

plantings and the scope of crop insurance coverage. In that case, the plaintiff was a dryland wheat farmer in New Mexico in a region that had suffered drought conditions for several years. The plaintiff did not plant a wheat crop after determining that the moisture level was too low and would not support a crop. The plaintiff's neighbors did plant a crop of wheat and their crop failed to mature resulting in severe wind erosion to their land. The plaintiff applied for crop insurance benefits on the basis that the drought prevented the plaintiff from planting a wheat crop. Coverage under the plaintiff's policy was provided for "prevented plantings," which was defined in part as the inability "to plant the insured crop due to an insured cause of loss that is general in the area (i.e., most producers in the surrounding area are unable to plant due to similar insurable causes)."<sup>13</sup>

The local Farm Service Agency denied the plaintiff's claim and the plaintiff appealed to the National Appeals Division (NAD) of the United States Department of Agriculture. The NAD hearing officer denied the claim, holding that the plaintiff's neighbors were able to and did plant wheat so the criteria were not met for "prevented plantings." On appeal to the Tenth Circuit, the plaintiff argued that the "prevented planting" provision in the policy was unreasonable because it required the plaintiff to violate sound conservation practices to be eligible to recover under the policy. The court upheld the administrative findings on the basis that the plaintiff had not demonstrated that the insurance program's general reliance on what other farmers do as a measure for determining whether planting is "prevented" was unreasonable or not in accordance with governing law.<sup>14</sup>

#### **Involuntary conversion?**

A further question is whether the proceeds from prevented plantings are eligible for involuntary conversion treatment<sup>15</sup> inasmuch as the language of the statute states that payments received because of inability to plant crops are to be treated as insurance proceeds received as a result of "destruction or damage to crops."<sup>16</sup> If the requirements for involuntary conversion treatment are met, the proceeds can be invested in other property "similar or related in service or use to the property so converted...." within two years after the close of the taxable year in which any part of the gain is realized.<sup>17</sup>

In a 1959 ruling, a farmer collected insurance on hail damage to a wheat crop.<sup>18</sup> IRS said it was an involuntary conversion and gain could be avoided by investing the insurance proceeds in another crop of standing wheat or a harvested crop.<sup>19</sup> The ruling

points out, however, that use of the insurance proceeds to cover the costs of planting a new crop is not the acquisition of eligible replacement property.<sup>20</sup>

Thus far, there is no authority confirming that prevented planting payments can be invested in eligible replacement property as an involuntary conversion with avoidance of recognition of gain.

#### **In conclusion**

The statutory language specifying that prevented planting payments are to be treated as crop insurance proceeds for the destruction or damage to crops seems broad enough to allow involuntary conversion treatment. However, until specific authority becomes available allowing such treatment, some question will exist over such reinvestment.

#### **FOOTNOTES**

<sup>1</sup> Treas. Reg. § 1.61-4(c). See generally 4 Harl, *Agricultural Law* § 27.03[7] (1999); Harl, *Agricultural Law Manual* § 4.02[4] (1999). See also Harl, "Income Assurance: Are Recoveries Deferrable?" 8 *Agric. L. Dig.* 49 (1999).

<sup>2</sup> I.R.C. § 451(d). See Rev. Rul. 91-55, 1991-2 C.B. 784, revoking Rev. Rul. 75-36, 1975-1 C.B. 143.

<sup>3</sup> Notice 89-55, 1989-1 C.B. 696.

<sup>4</sup> I.R.C. § 451(d).

<sup>5</sup> Rev. Rul. 74-145, 1974-1 C.B. 113.

<sup>6</sup> *Id.*

<sup>7</sup> See *id.*

<sup>8</sup> I.R.C. § 451(d).

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*

<sup>12</sup> *Snell v. Glickman*, No. 98-2190, 1999 U.S. App. LEXIS 6034 (10<sup>th</sup> Cir. 1999).

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> I.R.C. § 1033.

<sup>16</sup> I.R.C. § 451(d).

<sup>17</sup> I.R.C. § 1033(a)(2).

