value of the note, as the court suggests, but its basis. The Ninth Circuit's position that a shareholder note given in a tax-free exchange to a controlled corporation should receive a basis seems wide of the mark in terms of well-established tax law.

**The Second Circuit decision**

The *Peracchi* court, while following somewhat different reasoning, reached the same essential conclusion as *Lessinger v. Commissioner*[14] decided nearly a decade earlier. In *Lessinger*, no gain was recognized on the transfer of the taxpayer's sole proprietorship assets and liabilities to the taxpayer's wholly-owned corporation even though the liabilities exceeded the basis. The *Lessinger* court held that the gain was eliminated by the shareholder's contribution of a personal promissory note. The *Lessinger* decision was widely criticized at the time as an attempt to find a solution to a taxpayer's unfortunate plight.

**Possible solutions to the problem**

As a planning matter, if the problem of indebtedness in excess of basis is spotted in time, several solutions are possible.[15]

- Halt the transfer before conveyance of the assets and liabilities to the corporation.
- Contribute cash to the corporation sufficient to elevate the aggregate basis to the level of indebtedness.
- Leave assets with high indebtedness and low basis in the hands of the transferor.
- Arrange with the creditors for some of the indebtedness to remain with the transferor and be secured with stock received in the exchange rather than with the transferred assets.

**Policy solutions**

The case of *Lessinger v. Commissioner*[16] could be dismissed as an aberrational result from a court displaying judicial sympathy for a taxpayer caught in a trap of tax liability from a seemingly innocent transfer. The decision in *Peracchi*[17] makes it more difficult to ignore the problem.

One possibility is for IRS to recognize a negative basis in such situations, with recognition of the gain postponed, a result which the Service has loathed in the past.[18] Another is for Congress to amend I.R.C. § 357(c) to make it clear that the reading of the subsection by the Second and Ninth Circuits is incorrect. That policy solution seems to be a remote possibility, at best. The other policy solution is to concede that promissory notes, even to a controlled corporation, can be viewed as contributing basis to absorb liabilities taken over in the transfer.[19]

**FOOTNOTES**

1 I.R.C. § 351. See generally 7 Harl, *Agricultural Law* §§ 53.02-53.05 (1998); Harl, *Agricultural Law Manual* § 7.02[2][c] (1998). See also Harl, "Indebtedness in Excess of Basis," 1 *Agric. L. Dig. 185* (1990).

2 See 7 Harl, *supra* n. 1, § 53.03[d]; Harl, *supra* n. 1, § 7.02[2][c][i].

3 I.R.C. § 358(d).

4 I.R.C. § 357(c). See, e.g., Owen v. Comm'r, 881 F.2d 832 (9th Cir. 1989) (liabilities secured by personal guarantee for which guarantors remained liable not excluded). Compare Beaver v. Comm'r, T.C. Memo. 1980-429 (entering of loans on corporate books and use of corporate funds to repay sufficient for assumption); Ltr. Rul. 8331035, April 28, 1983 (upon incorporation of farm partnership by two equal partners, each would recognize gain to extent their respective shares of partnership liabilities exceeded adjusted basis of their respective interests in partnership); Ltr. Rul. 8331036, April 28, 1983 (same); Ltr. Rul. 9640001, Nov. 29, 1994 (shareholder's basis in stock was zero; building subject to liabilities in excess of basis).

5 Rev. Rul. 68-55, 1968-1 C.B. 140.

6 143 F.3d 487 (9th Cir. 1998).

7 See Lessinger v. Comm'r, 872 F.2d 519 (2d Cir. 1989), *rev'g*, 85 T.C. 824 (1985).

8 143 F.3d 487 (9th Cir. 1998).

9 *Id*.

10 Peracchi v. Comm'r, T.C. Memo. 1996-191.

11 1968-2 C.B. 154.

12 *Id*.

13 See Peracchi v. Comm'r, 143 F.3d 487 (9th Cir. 1998).

14 872 F.2d 519 (2d Cir. 1989).

15 See Harl, "Indebtedness in Excess of Basis," 1 *Agric. L. Dig*. 185 (1990).

16 872 F.2d 519 (2d Cir. 1989).

17 143 F.3d 487 (9th Cir. 1998).

18 See Shepherd, "Negative Basis, Economic Exposure and Runaway Metaphors," 80 *Tax Notes* 676 (1998).

19 See Bogdanski, "One Thumb Up for Peracchi," 79 *Tax Notes* 911 (1998). Compare Raby and Raby, "'Sorcery' Creates Tax Basis from 'Piece of Paper'," 79 *Tax Notes* 873 (1998).

# CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

## BANKRUPTCY

### GENERAL-*ALM* § 13.03.*

**AVOIDABLE TRANSFERS.** The debtor livestock corporation and a grain trading corporation were owned by the same person. The shareholder caused funds to be withdrawn from the grain trading corporation to meet margin calls for both corporations. The shareholder was not authorized to make this withdrawal and the bank sought recovery of the funds. The shareholder then withdrew funds from the debtor's account and paid them to the commodity broker who transferred the funds to the grain trading corporation's account, restoring the improperly withdrawn funds. The bankruptcy trustee sought recovery of the funds, under Section 550(a)(1) from the bank as an "entity for whose benefit such transfer was made." The court held that the bank did not meet this requirement because the bank received the funds transferred. Because the funds were first transferred to the commodity broker, the bank was also not an initial transferee from whom recovery could have been made

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under Section 550(a)(1). Although the result in this case is fair, the holding opens a loophole to debtors to circumvent the avoidable transfer rules by simply transferring funds to an intermediary which then transfers the funds to the intended transferee. Query: Is not the purpose of Section 550(a)(1) to allow recovery from the entity which received the benefit and thus had the means to repay the avoided transfer? ***In re*** **KZK Livestock, Inc., 221 B.R. 483 (Bankr. C.D. Ill. 1998)**.

**FEDERAL TAXATION-*ALM* § 13.03[7].***

**ADMINISTRATIVE EXPENSES**. As part of the debtors' reorganization plan, the debtors entered into a sale and debt refinancing loan and incurred expenses. The debtors supplied information about the total expenses without itemizing the amount and purpose of each expense. The debtors argued that all of the expenses were deductible as administrative expenses because the sale/loan transaction was part of the bankruptcy reorganization. The IRS argued that some of the expenses were business expenses but the expenses associated with the refinancing were to be capitalized over the loan term. The court held that the burden of proof on the character of the expenses was on the debtors because the debtors raised the issue in a motion to determine tax liability. The court held that, because the debtors failed to provide detailed evidence of the loan/sale transaction and the purpose of each expenditure, the IRS determination of the allowed deductions would be upheld. ***In re*** **Carden, 98-2 U.S. Tax Cas. (CCH) ¶ 50,686 (Bankr. E.D. La. 1998)**.

**AUTOMATIC STAY**. The debtor had filed a joint income tax return for 1988 with the debtor's nondebtor spouse. The tax claim for that year included self-employment taxes. After the debtor filed for bankruptcy, the IRS sought collection of the taxes from the nondebtor spouse and the debtor sought enforcement of the stay against nondebtor co-obligors on consumer debts. The IRS argued that taxes were not consumer debts. The court held that the taxes were a consumer debt because the debtor had no profit motive from incurring the tax debt and the income subject to the taxes was used for personal expenses. ***In re*** **Westberry, 219 B.R. 976 (Bankr. M.D. Tenn. 1998)**.

**DISCHARGE**. The debtor did not file income tax returns for 1981 and 1982. In June 1986, the IRS constructed a substitute return and filed a deficiency notice for taxes due based on the substitute return. The debtor supplied the IRS with sufficient information to determine the correct taxes and eventually reached a stipulated Tax Court decision for the amount of taxes owed. No Form 1040 was ever filed for either year. Under I.R.C. § 6020(a) a return is deemed filed when a taxpayer discloses information necessary to prepare a return and signs a disclosure statement. The evidence was unclear as to whether the debtor ever signed any disclosure statement. The debtor filed for bankruptcy in September 1992 and received a discharge. The issue was whether the debtor's cooperation with the IRS was sufficient to make the 1981 and 1982 taxes dischargeable under Section 523. The court held that the information supplied by the debtor was sufficient to make the taxes dischargeable. ***In re*** **Ashe, 98-2 U.S. Tax Cas. (CCH) ¶ 50,675 (C.D. Calif. 1998)**.

