CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

BANKRUPTCY

CHAPTER 13

DISPOSABLE INCOME. The debtors' Chapter 13 plan was confirmed and contained a provision that all income tax refunds to which the taxpayers became entitled during the plan were to be included in disposable income. The plan ended on April 4, 2001 and the debtors received a discharge on April 24, 2001. The trustee then learned that the debtors received an income tax refund for 2000 taxes and sought to include the refund in the disposable income. The court held that the debtors became entitled to the refund on December 31, 2000; therefore, the refund was included in disposable income under the plan. ***In re* Midkiff, 342 F.3d 1194 (10th Cir. 2003), *aff'g*, 271 B.R. 383 (Bankr. 10th Cir. 2002)**.

The debtors filed for Chapter 13 and excluded from disposable income payments for parochial school tuition for their children. The plan provided for 25 percent payment to unsecured creditors. If the tuition was included in disposable income, the payments would provide 62 percent to the creditors. The debtors argued that the tuition was excludible as a charitable deduction. The court noted a case, *In re* Grawey, *2001 Bankr. LEXIS 2124 (Bankr. C.D. Ill. Oct. 11, 2001)*, in which private school tuition was excluded from disposable income where the debtor sacrificed other excludible expenses to save the tuition. The court also cited *In re Burgos, 248 B.R. 446 (Bankr. M.D. Fla. 2000)*, where the debtor agreed to extend the plan to six years and the creditors would receive 70 percent of their claims. In this case, the court noted that the debtors had claimed several excessive expenses and refused to extend the plan beyond three years; therefore, the court held that the tuition would be considered disposable income and denied confirmation of the plan. ***In re* Watson, 299 B.R. 56 (Bankr. D. R.I. 2003)**.

FEDERAL TAX

REFUND. The debtors filed for bankruptcy in December 2001 and received a discharge in April 2002. In May 2002 the trustee filed a motion for turnover of the debtors' 2001 state and federal tax refunds. The debtors stated that they had not received the refund and that the IRS had offset the refund against amonts owed by the debtors to the state and U.S. Department of Education. The IRS argued that the setoff was made under I.R.C. § 6402 which provided that courts have no jurisdiction to review a setoff under Section 6402. The court held that it lacked jurisdiction to recover the setoff refund and dismissed the trustee's motion. ***In re* Duffy, 298 B.R. 775 (Bankr. D. Kan. 2003)**.

FEDERAL AGRICULTURAL PROGRAMS

LETTUCE. The AMS is requesting comments on creation of United States Standards for grades of field grown leaf lettuce, greenhouse tomatoes, sweet potatoes, and frozen celery. **68 Fed. Reg. 68858-68860 (Dec. 10, 2003)**.

MARKETING LOSS ASSISTANCE PROGRAM. The plaintiffs had entered into production flexibilty contracts for 1999 and were eligible for marketing loss assistance payments. The PFC contained a provision that eligiblity for payments would be lost if the plaintiffs' interest in the farm land was transferred. The plaintiffs filed for Chapter 7 bankruptcy in 1999 and received a discharge but did not file a reaffirmation of the PFC or successor in interest contract before the cut-off date of August 16, 1999. Because neither of these filings occurred before the cut-off date, the marketing loss assistance payment was withheld. The plainitffs argued that they failed to make the required filings because they relied on the statements of a county office employee that the filings were not required. The court held that the plaintiffs should have known about the filing requirements because the PFC had the requirements written on it; therefore, the plaintiffs did not reasonably rely on the county office for advice on this matter. **McKown v. Farm Service Agency, 276 F. Supp.2d 1201 (D. N.M. 2003)**.

MARKET PROMOTIONS. The AMS has issued proposed regulations which would exempt any person producing and marketing solely 100 percent organic products from paying assessments for market promotion, including paid advertising, activities to marketing order programs administered by the AMS. **68 Fed. Reg. 67381 (Dec. 2, 2003)**.

TUBERCULOSIS. The APHIS has adopted as final regulations changing California and New Mexico from accredited-free to modified accredited advanced status under the tuberculosis regulations. **68 Fed. Reg. 65831 (Nov. 24, 2003)**.

FEDERAL ESTATE AND GIFT TAXATION

ALTERNATE VALUATION DATE. The estate's Form 706 failed to make the election to value the estate on the alternate valuation date. By affidavit, the tax return preparer of the Form 706 stated that the preparer failed to consider the effect of the election for alternate valuation by the estate at the time the return was prepared and did not discuss the election with the executor at any time prior to the return being filed. The IRS granted an extension of time to make the election. **Ltr. Rul. 200348010, Aug. 18, 2003**.