<sup>18</sup> Rev. Rul. 59-8, 1959-1 C.B. 202.

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

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## CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

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### BANKRUPTCY

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#### **GENERAL-ALM § 13.03.\***

**AVOIDABLE LIENS.** The debtors had leased farm land from five different landlords. Three of the leases were written and included language that the rent was subject to a landlord's lien "as provided by law." A fourth lease was written but contained no language concerning a landlord's lien. The fifth lease was an oral lease and neither party alleged that there was any provision for a landlord's lien for the rent. The debtors sought to avoid, under

Section 545, all of the liens as statutory liens. The first three landlords argued that, because the liens were mentioned in the leases, the liens were nonavoidable consensual liens. The court held that the first three leases did not create separate liens but merely restated the landlords' statutory lien rights. In addition, the court held that, even if separate liens were created, the landlords failed to perfect the liens under the UCC. The court also allowed avoidance of the statutory landlord's lien in the other two leases. *In re Marshall* 238 B.R. 193 (Bankr. S.D. Ill. 1999).

**PLAN.** The debtor was a farm partnership with two partners. Each partner had filed for personal bankruptcy and listed the partnership debts in the cases. The partners each received

discharges. The partnership then filed for Chapter 11 and the plan provided for reorganization of the partnership as a corporation and transfer of all partnership obligations to the corporation such that if the plan payments were not made, only the corporation would be liable for the partnership's debts. A secured creditor objected to the plan because it removed the partners' personal liability for partnership debts. The court held that the plan could not be confirmed over the secured creditor's objection because the plan would remove the partners' personal liability for the secured claim. *In re E-H Farms*, 238 B.R. 661 (Bankr. N.D. Tex. 1999).

**CHAPTER 12-ALM § 13.03[8].\***

**CONVERSION.** The debtors were farmers who originally filed under Chapter 12. In previous rulings in their case, the debtors were found to have made fraudulent transfers of property during their case and the case was converted to Chapter 7. Although the issues had been litigated in early decisions and appeals, the debtors again argued that their case could not be converted to Chapter 7 involuntarily because an involuntary case could not be filed against a family farmer. The court reiterated its prior rulings that the debtors had made fraudulent transfers and that a Chapter 12 case could be involuntarily converted to Chapter 7. *In re Graven*, 186 F.3d 871 (8th Cir. 1999), *aff'g unrep. D. Ct. dec. aff'g*, 196 B.R. 506 (Bankr. W.D. Mo. 1996). See also *In re Graven*, 138 B.R. 587 (Bankr. W.D. Mo. 1992), *aff'd by unrep. D. Ct. dec., aff'd*, 64 F.3d 453 (8th Cir. 1995).

**FEDERAL TAX-ALM § 13.03[7].\***

**CLAIMS.** The IRS filed a claim for priority taxes more than three and one-half years after the bar date and sought a ruling that the taxes were still entitled to priority status. The IRS motion was filed before any plan distributions were made. If the IRS claim was allowed priority status, the unsecured creditors would not receive any distributions. The court held that there was no statutory authority to deprive the tax claim of priority status merely because the claim was untimely filed. In addition, the court refused to subordinate the tax claim because of equitable concerns because the trustee failed to show that the unsecured creditors were otherwise disadvantaged by the IRS delay in filing the claim. *In re Johnson Rehab. Nursing Home, Inc.*, 239 B.R. 168 (Bankr. N.D. Ill. 1999).

**POST-PETITION INTEREST.** The debtor's Chapter 12 plan provided for full payment of an unsecured priority tax claim but did not provide for payment of any post-petition interest on the claim. The debtor made all payments under the plan and received a discharge. The IRS sought collection of post-petition interest on the claim and the debtor. The debtor argued that the IRS was bound by the res judicata effect of the bankruptcy plan and discharge. The court cited *In re Bossert*, 201 B.R. 553 (Bankr. E.D. Wash. 1996) and *In re Mitchell*, 210 B.R. 978 (Bankr. N.D. Tex. 1997, *aff'd, unrep. D. Ct. dec. (N.D. Tex. 1997)*) in holding that the IRS was not entitled to post-petition interest. *In re Cousins*, 238 B.R. 503 (D. N.H. 1999), *aff'g*, 236 B.R. 119 (Bankr. D. N.H. 1999).

