

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

CHAPTER 12-ALM § 13.03[8].*

CONFIRMATION OF PLAN. The debtors had filed a previous Chapter 12 case which was dismissed because the debtors failed to make any payments to the major secured creditor, a bank. The debtors immediately refiled for the current Chapter 12 case and filed a proposed plan. The new plan changed several items which were included in the previous plan: (1) the bank's secured claim was decreased because some collateral was transferred to the debtors' corporation, (2) the projected income was reduced but remained more than the historical income for the farm, (3) the bank's secured claim interest rate was reduced, and (4) the value of the bank's collateral was reduced. The court found that the debtors had not provided any reasons for the changes to the bank's secured claim from the previous Chapter 12 plan, including the removal of some farm property from the list of collateral securing the bank's claim. The court characterized the new plan as an attempt to avoid portions of the secured claim without an adversary proceeding on the avoidance action. The court held that the reduction in interest rate on the secured claim was also improper without evidence that the reduced rate equaled the market rate for similar loans. In addition, the court held that the income projections were unreasonable given the recent history of the farm and the lack of any buffer between the income projections and the plan payments, even given the reduced collateral and interest rate. The court held that the plan violations and the circumstances of the immediate filing after a plan default in a previous Chapter 12 case demonstrated a bad faith filing and the court dismissed the case. *In re Szudera*, 269 B.R. 837 (Bankr. D. N.D. 2001).

FEDERAL TAX-ALM § 13.03[7].*

INTEREST. The debtor owned a residence which had a fair market value in excess of the nonrecourse indebtedness against it. The mortgagor obtained relief from the automatic stay to foreclose the mortgage and the property was sold to the mortgagor for less than the amount of indebtedness, with the remaining indebtedness discharged. The debtor sought to deduct the interest owed on the residence but the IRS argued that, because the residence sold for less than the fair market value, no part of the proceeds could be allocated to interest. The IRS also argued that, because the residence was property of the estate at the time of sale, any deductions accrued to the bankruptcy estate and not to the debtor personally. The Tax Court held that (1) the release of the automatic stay effected an abandonment of the residence such that the residence was no longer bankruptcy estate property at the time of sale and (2) in a foreclosure sale of a property with discharge of nonrecourse indebtedness, the amount of discharged indebtedness was deemed the amount received for the property. Because the

indebtedness included interest owed, the debtor was entitled to deduct the interest portion of the indebtedness discharged. The appellate court reversed, holding that the order releasing the automatic stay did not cause an abandonment of the residence because the order made no mention of any abandonment; therefore, the residence was bankruptcy estate property and any interest deduction belonged to the estate. *Catalano v. Comm'r*, 2002-1 U.S. Tax Cas. ¶ 50,203 (9th Cir. 2002), *rev'g*, T.C. Memo. 2000-82.

NET OPERATING LOSSES. The taxpayer was married to the decedent and filed a joint return for the year of the decedent's death. The decedent had been a debtor in bankruptcy when the decedent died; however, the decedent bankruptcy case continued after the decedent's death. The decedent, as debtor-in-possession, had net operating losses for the bankruptcy years and the taxpayer sought to include those net operating losses on the final joint income tax return. The IRS argued that the bankruptcy net operating losses were not available because the decedent died before the termination of the case. The court held that, under I.R.C. § 1398(j)(2), bankruptcy period net operating losses pass back to the "debtor" and, because the decedent was still considered the debtor after death, the NOLs passed to the decedent and were available on the taxpayer's last joint return. *Lassiter v. Comm'r*, T.C. Memo. 2002-25.

FEDERAL AGRICULTURAL PROGRAMS

CROP INSURANCE. The FCIC has issued proposed regulations which add a new section for the insurance of millet crops. The provisions will be used in conjunction with the Common Crop Insurance Policy Basic Provisions, which contain standard terms and conditions common to most crops. The intended effect of this action is to convert the millet pilot crop insurance program to a permanent insurance program administered by FCIC for the 2002 and succeeding crop years. **66 Fed. Reg. 3036 (Jan. 23, 2002).**

KARNAL BUNT. The APHIS has adopted as final regulations amending the karnal bunt regulations by adding Archer and Baylor counties in Texas to the list of regulated areas. **67 Fed. Reg. 3427 (Jan. 24, 2002).**

