CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

BANKRUPTCY

CHAPTER 12

ATTORNEY'S FEES. During the debtors' Chapter 12 plan period, the debtor changed the farming operation from breeder pigs to feeder pigs, resulting in the sale of collateral pigs and the purchase of new pigs. On the advice of the debtor's bankruptcy attorney, no court approval was sought for this change. The debtor's secured creditor filed a motion that this change constituted a default of the confirmed plan because collateral was sold and replaced without the creditor's consent. The matter was eventually resolved and the debtor's attorney filed for additional compensation, primarily for the legal work done to resolve the matter. Additionally, the attorney sought fees for legal and nonlegal work requested by the debtors. The court disallowed most of the fee request because the fees were incurred due to the erroneous advice of the attorney that the debtor could change the farming operation without the consent of the creditor or court. ***In re*** **Nilges, 301 B.R. 321 (Bankr. N.D. Iowa 2003)**.

FEDERAL TAX

DISCHARGE. The debtors, husband and wife had filed a previous bankruptcy case in which several years of taxes were discharged. In the three tax years that followed that case, the debtors failed to timely file their income tax returns and did not make any tax payments except under an installment agreement even though the debtors had substantial income during this period. The court held that the taxes were nondischargeable because the debtors willfully attempted to evade payment of the taxes, based on (1) the debtors' clear awareness of and ability to pay the taxes; (2) the debtors' transfer of assets to their children and lavish lifestyle, and (3) lack of records to support their characterization of financial dealings. The appellate court affirmed. ***In re*** **Hassan, 301 B.R. 614 (S.D. Fla. 2004), *aff'g*, 2003-1 U.S. Tax Cas. (CCH) ¶ 50,322 (Bankr. S.D. Fla. 2003)**.

ERRONEOUS REFUND. The taxpayers had filed a 2000 return and paid the tax. The IRS notified the taxpayers that the return was incorrect and issued a refund check. The IRS discovered that the refund was in error and made a supplemental assessment to recover the refund. The debtors filed for Chapter 7 and received a discharge which would have included the erroneous refund under Section 507. The IRS argued that the erroneous refund had changed in character because of the supplemental assessment; therefore, the assessment was not discharged. The court held that the erroneous refund was discharged because the refund takes on the priority status of the underlying taxes but not the discharge status of the taxes. The court also held that issuing the supplemental assessment did not change the nature of the erroneous refund. The appellate court reversed as to the holding that the refund was merely an erroneous refund claim but characterized the claim as an ordinary debt. However, as an ordinary debt, the refund claim was still discharged in the bankruptcy case. ***In re*** **Frontone, 301 B.R. 290 (C.D. Ill. 2004), *rev'g in part and aff'g in part,* 296 B.R. 184 (Bankr. C.D. Ill. 2003)**.

FEDERAL AGRICULTURAL PROGRAMS

FARM PROGRAMS. The FSA has issued proposed regulations which move the majority of its farm loan programs direct loan making and servicing rules from Chapter XVIII to Chapter VII of the Code of Federal Regulations. Prior to the Department of Agriculture Reorganization Act of 1994 (1994 Act), Chapter XVIII was assigned to the Farmers Home Administration (FmHA) and Chapter VII was assigned to the Agricultural Stabilization and Conservation Service (ASCS). Under the provisions of the 1994 Act, FmHA's Farm Loan Programs and ASCS's programs were consolidated under the newly created FSA while the remaining FmHA programs were transferred to one of the following Rural Development mission area agencies: Rural Business Cooperative Service, Rural Housing Service, and Rural Utilities Service. Chapter VII of the CFR is now assigned to FSA while Chapter XVIII is shared by FSA and the Rural Development mission area agencies. **69 Fed. Reg. 6055 (Feb. 9, 2004).**

FEDERAL ESTATE AND GIFT TAXATION

ADMINISTRATIVE EXPENSES. The decedent's will included a bequest to an organization so long as the organization qualified as a charitable organization under I.R.C. § 2055(a). The estate requested a closing letter from the IRS as to the estate tax liability and did not make any distributions until that letter was received. During the interim period, the estate was charged six percent interest under Texas law on undistributed bequests, including the charitable bequest. After over three years wait, the closing letter was received and the estate distributed the charitable bequest plus statutory interest. The estate then filed a claim for refund based upon the administrative expense or charitable deduction for the statutory interest paid. The court held that the interest expense was deductible as an administrative expense because the decedent's will specifically conditioned the charitable bequest on the organization's qualifying as a charitable organization and the estate's seeking of a closing letter was a reasonable method of making that determination. **Turner v.**

United States, 2004-1 U.S. Tax Cas. (CCH) ¶ 60,478 (N.D. Tex. 2004).