## FEDERAL AGRICULTURAL PROGRAMS

**BRUCELLOSIS.** The APHIS has adopted as final regulations amending the brucellosis regulations concerning the interstate movement of cattle by changing the classification of Kansas from Class A to Class Free. **64 Fed. Reg. 67695 (Dec. 3, 1999).**

**CROP INSURANCE.** The plaintiffs were farmers who applied for and received crop revenue insurance for durum wheat. The FCIC issued a policy which contained a coverage payment provision which was later amended because of a drop in wheat prices which substantially increased the payments which would be received by insureds who had covered losses. The plaintiffs argued that the retroactive amendment of the insurance policy was void as arbitrary and capricious administrative action. The court held that the action was arbitrary and capricious as violating the purposes of the crop insurance provisions which sought to establish a secure and reliable system of insurance. The court ordered the reinstatement of the original policy provisions and enjoined enforcement of the amended policy. The USDA has filed an appeal. *Wiley v. Glickman*, No. A3-99-32 (D. N.D. 1999).

The FCIC Board of Directors has announced that it has approved for reinsurance and subsidy the insurance of corn, grain sorghum, soybeans, cotton, and rice in select states and counties under the Crop Revenue Coverage plan of insurance for the 2000 crop year. **64 Fed. Reg. 66839 (Nov. 20, 1999).**

**ELEVATORS.** The CCC is soliciting public comment on the merits of whether the CCC should finance, in some manner, the installation or upgrading of grain cleaning systems at wheat export elevators in the United States. The goal of this initiative would be to improve the quality and competitiveness of U.S. wheat exports by insuring that foreign buyers may readily purchase U.S. wheat with dockage specifications substantially lower than currently available from export elevators. **64 Fed. Reg. 66606 (Nov. 28, 1999).**

**PEANUTS.** The FSA has announced a proposed national peanut poundage quota figure for 2000 in the range between 1,170,000 and 1,190,000 short tons. **64 Fed. Reg. 66790 (Nov. 30, 1999).**

**SCRAPIE.** The APHIS has issued proposed regulations which restrict the interstate movement of sheep and goats from states that do not follow effective flock management practices for scrapie. The amendments also require animal identification for sheep and goats moving interstate and reinstate a scrapie indemnity program to compensate owners of certain animals destroyed due to scrapie. **64 Fed. Reg. 66791 (Nov. 30, 1999).**

**STANDARDS.** The AMS has issued a notice of revisions to the United States Standards for Grades of Oranges, Grapefruit, Tangerines and Lemons. The changes will provide a minimum 25-count sample to be applied to tolerances for defects, revise the grades to make them uniform and consistent with each other and other recently revised U.S. grade standards, and, delete references to outdated industry practices and terminology. **64 Fed. Reg. 66162 (Nov. 24, 1999).**

**TOBACCO.** The CCC has adopted as final regulations setting the 1999 marketing quota for flue-cured tobacco at 666.2 million pounds and the 1999 price support level at 163.2 cents per pound. **64 Fed. Reg. 66717 (Nov. 30, 1999).**

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## FEDERAL ESTATE AND GIFT TAX

