13 See I.R.C. § 1245(a)(3)(B)(iii) (bulk storage of fungible commodities).

14 I.R.C. § 1245(b)(4); Treas. Reg. § 1.1245-4(d)(1), (4).

15 I.R.C. § 1031(d).

16 Treas. Reg. § 1.1245-5(a)(2).

17 I.R.C. § 1250(c).

18 I.R.C. § 1250(d)(4)(C). See Treas. Reg. § 1.1250-3(d).

19 I.R.C. § 1250(d)(4)(E).

20 Treas. Reg. § 1.1250-3(d)(4).

21 See Treas. Reg. § 1.1250-3(d)(4).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

BANKRUPTCY

GENERAL

AUTOMATIC STAY. The debtor filed for Chapter 7 and notice was served on the bank which held a mortgage against the debtor's home. After the notice was given, the bank filed an unlawful detainer action but the action was dismissed three weeks later. The debtor sought damages for emotional distress from the bank's violation of the automatic stay. The Bankruptcy Court and District Court held that damages for emotional distress could not be awarded for violation of the automatic stay. The appellate court reversed, holding that damages for emotional distress qualified as "actual damages" provided for in Section 362(h). ***In re* Dawson, 390 F.3d 1139 (9th Cir. 2004), *rev'g on reconsideration*, 367 F.3d 1174 (9th Cir. 2003)**.

The debtor and the debtor's father borrowed money from a bank to purchase a pickup truck. The bank records showed that the truck was purchased for operation at a farm and the loan was to be paid from farm income. The debtor and father executed a "Commercial Security Agreement" for the bank. The truck was listed as collateral for the loan as well as any other indebtedness of the debtors to the bank. The debtor filed for Chapter 13 bankruptcy and the bank levied against the father's bank account for payment of the loan. The debtor argued that the levy violated

the automatic stay against a co-debtor but the bank argued that the co-debtor automatic stay did not apply to commercial debts. The debtor claimed that the truck was used only for personal matters by the debtor who was not engaged in farming. The court held that the circumstances and representations of the debtor and father at the time of the loan controlled the nature of the loan. The court held that the bank's levy did not violate the co-debtor automatic stay because the loan involved commercial property. ***In re* Shaffer, 315 B.R. 90 (Bankr. W.D. Mo. 2004)**.

INVOLUNTARY PETITION. The debtor was a Nebraska nonstock cooperative association. The debtor's business consisted of isowean pigs from a farrower. The pigs were then shipped by independent contractor members to producers who raised the pigs to finishing weight. The debtor then sold the pigs to packers and shipped the pigs to the packers. The creditors who filed an involuntary bankruptcy petition against the debtor argued that the debtor was not a farmer because the debtor had no employees or livestock-raising facilities. The court held that the actions and facilities of the independent contractor members could be attributed to the debtor so that the debtor had significant involvement in the producing of the pigs. The creditors also argued that, because the debtor was prohibited from owning farmland under state law, the debtor could not be a farmer. The court held that the state law did not control the definition of the debtor as a farmer under state law. ***In re* Corn-Pro Nonstock Cooperative, Inc., 2004 Bankr. LEXIS 1975 (Bankr. D. Neb. 2004)**.

FEDERAL AGRICULTURAL PROGRAMS

MEAT. The FSIS has issued a notice to inform slaughterers of young calves, including those marketed, slaughtered, and labeled as "veal," of the need for such firms to reassess their Hazard Analysis and Critical Control Point (HACCP) System, including prerequisite programs, with respect to animal drug residues and the use of unapproved new animal drugs. FSIS is concerned about the widespread, illegal use of drug implants in young calves that was discovered in 2004 which represents a change that would affect the hazard analysis and could alter the HACCP plans of establishments that slaughter young calves. Therefore, under the HACCP regulations, the FSIS stated that any establishment that slaughters young calves, including those marketed, slaughtered, and labeled as veal, must, as part of its calendar year 2005 annual reassessment of its HACCP plans, determine whether unapproved new animal drugs are hazards reasonably likely to occur in its process if it has not previously done so. If the reassessment results in a determination that animal drug residues, including unapproved new animal drugs, are food safety hazards reasonably likely to occur, these hazards must be addressed in the establishment's HACCP plan. **69 Fed. Reg. 76884 (Dec. 23, 2004)**.