DISCLAIMERS. The taxpayer was a current beneficiary of a trust established by a grandparent. The taxpayer was also a remainder beneficiary of any trust corpus remaining at the termination of the trust. The taxpayer disclaimed in writing any interest in the trust corpus at termination within nine months after reaching majority age. The IRS ruled that the disclaimer was effective and did not result in a taxable gift. **Ltr. Rul. 200348011, Aug. 19, 2003**.

IRA. The decedent owned an interest in an IRA which passed on the decedent's death to a trust established for two heirs. The distributions from the trust were to be based on the oldest child's life expectancy. The trust was split into two trusts, one for each beneficiary, with the distributions still based on the life expectancy of the oldest beneficiary. The IRS ruled that the split did not affect the tax status of the IRA interests held by the trusts because no change was made to the distributions. **Ltr. Rul. 200349009, Sept. 9, 2003**.

FEDERAL INCOME TAXATION

LEGISLATION. The Ways and Means Committee of the U.S. House of Representatives has reported proposed legislation which would, among other things,provide that (1) income averaging for farmers would not increase AMT; (2) a principal residence would be eligible for like-kind exchange treatment under I.R.C. § 1031; (3) the corporate tax rate would be 34 percent through 2006 and 32 percent thereafter; (4) the phase-out for 15 and 25 percent corporate rates wold be raised from $1,000,000 to $1,420,000 at 3 percent; (5) the I.R.C. § 179 depreciation amounts would be extended for two more years (2006 and 2007), with the phase-out at $400,000 (inflation adjusted); (6) the 15-year depreciation for qualified lease-hold improvement property would continue; (7) an IRA could be a shareholder of an S corporation; (8) all members of one family would be treated as one shareholder of an S corporation; and the maximum number of shareholders of an S corproation would be increased to 100. **H.R. 2896**.

BUSINESS EXPENSES. The taxpayer worked as a forester for California. In 1994, the taxpayer purchased 39 acres of burned forest land after conducting studies as to whether the land would support a commercial tree farm operation. During 1995 and 1996, the taxpayer attempted to plant one species of tree on the property but determined that the land would not support the commercial production of these trees. Although the taxpayer continued to improve the property, by 2001 no trees had been planted and the taxpayer still had not decided what trees could be feasibly produced on the land. The taxpayer claimed deductions for the expenses incurred in clearing the land and making improvements, including a road. The Tax Court held that, during 1995 and 1996, the taxpayer was not conducting a trade or business and was not entitled to any business deductions for the expenses. In addition, the Tax Court held that the expenses were part of the start-up costs to any future business and could not be currently deducted. The appellate court affirmed in a decision designated as not for publication. **McKelvey v. Comm'r, 2004-1 U.S. Tax Cas. (CCH) ¶ 50,103 (9th Cir. 2003),** ***aff'g*****, T.C. Memo. 2002-63**.

CORPORATIONS

DIVIDENDS**.** The IRS has published guidance for persons required to file a Form 1099-DIV and other information in connection with dividends received from foreign corporations under the Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27). **Notice 2003-79, I.R.B. 2003-50**.

EMPLOYEE BENEFITS**.** In four consolidated case, the taxpayers incorporated their family farm and transferred all of the farm land and residence to the corporation. The taxpayers leased the farm from the corporation under a crop share lease. The taxpayers provided all of the labor and equipment and shared expenses with the corporation by the same ratio as the crop share lease rent. the taxpayers continued to use the farm residence as their residence but charged the cost of food, utilities, property tax, insurance, remodeling, and maintenance of the residence to the corporation. the taxpayers reported only their chare of the crop as taxable income. The corporation also adopted a medical benefits plan for the taxpayers, providing medical insurance and reimbursement of the taxpayer's medical expenses. The court held that the medical expenses and insurance payments were deductible, under I.R.C. §§ 105 and 106, by the corporation because the payments were made under a plan for the taxpayers as employees and not as shareholders. The court disallowed the deductions for the food and maintenance expenses for the residence as personal to the taxpayers and the payments for these items were included in the taxpayers' income. Although the corporation bylaws provided that the taxpayers were required to reimburse the corporation for any expenses which were later determined to be nondeductible, the taxpayers did not provide any evidence of reimbursement. The corporation was allowed a deduction for the property insurance and property taxes on all corporation real property, including the residence. The corporation was allowed a depreciation deduction on the residence. The Digest will publish an article by Neil Harl on these cases in a future issue. **Weeldreyer v. Comm'r, T.C. Memo. 2003-324; Schmidt v. Comm'r, T.C. Memo. 2003-325; Tschetter v. Comm'r, T.C. Memo. 2003-326; Waterfall Farms, Inc. v. Comm'r, T.C. Memo. 2003-327**.