The debtor failed to file tax returns for 1983 through 1989 and the IRS issued deficiency notices for taxes for those years based on W-2 forms supplied by the debtor's employer. The debtor appealed the deficiency to the Tax Court and eventually entered into a stipulation with the IRS as to the tax liability for those years. The IRS then assessed the taxes and within a month of the assessment, the debtor filed income tax returns which contained only the amount of wages and the stipulated amount of taxes due. The IRS argued that the returns were insufficient for Section 523(a)(1)(B) because the returns were filed after the taxes were assessed. The court held that the returns were effective under Section 523 because the returns were in compliance with the stipulations in the Tax Court case and Section 523(a)(1)(B) had no requirement that the returns be filed before any assessment. ***In re*** **Pierchoski, 220 B.R. 20 (Bankr. W.D. Pa. 1998)**.

The debtor filed income tax returns for 1979, 1980 and 1981 but the returns contained only the debtor's name, address, social security number and signature. The court held that these returns were not sufficient under Section 523(a)(1)(B) to make the taxes dischargeable. ***In re*** **Hillman, 221 B.R. 281 (Bankr. S.D. Fla. 1998)**.

**SET OFF**. The debtor filed for bankruptcy in 1988 and paid FUTA taxes for 1987 and 1989 in 1991. In 1992, the debtor paid state unemployment taxes for 1987 and 1989 and filed a claim for refund of FUTA taxes for those years. The estate sought recovery of the refund and the IRS sought to offset the refund against other tax claims filed in the bankruptcy case. The issue was the date the refund claim arose, when the FUTA taxes were originally due, when the FUTA taxes were paid or when the state tax was paid. The court held that no refund claim existed until the state unemployment taxes were paid. Because the state taxes were paid post-petition, the refund claim was a post-petition claim not entitled to offset the pre-petition tax claims. ***In re*** **Gordon Sel-Way, Inc., 98-2 U.S. Tax Cas. (CCH) ¶ 50,676 (Bankr. E.D. Mich. 1998)**.

# CONTRACTS

**HEDGE-TO-ARRIVE CONTRACTS**. In a proceeding before the Commodity Futures Trading Commission, hedge-to-arrive contracts were determined to be futures contracts subject to the Commodity Exchange Act. The respondents were an unregistered grain marketing consulting firm, a registered introducing broker firm and an individual who owned both firms and who was a registered associated person with an unrelated registered introducing broker firm. The respondents held seminars, published a newsletter and advised clients about using hedge-to-arrive contracts. The seminars promoted the HTAs as risk-free and failed to explain the risks from increasing grain prices and the inability to roll over the contracts several times. The CFTC ruled that the respondents were acting as commodity trading advisors and that the HTAs were off-exchange futures contracts; therefore, the respondents committed fraud, under Section 4(b) of the Commodity Exchange Act in misrepresenting the risks of the contracts. The CFTC ruled that the HTAs met all the factors of a futures contract in that the contracts provided "an effective means of discharge or offset that was, in practice, used routinely to liquidate the contract for cash with no delivery of grain required. … In addition, the contract was marketed, entered into and structured as a means of capturing price movements in the futures markets, not as a vehicle for delivery." The CFTC also held that the HTAs did not meet the exception provided for cash forward contracts with set delivery dates, because the deferral of delivery was not made "to accommodate commercial convenience or necessity" but was made routinely to capture price movements in the futures market. **In the Matter of Competitive Strategies For Agriculture, Ltd., CFTC Docket No. 98-4 (Aug. 27, 1998)**.

# FEDERAL AGRICULTURAL PROGRAMS

**BRUCELLOSIS**. The APHIS has issued interim regulations amending the brucellosis regulations concerning the interstate movement of cattle by changing the classification of Florida from Class Free to Class A. **63 Fed. Reg. 44544 (Aug. 20, 1998)**.

**SHARED APPRECIATION AGREEMENTS**. The FSA has adopted as final regulations governing payments of appreciation under shared appreciation agreements. The appreciation payments are due when (1) the agreement expires; (2) the property or a portion of the property (in which case a portion of the appreciation is due) is disposed of; (3) the loans are satisfied; (4) the borrower ceases farm operations or no longer has farm income; or (5) the notes are accelerated. **63 Fed. Reg. 6627 (Feb. 10, 1998)**.