The APHIS has adopted as final regulations amending the karnal bunt regulations by adding Throckmorton and Young counties in Texas to the list of regulated areas. **67 Fed. Reg. 5041 (Feb. 4, 2002).**

FEDERAL ESTATE AND GIFT TAX

POWER OF APPOINTMENT. The decedent was the income beneficiary of two trusts created by the decedent's parent prior to 1942. The trust provided that, upon the decedent's death, the trust principal was to be paid as the decedent directed by power of appointment either by will or separate instrument. The power had no restrictions as to its beneficiaries, including the decedent's estate. If the power of appointment was not exercised, the trust principal was to be paid to the decedent's heirs. The decedent did not exercise the power of appointment and the trusts' principal passed to the decedent's heirs. Under I.R.C. § 2041(a)(1) a decedent's estate does not include property which was subject to a power of appointment created prior to October 21, 1942 if the power holder does not exercise the power. The IRS ruled that, under I.R.C. § 2041(a)(1), the trusts' principal was not included in the decedent's estate. **Ltr. Rul. 200205033, Nov. 1, 2001.**

VALUATION OF STOCK. The decedent owned 39 percent of the stock of a champagne making company. The issue was the value of the stock for estate tax purposes and the court approved the use of a discounted cashflow method for valuing the company. The court also approved a 25 percent discount in the value of the shares for lack of marketability and a 10 percent discount for the minority interest. **Estate of Heck v. Comm'r, T.C. Memo. 2002-34.**

FEDERAL INCOME TAXATION

ACCOUNTING METHOD. In *Notice 2001-76, I.R.B. 2001-52, 613*, announced a proposed revenue procedure that would permit certain small businesses with average annual gross receipts of \$10 million or less to use the cash receipts and disbursements method of accounting ("cash method") and to treat inventoriable items as non-incident materials and supplies ("materials and supplies method") with respect to eligible trades or businesses. The IRS has announced that any qualifying small business taxpayer within the scope of the proposed revenue procedure ("small business taxpayer") may change to these methods of accounting with respect to its eligible trades or businesses for any taxable year ending on or after December 31, 2001. The notice also provides procedures for obtaining automatic consent to change to these accounting methods. **Notice 2002-14, I.R.B. 2002-__.**

CAPITAL EXPENSES. The IRS has announced the intent to issue proposed regulation providing rules and standards that the IRS and Treasury Department expect to propose in 2002 that will clarify the application of I.R.C. § 263(a) to expenditures incurred in acquiring, creating, or enhancing certain intangible assets or benefits. The proposed regulations are expected to cover the following circumstances:

1. *Amounts Paid To Acquire Financial Interests.* Under the expected regulations, capitalization will be required for an amount paid to purchase, originate, or otherwise acquire a security, option, any other financial interest described in section 197(e)(1), or any evidence of indebtedness

2. *Amounts Paid To Acquire Intangible Property From Another Person.* Under the expected regulations, capitalization will be required for an amount paid to another person to purchase or otherwise acquire intangible property from that person.

3. *Amounts Paid To Create or Enhance Certain Intangible Rights or Benefits.* The proposed regulations will include a 12-month rule applicable to expenditures paid to create or enhance certain intangible rights or benefits. Under the rule, capitalization under Section 263(a) would not be required for

- (1) prepaid items;
- (2) certain market entry payments;
- (3) amounts paid to obtain certain rights from a governmental agency;
- (4) amounts paid to obtain or modify contract rights;
- (5) amounts paid to terminate certain contracts;
- (6) amounts paid in connection with tangible property owned by another; and

(7) defense or perfection of title to intangible property. unless that expenditure created or enhanced intangible rights or benefits for the taxpayer that extend beyond the earlier of (1) 12 months after the first date on which the taxpayer realizes the rights or benefits attributable to the expenditure, or (2) the end of the taxable year following the taxable year in which the expenditure is incurred.