SUGAR. The CCC has announced the establishment of the sugar overall allotment quantity for the 2004 crop year which runs from October 1, 2004 through September 30, 2005. CCC set the 2004 crop overall allotment quantity of domestic sugar at 8.100 million short tons raw value (STRV), with 4.402 million STRV to the beet sector and 3.698 million STRV to the cane sector. Because Puerto Rico has ceased production of sugar for more than two years, CCC also eliminated the allotment to Puerto Rico and the allocations to Puerto Rico's two sugarcane processors. **69 Fed. Reg. 76684 (Dec. 22, 2004)**.

TOBACCO. The CCC has adopted as final regulations which amend the regulations governing the tobacco price support program to remove the requirement that flue-cured tobacco farmers designate the auction warehouses where they will sell their tobacco and that burley tobacco farmers designate all locations where they will sell their tobacco. Previous regulations provided that price support was available only at designated auction warehouses on eligible tobacco. **69 Fed. Reg. 70367 (Dec. 6, 2004)**.

FEDERAL ESTATE AND GIFT TAXATION

ADMINISTRATIVE EXPENSES. The decedent's estate included property held in trust from the estate of a predeceased spouse, stock in a closely-held business and other property. The non-business assets were insufficient to pay the federal estate taxes and other costs and the decedent's executor determined that the sale of the stock would not be a prudent exercise of the executor's fiduciary duty and obtained a commercial loan to pay the remaining estate taxes. The decedent's corporation then issued redemption notes to the estate and the trust in exchange for some of the corporation's stock. The notes were used as collateral to secure the commercial loan. The IRS ruled that the interest on the loan was deductible as an administrative expense if the loan could be shown to be necessary for the administration of the estate. The IRS did not discuss or rule on whether the loan was necessary for the administration of the estate. **Ltr. Rul. 200449031, July 29, 2004**.

The decedent's estate included substantial business holdings. The estate executor was an officer of the decedent's corporations. The decedent's will had directed the sale of the businesses and executor decided that the estate should borrow most of the funds needed to pay bequests, administrative fees and state and federal taxes. The executor caused the businesses to reorganize and to provide collateral for the loans. The IRS argued that none of the interest for the loans was deductible as an administrative expense because the estate had sufficient liquid assets to pay taxes and other administrative expenses. The court disallowed a deduction for interest to the extent the loans were used to pay the executor's compensation because the executor's duties were performed for the corporation. The court also disallowed interest for a portion of the loans used to pay unspecified administrative expenses. However, the court allowed an interest expense deduction as an administrative expense used to pay the state and federal taxes because the estate

business assets were difficult to sell and the loans were of a short duration. **Estate of Gilman v. Comm'r, T.C. Memo. 2004-286**.

ALTERNATE VALUATION DATE. The decedent's estate hired an attorney to file the federal estate tax return. The attorney did not advise the estate that an election was available to value the estate property on the alternate valuation date and the estate tax return was filed without the election. The estate later filed an amended return which made the alternate valuation date election and the estate filed for an extension of time to make the election. The IRS granted the extension. **Ltr. Rul. 200449028, Aug. 4, 2004**.

The decedent's estate hired a certified public accountant to file the federal estate tax return. The accountant concluded that the value of some estate property was less on the date of death than on the alternate valuation date and did not advise the estate that an election was available to value the estate property on the alternate valuation date; therefore, the estate tax return was filed without the election. The estate later determined that the accountant was wrong on the valuation of the property and filed an amended return which made the alternate valuation date election and the estate filed for an extension of time to make the election. The IRS granted the extension. **Ltr. Rul. 200452030, Sept. 13, 2004**.