# FEDERAL ESTATE AND GIFT TAX

**CLAIMS**. The decedent had made an agreement with an unrelated person to provide personal services to the decedent in exchange for one-third of the decedent's estate. After eight years of service, however, the decedent decided to remove the caregiver from the will. After the decedent's death, the caregiver filed a claim against the estate for one-third of the estate. The caregiver received a jury verdict for $75,000 as compensation for the services rendered but the caregiver received $400,000 under a settlement with the estate. The IRS argued that the estate was entitled to a deduction only for $75,000 because the jury verdict determined the value of the caregiver's claim. The court held that the entire amount paid was allowed as a deduction from the estate because, at the time of the agreement between the decedent and the caregiver, both parties gave full and adequate consideration for their portion of the agreement. The court held that the caregiver's promise to provide lifetime services to the decedent was sufficient consideration for the decedent's promise to bequeath one-third of the estate. The court held that events which occurred after the execution of the agreement were not relevant in determining whether full and adequate consideration was given at the time of the agreement. **Estate of Wilson v. Comm'r, T.C. Memo. 1998-309**.

**DISCLAIMER**. The decedent died intestate, because the decedent's will could not be found, and the surviving spouse and the decedent's father decided to take the decedent's estate under the provisions of the prior will. Property which passed to the father under the state laws of inheritance was renounced by the father in a written irrevocable and unqualified statement. The spouse executed a trust in which all of the decedent's farm property passed. Under the trust, the farm property was operated as it had been when the decedent was alive, as a partnership with the father. Therefore, the disclaimed property passed to the spouse's trust. A short time later, the trust and the father exchanged properties so that the father's property was all in one county near the father's residence. The IRS argued that the disclaimer was not effective because the father received consideration or other value in exchange for the disclaimer. The court found that the transactions were all separate and not made in exchange for each other. The disclaimer was made in order to remove the decedent's property from the father's estate and the trust was formed to maintain the decedent's business operations. The estate was eligible for a marital deduction for the disclaimed property which passed to the trust for the surviving spouse. **Estate of Lute v. United States, 98-2 U.S. Tax Cas. (CCH) ¶ 60,321 (D. Neb. 1998)**.

**JOINT TENANCY PROPERTY**. The decedent owned several properties in joint tenancy with another person who was the decedent's domestic companion. The companion had separate income which was commingled with the decedent's in bank accounts. The companion also provided services for some of the properties which were residential rental properties. The decedent's estate claimed only one-half of the value of each property in the decedent's gross estate, claiming that the companion provided either money or services to the properties. The court held that where the estate had proved the value of the companion's services and the amount of money contributed to the cost of the property, the value of the property included in the estate would be reduced by those amounts. The decedent's residence was not decreased by the services provided by the companion because the companion also used the property as a residence. The estate also sought to decrease the value of the decedent's interests in the property by a discount for a fractional interest. The court held that I.R.C. § 2040 had no provision for reduction of value of estate joint tenancy property for a fractional interest. **Estate of Fratini v. Comm'r, T.C. Memo. 1998-308**.

**PENSION PLAN**. The decedent owned an interest in a pension plan and had named the decedent's estate as sole beneficiary. The surviving spouse was the executrix and, with the other heirs, executed disclaimers of various interests in the estate such that the spouse would receive a pecuniary bequest from the estate. The spouse, as executrix, then caused the amount in the pension plan to be distributed directly to the spouse with a rollover to an IRA in the spouse's name. The IRS ruled that the pension plan funds would not be included in the spouse's gross income. **Ltr. Rul. 9835005, May 22, 1998**.

**SPECIAL USE VALUATION-*ALM* § 5.03[2].*** The IRS has announced that it acquiesces in *Est. of Hoover v. Comm'r, 69 F.3d 1044 (10th Cir. 1995), rev'g, 102 T.C. 777 (1994)*. The Tax Court had held that an estate could not claim a minority discount if a special use valuation election is made. The appellate court reversed, holding that no statute or regulation prevented the use of discounting factors in determining the fair market value of interests in partnerships for purposes of the special use valuation election where the $750,000 maximum reduction of the gross estate had been reached for purposes of special use valuation. See, Harl, "'Stacking' Deductions for Special Use Valuation and Minority Discount," 7 *Agric. L. Dig.* 9 (1996). **I.R.B. 1998-__, __**.