4. *Transaction Costs.* The proposed rules will require a taxpayer to capitalize certain transaction costs that facilitate the taxpayer's acquisition, creation, or enhancement of intangible assets. In addition, this rule would require a taxpayer to capitalize transaction costs that facilitate the taxpayer's acquisition, creation, restructuring, or reorganization of a business entity, an applicable asset acquisition within the meaning of section 1060(c), or a transaction involving the acquisition of capital, including a stock issuance, borrowing, or recapitalization. However, this rule would not require capitalization of employee compensation (except for bonuses and commissions that are paid with respect to the transaction), fixed overhead (e.g., rent, utilities and depreciation), or costs that do not exceed a specified dollar amount, such as \$5,000. **67 Fed. Reg. 3461 (Jan. 24, 2002).**

CASUALTY LOSS. The taxpayers claimed a casualty loss for damage to a boat from a storm. The taxpayers presented photographs of the boat, allegedly before and after the storm. However, the post-storm pictures had dates on the back that indicated that the pictures were taken before the storm; therefore, the court held that the taxpayers could not claim the casualty loss deduction for the boat because the taxpayers failed to prove that the storm occurred or that the boat was damaged by a storm. **Stoddard v. Comm'r, T.C. Memo. 2002-31.**

DEPRECIATION-ALM § 4.03[4].* The IRS has issued tables detailing the (1) limitations on depreciation deductions

for owners of passenger automobiles first placed in service during calendar year 2002, including separate limitations on passenger automobiles designed to be propelled primarily by electricity and built by an original equipment manufacturer (electric automobiles); (2) the amounts to be included in income by lessees of passenger automobiles first leased during calendar year 2002, including separate inclusion amounts for electric automobiles; and (3) the maximum allowable value of employer-provided automobiles first made available to employees for personal use in calendar year 2002 for which the vehicle cents-per-mile valuation rule provided under Treas. Reg. § 1.61-21(e) may be applicable.

For automobiles (other than electric automobiles) placed in service in 2002 the depreciation limitations are as follows (the amounts are identical to 2001):

<u>Tax Year</u>	<u>Amount</u>
1st tax year.....	\$3,060
2d tax year.....	4,900
3d tax year.....	2,950
Each succeeding year	1,775

For electric automobiles placed in service in 2002 the depreciation limitations are as follows:

<u>Tax Year</u>	<u>Amount</u>
1st tax year.....	\$9,180
2d tax year.....	14,700
3d tax year.....	8,750
Each succeeding year	5,325

Rev. Proc. 2002-14, I.R.B. 2002-5, 450.

The taxpayer was self-employed as a consultant and claimed depreciation deductions for a vehicle used in the business. The taxpayer supported the deduction with two oil change receipts and a mileage log constructed during an IRS audit of the taxpayer’s return. The court held that the taxpayer was not allowed a depreciation deduction and could not claim any other deductions in excess of those allowed by the IRS based on the standard mileage rate, because the taxpayer failed to substantiate the business use of the vehicle. **Clark v. Comm’r, T.C. Memo. 2002-32.**

HOME OFFICE. The IRS has issued a consumer alert regarding home-based business schemes that purport to offer tax “relief.” The promoters of these schemes claim that individual taxpayers can deduct most, or all, of their personal expenses as business expenses by setting up a bogus home-based business. However, the tax code requires that there be a clear business purpose and profit motive in order to claim business expenses. **IR-2002-13.**

LABOR EXPENSES. The taxpayer was an airline pilot who was involved in airplane racing. The taxpayer claimed deductions for labor expenses during the period when the taxpayer was constructing a racing airplane. The court held that the labor expenses incurred to build the airplane had to be capitalized in the basis of the airplane and could not be deducted currently. Also, the airplane was not placed in service during the year so no depreciation was allowed. **Rose v. Comm’r, T.C. Summary Op. 2002-8.**

LIKE-KIND EXCHANGES. The IRS has adopted as final regulations amending the definition of “disqualified person” for

purposes of the like-kind exchange rules. Treas. Reg. § 1.1031(k)-1(k) defines a disqualified person to include an agent of the taxpayer at the time of the transaction. An agent includes a person that has acted as the taxpayer’s employee, attorney, accountant, investment banker or broker, or real estate agent or broker within two years of the taxpayer’s transfer of relinquished property. However, in determining whether a person is a disqualified person, services provided by such person for the taxpayer with respect to Section 1031 exchanges of property and routine financial, title insurance, escrow, or trust services provided to the taxpayer by a financial institution, title insurance company, or escrow company are not taken into account. Under Treas. Reg. § 1.1031(k)-1(k)(4), a person that is related to a disqualified person, determined by using the attribution rules of I.R.C. §§ 267(b), 707(b), but substituting 10 percent for 50 percent, is also considered a disqualified person.