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**ADMINISTRATIVE EXPENSES.** In response to the holding in *Estate of Hubert v. Comm'r*, 520 U.S. 93 (1997), see 8 *Agric. L. Dig.* 52 (1997), the IRS has adopted as final regulations providing that only administration expenses of a certain character which are charged to the marital property bequest will reduce the value of the property for marital deduction purposes. The rules also apply for purposes of the estate tax charitable deduction. Under the regulations, a reduction is made to the date of death value of the property interest which passes from the decedent to the surviving spouse (or to a charitable organization described in I.R.C. § 2055) for the dollar amount of any estate transmission expenses incurred during the administration of the decedent's estate and charged to the property interest. Such a reduction is proper because these expenses would not have been incurred but for the decedent's death. No reduction is made for estate management expenses incurred with respect to the property and charged to the property because these expenses would have been incurred even if the death had not occurred. However, a reduction is made for estate management expenses charged to the marital property interest passing to the surviving spouse if the expenses were incurred in connection with property passing to someone other than the surviving spouse and a person other than the surviving spouse is entitled to the income from that property. Estate transmission expenses are all estate administration expenses that are not estate management expenses and include expenses incurred in collecting estate assets, paying debts, estate and inheritance taxes, and distributing the decedent's property. Estate management expenses are expenses incurred in connection with the investment of the estate assets and with their preservation and maintenance during the period of administration. **64 Fed. Reg. 67763 (Dec. 3, 1999).**

**GENERATION SKIPPING TRANSFERS.** The trustee and beneficiaries of a trust established prior to 1985 petitioned a state court to amend the trust provisions for appointing trustees. The state court allowed the modifications. The IRS ruled that the modifications did not subject the trust to GSTT. **Ltr. Rul. 9946021, Aug. 23, 1999; Ltr. Rul. 9946030, Aug. 18, 1999; Ltr. Rul. 9946031, Aug. 18, 1999; Ltr. Rul. 9946032, Aug. 18, 1999.**

**VALUATION.** The IRS has adopted as final regulations governing the limitation period for assessment of tax on gifts for gift and estate tax purposes. For gifts after August 5, 1997, I.R.C. § 6501(c)(9) extends the period of assessment indefinitely unless the gifts were disclosed on the gift tax return in a manner adequate to apprise the IRS of the nature of the transfer. The regulations identify the information which must be disclosed before the limitation period will begin to run. The required information must completely and accurately describe the transaction and include: the nature of the transferred property; the parties involved; the value of the transferred property; and how the value was determined, including any discounts or adjustments used in valuing the transferred property. In addition, the return must disclose the facts affecting the gift tax treatment of the transaction in a manner that reasonably may be expected to apprise the IRS of the nature of any potential controversy

regarding the gift tax treatment of the transfer. **Treas. Reg. § 20.2001-1.**

Under I.R.C. § 2504(c) as amended in 1997 and 1998, if a gift was adequately disclosed such that the time has expired for assessing gift tax for a preceding calendar period under I.R.C. § 6501, then the value of such gift made in the prior calendar period cannot be adjusted (regardless of whether or not a gift tax has been assessed or paid for a prior calendar period). Rather, the value of the gift is the value as finally determined for gift tax purposes, as defined in I.R.C. § 2001(f). A similar rule applies with respect to any increase in taxable gifts required under I.R.C. § 2701(d). I.R.C. § 2504(c) applies only to adjustments involving issues of valuation. Thus, even after the 1997 and 1998 amendments to I.R.C. § 2504(c), adjustments to prior taxable gifts may be made if the adjustment is not related to the valuation of the gift; e.g., the erroneous inclusion or exclusion of property for gift tax purposes. **Treas. Reg. § 25.2504-2.**

Under I.R.C. § 2001(f), if the time has expired for assessing gift tax for a preceding calendar period under I.R.C. § 6501, then the value of a gift, for purposes of computing the estate tax liability, is the value of the gift as finally determined for gift tax purposes. A similar rule applies for any increase in taxable gifts required under I.R.C. § 2701(d). Under the statute, the value of a gift is finally determined if: the value is shown on a gift tax return and the IRS does not contest the value before the period for assessing gift tax expires; or, before the period for assessing gift tax expires, the value is specified by the IRS and the taxpayer does not contest the specified value; or, the value is determined by a court or pursuant to a settlement agreement between the taxpayer and the IRS. Again, the provision only limits the IRS' ability to make adjustments related to the value of a gift. Thus, the IRS is not precluded from making adjustments that are not related to value, such as the erroneous inclusion or exclusion of property for gift tax purposes. **Treas. Reg. § 301.6501(c)-1. 64 Fed. Reg. 67767 (Dec. 3, 1999).**