WORTHLESS STOCK. The taxpayer was a domestic corporation on a calendar tax year. The taxpayer owned all of the equity interests in another foreign entity that derived all of its gross receipts from manufacturing operations. The other entity is indebted to the taxpayer and to trade creditors. The other entity was an eligible entity within the meaning of I.R.C. § 301.7701-3(a) and, prior to July 1, 2003, was treated as a corporation within the meaning of I.R.C. § 7701(a)(3) for federal tax purposes. On December 31, 2002, the taxpayer's stock in the entity was not worthless. On July 1, 2003, the taxpayer filed a valid Form 8832, Entity Classification Election, changing the classification of the other entity from a corporation to a disregarded entity for federal tax purposes effective as of that date. The election has no effect on the treatment of the other entity under the foreign country's law. In the first example, at the close of the day immediately before the effective date of the election, the fair market value of

the entity's assets, including intangible assets such as goodwill and going concern value, exceeded the sum of its liabilities. However, at that time, the fair market value of the entity's assets, excluding intangible assets such as goodwill and going concern value, did not exceed the sum of its liabilities. In the second example, at the close of the day immediately before the effective date of the election, the fair market value of the entity's assets, including intangible assets such as goodwill and going concern value, did not exceed the sum of its liabilities. The IRS ruled in the first example, that the change in classification of the entity resulted in a deemed liquidation and the taxpayer would not be allowed a worthless stock deduction because the taxpayer received at least a partial payment for the stock. The IRS ruled in the second example, that the change in classification of the entity resulted in a deemed liquidation and the taxpayer would be allowed a worthless stock deduction because the taxpayer did not receive payment for its stock. **Rev. Rul. 2003-125, I.R.B. 2003-__**.

COURT AWARDS AND SETTLEMENTS. The taxpayer sued a former employer for race discrimination in termination of employment. The suit asked only for back pay and attorneys' fees as damages. The parties reached a settlement which characterized the payments as for personal injury to the taxpayer. The Tax Court held that the character of the settlement proceeds was determined by the pending claims made in the lawsuit; therefore, the settlement proceeds were for back pay and attorneys' fees and were included in the taxpayer's income. The appellate court reversed only as to the attorney's fees which were excludible from income. **Banks v. Comm'r, 345 F.3d 373 (6th Cir. 2003), *aff'g in part and rev'g in part*, T.C. Memo. 2001-48**.

The taxpayer was injured in an accident during a professional basketball game when a player ran into the taxpayer on the sidelines. The taxpayer hired an attorney to negotiate with the basketball player's attorney a settlement for the taxpayer's claims of physical injury. Although the player was skeptical that any injury occurred, a settlement was reached, paying the taxpayer $200,000. The IRS argued that the entire settlement should be included in the taxpayer's income because there was no evidence of any physical injury. The court held that the validity of the taxpayer's claim was not relevent but the issue was whether the settlement was paid in satifaction of a claim for physical injuries. The court held that part of the settlement was excluded from income as payment for a physical injury claim. **Amos v. Comm'r, T.C. Memo. 2003-329**.

DISASTER LOSSES. On November 21, 2003, the President determined that certain areas in Puerto Rico were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of severe storms, flooding, and landslides on November 10, 2003. **FEMA-1501-DR**. On Nvember 21, 2003, the President determined that certain areas in West Virginia were eligible for assistance under the Act as a result of severe storms, flooding and land slides on November 21, 2003. **FEMA-1500-DR**. Accordingly, taxpayers who sustained losses attributable to the disaster may deduct the losses on their 2002 federal income tax returns.