As a consequence of the Gramm-Leach-Bliley Act, Public Law 106-102, 113 Stat. 1341 (1999), and other changes in policy by the Federal Reserve System in recent years, many banks are, or are in the process of becoming, members of controlled groups that include investment banking and brokerage firms. These new relationships between banks and investment banking and brokerage firms may make it difficult for some banks to continue their traditional practices of providing qualified escrow, qualified trust, and qualified intermediary services without violating the disqualified person rules. To allow banks to continue to perform these services, the regulations provide that a bank that is a member of a controlled group that includes an investment banking or brokerage firm as a member will not be a disqualified person merely because the related investment banking or brokerage firm provided services to an exchange customer within a two-year period ending on the date of the transfer of the relinquished property by that customer. **67 Fed. Reg. 4907 (Feb. 1, 2002), amending Treas. Reg. § 1.1031(k)-1(k).**

PASSIVE LOSSES. The taxpayer was the sole shareholder of a corporation which operated several retail businesses on property leased from the taxpayer. The losses from the activities were classified as passive activity losses because the taxpayer failed to prove that the taxpayer spent more than 500 hours annually on the activities. The court also upheld the recharacterization of income from the taxpayer’s real property rental activity as nonpassive and the losses from the activities as passive under the self-rented rule of Treas. Reg. § 1.469-2(f)(6). **Shaw v. Comm’r, T.C. Memo. 2002-35.**

The taxpayer was the sole shareholder of two C corporations which owned commercial buildings. One corporation leased its building to a third party and realized a net loss for the tax year. The other corporation leased its building to the shareholder’s law firm and realized net income for the tax year. The taxpayer offset the income and loss as both passive items. The IRS applied Treas. Reg. § 1.469-2(f)(6) to recharacterize the income as nonpassive, preventing offset against the passive loss. The court upheld the regulation as valid, citing *Schwalbach v. Comm’r, 111 T.C. 215 1998*). **Krukowski v. Comm’r, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,219 (7th Cir. 2002), aff’g, 114 T.C. 366 (2000).**

PENSION PLANS. For plans beginning in January 2002, the weighted average is 5.71 percent with the permissible range of 5.14 to 6.00 percent (90 to 106 percent permissible range) and 5.14 to 6.28 percent (90 to 110 percent permissible range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). **Notice 2002-9, I.R.B. 2002-5, 450.**

The IRS has issued a reminder to employers and retirement plan administrators that they must amend their calendar year employees' retirement plans to comply with the changes made by the "GUST" laws by the February 28, 2002, deadline. The deadline for non-calendar year plans is the last day of the plan's fiscal year that began in 2001. The deadline affects qualified retirement plans, including Section 401(k) plans, defined benefit pension plans, profit-sharing plans, ESOPs and Keogh plans. Plans directly affected by the September 11 terrorist attack have been given an automatic extension to June 30, 2002, with the possibility to extend that deadline to December 31, 2002, upon filing an application for extension. **IR-2002-19.**

The IRS has provided additional relief with respect to employee benefit plans for affected taxpayers who are unable to meet their federal tax obligations due to the September 11, 2001, terrorist attacks. Pursuant to the Victims of Terrorism Tax Relief Act of 2001 (P.L. 107-134) enacted on January 23, 2002, with respect to minimum funding requirements in the event of temporary substantial business hardship, if the dates described in I.R.C. § 412(c)(10), (m) and Section 302(c)(10)(e) of ERISA for making contributions to a plan fell within the period beginning on September 11, 2001, and ending on September 23, 2001, then the date on which such contributions must be made is postponed to September 24, 2001. If the date described in I.R.C. § 412(d)(4) and Section 303(d)(1) of ERISA for applying for a waiver of the minimum funding requirements fell within the period beginning on March 15, 2001, and ending on February 28, 2002, then the date on which such waiver must be applied for is postponed to March 1, 2002. With respect to plans that are directly affected by the terrorist attacks, if the date described in I.R.C. § 412(c)(10) or (m) and Section 302(c)(10) or (e) of ERISA for making contributions fell within the period beginning on September 11, 2001, and ending on February 11, 2002, then the date on which such contributions must be made is postponed to February 12, 2002. **Notice 2002-7, I.R.B. 2002-6.**