ALTERNATE VALUATION DATE. The decedent's estate hired an attorney to file the federal estate tax return but the attorney failed to file an election to value estate property on the alternate valuation date. The estate representative learned that the election was available by an IRS agent who had requested additional information about the estate. The IRS granted the estate an extension of time to file the election. **Ltr. Rul. 200406039, Oct. 23, 2003**.

DISCLAIMER. The taxpayer was the parent of the decedent who died owning an interest in a family limited liability company. The interest passed by intestacy to the taxpayer who also served as co-executor of the estate. As co-executor, the taxpayer participated in the management of the LLC to the extent of agreeing to an amendment to the LLC agreement to require an increase from at least 50 percent to at least a 67 percent of all members' interests as an affirmative vote for certain LLC actions. The taxpayer did not own any other interest in the LLC and executed a written disclaimer of the interest that passed from the decedent after the amendment of the agreement but before nine months had passed since the decedent's death. The IRS ruled that the decedent's participation in the LLC agreement amendment as co-executor would not be considered an acceptance of any of the benefits of the LLC interest; therefore, the disclaimer was effective. **Ltr. Rul. 200406038, Oct. 24, 2003**.

MARITAL DEDUCTION. The decedent's will bequeathed a life estate in property to the surviving spouse. The estate tax return included the life estate property on Schedule M, effectively making a QTIP election for the property, even though the estate did not have any federal estate tax liability. The estate sought a ruling that the QTIP election was null and void as not necessary to reduce the estate tax liability. The IRS ruled that, under Rev. Proc. 2001-38, 2001-1 C.B. 133, the IRS will disregard the QTIP election and the property would not be included in the surviving spouse's estate. **Ltr. Rul. 200407016, Oct. 24, 2003**.

TRANSFERS WITH RETAINED INTERESTS. The decedent had owned several commercial properties when placed under a guardianship. The guardian and the decedent's heirs agreed to an estate plan for the decedent and the commercial properties were transferred to family limited partnerships with various heirs as partners and the decedent as general and limited partner. The estate plan provided for gifts of the decedent's partnership interests up to the annual exclusion amount. The court found that the parties had an agreement that all of the income from the partnerships would be available to the decedent during life; therefore, the decedent retained a right to the income from the partnerships and the partnerships were included in the decedent's estate under I.R.C. § 2036, except to the extent the decedent received money from the partnerships in exchange for the property transferred to the partnerships. **Estate of Abraham v. Comm'r, T.C. Memo. 2004-39**.

VALUATION OF STOCK. The taxpayers, husband and wife, had split their family corporation into two S corporations because of a state law requirement. The husband and children owned all the stock in one corporation and the wife owned all the stock in the other corporation. After the state law requirement was removed, the taxpayers consolidated the two corporations into a new third S corporation. Each taxpayer received one voting share and 20 nonvoting shares of stock in the new corporation in exchange for each share of old stock. The IRS ruled that I.R.C. §§ 2701, 2703 did not apply to the conversion of stock because the value of the interests of the parties did not change more than a de minimis amount. **Ltr. Rul. 200407006, Nov. 5, 2003**.

FEDERAL INCOME TAXATION

COURT AWARDS AND SETTLEMENTS. The taxpayers had filed a medical malpractice claim against a hospital which was settled for the maximum amount under state law. The taxpayers then filed a claim against the Louisiana Patient's Compensation Fund (LPCF) for additional recovery. Again, under state law, their recovery from the LPCF was limited to $400,000; however, the court awarded interest and attorneys fees. The parties then settled for $839,000 and the taxpayers argued that the entire amount was excluded from income because the settlement did not allocate any of the amount for interest. The court held that, because the award was limited to $400,000, the remainder of the settlement was allocated to prejudgment interest and was included in income. **McCann v. Comm'r, 2004-1 U.S. Tax Cas. (CCH) ¶ 50,169 (5th Cir. 2004), *aff'g*, T.C. Memo. 2003-36**.

