as net earnings from self-employment under I.R.C. § 1402(a) but that net earnings are determined only with respect to a trade or business in which personal services of the taxpayer are a material income-producing factor.[20]

Therefore, self-employed individuals, where their personal services are a material income-producing factor, are eligible to establish and contribute to a SEP.

Levine v. Commissioner

In the 2005 case of Levine v. Commissioner,[21] the taxpayer was employed on a full-time basis as an industrial hygienist by the United States Department of State under two personal service contracts.[22] Some features of her employment resembled an employer-employee relationship— the taxpayer was paid an annual salary calculated on a work year of 2,087 hours, was paid overtime for hours worked in excess of 40 hours per week, was entitled to paid leave for Federal holidays and accrued annual leave and sick leave. The Department of State withheld payroll taxes in the same manner as for employees. When in Washington, the taxpayer was under contract to work eight hours per day, Monday through Friday with the precise hours specified. However, the taxpayer performed approximately 40 percent of the services outside the United States and was subject to relatively little control by the Department of State as employer.

The taxpayer contributed $8,638 to her SEP for 1999, figured on the basis of the income earned under the personal service contracts and specifically noted on the return that she was an independent contractor. The Internal Revenue Service objected to the deduction on the grounds she had not established that she was "entitled to this deduction."

Although conceding that it was a close case, the Tax Court stated that the Department of State "had little control over the means and manner by which the petitioner's work was accomplished" and concluded that the taxpayer was an independent contractor.[23] As such, she was entitled to a SEP deduction.

FOOTNOTES

[1] See I.R.C. § 408(k).

[2] *Id.*

[3] See I.R.C. Secs. 401(c), 401(c)(1)(A).

[4] Levine v. Comm'r, T.C. Memo. 2005-86.

[5] I.R.C. § 408(k)(1).

[6] I.R.C. § 408(k)(2).

[7] I.R.C. § 408(k)(3).

[8] I.R.C. Secs. 402(h)(2), 404(h)(1). See Notice 2003-73, 2003-2 C.B. 1017.

[9] I.R.C. § 4973(a).

[10] I.R.C. § 219(b)(5).

[11] I.R.C. § 219(b)(5)(A).

[12] I.R.C. § 219(b)(5)(B).

[13] I.R.C. Secs. 402(h)(3), 408(d).

[14] See I.R.C. § 1402(a).

[15] I.R.C. Secs. 401(c)(4), 408(k)(7).

[16] I.R.C. § 1402(a).

[17] I.R.C. § 1402(c)(2).

[18] I.R.C. § 401(c)(1)(A).

[19] I.R.C. § 401(c)(1)(B).

[20] I.R.C. § 401(c)(2)(A).

[21] T.C. Memo. 2005-86.

[22] *Id.*

[23] *Id.*

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

ADVERSE POSSESSION

PAYMENT OF TAX. The plaintiffs sought to quiet title to a strip of land between the plaintiffs' and defendants' lands. The plaintiff had shown that they used the disputed strip for various farming and ranching purposes for many years and the trial court had granted title to the plaintiffs by adverse possession. The appellate court reversed, holding that the Indiana adverse possession statute, Ind. Code § 31-21-7-1, prohibited passage of title by adverse possession unless the adverse possessor had paid all taxes attributable to the disputed land. Because the plaintiffs had not demonstrated that they paid all the taxes, the court held that the statute prevented them from acquiring the land by adverse possession, even if all other elements had been met. **Fraley v. Minger, 2005 Ind. LEXIS 539 (Ind. 2005), aff'g, 786 N.E.2d 288 (Ind. Ct. App. 2003)**.

BANKRUPTCY

FEDERAL TAX

DISCHARGE. The debtor filed Form 4868 "Automatic Extension of Time to File U.S. Individual Income Tax Return" for the debtor's 2000 tax return, extending the filing date to August 15, 2001. The debtor filed the 2000 return on April 22, 2001. The debtor filed for Chapter 7 on June 15, 2004, less than three years after the extended due date for the 2000 tax return. The court held that the three year period of Section 523(a)(1)(A) applied to the due date of the tax return, including extensions, and not the actual date of the filing. In addition, the court held that the filing of the return early did not remove the extension; therefore, the court held

that the 2000 taxes were not dischargeable. ***In re* Dippel, 2005-2 U.S. Tax Cas. (CCH) ¶ 50,431 (Bankr. S.D. Fla. 2005).**

The debtors, husband and wife, owed taxes which were established by a court proceeding. After the tax judgment was final, the taxpayers transferred a residence to one of their children for no consideration. The record showed that, at the time of the transfer, the debtors were insolvent and the taxpayers had little income. The taxpayer continued to live in the residence after the transfer. The court held that the transfer of the residence was fraudulent and the tax judgment claim was nondischargeable under Section 523(a)(1)(c). In addition, the court voided the transfer of the residence and allowed the IRS to levy against the residence for the taxes owed. **United States v. Verduchi, 2005-1 U.S. Tax Cas. (CCH) ¶ 50,414 (D. R.I. 2005)**.