FAMILY-OWNED BUSINESS DEDUCTION. The decedent's estate included business real property. The estate's attorney erroneously made the special use valuation election instead of the FOBD election. After an IRS audit of the estate tax return had begun, the estate's new advisor discovered the erroneous election and sought an extension of time to file the FOBD election. The IRS granted the extension of time to file the FOBD election. **Ltr. Rul. 200450027, Sept. 1, 2004**.

IRA. The decedent's estate included interests in an IRA and deferred annuity contracts. The decedent's will included a bequest to a charity and the decedent's estate assigned the IRA and deferred annuity contracts to the charity in satisfaction of the bequest. The IRS ruled that the assignment of the IRA and deferred annuity contracts did not result in any taxable income to the estate or distributable net income. **Ltr. Rul. 200452004, Aug. 10, 2004**.

The decedent's estate included an interest in an IRA which passed, under the decedent's will, to a trust for the decedent's children. The trustee divided the IRA into several sub-IRAs, one for each beneficiary. The IRS ruled that the division of the IRA did not result in recognition of income to the trust or beneficiaries. **Ltr. Rul. 200453023, Oct. 4, 2004**.

MARITAL DEDUCTION. The decedent's spouse elected to receive the statutory share of the property in the decedent's estate. The statutory share was one-third of the value of all property passing under the decedent's will, after payment of all debts and charges against the estate. The estate's accountant filed the estate tax return and included a QTIP election for the property passing to the surviving spouse but miscalculated the amount of property passing under the statutory share. The IRS ruled that, because the QTIP election otherwise accurately identified the extent of the election and the property subject to the election, the miscalculation of the amount of property passing to the surviving spouse on Schedule M did not preclude a marital deduction for the full amount of property which actually passed to the surviving spouse; therefore, the estate could file a supplemental return with the correct Schedule M amount. **Ltr. Rul. 200450004, Sept. 1, 2004**.

TRUSTS. The decedent was the beneficiary of a testamentary trust established by a predeceased relative. The trust provided that the trust would continue for the maximum period allowed by law. Because there remained a living beneficiary at the time of the decedent's death, the decedent's estate argued that the trust did not terminate as to the decedent's portion of the trust and that property was not included in the decedent's estate. At the time of the establishment of the trust, Louisiana law provided for trusts that terminated with the last surviving beneficiary. The law was amended later to cause the termination of each portion of the trust with the death of a beneficiary; however, the law allowed existing trust provisions to remain valid. The court found that the trust agreement clearly provided for termination of the trust only at the death of the last surviving beneficiary; therefore, the court held that the decedent's share of the trust did not terminate at the death of the decedent and the trust property was not included in the decedent's estate. **Estate of Schneider v. United States, 2004-2 U.S. Tax Cas. (CCH) ¶ 60,496 (E.D. La. 2004)**.

FEDERAL INCOME TAXATION

ACCOUNTING METHOD. The IRS has issued a revenue procedure for taxpayers to obtain automatic consent to change their method of accounting for intangibles costs and business restructuring costs to one of the methods permitted under Treas. Reg. §§ 1.263(a)-3, -4, -5 (effective for costs incurred in 2004 and later). The procedure applies to accounting method changes for the taxpayer's second tax year ending on or after December 31, 2003 (i.e., 2004 for calendar-year taxpayers). A separate procedure applied to similar changes in accounting methods for the taxpayer's first tax year ending on or after December 31, 2003 (See *Rev. Proc. 2004-23, I.R.B. 2004-16, 785, and Rev. Proc. 2004-57, I.R.B. 2004-38, 498* (granting an extension of time to comply)). **Rev. Proc. 2005-9, I.R.B. 2005-__**.

ALTERNATIVE MINIMUM TAX. The IRS has adopted as final regulations governing the time and manner of making an election under I.R.C. § 59(c) for the ten-year write-off of certain tax preferences. The regulations also provide guidance for revoking the election. **69 Fed. Reg. 76614 (Dec. 22, 2004)**.