DISCHARGE OF INDEBTEDNESS. The taxpayers filed for Chapter 7 bankruptcy with the estate consisting of a business debt owed to the taxpayer and two properties secured by mortgages. After the bankruptcy filing, the business debt became worthless, the automatic stay was lifted as to the two properties and the properties were sold for less than the lenders' claims. The lenders did not file a claim for the deficiencies in the bankruptcy case. The taxpayer did not include the discharged deficiencies in income but claimed a net operating loss from the worthless business debt. The court held that the deficiencies were discharged in the bankruptcy case, resulting in income to the taxpayer which offset the net operating loss from the worthless business debt. **Johnson v. Comm'r, T.C. Memo. 2004-37**.

DISASTER LOSSES. On January 26, 2004, the President determined that certain areas in Ohio were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of severe storms, flooding, mudslides and landslides that began on January 3, 2004. Accordingly, taxpayers who sustained losses attributable to the disaster may deduct the losses on their **2003** federal income tax returns. **FEMA-1507-DR**.

On January 26, 2004, the President determined that certain areas in Maine were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of record snow that began on December 14, 2003. Accordingly**,** taxpayers who sustained losses attributable to the disaster may deduct the losses on their **2002** federal income tax returns. **FEMA-3194-EM**.

ENVIRONMENTAL CLEANUP COSTS. The taxpayer was a corporation in the business of manufacturing products which it places in inventory. The taxpayer had disposed of hazardous waste on the site of its manufacturing plants and was required by state and federal law to clean up the soil and groundwater contaminated by the waste. The taxpayer incurred costs for soil remediation and ground water treatment that restored the land to essentially the same condition as before the contamination and the land continued to be used for the manufacturing processes. The IRS ruled that the soil and groundwater remediation costs had to be capitalized into the cost of the products produced by the taxpayer. The IRS noted that it would not challenge the taxpayer's current deduction of these remediation costs for taxable years before 2004 but that the change from current deduction to capitalization was a change in accounting that required filing Form 3115 in accordance with *Rev. Proc. 2002-9,2002-1 C.B. 327, as amplified, clarified and modified by Rev. Proc. 2002-54, 2002-2 C.B. 432, and Rev. Proc. 2002-19, 2002-1 C.B. 696*. **Rev. Rul. 2004-18, I.R.B. 2004-8**.

The taxpayer was a corporation in the business of manufacturing products which it places in inventory. The taxpayer had legally disposed of hazardous waste on the site of its manufacturing plants. However, due to changes in state and federal law, the taxpayer was required to clean up the soil and groundwater contaminated by the waste. The taxpayer incurred costs for soil remediation and ground water treatment that restored the land to essentially the same condition as before the contamination and the land continued to be used for the manufacturing processes. The IRS examined the effect of the claim of right doctrine, under I.R.C. § 1341, on two different methods of deducting the initial waste disposal costs. In the first situation, the waste disposal costs were deducted currently, and in the second situation, the disposal costs were capitalized in the inventory production costs. The IRS ruled in both situations that cleanup costs incurred in later years were not repayment of income received and taxed in the earlier years. The IRS noted that waste disposal costs included in the cost of inventory production are not deductions from income but adjustments to gross income. Similarly, the cleanup costs are either recoverable in the cost of inventory produced during the cleanup or deductible currently. **Rev. Rul. 2004-17, 2004-8**.

ESOP. The taxpayer owned most of the stock of a corporation and, upon retirement, sold the stock to the corporation's Employee Stock Ownership Plan (ESOP) for cash. The taxpayer then purchased stock which was qualified replacement property under I.R.C. § 1042(c)(4). However, when the taxpayer filed the income tax return for the year of the sale, the return did not report the sale of stock, in any manner, and did not include a statement of election pursuant to I.R.C. § 1042, a statement from the corporation consenting to the application of I.R.C. §§ 4978, 4979A, or a statement of the taxpayer's purchase of qualified replacement property with the proceeds of the stock sale to the ESOP. See *Treas. Reg. § 1.1042-1T*. The taxpayer attempted to make the election by an amended return filed after the due date for the original return. The court held that the taxpayer could not defer the gain from the sale of the stock to the ESOP and purchase of qualified replacement property because the election was not timely made. The court also refused equitable relief because the taxpayer had not disclosed any aspects of the transaction on the original return which would provide any notice to the IRS that the taxpayer intended to make the election. The court also rejected the taxpayer's excuse that the election was not made because of the lack of experience of the return preparer. **Estate of Clause v. Comm'r, 122 T.C. No. 5 (2004)**.