FEDERAL AGRICULTURAL PROGRAMS

COTTON. The CCC has issued interim regulations changing the Extra Long Staple cotton price used to calculate the payment rate from the "average domestic spot price quotation for base quality U.S. Pima cotton" to the "American Pima c.i.f. Northern Europe" price. **70 Fed. Reg. 35367 (June 20, 2005)**.

The CCC has issued proposed regulations which implement provisions of the Military Construction Appropriations and Emergency Hurricane Supplemental Appropriations Act, 2005, to provide assistance to producers and first-handlers of the 2004 crop of cottonseed in counties declared a disaster by the President due to 2004 hurricanes and tropical storms. **70 Fed. Reg. 36536 (June 24, 2005)**.

CROP INSURANCE. The FCIC has adopted as final regulations amending the Nursery Crop Insurance provisions to (1) make container and field grown plants separate crops; (2) provide coverage for plants in containers that are equal to or greater than one inch in diameter; (3) provide separate basic units by share which will be further divided into basic units by plant type and a basic unit for all liners when additional coverage is purchased; (4) offer one coverage level and price election for each basic unit when additional coverage is purchased; (5) offer optional units by location for field grown plants; (6) allow increases to the plant inventory value report if made on or before August 31 of the crop year; (7) change the provision that precludes acceptance of an application for insurance for any current crop year after May 31 of the crop year; and (8) make other policy changes to improve coverage of nursery plants. **70 Fed. Reg. 37221 (June 28, 2005)**.

GUARANTEED FARM LOANS. The FSA has issued proposed regulations which revise the Interest Assistance Program as to how a guaranteed loan borrower may obtain a subsidized interest rate on a guaranteed farm loan. The changes include (1) deletion of annual review requirements, (2) limitations on loan size and period of assistance, and (3) streamlining of claim submission. **70 Fed. Reg. 36055 (June 22, 2005)**.

ORGANIC FOODS. The AMS has issued advance notice of proposed rulemaking concerning the expiration, on October 21, 2007, of the allowed use of 165 synthetic and non-synthetic substances in organic production. On the same date the prohibition of nine non-synthetic substances will also expire. The AMS seeks public comment on the changes. **70 Fed. Reg. 35177 (June 17, 2005)**.

The AMS has issued a notice pursuant to a consent final judgment and order issued in the case *Harvey v. Johanns, Civil No. 02-216-P-H (D. Me. June 9, 2005)*. The court issued a declaratory judgment that 7 CFR § 205.606 shall be interpreted to permit the use of a nonorganically produced agricultural product only when the product has been listed in Section 205.606 pursuant to National List procedures, and when an accredited certifying agent has determined that the organic form of the agricultural product is not commercially available. The court's order limited an accredited certifying agent's commercially available determinations for nonorganic agricultural products used in or on processed organic products to the five substances contained in 7 CFR § 205.606. The products involved are native cornstarch, water extracted gums, kelp when used as a thickener and dietary supplement, unbleached lecithin, and high methoxy pectin. **70 Fed. Reg. 38090 (July 1, 2005)**.