The taxpayer was a corporation which had alternative minimum tax net operating losses in 1987 and thereafter. In an audit, the IRS carried these AMT NOLs back to 1986 and offset the NOLs against regular income. The taxpayer argued that this carryback was improper because the corporation did not have

any AMT income in 1986 because the AMT for corporations did not exist until after 1986. The taxpayer argued that the AMT was a parallel and separate tax system which prevent use of its tax items against tax items of the regular tax system. The court held that the AMT NOLs could be offset against regular income because the AMT was not a separate tax system. **Sequa Corp. & Affilliates v. United States, 2005-1 U.S. Tax Cas. (CCH) ¶ 50,110 (S.D. N.Y. 2004)**.

BAD DEBTS. The taxpayer was a shareholder in a corporation and brought legal action against other shareholders to recover the taxpayer's investment in the corporation. The taxpayer's legal efforts continued for five years until the other shareholder left the country, making collection efforts futile. The IRS ruled that the remaining unpaid debts became deductible bad debts in the fifth year when the collection efforts no longer had any hope of enforcement. **Ltr. Rul. 200453001, Sept. 22, 2004**.

CLEAN-BURNING FUEL DEDUCTION. The IRS has announced that it has certified the 2005 Ford Escape as eligible for the clean-burning fuel deduction (up to $2,000 for 2004 and 2005 and $500 for 2006) under I.R.C. § 179A as amended by Pub. L. No 108-311, the Working Families Relief Act of 2004. See Harl & McEowen, "Working Families Relief Act of 2004: Summary of Provisions," p. 153, 155 *supra*. **IR-2004-147**.

CORPORATIONS

COMPENSATION. The taxpayers, husband and wife, owned and operated a corporation which ran a mobile home sales business. The corporation did not pay dividends and made two large distributions to the taxpayers in two consecutive years. The court applied the nine factor test of *Owensby & Kritikos, Inc. v. Comm'r, 819 F.2d 1315 (5th Cir. 1987)* and ruled that the distributions were not entirely deductible as compensation but were, in part, constructive dividends. The appellate decision is designated as not for publication. **Brewer Quality Homes, Inc. v. Comm'r, 2005-1 U.S. Tax Cas. (CCH) ¶ 50,114 (5th Cir. 2004), *aff'g*, T.C. Memo. 2003-200**.

DEPENDENTS. The taxpayer was divorced and had partial physical custody of a child, shared with the former spouse who was designated as the primary custodial parent. The taxpayer filed under the status of head of household and claimed the dependent exemption and the child tax credit for the child. The taxpayer claimed to have had the most physical possession of the child during the tax year but did not provide any evidence to support the claim. The court found that the custody arrangement did not support the taxpayer's claim in that the arrangement provided for more physical custody with the former spouse. The taxpayer had not received a written declaration from the former spouse that the former spouse would not claim the child as a dependent. The court held that the taxpayer could not claim the dependency exemption or child tax credit for the child. **Caputi v. Comm'r, T.C. Memo. 2004-283**.

The taxpayer claimed a dependency exemption for the taxpayer's parents. The parents' income consisted of only social security payments and the taxpayer claimed that the parents' expenses were more than twice the payments and that the taxpayer provided the amount in excess of the social security payments. The court rejected the testimony and written evidence presented by the taxpayer because the evidence failed to clearly identify the expenses in amount and purpose. Because the taxpayer failed to prove the extent of the taxpayer's contribution to the support of the parents, the taxpayer was not allowed to claim the parents as dependents for purposes of the dependency exemption. **Szasz v. Comm'r, T.C. Summary Op. 2004-169**.

DISASTER LOSSES. On November 15, 2004, the President determined that certain areas in Alaska were eligible for assistance under the Disaster Relief and Emergency Assistance Act (42 USC 5121) as a result of a severe winter storm, tidal surges and flooding, which began on October 18, 2004. **FEMA-1571-DR**. On November 15, 2004, the President determined that certain areas in Delaware were eligible for assistance under the Act as a result of severe storms, tornadoes and flooding, which began on September 28, 2004. **FEMA-1572-DR**. Accordingly, taxpayers in the affected areas who sustained losses may deduct them on their 2003 federal income tax returns.