The shareholders of a corporation exchanged all of their stock for stock in an LLC in a transaction intended to qualify as a tax-free reorganization under I.R.C. § 368(a)(1)(F). The LLC was authorized to issue membership units with rights, preferences, and restrictions identical to the classes of stock exchanged. After the corporation was merged into the LLC, the shareholders exchanged their shares in the corporation for an identical number of units in the LLC with rights, preferences, and restrictions identical to the rights, preferences, and restrictions each shareholder held in the corporation before the transfer. The IRS ruled that the exchange was not subject to I.R.C. § 2701 valuation rules because the shareholders' interests in the LLC were identical to their interest in the corporation. **Ltr. Rul. 9947034, Aug. 26, 1999.**

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## FEDERAL INCOME TAXATION

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**COOPERATIVES.** The taxpayer was a nonexempt agricultural cooperative which owned directly or through stock ownership oil and gas refinery businesses which provided petroleum products to the members of the taxpayer. The taxpayer sold the stock and properties when the businesses became nonprofitable and the issue was whether the proceeds of the sales were patronage-sourced income. The court held that the proceeds were patronage-

sourced income because the property was directly related to the taxpayer's business with its members. The court rejected the IRS argument that all capital gain was nonpatronage-sourced income. **Farmland Indus., Inc. v. Comm'r, T.C. Memo. 1999-388.**

**HOBBY LOSSES.** The taxpayers, husband and wife, operated an activity that included the breeding, care, showing, and occasional sale of cutting horses used in competitions. The husband was employed full time in another business and the wife devoted at least six hours a day to the horse activity. The horse activity never had a taxable profit. The court held that the taxpayers did not operate the horse activity with the intent to make a profit, based on the following findings: (1) although the taxpayers maintained accurate and separate records of the activity, the taxpayers did not use the records to evaluate the profitability of the activity; (2) the taxpayers did not create a plan for profitability other than to try to economize in purchases; (3) although the wife developed expertise in the riding and breeding of horses, the taxpayers did not have or acquire expertise in operating a business involving horses; (4) the wife devoted substantial time to the activity but much of the time had an element of personal enjoyment and recreation; (5) the taxpayers failed to demonstrate that any of the horses would appreciate sufficiently to offset the years of losses; (6) the activity had 23 years of losses; and the taxpayers had substantial income from the husband's employment which was offset by the horse activity losses. The appellate court affirmed in an opinion designated as not for publication. **Sullivan v. Comm'r, 99-2 U.S. Tax Cas. (CCH) ¶ 50,987 (5th Cir. 1999), aff'g, T.C. Memo. 1998-367.**

**INTEREST ON TAXES.** The IRS has announced a change in the IRS's litigating position with respect to when interest begins to accrue on a deficiency in tax if, pursuant to the taxpayer's election, the IRS credited the reported overpayment against the taxpayer's estimated tax liability for the succeeding taxable year. This issue was litigated in *The May Department Stores Co. v. United States*, 36 Fed. Cl. 680 (1996), acq., AOD CC-1997-008 (Aug. 4, 1997). In subsequent guidance, *Rev. Rul. 99-40, I.R.B. 1999-40 441*, the IRS stated that, when the taxpayer files its return on or before the due date or the due date as extended and elects to credit its reported overpayment against its estimated tax for the succeeding year, the overpayment is considered as applied to the unpaid installments of estimated tax due on or after the date(s) the overpayment arose in the order in which they are required to be paid to avoid an addition to tax for failure to pay estimated income tax under I.R.C. §§ 6654, 6655 with respect to such year. The IRS, therefore, will no longer litigate cases where the taxpayer elected to credit its reported overpayment to its estimated tax for the succeeding year and interest was assessed on a deficiency, or portion thereof, that is equal to or less than the claimed overpayment before the claimed overpayment, or a portion thereof, was needed to avoid an addition to tax for failure to pay estimated tax, or to the extent that a portion of the overpayment was not needed to satisfy the specific installments of estimated tax, from the original due date of the succeeding year's income tax return. **Chief Counsel Notice N(35)000-165.**