PERISHABLE AGRICULTURAL COMMODITIES ACT. The plaintiffs were sellers of agricultural commodities to a merchant who failed to pay for the produce but used PACA trust funds to pay on a loan from the defendant bank. The plaintiffs argued that the bank was liable for the merchant's breach of the PACA trust. The defendant argued that the plaintiffs failed to preserve their rights in the PACA trust and that the defendant was not liable for the merchant's breach of the PACA trust duties because the defendant did not know about the breach. The defendant claimed that the plaintiffs did not mail notification of their intent to preserve their PACA trust rights to the merchant. On the first issue, the court noted that, under New York law, proof of mailing can be made by evidence of standard office procedures. The plaintiffs provided testimony of their office procedures, the mailing of the notices to the merchant on a routine basis, and certified copies of the same notices sent to the USDA. In addition, the court noted that the merchant did not deny ever receiving the notices. The court held that the plaintiffs did provide a PACA trust notice to the merchant and USDA. Some plaintiffs provided only certified copies of their notices to the USDA and the court held that they failed to prove that they provided notices to the merchant, thus losing their PACA trust rights. On the second issue, the court noted that the merchant had a cash-flow problem which was known by the defendant because the merchant had applied for an overdraft protection line-of-credit and continuously and excessively exceeded the credit limit on this account. The defendant took steps to reduce the merchant's debts to the defendant and threatened to close the merchant's account if the loan amounts were not reduced. The court held that the defendant did not take the steps of a reasonably prudent lender in failing to investigate whether the merchant was meeting the fiduciary obligation to the PACA trust. The court held that the defendant lender was liable for the PACA trust funds paid to the defendant by the merchant. Because most of the funds paid to the defendant were reloaned to the merchant for payment of more produce, the damages were limited to the payments made to other, non-PACA suppliers and creditors. On appeal of the

second issue, the appellate court noted its decision in *E. Armata, Inc. v. Korea Commercial Bank, 367 F.3d 123 (2d Cir. 2004)* which held that the deposit of PACA trust funds into a negative balance checking account was not per se a violation of the PACA trust. Therefore, the court held that the defendant could not be held liable for the deposits or subsequent withdrawals. In addition, the appellate court held the defendant liable only for the amount of bank charges and interest retained by the defendant which exceeded a commercially reasonable amount. **Albee Tomato Co., Inc. v. Korea Commercial Bank of New York, 2005 U.S. App. LEXIS 10374 (2d Cir. 2005), *aff'g in part and rev'g in part*, 282 F. Supp.2d 6 (S.D. N.Y. 2003)**.

PLANT VARIETY PROTECTION ACT. The plaintiff purchased non-genetically modified soybean seeds produced by the defendant seed company. The seeds were not patented or certified under the Plant Variety Protection Act (PVPA). Each bag of seed had a label which prohibited the buyer from reselling the seed or saving seeds from plants produced by the seed. The plaintiff argued that the labels violated 7 U.S.C. § 2568 as false marking in that the seed was not patented or certified under the PVPA. The plaintiff argued that the prohibition against seed saving language was similar to the statutory prohibition against use of "Unauthorized Propagation Prohibited" on the labels of non-PVPA certified or patented seed. The court held that the labels did not violate the PVPA because the labels did not contain the specific language prohibited by the statute or similar language. The court held that the labels merely established certain contract rights and obligations on the non-certified seed buyers which were not prohibited by the PVPA. The court focused on the purpose of the statute as preventing the representation of seed as certified under PVPA and not for the purpose of preventing the prohibition of seed saving for non-certified or patented seed. **Showmaker v. Advanta USA, Inc., 2005 U.S. App. LEXIS 11117 (Fed. Cir. 2005), aff'g, 2004 U.S. Dist. LEXIS 28066 (S.D. Ill. 2004)**.

SHARED APPRECIATION AGREEMENTS. The plaintiffs (the case consolidated two appeals) entered into several 10-year shared appreciation agreements with the USDA as part of a farm loan write-down. When the agreements expired, the USDA had the property appraised and sought payment of one-half of the appreciation in value of the farms during the 10-year agreements. The court cited *Stahl v. USDA, 327 F.3d 697 (8th Cir. 2003); Pauly v. USDA, 348 F.3d 1143 (9th Cir. 2003) (per curiam); Israel v. USDA., 282 F.3d 521 (7th Cir. 2002)* to support its holding that the USDA was entitled to recover one-half of appreciation in value of the farms during the 10-year agreements. The court noted that the agreements and the written instructions distributed with the agreements notified the plaintiffs that one-half of the appreciation would need to be paid at the end of the agreements. The plaintiffs argued that the USDA should be estopped from claiming the right to payments because local officials told the plaintiffs that nothing would need to be paid if the plaintiffs continued to farm the property after the 10-year agreements expired. The court held that the USDA was not estopped because the plaintiffs did not show any affirmative misconduct by the USDA or its employees. In the plaintiffs' motion for rehearing, the plaintiffs submitted newly discovered USDA documents which the plaintiffs argued demonstrated that the USDA had intended that the appreciation would not be assessed if the plaintiffs owned their farms for ten years. The court denied a rehearing on the basis that the original rulings were based on the unambiguous language of the statutes and were independent of the USDA intent. **Estate of James v. USDA, 404 F.3d 989 (6th Cir. 2005), *rehearing denied*, 2005 U.S. App. LEXIS 11264 (6th Cir. 2005)**.

