
CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ADVERSE POSSESSION

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

BANKRUPTCY

FEDERAL TAX-ALM § 13.03[7].*

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

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

FEDERAL AGRICULTURAL PROGRAMS

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

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

FEDERAL ESTATE AND GIFT TAX

DEDUCTIONS. The decedent had an usufruct (life estate) in real property which produced substantial revenues from oil and gas and other mineral leases. The decedent's estate claimed a deduction for the revenues, less taxes paid by the decedent, because the estate claimed that the decedent was required to account for these revenues to the remainder holders, the decedent's children. At the time of the creation of the usufruct by the decedent's parent, the law of Louisiana required the accounting, but the law was changed during the usufruct to no longer require the accounting. The IRS argued that the revenues received after the change in the law were not eligible for the deduction. The court adopted the magistrate's opinion that the amendment of the law removed the decedent's obligation to account for revenues received after the amendment; therefore, no deduction for those revenues would be allowed for the estate. **Estate of Albritton v. United States**, 2002-1 U.S. Tax Cas. (CCH) ¶ 60,434 (M.D. La. 2001).

GIFT. Several years before death, the decedent owned just over 50 percent of a corporation, with the decedent's child owning the remaining shares. As part of an estate plan, the decedent transferred the shares to the child in exchange for a 10 year promissory note under which the child would pay interest only for 10 years with the balance due on maturity of the note. The note was for \$3 million. No attempt was made to negotiate the price or to determine the actual fair market value of the shares. The IRS assessed gift tax on the transfer several years later after the decedent's death. The IRS argued that the value of the stock was over \$8 million at the time of the gift. The estate argued that the gift was not complete because the child committed fraud in failing to pay the fair market value of the shares. The court held that the estate could not argue that the decedent had not fully understood the purpose of the original transaction as an estate planning device which froze the value of the decedent's estate and completed the intent of the decedent that the child should have the stock. The court also determined the value of the stock to have been \$4.9 million because of a marketability discount and a control premium. The appellate court affirmed as to the incomplete gift argument but remanded the case because the Tax Court did not consider and rule on the issue of whether a post-gift settlement could be considered as part consideration for the transfer of stock and thus lessening the amount of the gift. The appellate decision is designated as not for publication. **Estate of Maggos v. Comm'r, 2002-1 U.S. Tax Cas. (CCH) ¶ 60,433 (9th Cir. 2002), aff'g in part and rem'g in part, T.C. Memo. 2000-129.**

POWER OF APPOINTMENT. The decedent had established a revocable trust which became irrevocable upon the decedent's death. After the decedent's death, the trust continued as a "family trust" for the benefit of the decedent's child. The child had the testamentary power to appoint the trust corpus outright or in trust "for such one or more of settlor's descendants with such powers and in such manner and proportions as [child] may appoint by [the child's] will making specific reference to this power of appointment." Any property not so appointed passed to the decedent's living descendants. The child also died and exercised the power of appointment to distribute the trust corpus outright to the child's adult children. The IRS ruled that the child did not have a general power of appointment over the family trust because (1) the power was testamentary only and (2) the power was restricted to the decedent's descendants; therefore, the corpus could not be appointed to the child's estate or creditors. Thus, the trust corpus was not included in the child's estate. **Ltr. Rul. 200210038, Dec. 5, 2001.**

RECIPROCAL GIFTS. The decedent and brother each owned a portion of two agricultural businesses. The decedent and brother agreed that one business should pass to the decedent's heirs and the other business pass to the brother's family. The decedent transferred stock in one company to the brother's heirs. The brother transferred stock in the other corporation to the decedent's heirs. The decedent's estate argued that the gifts were valid because they had a business purpose of passing the separate

businesses to separate families. The court characterized the gifts as reciprocal and not eligible for the annual exclusion. The court also held that the transfers did not have a business purpose because the parties' interests in the businesses were not changed substantially by the transfers. The appellate court affirmed, holding that the Tax Court had substantial evidence to support its ruling. **Estate of Schuler v. Comm'r, 2002-1 U.S. Tax Cas. (CCH) ¶ 60,432 (8th Cir. 2002), aff'g, T.C. Memo. 2000-392.**

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

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

FEDERAL INCOME TAXATION

Job Creation and Worker Assistance Act of 2002

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

ACCOUNTING METHOD. The IRS has issued a revenue procedure which provides guidance for IRS-imposed accounting method changes and accounting method issues affected by non-accounting method changes. The procedures revise and finalize procedures proposed in *Notice, 98-31, 1998-1 C.B. 1165. Rev. Proc. 2002-18, I.R.B. 2002-__.*

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

DISASTER LOSSES. On March 1, 2002, the President determined that certain areas in New York were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of a severe winter storm on December 24, 2001. **FEMA-1404-DR.** On March 12, 2002, the President determined that certain areas in Oregon were eligible for assistance under the Act as a result of severe winter storm on February 7-8, 2002. **FEMA-1405-DR.** Accordingly, a taxpayer who sustained a loss attributable to the disasters may deduct the loss on his or her 2001 federal income tax return.