EMPLOYEE EXPENSES. The IRS has announced an update of the simplified per diem rates that employers (or their agents or third parties) can use to reimburse employees for lodging, meals and incidental expenses incurred on or after December 31, 2004 during business travel away from home without the need to produce receipts. **Rev. Proc. 2005-10, I.R.B. 2005-3**.

LIKE-KIND EXCHANGES. The taxpayer was a corporation which leased vehicles to customers. When the leased vehicles were returned by the customers, the taxpayer exchanged the vehicles, usually in lots of 100 or more, for new vehicles which would be offered to new lease customers or as replacement vehicles for current leasing customers. The exchanges were made through a qualified intermediary. Some of the exchanged leased vehicles were SUVs and some were passenger automobiles. The IRS ruled that, even within the more restrictive parameters of the like-kind standard as applied to personal property, the differences between an automobile and an SUV do not rise to the level of a difference in nature or character but are merely a difference in grade or quality, therefore, the two types of vehicles were like-kind property. **Ltr. Rul. 200450005, Aug. 30, 2004**.

NET OPERATING LOSS. The taxpayer owned business property in Iran until 1988 when the taxpayer left Iran. Although the taxpayer attempted to regain control of the property through the efforts of the taxpayer's business partners, the taxpayer did not regain control of the property. The taxpayer claimed a net operating loss in 1995 based on the loss of the property in Iran. The court reviewed the political upheavals in Iran and found that the taxpayer had lost control of the property well before 1995 and the court held that no operating loss could be claimed in 1995 for the loss of the property some years before. **Golshani v. Comm'r, T.C. Summary Op. 2004-174**.

PENALTIES. The IRS has issued a revenue procedure which identifies circumstances under which the disclosure on a taxpayer's return, for 2004 and later, of a position with respect to an item is adequate for the purpose of reducing the understatement of income tax under I.R.C. § 6662(d) (relating to the substantial understatement aspect of the accuracy-related penalty), and for the purpose of avoiding the preparer penalty under I.R.C. § 6694(a) (relating to understatements due to unrealistic positions). **Rev. Proc. 2004-73, I.R.B. 2005-51, *amending*, Rev. Proc. 2003-77, I.R.B. 2003-44**.

PENSION PLANS. The IRS has published the 2004 Cumulative List of Changes in Plan Qualification Requirements (2004 Cumulative List), that identifies statutory, regulatory and IRS guidance changes that must be taken into account in a plan sponsor's submissions to the IRS for opinion, advisory and determination letters whose remedial amendment period is proposed to end on January 31 of the second calendar year following release of the list. **Notice 2004-84, I.R.B. 2004-52**.

For plans beginning in December 2004 for purposes of determining the full funding limitation under I.R.C. § 412(c)(7), the corporate bond weighted average is 6.14 percent with the permissible range of 5.52 to 6.14 percent (90 to 100 percent permissible range). The 30-year Treasury securities rate for this period is 5.11 percent, the 90 percent to 105 percent permissible range is 4.60 percent to 5.37 percent, and the 90 percent to 110 percent permissible range is 4.62 percent to 5.62 percent. **Notice 2004-82, I.R.B. 2004-51**.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. 107-16), required that mandatory distributions of more than $1,000 from a qualified retirement plan be paid in a direct rollover to an individual retirement plan unless the distributee elects to have the amount rolled over to another retirement plan or to receive the distribution directly. Also, the plan administrator must notify the distributee in writing that the distribution may be paid in a direct rollover to an IRA. The new rules will become effective on March 28, 2005. The IRS has issued guidance, in question and answer form, for the new rules, including a sample plan amendment for sponsors to use to amend their plans to conform to the new rules. **Notice 2005-5, I.R.B. 2005-3**.

RETURNS. The IRS has issued Publication 1494, which contains tables that are to be used in computing the amount of an individual's income that will be exempt from a notice of levy to collect delinquent taxes in 2005. **Notice 2004-81, I.R.B. 2004-51**.