HEALTH SAVINGS ACCOUNTS. The Medicare Reform Act signed December 8, 2003 creates Health Savings Accounts (HSAs) to be used for health care expenses (including prescription drugs, qualified long term care and long term care insurance, COBRA coverage, Medicare expenses and retiree health expenses for those 65 or older). The HSA cannot be used for regular health insurance. An HSA is a trust with a bank, insurance company or qualified individual as trustee and is exempt from income tax; however, any amount paid or distributed which is not used for medical care is taxable, with a 10 percent additional tax for distributions includible in income except for disability or death. HSAs are taxable at death unless they pass to a surviving spouse. HSA can be offered under cafeteria plans and contributions can be made by individuals, family members or employers and are tax deductible. The insured's deductible must be at least $1,000 for individuals, $2000 for couples. The HSAs allow for tax-free withdrawals from the HSA after age 65. HSA participants can contribute up to the lesser of the deductible or $4500. An additional $500 contribution is allowed in 2004 (the additional amount increases in later years) for those over 55. The Act also provides a 28-percent excludable subsidy for employers that maintain retiree prescription drug coverage once the new drug benefit starts in 2006. **Pub. L. 108-173, ___ Stat. ___ (2003)**.

NON-COMPETITION AGREEMENT. The taxpayer purchased an interest in a car dealership. As part of the sales agreement, the seller agreed not to open or operate a car dealership within a certain distance. The initial agreement was entered into in 1990 but the sale did not close and no noncompetition agreement was executed because the seller did not receive payment for the agreement. The dealership was resold in 1993 under similar terms but the sales agreement expressly stated that the earlier sale contract was terminated. The taxpayer argued that the second sales agreement was an extension or amendment of the 1990 agreement; therefore, 1990 law applied and the noncompetition agreement payments did not need to be amortized. The court held that the 1990 agreement had been terminated; therefore, the 1993 sales contract was a new contract and I.R.C. § 197 required the noncompetition agreement to be amortized over 15 years. The appellate court affirmed ina decision designated as not for publication. **Burien Nissan, Inc. v. Comm'r, 2004-1 U.S. Tax Cas. (CCH) ¶ 50,102 (9th Cir. 2003), *aff'g*, T.C. Memo. 2001-116**.

PENSION PLANS. The IRS has issued tables of covered compensation under I.R.C. § 401(l)(5)(E) for the 2004 plan year. **Rev. Rul. 2003-124, I.R.B. 2003-49**.

For plans beginning in December 2003, the weighted average is 5.26 percent with the permissible range of 4.74 to 5.79 percent (90 to 120 percent permissible range) and 4.74 to 6.32 percent (90 to 110 percent permissible range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). **Notice 2003-80, I.R.B. 2003-51**.

RETURNS. The IRS has announced the publication of IRS Publication 1179 (Rev. Proc. 2003-28), General Rules and Specifications for Substitute Forms 1096, 1098, 1099, 5498, W-2G, and 1042-S. The IRS also revised the instructions for the 2003 Form 1099-MISC to provide that substitute payments in lieu of dividends paid to individuals are to be reported in Box 8

of Form 1099- MISC, and not Form 1099-DIV. The publications are available now on the IRS web site, www.irs.gov, and can be ordered by calling toll-free 1-800-829-3676. **Ann. 2003-75, I.R.B. 2003-49, 1195**.

PRODUCTS LIABILITY

PESTICIDE. The plaintiffs were blueberry farmers who applied an insecticide manufactured by the defendant on their crops. the plaintiffs alleged that the insecticide, when applied with a third party fungicide, caused damage to the blueberries. The plaintiffs filed suit in negligence, fraud, negligent misrepresentation, breach of covenant of good faith anf fair dealing, breach of warranty and breach of the New Jersey Fraud Act. The essence of the plaintiffs' claims was that the insecticide caused the damage when applied with the fungicide and that the insecticide was defective for this purpose. The court held that all the claims were preempted by FIFRA because the defendant would have to change the EPA-approved label to avoid liability on the claims. **Mortellite v. Novartis Crop Protection, Inc., 278 F. Supp.2d 390 (D. N.J. 2003)**.

WATER

RIPARIAN RIGHTS. The defendant owned land upstream from the plaintiff's land and contructed a dam across a stream which diverted all of the flow to two ponds constructed by the defendant for recreational purposes. The plaintiff had used the stream water to water cattle on the plaintiff's property but was forced to sell cattle when the water supplied was removed. The court held that the defendant's complete blocking of the stream for recreational purposes was an unreasonable use of the water in that it completely prevented the plaintiff from the historical use of the water for watering livestock. The court upheld the trial court's award of a permanent injunction against the defendant from blocking the stream. **Edmondson v. Edwards, 111 S.W.2d 906 (Mo. Ct. App. 2003)**.

CITATION UPDATES

Big Meadows Grazing Assoc. v. United States, 344 F.3d 940 (9th Cir. 2003) (wetlands conservation program) see p. 147 *supra*.

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