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

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

HEDGES. The IRS has issued proposed regulations which revise the hedging regulations to reflect changes made by the Ticket to Work and Work Incentives Improvement Act of 1999. The final regulations have been restructured to implement the risk management standard of I.R.C. § 1221(b)(2)(A). No definition of risk management is provided, but instead, the rules characterize a variety of classes of transactions as hedging transactions because they manage risk. Risk reducing transactions still qualify as one class of hedging transactions, but there are also others. In addition, specific provision is made for the recognition of additional types of qualifying risk management transactions through published guidance or private letter rulings. Under the final regulations, as under the proposed regulations, transactions entered into for speculative purposes will not qualify as hedging transactions. The final regulations permit the determination of whether a transaction manages risk to be made on a business unit basis provided that the business unit is within a single entity or consolidated return group that adopts the single-entity approach. **67 Fed. Reg. 12863 (March 20, 2002), amending Treas. Reg. § 1.1221-2.**

INSTALLMENT REPORTING. The taxpayer, a trust, owned a meat packing business which was operated by the beneficiaries' family for many years. The business had financial trouble and was sold to another company for cash and a promissory note. The note provided for payments depending upon the net income of the business but also provided for full payment by a date certain. The company was later resold and the notes were modified as to the payment schedules. The taxpayers did not include the face value of the note in income for the year of the first sale. The taxpayers argued that the note had no ascertainable value in the first year as an open transaction because the payments

were uncertain in that the payments depended upon the net income of the business. The court held that the open transaction rule was rarely applied because gain could be reported by the installment method of reporting. The court held that the notes had an ascertainable value in the year of sale because the business was well established and was reasonably expected to provide annual net income. The appellate court affirmed in a decision designated as not for publication. **Bernice Patton Testamentary Trust v. United States**, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,277 (Fed. Cir. 2002), *aff'g*, 2001 U.S. Tax Cas. (CCH) ¶ 50,332 (Fed. Cls. 2001).

The taxpayers owned an S corporation which manufactured, sold and leased farm irrigation equipment. The company provided financing to the buyers by taking promissory notes as part of the purchase price. The corporation reported the income from these sales on the installment method. The taxpayers agreed that dealers are not allowed the use of installment reporting of gain from the sale of personal property in the course of business. However, the taxpayers argued that the exception for farm property in I.R.C. § 453(1)(2)(A) applied to allow installment reporting because the irrigation equipment was used in farming by the purchasers. The court held that the exception applied only to farmers who sell personal property used by both the buyer and seller in a farming business; therefore, the taxpayer was not entitled by the exception to use the installment method of reporting. **Thom v. United States**, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,293 (8th Cir. 2002), *aff'g*, 134 F. Supp.2d 1093 (D. Neb. 2001).

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

PARTNERSHIPS-ALM § 7.03.*

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

TRANSACTIONS WITH PARTNERS. The taxpayer was a general partnership with another partnership as a partner. The partner was a management company and contracted with the taxpayer for management services. The partner failed to file and pay employment taxes for its

employees and the IRS sought to recover the unpaid taxes from the taxpayer. The court held that the management contract was treated as a transaction with a nonpartner because the compensation for the services was not tied to the partnership income. **In re Sewickley Hospitality, Ltd.**, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,273 (Bankr. S.D. Tex. 2002).

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

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

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

S CORPORATIONS-ALM § 7.02[3][c].*

DISCHARGE OF INDEBTEDNESS. Section 402 of Pub. L. 107-147, 107th Cong., 2d Sess. (2002) amends I.R.C. § 108(d)(7)(A), effective for cancellations of indebtedness after October 11, 2001. The amendment overrules the decision in the following case. The taxpayer was a shareholder in an S corporation which was a partner in a joint venture which realized discharge of indebtedness income in 1991. The taxpayer increased the basis of the taxpayer's S corporation stock by the taxpayer's share of the discharge of indebtedness income passed through the S corporation. At the time of the discharge of the indebtedness, the S corporation was insolvent and had net operating losses. The increase in the stock basis enabled the taxpayer to deduct the carried-over losses in a later year. The IRS argued that the discharge of indebtedness income was not an item of income for purposes of determining stock basis because discharge of indebtedness income was excluded under the insolvency exclusion rule of I.R.C. § 108. The Tax Court held that, because the corporation was insolvent, I.R.C. § 108 caused an exclusion of the discharge of indebtedness income at the corporation level which was offset by reduction in tax attributes of the corporation, leaving no tax consequences to flow to the shareholders such as would increase the shareholders' basis in stock. The Supreme Court reversed, holding that discharge of indebtedness income was a pass-through item of corporation income which was applied first to increase the

shareholders' basis, second to any shareholder losses, and finally to offset any tax attributes. In this case, the shareholders had sufficient losses to use up the entire discharge of indebtedness income. **Gitlitz v. United States, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,147 (S. Ct. 2001), rev'g, 182 F.3d 1143 (10th Cir. 1999), aff'g sub nom., Winn v. Comm'r, T.C. Memo. 1998-71, withdrawing T.C. Memo. 1997-286.**