**INTEREST RATE.** The IRS has announced that, for the period January 1, 2000 through March 31, 2000, the interest rate paid on tax overpayments is 8 percent (7 percent in the case of a corporation) and for underpayments is 8 percent. The interest rate for underpayments by large corporations is 10 percent. The overpayment rate for the portion of a corporate overpayment

exceeding \$10,000 is 5.5 percent. **Rev. Rul. 99-53, I.R.B. 1999-**

**PREPRODUCTIVE PERIOD EXPENSES.** The taxpayers purchased farm land in the first tax year and planted one-year old grape vines in the third tax year. The taxpayers did not claim any farming expenses as business deductions and did not file Schedule Fs for the first three years. The vines produced a sufficient quantity of grapes for sale in tax year four but the quantity was reduced by deer damage and was only 3.3 percent of mature vines. The fifth year crop was larger but was reduced by bird damage and was only 3.9 percent of a mature vine crop. The sixth year crop was larger still but suffered losses from mildew and was 39 percent of a mature vine crop. The seventh crop was unusually bountiful. The taxpayers were on the cash accounting method. The IRS ruled that the nationwide weighted average preproductive period for wine grapes was four years; therefore, the taxpayer was not eligible for the exemption from capitalizing preproductive costs. The IRS stated that the taxpayer had to capitalize preproductive costs until the vines produced a marketable quantity, which the IRS defined as a quantity which could be sold for an amount sufficient to recover production costs plus more than a de minimis recovery of investment costs. The IRS ruled that the taxpayer's vines did not produce a marketable quantity until the sixth year. The IRS disavowed its own Market Segment Specialization Program Paper for the Wine Industry which defined a "commercially harvestable crop" merely as a crop sufficient to recover the costs of production. The IRS also ruled that the preproductive expense capitalization period ended at the harvest of the first marketable crop in the sixth crop year, not at the beginning of the sixth crop year. Finally, the IRS ruled that, because the taxpayer planted the vines in the third tax year and incurred preproduction expenses in that year but did not make an explicit election to not capitalize preproduction expenses nor an implicit election by deducting the expenses currently, the taxpayer did not make an election to currently deduct preproduction expenses. Thus, the taxpayer was required to capitalize all preproduction expenses up to the time of the sixth crop harvest. **Ltr. Rul. 9946003, Aug. 6, 1999.**

**QUALIFIED DEBT INSTRUMENTS.** The IRS has announced the 2000 inflation adjusted amounts of debt instruments which qualify for the 9 percent discount rate limitation under I.R.C. §§ 483 and 1274:

Year of Sale or Exchange	1274A(b) Amount	1274A(c)(2)(A) Amount
2000	\$3,960,100	\$2,828,700

The \$3,960,100 figure is the dividing line for 1999 below which (in terms of seller financing) the minimum interest rate is the lesser of 9 percent or the Applicable Federal Rate. Where the amount of seller financing exceeds the \$3,960,100 figure, the imputed rate is 100 percent of the AFR except in cases of sale-leaseback transactions, where the imputed rate is 110 percent of AFR. If the amount of seller financing is \$2,828,700 or less (for 2000), both parties may elect to account for the interest under the cash method of accounting. **Rev. Rul. 99-50, I.R.B. 1999-**

**PENSION PLANS.** For plans beginning in November 1999, the weighted average is 5.99 percent with the permissible range of 5.39 to 6.29 percent (90 to 106 percent permissible range) and 5.39 to 6.59 percent (90 to 110 percent permissible range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). **Notice 99-54, I.R.B. 1999-**

**RETURNS.** The IRS has announced plans to test a new internet system for handling taxpayer account questions. The initial test

will involve only selected, established electronic return filers who are members of the National Association of Enrolled Agents. **IR-1999-95**.

The IRS has issued proposed regulations defining "last known address" in relation to the mailing of notices of deficiency and other notices, statements, and documents sent to a taxpayer's last known address. The proposed regulations affect taxpayers who receive notices of deficiency and other notices, statements, and documents sent to taxpayers' last known addresses. **64 Fed. Reg. 63768 (Nov. 22, 1999)**.