TOBACCO. The CCC has issued a request for public comment on the documents to be used by the CCC in the administration of the Tobacco Transition Payment Program with respect to successor-in-interest contracts, which allow a tobacco quota holder or a tobacco producer who is participating in this program to transfer their rights and obligations to a third-party. **70 Fed. Reg. 36919 (June 27, 2005)**.

WETLANDS. In 1990, the plaintiff was notified by the USDA that a one acre portion of the plaintiff's land was wetland. In 1995, the EPA issued an Order for Compliance, requiring the plaintiff to cease unauthorized filling of the wetland. After receiving a complaint that the filling continued, the USDA withheld farm program payments, pending a review of the plaintiff's actions on the wetlands. In 2003 the land was inspected and found to contain converted wetlands and the plaintiff's farm program benefits were denied. The plaintiff pursued full administrative appeal of the denial of benefits before bringing the present suit. The court held that the USDA denial of benefits was supported by substantial evidence that the land contained wetlands and that the land was converted by the plaintiff to non-wetlands. **Holly Hills Farm Corp. v. United States, 2005 U.S. Dist. LEXIS 12875 (E.D. Va. 2005)**.

FEDERAL ESTATE AND GIFT TAXATION

ANNUITIES. The decedent had been receiving annual payments under a structured settlement of a personal injury lawsuit. The payments could not be "accelerated, deferred, increased or decreased" or "anticipated, sold, assigned or encumbered." The estate argued that the value of the decedent's right to the payments was not valued using the I.R.C. § 7520 annuity tables because, under Treas. Reg. § 20.7520-3(b)(1)(i)(a), the payments were subject to substantial restrictions. The estate sought to value the payments with a discount for lack of marketability. The court held that the exception in the regulations did not apply because the restrictions did not affect the amount of or the number of remaining payments. The court also held that a discount for lack of marketability was not allowed because the annuity tables already took into account the lack of marketability of a private annuity. **Anthony v. United States, 2005-2 U.S. Tax Cas. (CCH) ¶ 60,504 (M.D. La. 2005)**.

DISCLAIMERS. The decedent owned an IRA with the decedent's spouse as the sole designated beneficiary after the decedent's death in 2004 and with the decedent's child as the remainder beneficiary. The IRA distributed to the spouse the 2004 minimum distribution. In the first situation, the spouse filed a timely and valid written disclaimer of a specific amount

of the IRA and the income which was earned by the IRA since the decedent's death. The disclaimed amounts passed to the child. In the second situation, the spouse filed a timely and valid written disclaimer of a percentage of the IRA principal and interest after the 2004 distribution. In the third situation, the child is designated as the sole IRA beneficiary and the spouse is the remainder beneficiary. The child filed a timely and valid written disclaimer of the child's entire interest in the IRA except for the income portion of the 2004 distribution. The disclaimed portion passed to the surviving spouse. The IRS ruled the disclaimers were effective for the disclaimed amount and the IRA income in the 2004 distribution attributable to the disclaimed amount. The IRS stated that the 2004 distribution constituted an acceptance of the income included in that distribution; therefore, that income could not be disclaimed. **Rev. Rul. 2005-36, I.R.B. 2005-26**.

GENERATION SKIPPING TRANSFERS. I.R.C. § 2632 provides deemed allocation rules pursuant to which an individual's available GST exemption is automatically allocated to certain kinds of transfers, without any action on the part of the transferor. Under I.R.C. § 2632(c)(5)(A)(i)(I), an individual may elect out of the deemed allocation rules so that the GST exemption will not be allocated automatically to a particular transfer that is an indirect skip. Under I.R.C. § 2632(c)(5)(B)(i), this election out with regard to a particular indirect skip shall be deemed timely if made on a timely filed gift tax return for the calendar year in which the transfer was made, or deemed to have been made under I.R.C. § 2632(c)(4) with regard to trusts subject to an estate tax inclusion period, or on such later dates as may be prescribed in regulations. The IRS has adopted as final regulations which provide guidance for making the election under I.R.C. § 2632(c)(5)(A)(i) to not have the deemed (automatic) allocation of unused GST tax exemption under I.R.C. § 2632(c)(1) apply with regard to certain transfers to a GST trust, as defined in I.R.C. § 2632(c)(3)(B). Under the regulations, the election out of the automatic allocation rules for indirect skips and the election to treat any trust as a GST trust are to be made on a timely filed federal gift tax return. Under the regulations, a transferor who wants to elect out of the automatic allocation rules for indirect skips has the option of electing out for the specific transfer to the GST trust, or making a single election with regard to the trust that applies to the current transfer and all subsequent transfers made by that transferor to the trust. Under the second option, once the election is made with regard to a trust, the election remains effective for all subsequent transfers to that trust by the electing transferor, until that transferor's election is terminated. If, under the terms of the trust instrument, distributions to skip persons are unlikely, the transferor may choose not to allocate the GST exemption to the trust. The regulations also provide guidance for making the election under I.R.C. § 2632(c)(5)(A)(ii) to treat a trust as a GST trust. **70 Fed. Reg. 37258 (June 29, 2005)**.