RETURNS. The IRS has announced that taxpayers in Maine, Massachusetts, Michigan, Rhode Island and upstate New York (north of Westchester and Rockland counties) will have an extra day to file income tax returns because this year's filing deadline falls on a state holiday where the IRS filing office is located, Andover, Mass. April 15, 2002, is Patriots' Day in Maine and Massachusetts. Taxpayers in Connecticut, New Hampshire and Vermont, who used to file at Andover, now send returns to Philadelphia, where April 15 is not a holiday and no extra day applies.

The IRS has announced that employers have until February 15, 2002, to furnish household employees with W-2 Forms showing wages paid and employment taxes withheld. The extension of time is a result of a delay in shipment of Package H, the forms and instruction booklets sent yearly to those who filed tax returns as household employers in the prior year, to

the IRS by its printer. Employers must still file Forms W-2 and W-3 with the Social Security Administration by February 28, 2002. **Ann. 2002-19, I.R.B. 2002-__.**

The IRS has announced the redesign of Schedule D, used to calculate capital gains and losses on the sales, exchanges and other disposition of investment property. On the redesigned form, 14 lines were cut to eliminate difficulty to the taxpayer, while four lines were added to enable taxpayers to take advantage of the new 8 percent rate on qualified capital gains. The redesigned form also eliminated 18 other lines to ease the potential burden that comes from calculating unrecaptured Section 1250 gains (generally related to the sale of real property) and the class of capital gains subject to the 28 percent rate. **IR-2002-15.**

S CORPORATIONS-ALM § 7.02[3][c].*

SHAREHOLDER BASIS. The taxpayer was the sole shareholder of a corporation which operated an insurance company. The taxpayer was also the majority shareholder in a corporation in the restaurant business. The insurance corporation made several payments to the restaurant corporation with the payments shown as loans on the restaurant corporation's books and as shareholder loans on the insurance corporation's books. The court held that the insurance corporation made the payments on behalf of the taxpayer and that the restaurant corporation was indebted to the taxpayer and not the insurance corporation for the payments. Therefore, the payments increased the taxpayer's basis in the restaurant corporation stock and allowed the taxpayer to take the taxpayer's share of the restaurant corporation's losses. The trial court determined the amount of the restaurant corporation's losses based upon a last minute raising of the issue by the IRS. The taxpayer argued on appeal that it was denied due process because the issue of the amount of loss was not raised in the petition or during the trial. In a case designated as not for publication, the appellate court affirmed the allowance of a deduction for the taxpayer's share of loss but reversed on the issue of the amount of loss, holding that the IRS failure to properly raise the issue precluded the trial court from changing the amount of loss deduction once it had been held that the taxpayer was entitled to a loss deduction. **Culnen v. Comm'r, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,200 (3d Cir. 2001), aff'g in part and rev'g in part, T.C. Memo. 2000-139.**

TRAVEL EXPENSES. The taxpayer was an airline pilot who was involved in airplane racing. The taxpayer claimed travel expenses during the period when the taxpayer was constructing a racing airplane. Although the taxpayer was stationed as a pilot in several other cities, the taxpayer maintained a residence in the city where the plane was constructed. The taxpayer claimed travel expenses for trips to the city of residence to work on the plane. The taxpayer claimed the per diem rate for travel expenses listed in *Rev. Proc. 94-77, 1994-2 C.B. 825*. The taxpayer did not keep records of the time and place of the alleged business activity but only substantiated the business purpose of each trip. The court held that the per diem rate was not available for use by self-employed individuals and that the expenses could not be deducted for lack of substantiation. In addition, the court held

that the travel expenses were not deductible because the travel was to the taxpayer's city of residence. **Rose v. Comm'r, T.C. Summary Op. 2002-8.**