The IRS has posted to its website, www.irs.gov, Publication 600, "Optional Sales Tax Tables," which may be used by taxpayers for their 2004 tax returns for purposes of calculating the sales tax deduction for Schedule A in lieu of the state and local income taxes. A copy of Publication 600 will also be sent to taxpayers who receive a Form 1040 tax package. **IR-2004-153**.

The IRS has announced that it has removed Airborne Express and substituted DHL Express (resulting from a merger of those companies) to the list of private delivery services for filing of returns. **Notice 2004-83, I.R.B. 2004-52**.

The IRS has adopted as final regulations which remove the requirement of a signature for filing of Form 7004, "Application for Automatic Extension of Time To File Corporation Income Tax Return," to obtain a six-month automatic extension of time to file a corporation income tax return. The final regulations also allow filers and transmitters of information returns on Form 1099 (series), 1098 (series), 5498 (series), W-2 (series), W-2G, 1042-S, and 8027 to request an automatic 30-day extension of time to file without having to sign Form 8809 and provide an explanation. An explanation and a signature are required if filers and transmitters need additional time to file after receiving the automatic 30-day extension. The regulations also permit employers to obtain an extension of time to file the Social Security Administration copy of Forms W-2 and W-3 without providing a statement of the reasons for requesting the extension. **69 Fed. Reg. 70547 (Dec. 7, 2004)**.

S CORPORATIONS

BANKRUPTCY. An S corporation filed for Chapter 11 bankruptcy in 1996, and in 1997, a plan was confirmed and the corporation's assets sold. The bankruptcy trustee filed Form 1120S for the corporation's 1997 tax year and reported gain from the sale of the assets. The taxpayer was the sole shareholder of the corporation and did not report the taxpayer's share of the gain on the taxpayer's personal income tax return. The taxpayer argued that the filing of the bankruptcy petition terminated the corporation; therefore, the taxpayer was not a shareholder in 1997. The court held that the filing of the bankruptcy petition did not terminate the corporation's Subchapter S status and the taxpayer remained a shareholder until the corporation was terminated. **Mourad v. Comm'r, 2004 U.S. Tax Cas. (CCH) ¶ 50,419 (1st Cir. 2004), *aff'g*, 121 T.C. 1 (2003)**.

EMPLOYEE STOCK OPTION PLANS. The IRS has announced that it has sent approximately 1,700 letters to S corporation employee stock option plans which violate I.R.C. § 409(p) because the ESOP is concentrated in a few of the owners of the S corporation. **IR-2004-155.**

The IRS has issued temporary regulations governing the requirements of ESOPs holding stock in S corporations. The temporary regulations provide guidance on the definition and effects of a prohibited allocation under I.R.C. § 409(p), identification of disqualified persons and determination of a nonallocation year, calculation of synthetic equity under I.R.C. § 409(p)(5), and standards for determining whether a transaction is an avoidance or evasion of I.R.C. § 409(p). **69 Fed. Reg. 75455 (Dec. 17, 2004)**.

REORGANIZATION**.** An S corporation decided to change its organizational form to a general partnership for business reasons. The general partnership elected to be taxed as a corporation for federal income tax purposes. All corporate assets and liabilities were transferred to the partnership and the shareholders received an identical share in the partnership. The IRS ruled that the reorganization qualified for tax-free transfers

under I.R.C. § 368(a)(1)(F), "type F" reorganization. **Ltr. Rul. 200450012, Aug. 26, 2004**.

SAFE HARBOR INTEREST RATES
January 2005

	Annual	Semi-annual	Quarterly	Monthly
Short-term				
AFR	2.78	2.76	2.75	2.74
110 percent AFR	3.06	3.04	3.03	3.02
120 percent AFR	3.34	3.31	3.30	3.29
Mid-term				
AFR	3.76	3.73	3.71	3.70
110 percent AFR	4.14	4.10	4.08	4.07
120 percent AFR	4.53	4.48	4.46	4.44
Long-term				
AFR	4.76	4.70	4.67	4.65
110 percent AFR	5.24	5.17	5.14	5.12
120 percent AFR	5.72	5.64	5.60	5.57

Rev. Rul. 2005-2, I.R.B. 2005-2.