SPECIAL USE VALUATION. The decedent's estate included farmland which continued to be farmed by the decedent's heirs. The estate hired an attorney and accountant to file the estate tax return and the return included a protective election for special use valuation; however, the accountant did not inform the estate that the protective election had to be perfected within 60 days after issuance of the estate tax closing letter. The estate did file a supplemental return attempting to perfect the protective election, but the return was filed more than 60 days after the closing letter. After the IRS rejected the supplemental return as untimely, the estate requested an extension of time to perfect the protective election. The IRS granted the extension. **Ltr. Rul. 200523015, March 7, 2005**.

TRANSFERS WITH RETAINED INTERESTS. The taxpayer established several trusts for the taxpayer's benefit and for the taxpayer's children's benefit. The trustee for the trust was a trust company in which the taxpayer owned stock. The company articles of incorporation and bylaws and the trust agreements prohibited the taxpayer from taking part in any trustee decisions as to the trusts. The IRS ruled that the trusts were not includible in the taxpayer's estate because the taxpayer did not retain any control over the trust principal or income. **Ltr. Rul. 200523003, March 8. 2005**.

FEDERAL INCOME TAXATION

ADOPTION EXPENSES. The IRS has issued a revenue procedure with guidance for determining the date of the finality of a foreign adoption for purposes of the adoption expenses credit under I.R.C. § 23. **Rev. Proc. 2005-31, I.R.B. 2005-26, *modifying*, Notice 2003-15, 2003-1 C.B. 540**.

CASUALTY LOSSES. The taxpayer claimed a casualty loss deduction for flood damage to the taxpayer's residence and personal property. The taxpayer had no proof of the clean-up costs or value of damaged property other than the taxpayer's own testimony. The court upheld the IRS denial of the deductions for lack of substantiation. **Hill v. Comm'r, T.C. Summary Op. 2005-83**.

CLEAN FUEL VEHICLE DEDUCTION. The IRS has certified the 2006 Toyota Highlander Hybrid as eligible for the clean-fuel vehicle deduction provided by I.R.C. § 179A. The deduction is $2,000 for vehicles first purchased and first used by the original owner in 2005 and $500 for vehicles first purchased and first used by the original owner in 2006. **IR-2005-69**.

COOPERATIVES. The taxpayer was a tax-exempt agricultural marketing cooperative but ceased operations for several years. Although the stockholders and board of directors held the cooperative property in hopes of reopening the business, the cooperative property was eventually sold several years after the cooperative ceased business operations. The sale proceeds were distributed to the persons who were members when the business operations ceased. The IRS ruled that the cooperative could not apply the patronage dividend deduction of Subchapter T to the sale proceeds because the business was no longer operated on a cooperative basis. **Ltr. Rul. 200526012, March 22, 2005**.

COURT AWARDS AND SETTLEMENTS. The taxpayer sued an employer for sex discrimination under the Federal Civil Rights Act of 1964 and for age discrimination under the California Fair Employment and Housing Act. The jury awarded money damages to the taxpayer for "intentional discrimination based upon gender or age, or negligent infliction of emotional distress." The jury also awarded punitive damages, although the punitive damages were later removed by an appellate court. The taxpayer reported the entire award plus interest on the taxpayer's federal income tax return but subtracted the attorneys' fees paid from the award and 50 percent of the resulting amount as nontaxable because it was attributable to the jury award for emotional distress. The court held that I.R.C. § 104(a)(2) did not allow exclusion from taxable income amounts paid for emotional distress. **Hawkins v. Comm'r, T.C. Memo. 2005-149**.

DEPRECIATION. The IRS ruled that a motor racetrack was classified as Asset Class 79.0, Recreation, for purposes of depreciation deductions, and not Asset Class 80.0, Theme and Amusement Parks. However, the exceptions were land improvements which would be classified as Asset Class 00.3, Land Improvements. **T.A.M. 200526019, March 10, 2005**.