PASSIVE ACTIVITY LOSSES. The taxpayers, husband and wife, were eligible to elect to treat all interests in rental real estate as a single rental real estate activity under I.R.C. § 469(c)(7)(A) and (B). The taxpayers inadvertently failed to make this election for on tax year when they did not include the statement required under Treas. Reg. § 1.469-9(g)(3) with their joint return for that year. The IRS granted an extension of time to file the election statement. **Ltr. Rul. 200406001, Oct. 27, 2003**.

PENSION PLANS. The IRS has issued proposed regulations which provide that any life insurance contract transferred from an employer or a tax-qualified plan to an employee is taxable at its full fair market value (FMV). That requirement is controlling in situations even where the existing regulations provide for the inclusion of the entire cash value. Thus, in cases where a qualified plan distributes a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, the FMV of such a contract would generally be included in the distributee's income, and not just the contract's cash value. If a qualified plan transfers property to a plan participant or beneficiary for consideration that is less than the property's FMV, the transfer would be treated as a plan distribution to the recipient to the extent that the FMV exceeds the amount received in exchange. Consequently, any bargain element in the sale would be treated as a distribution under I.R.C. § 402(a). Moreover, any bargain element would be deemed a distribution for other purposes of the tax code, including the limitations on in-service distributions from certain qualified retirement plans and the limitations set forth in I.R.C. § 415. **69 Fed. Reg. 7384 (Feb. 17, 2004)**.

In conjunction with the proposed regulations discussed above, the IRS has released a revenue procedure that provides a temporary safe harbor for determining FMV. Under these interim rules, the cash value of a life insurance contract distributed from a qualified plan may be treated as that contract's FMV. Effective February 13, 2004, the rules permit the use of values that should be readily available from insurance companies because the cash value is an amount that, in the case of a flexible insurance contract, is generally reported in policyholder annual statements, and in the case of traditional insurance contracts, is fixed at issue and provided in the insurance contract. A plan may treat the cash value as the contract's FMV at the time of distribution if that cash value is at least as large as the aggregate of (1) the premiums paid from the date of issue through the date of distribution, plus (2) any amounts credited to the policyholder with respect to those premiums, minus (3) reasonable mortality charges and reasonable charges, but only if they are actually charged on or before the distribution date and are expected to be paid. **Rev. Proc. 2004-16, I.R.B. 2004-__**.

The IRS has ruled that a qualified pension plan will not satisfy the requirements for a I.R.C. § 412(i) plan if it holds life insurance and annuity contracts for the benefit of a participant that provide for benefits at normal retirement age in excess of the participant's benefits at normal retirement age under the terms of the plan. Further, employer contributions under a qualified defined benefit plan that are used to purchase life insurance coverage for a participant in excess of that party's death benefit under the plan are not fully deductible when contributed. Instead, they are carried over to be treated as contributions in future years and deductible in future years when other plan contributions that are taken into account for the tax year are less than the maximum amount deductible for the year pursuant to the limits of I.R.C. § 404. Such transactions have been identified as "listed transactions" effective February 13, 2004, provided that the employer deducted premiums paid on a contract for a participant with a death benefit that exceeds the participant's plan death benefit by more than $100,000. **Rev. Rul. 2004-20, I.R.B. 2004-__**.

The IRS has ruled that a I.R.C. § 412(i) plan cannot use differences in life insurance contracts to discriminate in favor of highly compensated employees. A plan that is funded, in whole or in part, with life insurance contracts will not satisfy the I.R.C. § 401(a)(4) nondiscrimination rules if: (1) the plan permits highly compensated employees to purchase those life insurance contracts at cash surrender value prior to the distribution of retirement benefits; and (2) any rights under the plan for nonhighly compensated employees to purchase life insurance contracts from the plan prior to distribution of retirement benefits are not of inherently equal or greater value than the purchase rights of highly compensated employees. **Rev. Rul. 2004-21, I.R.B. 2004-__**.