SOCIAL SECURITY TAX. The IRS has adopted as final regulations governing whether wages are subject to social security taxes where the wages are received by students employed by a college or university while attending classes. Also excluded are wages from a student's domestic service employment with a college club, fraternity or sorority. **59 Fed. Reg. 76404 (Dec. 21, 2004)**. The IRS has also issued a revenue procedure providing guidance for the rules provided in the final regulations. **Rev. Proc. 2005-11, I.R.B. 2005-2**.

STATE INCOME TAX DEDUCTION. A taxpayer sought a ruling on the federal income tax consequences of the Wisconsin dairy investment tax credit. Wis. Stat. §§ 71.07(3n), 71.28(3n) provide for a tax credit of 10 percent of the costs of farm modernization or expansion related to a dairy farm. Under the state statute "dairy farm modernization or expansion" means the construction, improvement, or acquisition of equipment for dairy animal housing, confinement, animal feeding, milk production, or waste management. The credit is not allowed for expenditures that are claimed as a deduction under I.R.C. § 162. The credit is nonrefundable and may be carried forward up to 15 years. In a chief Counsel Advice letter, the IRS ruled that the tax credit, for purposes of the deduction for state income taxes, is treated as a reduction of the state taxes paid and not as an item of income and an offsetting payment of tax. The IRS also ruled that, because the dairy investment credit is treated as a reduction in state tax liability, not a recovery or reimbursement of the expenditures that qualify a taxpayer for the credit, the credit does not affect the basis, for federal tax purposes, of the assets with respect to which those expenditures are made, whether the taxpayer took depreciation on those assets or expensed their cost under I.R.C. § 179. **CCA Ltr. Rul. 200451041, Nov. 17, 2004**.

TAX SHELTERS. The taxpayers were promoters of abusive tax shelter schemes using trusts and something they called a "Common Law Business Organization." The taxpayers also promoted tax schemes which claimed that under I.R.C. § 861, a taxpayer could reduce taxable income if no foreign income was received. The IRS sought and was granted a preliminary injunction against the taxpayers' promotion of these and similar tax shelter schemes. **United States v. Binge, 2005-1 U.S. Tax Cas. (CCH) ¶ 50,121 (N.D. Ohio 2004)**.

A cattle rancher organized and promoted cattle and sheep breeding partnerships which were sold to investors. The cattle rancher served as general partner and tax matters partner of the partnerships and prepared the income tax returns for the partnerships, serving as an enrolled agent until disenrolled by the IRS. The IRS audited the partnerships and announced to the investor-partners that tax benefits from the partnerships would be disallowed and refunds denied based on the disallowance of tax benefits. The cattle rancher's company was liquidated in bankruptcy and the cattle rancher was convicted of federal crimes and ordered to pay restitution. The taxpayer was one of the investors in the cattle breeding partnerships, basing the value of the investment on the statements in the promotional brochure, even though the brochure warned that the tax benefits were based on risky tax law interpretations. The taxpayer's tax benefits from the partnerships were disallowed and an accuracy-related penalty imposed. The taxpayer argued that the taxpayer had reasonably relied on the professional advice of the partnership promoters and should not be assessed the accuracy-related penalty. The court held that the taxpayer had unreasonably relied on the persons who benefitted from their own representations and failed to independently confirm the large tax benefits claimed by the partnership promoters. The taxpayer also argued that the fraud of the promoters excused the taxpayer from negligence. The court held that the fraud of the promoters did not excuse the taxpayer from the unreasonable reliance on the promoters' claims. **Mortensen v. Comm'r, T.C. Memo. 2004-279; Van Scoten v. Comm'r, T.C. Memo. 2004-275**.