The taxpayer owned an eight apartment building and used one of the apartments as the taxpayer's residence. In a Chief Counsel Advice letter, the IRS ruled that the portion of the apartment used by the taxpayer exclusively for a home office was eligible for the depreciation deduction as 27.5-year recovery property, or 40-year recovery property if the alternative depreciation system applied. The IRS noted that this result applied because over 80 percent of the building was used to rent to third parties. For residential units, such as a single residence, the depreciation period is 39 years for a home office area. **CCA Ltr. Rul. 200526002, May 9, 2005**.

DISASTER PAYMENTS. The IRS has issued a revenue ruling governing the income tax treatment for businesses of state grants of disaster aid. The ruling covered grants which the business used to purchase new equipment to replace destroyed equipment within two years after the disaster. In general, the IRS ruled that the grants were taxable income and noted that the grants were not excluded under (1) I.R.C. § 139 as qualified disaster payments because the exclusion applies only to personal expenses; (2) *Rev. Rul. 74-205, 1974-1 C.B. 20* as general welfare payments because the exclusion applies to social benefit program for general welfare; (3) I.R.C. § 102 as gifts because the grants did not have a donative purpose; and (4) I.R.C. § 118 as capital contributions because the grants are more like insurance payments. However, the IRS did rule that the grants were eligible for the deferment of gain under I.R.C. § 1033 for replacement property purchased within two years after the disaster. The IRS also stated that, if the taxpayer claimed a deduction for the original loss, the grant payments for the deducted losses would be ordinary income. **Rev. Rul. 2005-46, I.R.B. 2005-30**.

ENVIRONMENTAL CLEAN-UP COSTS. The taxpayer was a manufacturer who had buried hazardous waste on the manufacturing site for several years. The taxpayer was required to remove the waste and to remediate the soil and water to comply with federal, state and local environmental laws. The IRS ruled that the costs of clean-up must be allocated under the uniform capitalization rules to the taxpayer's inventory created during the tax year the clean-up costs are incurred. Additionally, the IRS ruled that the remediation expenditures remain allocable to inventory produced in the clean-up year even if the taxpayer no longer produces inventory of the type produced in the tax years that the contamination occurred, it temporarily halts production for part of the clean-up year while it conducts the remediation, it currently conducts its manufacturing activities at a different site, or the clean-up site is a remote dump-site owned by a third party. The ruling expands the scope of *Rev. Rul. 2004-18, 2004-1 C.B. 509*. **Rev. Rul. 2005-42, I.R.B. 2005-28**.

IRA. The taxpayer had accumulated funds in an employee pension plan. The taxpayer terminated the employment and attended school, using borrowed funds to pay for the education. In the third year, the taxpayer had the pension funds rolled over to an IRA and made distributions from the IRA which were used to pay for current education expenses and to pay off the loans used earlier for two years of education expenses. The taxpayer claimed that the distributed IRA funds were eligible for the education exemption from the 10 percent early withdrawal penalty. The court held that the exemption applied only where the distribution is used for current tax year education expenses and did not apply to repayment of loans for education expenses in pre-distribution tax years. **Lodder-Beckert v. Comm'r, T.C. Memo. 2005-162**.

MEDICAL INSURANCE. The taxpayer was self-employed and purchased medical care insurance for the taxpayer and family. In a Chief Counsel Advice letter, the IRS ruled that the taxpayer could claim the cost of the insurance as a deduction so long as the taxpayer's earned income exceeded the cost of the insurance. The IRS also ruled that the taxpayer could not aggregate the profits and losses of two or more businesses for purposes of determining the earned income. The medical insurance costs must be tied to a specific plan under one trade or business. **CCA Ltr. Rul. 200524001, May 17, 2005**.

PARTNERSHIPS

DISCHARGE OF INDEBTEDNESS**.** The taxpayer partnership had two withdrawn partners to which it owed, under the partnership agreement, withdrawn partner obligations. However, the partnership agreement provided that the withdrawn partner obligations were to be paid only if the payments would not produce a financial hardship on the partnership. The partnership did not claim any deduction for the withdrawn partner obligations or changed the basis of partnership assets based on the withdrawn partner obligations. The withdrawn partner obligations had increased significantly and the tax matters partner stated that the withdrawn partner obligations were unlikely to ever be paid. The partnership was sold and the

withdrawn partner obligations were satisfied for a nominal amount. The IRS ruled that the withdrawn partner obligations were contingent obligations and the settlement of the obligations for a nominal amount did not result in discharge of indebtedness income to the partnership. **Ltr. Rul. 200523007, Feb. 24, 2005**.