SALE AND LEASEBACK. The taxpayers purchased telephone equipment from a corporation and leased the equipment back to the corporation. The taxpayers were not in the trade of business of leasing the equipment and the transactions were found to be essentially investments in the corporation. The corporation suffered financially and started using the proceeds of the sales to fund the lease payments. The corporation eventually filed for chapter 11 reorganization and the taxpayer had the choice of receiving stock for their leases, obtaining payment from a litigation trust fund or reducing their claims to one dollar. In a Chief Counsel letter, the IRS ruled that the taxpayers' losses were not theft losses because the corporation was a bona fide viable corporation which sold and leased actual equipment and there was no evidence that the corporation fraudulently induced the investments. The IRS also ruled that, if the investments are not recast as loans, the losses would be capital losses from investments since the taxpayers were not in the trade or business of leasing telephone equipment. Because the IRS believed that the sale and leaseback transactions were actually loans, the IRS also ruled that the taxpayers' losses were deductible as nonbusiness bad debts. Because the bankruptcy and fraud litigation had not yet been resolved, only the taxpayers who accepted one dollar for their leases could claim the bad debt deduction. The other could claim the deduction when the litigation had concluded. **CCA Ltr. Rul. 200406046, Jan. 2, 2004**.

S CORPORATIONS

ESOP**.** *Rev. Proc. 2003-23, 2003-1 C.B. 599*, provided that the IRS will accept the position that an S corporation's election is not affected as a result of an ESOP's distribution of S corporation stock in a direct rollover to an IRA if the terms of the ESOP require that the S corporation repurchase its stock immediately upon the ESOP's distribution of the stock to the IRA, the S corporation actually repurchases the stock, and the other requirements of that revenue procedure are satisfied. The IRS has issued a revenue procedure which modifies *Rev. Proc. 2003-23* by providing that the IRS also will accept the position that an S corporation's election is not affected as a result of an ESOP's distribution of S corporation stock in a direct rollover to an IRA if the terms of the ESOP require that the S corporation repurchase its stock immediately upon the ESOP's distribution of the stock to the IRA, the ESOP is permitted to assume the rights and obligations of the S corporation to repurchase the S corporation stock immediately upon the ESOP's distribution of the stock to an IRA, the ESOP repurchases the stock, and the other terms of the revenue procedure are satisfied. **Rev. Proc. 2004-14, I.R.B. 2004-__**.

ONE CLASS OF STOCK. The taxpayers, husband and wife, had split their family corporation into two S corporations because of a state law requirement. The husband and children owned all the stock in one corporation and the wife owned all the stock in the other corporation. After the state law requirement was removed, the taxpayers consolidated the two corporations into a new third S corporation. Each taxpayer received one voting share and 20 nonvoting shares of stock in the new corporation in exchange for each share of old stock. The IRS ruled that the voting and nonvoting shares would not be treated as different classes of stock for purposes of qualifying the corporation for Subchapter S status. **Ltr. Rul. 200407006, Nov. 5, 2003**.

SHAREHOLDER LOANS. The taxpayers owned several S corporations which were part of their trucking business. The corporations made a series of loans to the shareholders and the other corporations and the taxpayers, in turn, loaned the money to the S corporations. The court found that the loans were without economic substance but were merely offsetting bookkeeping entries since the loans were not repaid until the IRS started to investigate the legitimacy of the loans and the taxpayers' increase of basis in their interests in the corporations. The court held that the taxpayers' loans to the corporations did not increase their basis in the corporations because the loans lacked economic substance. The taxpayers had also guaranteed some of the corporations' loans but the court also held that the guarantees did not affect the basis for the same reason. **Oren v. Comm'r, 2004-1 U.S. Tax Cas. (CCH) ¶ 50,165 (8th Cir. 2004), *aff'g*, T.C. Memo. 2002-172**.