TRUSTS. The taxpayers, husband and wife and children, owned and operated a missionary company which supported their missionary work in New Guinea. The taxpayers transferred their company and personal assets to trusts for their benefit. The trust paid the taxpayers' personal expenses and received the income from the missionary work. The court held that the trusts could be ignored for federal income tax purposes because (1) the trusts were created as a guise for deducting personal consumption expenses; (2) the income of the trusts was taxable to the taxpayers under the assignment of income doctrine; (3) the trusts were grantor trusts; and (4) the trusts lacked economic substance. **Kooyers v. Comm'r, T.C. Memo. 2004-281**.

MEDICAID

ELIGIBILITY. The plaintiff was denied eligibility for Medicaid benefits on the grounds that the plaintiff had nonexempt available resources in excess of regulatory limits. The plaintiff had inherited stock in a telephone company from the plaintiff's deceased spouse. In 1994, more than seven years before filing a claim for Medicaid benefits, the plaintiff added two nieces as owners of the stock as joint tenants with rights

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of survivorship. The joint tenancy prevented sale of the stock without the consent of all three owners. The state department of social services ruled that the plaintiff's guardian had not taken reasonable steps to sell the plaintiff's share of the stock. The plaintiff claimed that a sale of the plaintiff's share would incur costs in excess of the value of the plaintiff's share of the stock. The state pointed to the Kansas Economic and Employment Support Manual (KEESM) for support that the full value of the stock was to be deemed owned by the plaintiff unless the plaintiff demonstrated that the other joint tenants had contributed to the equity in the stock. Because the nieces received their shares by gift, all of the stock was deemed owned by the plaintiff. The court noted that the KEESM was not official state regulation or statute but provided the state's interpretation of its statutes and regulations. In addition, the court held that the plaintiff failed to prove that the cost of partition of the stock would exceed the value of the plaintiff's share of the stock and the court upheld the denial of benefits. The dissent focused on the legal limitation placed on the plaintiff's ability to liquidate the plaintiff's interest in the stock and the federal requirement that states could not include in an applicant's assets, property interests which could not be liquidated into cash and used by the applicant. **Brewer v. Schalansky, 2004 Kan. LEXIS 770 (Kan. 2004)**.

STATE REGULATION OF AGRICULTURE

POTATOES. The plaintiff was a potato processor who elected to have the plaintiff's end product, french fries, inspected by state inspectors instead of federal inspectors. The state charged inspection fees. The plaintiff changed to private inspectors and petitioned the state for a refund of a portion of the fees to the extent the Oregon Department of Agriculture had charged fees in excess of those need to pay the inspection costs and the costs of administration. The plaintiff argued that Or. Rev. Stat. limited the inspection fees to the actual costs of the inspections, including administrative costs. The refund request was based on Or. Rev. Stat. § 293.445(2) which provided for refund of fees levied in excess of an amount legally due to an agency. The refunds could not be made more than three years after the initial payment to the agency. Although the plaintiff paid the inspection fees more than three years before its refund claim, the plaintiff argued that the legislature's continuing appropriation of funds for the refunds allowed the agency to make refunds more than three years after the initial payment. The court held that the appropriations of the legislature did not affect the clear three year limitation on payment of refunds and held that the plaintiff's refund claim was untimely. **J.R. Simplot Co. v. Department of Agriculture, 96 P.3d 1262 (Or. Ct. App. 2004)**.

PARTNERSHIPS

DISSOLUTION. The parties were brother and sister and the brother owned 75 percent of a farm partnership, with the sister owning the remaining 25 percent. The ownership was changed to 50 percent each after the sister contributed additional property to the partnership. The sister brought suit against the brother for conversion of partnership property and sought a dissolution and accounting. The sister prevailed and a dissolution and accounting were ordered. However, instead of liquidating the partnership, a special master was appointed to value the partnership property and the partner's interests. When the value was determined, the brother offered to pay the sister for her share of the partnership, based on the special master's valuation. The sister objected and sought complete dissolution, liquidation of all partnership assets and distribution according to her share. The court held that, once dissolution of the partnership was ordered, the partnership had to be liquidated and wound-up with distribution of the resulting net surplus in cash. **McCormick v. Brevig, 96 P.3d 697 (Mont. 2004)**.