PASSIVE ACTIVITY LOSSES. The taxpayer was an attorney who specialized in class action lawsuits. The taxpayer purchased computers, audio-visual equipment and office furniture which the taxpayer leased to the taxpayer's law firm. The equipment was designed for use in the special aspects of class action lawsuits. The court held that the rental income and loss from the leasing of the property was passive income and loss but was treated as nonpassive because the leasing activity was incidental to the taxpayer's law practice. **Misko v. Comm'r, T.C. Memo. 2005-166**.

SAFE HARBOR INTEREST RATES

July 2005

	Annual	Semi-annual	Quarterly	Monthly
Short-term				
AFR	3.45	3.42	3.41	3.40
110 percent AFR	3.80	3.76	3.74	3.73
120 percent AFR	4.14	4.10	4.08	4.07
Mid-term				
AFR	4.86	3.82	3.80	3.79
110 percent AFR	4.24	4.20	4.18	4.16
120 percent AFR	4.63	4.58	4.55	4.54
Long-term				
AFR	4.35	4.30	4.28	4.26
110 percent AFR	4.79	4.72	4.70	4.68
120 percent AFR	5.23	5.16	5.13	5.11

Rev. Rul. 2005-38, I.R.B. 2005-27.

S CORPORATIONS

TERMINATION. The taxpayer was an S corporation with three shareholders and one class of stock. The taxpayer made payments to government entities for the taxes owed personally by the shareholders. The tax payments were not proportional to the shareholders' interests in the corporation and potentially caused the termination of the Subchapter S status of the taxpayer. The taxpayer claimed that the disproportionate distributions were corrected upon learning that the tax payments violated the S corporation status requirements. The IRS ruled that the disproportionate distribution followed by the adjustments did not result in the taxpayer terminating for having more than one class of stock. **Ltr. Rul. 200524020, Feb. 16, 2005**.

SELF-EMPLOYMENT INCOME. The taxpayer had self-employment income for two years but failed to timely file income tax returns for those years. The taxpayer eventually filed returns which included the self-employment income. Because the returns were not timely filed, the Social Security Administration (SSA) determined that it would not give the taxpayer any social security credit for the income. The taxpayer filed amended returns without the self-employment income and claimed a refund. The taxpayer argued that if the SSA did not recognize the self-employment income for social security purposes, the IRS also could not tax the self-employment income. The court held that liability of the self-employment income for income tax was separate from the social security credit for the same income; therefore, the self-employment income was still taxable. **Shearin v. United States, 2005-1 U.S. Tax Cas. (CCH) ¶ 50,409 (D. Del. 2005)**.

The taxpayer was employed as a fishing crew member and was paid a share of the catch after the boat owner's expenses were deducted. The taxpayer argued that, under Treas. Reg. § 31.3121(b)(2)-1(a)(1), the taxpayer was considered an employee because the taxpayer's share was not determined by the gross catch. The court held that the history of the provision and the traditional practice in the industry supported the IRS interpretation that a crew member's share could be a share of the net catch and still be self-employment income. The appellate decision is designated as not for publication. **Anderson v. Comm'r, 2005-2 U.S. Tax Cas. (CCH) ¶ 50,455 (1st Cir. 2005), *aff'g*, 123 T.C. 219 (2004)**.

TAX SCHEMES. The taxpayer promoted tax schemes by which clients would form ministerial trusts which would be attached as auxiliary trusts to the taxpayer's corporation sole. The taxpayer advised the clients that the tax-exempt status of the corporation would pass to the income assigned to the trusts, resulting in no tax to the clients. The court held that the tax scheme was an improper evasion of income tax and ordered a preliminary injunction against the taxpayer from promoting the scheme. **United States v. Stoll, 2005-2 U.S. Tax Cas. (CCH) ¶ 50,459 (W.D. Wash. 2005)**.

THEFT LOSSES. The taxpayers, husband and wife, entered into construction contracts for the building of a custom house as their residence. After the house was completed, the taxpayers filed suit against the builder and the builder's insurance company for defects and omissions in the construction of the residence. The suit was eventually settled with the builder purchasing the house from the taxpayers. The taxpayers claimed a theft loss for the cost of the omissions from the residence. The court found that the taxpayers failed to provide sufficient credible evidence of the time of discovery of the alleged theft, the value of the property involved and the reasonable prospect of recovery; therefore, the court held that the theft loss deductions were not allowed. **Davis v. Comm'r, T.C. Memo. 2005-160**.