SAFE HARBOR INTEREST RATES
March 2004

	Annual	Semi-annual	Quarterly	Monthly
Short-term				
AFR	1.58	1.57	1.57	1.56
110 percent AFR	1.74	1.73	1.73	1.72
120 percent AFR	1.89	1.88	1.88	1.87
Mid-term				
AFR	3.34	3.31	3.30	3.29
110 percent AFR	3.67	3.64	3.62	3.61
120 percent AFR	4.01	3.97	3.95	3.94
Long-term				
AFR	4.84	4.78	4.75	4.73
110 percent AFR	5.33	5.26	5.23	5.20
120 percent AFR	5.82	5.74	5.70	5.67

Rev. Rul. 2004-25, I.R.B. 2004-__.

TAX SCAMS. The IRS has announced the addition of a new section on its website, www.IRS.gov, providing information about abusive schemes involving employee retirement plans that are "listed transactions." The new section also provides recently issued guidance, including regulations and revenue rulings, that are intended to shut down abusive transactions. The Treasury Department has recently identified as listed transactions a scheme involving indirect contributions to Roth IRAs and one involving S corporation employee stock ownership plans. The new employee plans information is located in the Retirement Plans section under "EP Abusive Tax Transactions." The new section also provides contact information for reporting suspected abusive transactions to the IRS. **IR-2004-20**.

WAGES. The taxpayer, the sole shareholder of three corporations, hired an office manager who worked part-time performing various office duties for the corporations. The manager was allowed to make purchases of personal items using business funds. The taxpayer did not report the value of the personal items as additional compensation on the manager's Form W-2. The court held that the value of the personal items was not intended as compensation but was only intended as gifts based on the personal friendship of the parties. **Troutman v. Comm'r, T.C. Memo. 2004-32**.

The taxpayer was the sole shareholder of a corporation which sold modular homes. In late December 1998 the taxpayer had a check drawn on the corporation's checking account and made out to the taxpayer. The taxpayer did not cash the check until March 1999 and immediately redeposited the funds back to the corporation's checking account. The taxpayer argued that the amount of the check was not wages but an attempt to inflate the wage deduction for the corporation for 1998. The court noted that the taxpayer had complete control over the corporation and presented no evidence of the purpose of the check; therefore, the court held that the amount of the check was wage income to the taxpayer. **Cavender v. Comm'r, T.C. Memo. 2004-33**.

NEGLIGENCE

CROP SPRAYING. The plaintiff owned a tree farm neighboring the defendant's farmland. The defendant's farmland was managed by another defendant and farmed by a third defendant under a cropshare lease. The plaintiff alleged that the defendants negligently sprayed herbicide on the farmland when the wind was high enough to cause drift onto the plaintiff's trees, causing damage. The plaintiff argued that liability extended to all three defendants because they operated the farm as a partnership or joint venture. The court agreed with the landowner and manager that the arrangement was a cropshare lease with the tenant and that they were not liable for the actions of the tenant in spraying the herbicide. **Byrd v. E.B.B. Farms, 796 N.E.2d 747 (Ind. Ct. App. 2003)**.

IN THE NEWS

BEEF. An Alabama Federal District Court jury has awarded a plaintiff's class of beef producers $1.28 billion against Iowa Beef Packers, Inc. (now owned by Tyson Fresh Meats, Inc.) for anti-competitive behavior and price fixing under the Packers and Stockyards Act. Roger McEowen will write an article on this case for the next issue of the *Digest*. **See Agriculture Online, www.agriculture.com/default.sphAgNews.class ?FNC=MonsentoDetail__ANewsindex_html___51323**.

FARM LABOR. The National Agricultural Statistics Service has issued farm employment figures as of January 11-17, 2004. There were 847,000 hired workers on the nation's farms and ranches the week of January 11-17, 2004, down 5 percent from a year ago. Of these hired workers, 667,000 workers were hired directly by farm operators. Agricultural service employees on farms and ranches made up the remaining 180,000 workers. All NASS reports are available free of charge on the internet. For access, go to the NASS Home Page at: http:/www.usda.gov/nass/ .

LIVESTOCK IDENTIFICATION. A bill has been introduced in the U.S. House of Representatives which would provide $175 million for implementation of a mandatory livestock identification program in 90 days. See Agriculture Online http://email.agriculture.com/cgi-bin1/DM/y/efOX0BElVQ0TM0FqK20AZ

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