SAFE HARBOR INTEREST RATES

April 2002

	Annual	Semi-annual	Quarterly	Monthly
Short-term				
AFR	2.88	2.86	2.85	2.84
110 percent AFR	3.17	3.15	3.14	3.13
120 percent AFR	3.46	3.43	3.42	3.41
Mid-term				
AFR	4.65	4.60	4.57	4.56
110 percent AFR	5.12	5.06	5.03	5.01
120 percent AFR	5.60	5.52	5.48	5.46
Long-term				
AFR	5.62	5.54	5.50	5.48
110 percent AFR	6.18	6.09	6.04	6.01
120 percent AFR	6.76	6.65	6.60	6.56

Rev. Rul. 2002-17, I.R.B. 2002-__.

TAX SHELTERS. The IRS has issued an announcement warning taxpayers about a tax shelter scam which creates tax loss deductions which will not be recognized by the IRS. In the type of transaction described in the Notice, a third party ("transferor") borrows money from a lender and uses the proceeds to purchase assets. The transferor sells a portion of the assets to another U.S. taxpayer in consideration for the taxpayer's agreement to become liable on the entire loan. The transferor agrees to pay all interest on the loan, and the taxpayer agrees to pay the principal at maturity. As a matter of economic reality, the taxpayer will bear responsibility for the repayment of the loan only to the extent of the assets it purchased from the transferor. Nevertheless, the taxpayer claims that, as a result of its assumption of liability on the entire loan, the entire principal amount of the loan is included in taxpayer's basis in the conveyed assets. The taxpayer sells the conveyed assets and claims a loss. **Notice 2002-21, I.R.B. 2002-__.**

PRODUCT LIABILITY

FUNGICIDE. The plaintiff purchased a blended fungicide which contained two fungicides in specific portions. The fungicide was applied to the plaintiff's peanut crop but the crop was still damaged by blight. The plaintiff alleged that the purchased product did not contain the proper portions of each fungicide, causing the lack of control of the blight. The plaintiff sued the manufacturer, retailer and packager for fraud, misrepresentation, negligence, breach of warranty and conspiracy. The defendants argued that the claims were all preempted by FIFRA in that the basic issue was whether the label was correct in identifying how much of each fungicide was contained in the blend. The court held that the claims were not preempted by FIFRA because the claim did not allege

that the blend was mislabeled and because no environmental damage was claimed. **Hughes v. Southern States Co-op, Inc., 180 F. Supp.2d 1295 (M.D. Ala. 2001).**

PROPERTY

DRAINAGE. The parties owned neighboring farms which were subject to occasional flooding. The defendant built a levee on the property line in order to prevent the flood waters from reaching the defendant's land. However, the levee directed the flood waters on to the plaintiff's land and the plaintiff brought suit, claiming that the defendant had not obtained the necessary permit for the levee and that the levee was a public nuisance. The trial court held that the plaintiff was required to bring the case before an administrative appeals boards, even though the appeals board did not exist until after the suit was filed. The appellate court reversed, holding that Ark. Code § 14-268-105 did not require an exhaustion of administrative remedies before seeking an adjudication. The case was remanded for a new trial. **Hurst v. Holland, 61 S.W.2d 180 (Ark. 2001).**

STATE TAXATION

VALUATION. The plaintiffs owned various tracts of pasture land in one county. The plaintiff challenged the state valuation of the tracts under a system used by the Director of Property Valuation (DPV) as violating Kan. Stat. § 79-1476. The plaintiffs argued that (1) the DPV valuation districts did not contain homogenous land, (2) the use of soil qualities and types to determine rental value did not comply with the statute, and (3) the statute's requirement of the use of "land classes" did not permit the use of soil types to classify and value land. The court held that the DPV method complied with the statute and made use of several types of data to establish valuation within the valuation districts and that the plaintiffs failed to demonstrate that the fair market value of their lands did not match the valuations determined by the DPV. **In re Protest of Smith, 39 P.3d 66 (Kan. 2002).**

CITATION UPDATES

In re Vote, 276 F.3d 1024 (8th Cir. 2002), aff'g, 261 B.R. 439 (Bankr. 8th Cir. 2001) (estate property) see p. 35 *supra*.

Estate of Armstrong, 277 F.3d 490 (4th Cir. 2002), aff'g, 132 F. Supp.2d 421 (W.D. Va. 2001) (valuation) p. 20 *supra*.

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