TOBACCO QUOTA TRANSITION PAYMENTS. The IRS has issued guidance for income tax treatment of payments made under the Tobacco Transition Payment Program for taxpayers' tobacco quotas. The IRS, stated that a tobacco quota owner has a taxable gain if the amounts received are more than the owner's adjusted basis in the quota or the owner may have a loss deductible under I.R.C. § 165 if the amounts received are less than the owner's adjusted basis in the quota. The amounts received for the quota should not include any portion of the payment that is treated as interest for federal tax purposes. The portion of the payment that is treated as interest is determined under the rules of I.R.C. § 483 or § 1274 but no portion is treated

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as interest if the payment is $3,000 or less. The income tax basis of a quota received directly from the government has a zero basis and the income tax basis of a purchased quota is the purchase price. The ordinary or capital nature of the gain or loss is determined by the use of the quota by the taxpayer. For example, a quota held for investment purposes would produce a capital loss or gain. If the quota was used in the trade or business of farming and was held for more than one year, the transition payments would be considered an I.R.C. § 1231 transaction, producing long-term capital gain or ordinary loss. However, if the quota owner claimed certain deductions with respect to the quota, some or all of the gain would be reported as ordinary gain. The IRS will issue future guidance as to payments for tobacco marketing quotas and price supports. **Notice 2005-51, I.R.B. 2005-27**.

TRUSTS. The taxpayer was the beneficiary of a testamentary trust established by the taxpayer's deceased parent's will. The trustees had broad authority to invest the trust principal and the trustees hired an investment company to manage the trust's investments. The trust claimed the entire investment company fees as a deduction on line 15a "Other deductions not subject to the 2% floor" of Form 1041 for the trust. The trust argued that I.R.C. § 67(e)(1) allowed full (i.e. not subject to the 2 percent floor) deductions for trusts for costs of administration which would not have been incurred if the property were not held in trust. The trust argued that the trustees were required by their fiduciary duty to seek professional investment advice, which would not be required if the property were held by an individual. The IRS argued that there was no such fiduciary duty under state law and that investment services were commonly used by individuals; therefore, investment services costs were not excluded from the 2 percent floor. The court noted a split in authority in the reported cases, with *Scott v. United States, 328 F.3d 132 (4th Cir. 2003) and Mellon Bank, N.A. v. United States, 265 F.3d 1275 (Fed. Cir. 2001)* holding that investment costs were subject to the 2 percent floor and *O'Neill v. Comm'r, 994 F.2d 302 (6th Cir. 1993), revg. 98 T.C. 227 (1992)* holding that investment costs were not subject to the 2 percent floor. The court decided to follow the holdings of *Scott* and *Mellon Bank* to hold that the investment costs were subject to the 2 percent floor because investment services were not unique to trusts and were not required by any fiduciary duty. The decision is appealable to the Second Circuit which has not ruled on the issue in any prior case. **William L. Rudkin Testamentary Trust v. Comm'r, 124 T.C. No. 19 (2005)**.

IN THE NEWS

CATTLE. The National Cattlemen's Beef Association has announced that an industry-created computer database of cattle, hogs and poultry could be operational by January 2006, three years ahead of a government database. Testing of the database will begin in October 2005. The Association hopes the database will forestall the government database because the Association believes the government system could allow confidential business information to become public. **Reuters, July 8, 2005**.

ESTATE TAX. The Congressional Budget office has published "Effects of the Federal Estate Tax on Farms and Small Businesses, " July 2005. The report confirms earlier studies that the federal estate tax has very little impact on farms and ranches. The *Digest* will publish an article by Neil Harl on this report.

AALA ANNUAL AGRICULTURAL LAW SYMPOSIUM

The American Agricultural Law Association is holding its annual Agricultural law Symposium on October 7 & 8, 2005 at the Country Club Plaza Marriott in Kansas City, MO. New this year is 165 minutes of farm and ranch taxation presentations on Friday, October 7. The presentations will be made by Neil E. Harl, Roger A. McEowen and Phil Harris. A special "Friday only" registration is offered to allow tax professionals to attend the Friday tax presentations without having to attend both days. More information can be found on the AALA web site http://www.aglaw-assn.org or by contacting Robert Achenbach, AALA Executive Director at RobertA@aglaw-assn.org or by phone at 541-485-1090.