LANDLORD AND TENANT

OPTION TO PURCHASE. The plaintiff's decedent leased real property to the defendant and the lease agreement allowed the plaintiff's decedent to continue to live on the property and granted the defendant an option to purchase the property at a certain price. When the decedent died, the decedent's family continued to live on the property although the lease did not allow them to do so. The residence was destroyed by fire and the decedent's family left the property. Nearly two years after the fire, the defendant served notice to exercise the option at the agreed upon price, without any reduction for the loss of the residence. The plaintiff sued for unpaid rent and damages and the defendant sought specific performance of the purchase option; however, the defendant sought a reduction in the option price to compensate for the loss of the residence. The court held that, once the option had been exercised without reservation, the defendant was not entitled to any abatement for the loss of the residence because the loss occurred before the option was exercised. **Riddle ex rel. Riddle v. Elk Creek Salers, 52 S.W.3d 644 (Mo. Ct. App. 2001).**

PROPERTY

EASEMENT. The plaintiff owned and operated a grain elevator neighboring a foundry owned by the defendant. The plaintiff had filed suit against the defendant for recognition of an easement over a portion of the foundry property for use as switch track for railroad cars. The switch track allowed the plaintiff to load a sufficient number of railroad cars so as to qualify for a \$100/car discount. Although the easement was declared by a court, the defendant continued to hamper the plaintiff's use of the switch track by placing a gate on the easement area. The trial jury found that the defendant unreasonably prevented the plaintiff's reasonable use of the easement and awarded actual damages and prejudgment interest. The defendant appealed the jury verdict, arguing that there was no evidence to support the jury finding and that the plaintiff did not suffer any damages because the plaintiff could otherwise qualify for the large car discount. The appellate court affirmed the jury verdict as based on sufficient evidence. **Taylor Foundry Co. v. Wichita Falls Grain, 51 S.W.3d 766 (Tex. Ct. App. 2001).**

SECURED TRANSACTIONS

INSURANCE PROCEEDS. The defendants had borrowed money from the FSA for their ranch and had granted a mortgage to the FSA in the property, including a residence. Under the loan agreement, the defendants were required to

carry insurance on the house and did so. The house was destroyed by a fire and the insurance company paid the defendants the value of the house. The defendants used the proceeds to purchase a mobile home which was placed on other property. The defendants defaulted on the FSA loan and the ranch was sold upon foreclosure for an amount less than the loan balance. The FSA sought an equitable lien against the new house, claiming that, without the lien, the defendants would be unjustly enriched. The court held that the FSA lien against the house continued as to the insurance proceeds since the loan agreement required the defendants to carry insurance. The court also held that the doctrine of unjust enrichment applied to support an equitable lien against the new house. The court found that all five factors supported unjust enrichment: (1) enrichment of the defendants through the acquisition of the mobile home without a lien, (2) impoverishment of the FSA through the loss of its lien, (3) a link between the enrichment of the defendants and the impoverishment of the FSA, (4) lack of any justification for the enrichment or impoverishment, and (5) lack of a other legal remedy for the FSA. The court held that the amount of the lien was the amount of insurance proceeds plus interest. **In re Wilson, 269 B.R. 829 (Bankr. D. N.D. 2001).**

STATE TAXATION

AGRICULTURAL USE. The defendant bank acquired farm property through foreclosure and leased the property for several years to someone who was supposed to farm the land. The land was taxed as farmland and was subject to rollback taxes if the land was not used for farming. Apparently, the tenant did not actually farm the land in 1991 through 1993. The plaintiff had purchased the land from the defendant bank in December 1995 and the deed warranted that no existing encumbrance existed except as shown in public records. However, in 1996, the plaintiff was assessed rollback taxes for 1991 through 1993, based upon a determination made in June 1996 by the county tax appraiser. The plaintiff sued for breach of the deed warranty, claiming that the rollback taxes were an encumbrance when the deed was transferred. The plaintiff sought recovery of the rollback taxes paid. The court held that Tex. Tax Code § 23.55(a) requires a determination by the chief appraiser before a rollback tax and lien can attach to a property. Because the plaintiff failed to provide evidence of a chief appraiser's determination prior to the transfer of the deed, no breach of the deed warranty occurred. There was no discussion of the defendant's liability based upon its knowledge of the tenant's failure to farm the property. **Compass Bank v. Bent Creek Investments, 52 S.W.3d 419 (Tex. Ct. App. 2001).**



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