#### SAFE HARBOR INTEREST RATES

##### December 1999

	Annual	Semi-annual	Quarterly	Monthly
<b>Short-term</b>				
AFR	5.74	5.66	5.62	5.59
110 percent AFR	6.33	6.23	6.18	6.15
120 percent AFR	6.91	6.79	6.73	6.70
<b>Mid-term</b>				
AFR	6.20	6.11	6.06	6.03
110 percent AFR	6.83	6.72	6.66	6.63
120 percent AFR	7.46	7.33	7.26	7.22
<b>Long-term</b>				
AFR	6.47	6.37	6.32	6.29
110 percent AFR	7.13	7.01	6.95	6.91
120 percent AFR	7.79	7.64	7.57	7.52

**Rev. Rul. 99-48, I.R.B. 1999-\_\_\_**.

#### S CORPORATIONS-ALM § 7.02[3][c].\*

**ELECTION.** The IRS has adopted as final regulations describing how elective changes in an entity's classification will be treated for federal tax purposes. Under the regulations, there are four possible changes in classification by election: (i) a partnership elects to be an association; (ii) an association elects to be a partnership; (iii) an association elects to be a disregarded entity; and (iv) a disregarded entity elects to be an association.

The regulations provide a specific characterization for each of the four possible elective changes. In each case, the characterization provided in the regulations attempts to minimize the tax consequences of the change in classification and achieve administrative simplicity. The regulations provide that if an association elects to be classified as a partnership, the association is deemed to liquidate by distributing its assets and liabilities to its shareholders. Then, the shareholders are deemed to contribute all of the distributed assets and liabilities to the partnership. See also *Rev. Rul. 63-107, 1963-1 C.B. 71*.

If a partnership elects to be classified as an association, the partnership is deemed to contribute all of its assets and liabilities to the association in exchange for stock in the association. Then,

the partnership is deemed to liquidate by distributing stock in the association to its partners. The regulations do not affect the holdings in *Rev. Rul. 84-111, 1984-2 C.B. 88*, in which the IRS ruled that it would respect the particular form undertaken by the taxpayers when a partnership converts to a corporation.

If an association elects to be disregarded as an entity separate from its owner, the association is deemed to liquidate by distributing its assets and liabilities to its sole owner. Conversely, if an eligible entity that is disregarded as an entity separate from its owner elects to be classified as an association, the owner of the eligible entity is deemed to contribute all of the assets and liabilities of that entity to the association in exchange for stock of the association.

The regulations also provide that the tax treatment of an elective change in classification is determined under all relevant provisions of the I.R.C. and general principles of tax law, including the step transaction doctrine. This provision is intended to ensure that the tax consequences of an elective change will be identical to the consequences that would have occurred if the taxpayer had actually taken the steps described in the regulations. **64 Fed. Reg. 66580 (Nov. 29, 1999)**.

**TRUSTS.** The taxpayer was a medical doctor and formed a trust with the taxpayer as beneficiary. The taxpayer transferred the taxpayer's residence and assigned income to the trust which allowed the taxpayer to reside in the residence and paid the taxpayer for the taxpayer's services. The court held that the trust was a sham because it lacked any economic substance in that the taxpayer performed all the services that produced trust income and treated the trust property as the taxpayer's own. **George v. Comm'r, T.C. Memo. 1999-381**.

The taxpayers had owned and operated a family farm for more than 46 years when they transferred business and personal assets to a trust. The trustees were corporations formed by promoters of the trust scheme as a method of reducing the taxpayers' taxes. The court held that the trusts were sham entities created solely for tax evasion because the control over the farm and personal assets and income remained with the taxpayers. **Zachman v. Comm'r, T.C. Memo. 1999-391; Zachman v. Comm'r, T.C. Memo. 1999-392**.

## CITATION UPDATES

*In re Orr, 239 B.R. 130 (S.D. Tex. 1998), aff'd, 180 F.3d 656 (5th Cir. 1999)* (tax liens) see p. 168 *supra*.

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