**TRUSTS**. The taxpayers, husband and wife, established an irrevocable trust for their minor daughter. The settlor-father was a co-trustee of trust, and the trust instrument did not preclude the settlor-mother from becoming a co-trustee. The trust instrument provided that the settlors, in their capacities as trustees, had no power or authority with respect to discretionary distributions of income or principal from the trust. Moreover, in their capacities as trustees, the settlors had no power or authority with respect to the appointment of successor trustees. The non-settlor trustee, who was the father of the settlor-father and the grandfather of the beneficiary, had the power to distribute to the beneficiary so much of the income and principal of the trust "as he deems proper" for certain purposes, including the beneficiary's health, education, support and maintenance. The settlors had a legal obligation to support the beneficiary as their minor child. The IRS interpreted state law as imposing a fiduciary duty on the non-settlor trustee to act independently of the settlors in exercising the discretionary power of distribution. The IRS ruled that, provided there was no implied or express understanding or agreement that the non-settlor trustee would exercise the power of distribution other than independently of the settlors, the trust property would not be included in the gross estate of either settlor under I.R.C. § 2036 or § 2038. **Ltr. Rul. 9834004, May 14, 1998; Ltr. Rul. 9834005, May 14, 1998**.

**UNIFIED CREDIT**. The decedent's will bequeathed in trust to the surviving spouse "an amount equal to the unified credit as provided under the Internal Revenue Code, as amended, and as existing at the time of my death.…" The surviving spouse petitioned a Florida court for an interpretation of that bequest and the court ruled that the decedent intended the bequest to equal "the largest amount permitted to pass at Decedent's death that will not result in the imposition of a Federal Estate Tax with respect to his estate, after allowing for transfers made during his lifetime and any credits and deductions permitted to enable his estate to take full advantage of the maximum value of assets sheltered by the unified credit provision of the Internal Revenue Code." The IRS ruled that it was not necessarily bound by the state court ruling, citing *Commissioner v. Estate of Bosch, 387 U.S. 456 (1967)*; however, the IRS ruled that the state court ruling was an accurate interpretation of the will under state law and would apply for federal estate tax purposes. **Ltr. Rul. 9834027, May 26, 1998**.

**VALUATION**. The decedent owned a residence as joint tenant with a sister. Each contributed one-half of the purchase price. For federal estate tax purposes, the value of the property included in the decedent's estate was determined by the estate by including one-half of the current value less a discount for lack of control. The IRS ruled that I.R.C. § 2040 had no provision for discounting the value of estate property held in joint tenancy for lack of control. **FSA 1993-0908-2 (Sept. 8, 1993). See also Estate of Fratini, *supra* under Joint Tenancy Property.**

The decedent was a majority shareholder in a small closely-held corporation. The shareholders had entered into a stock restrictive sale agreement in 1960 which provided for redemption of stock if a shareholder left the company. In 1987, as part of the decedent's plan to leave control of the company with an employee but to reduce the estate tax burden on the decedent's heirs, the decedent executed another stock buy-sell agreement which established the value of the stock for redemption by the decedent's estate. Any unredeemed stock was to pass to the employee. The corporation was required to redeem so much of the decedent's stock as necessary to pay federal and state taxes on the estate. The Tax Court held that the agreement was not unenforceable because of I.R.C. § 2703, because the stock agreement was executed prior to the effective date of I.R.C. § 2703. However, the buy-sell agreement was held to be ineffective to set the stock value because the agreement had a testamentary purpose to pass estate property to "the natural object" of the decedent's bounty. Therefore, the stock was valued at fair market value at the time of the decedent's death (actually, in this case the alternate valuation date was elected). The appellate court reversed, holding that the employee did not have a sufficiently close relationship with the decedent to be considered a natural object of the decedent's bounty. The court pointed out that the redemption agreement left the employee with less assets than held before the decedent's death. The court upheld the redemption agreement value of the stock, noting that the value was determined by objective methods. **Estate of Glockner v. Comm'r, 98-2 U.S. Tax Cas. (CCH) ¶ 60,323 (2d Cir. 1998), *rev'g*, T.C. Memo. 1996-148**.

**VALUATION OF STOCK**. The taxpayer owned shares of stock in a C corporation which owned one asset, a building leased to business tenants. The taxpayer made gifts of stock to family members and valued the stock gifts by first determining the value of the corporation's asset less the tax costs of corporate liquidation and then discounting the fair market value of the stock by a 25 percent minority interest discount. The Tax Court found that no sale of the corporation's asset was contemplated or necessary and that the donees had the power to prevent recognition of the built-in gains indefinitely. The Tax Court held that neither the costs of sale nor the tax costs of liquidation could reduce the fair market value of the corporation's asset for gift tax purposes. The appellate court reversed, holding that the tax liability of the corporation for capital gains from the sale of corporate assets was a factor in determining the fair market value of stock. The appellate court stated that "a hypothetical willing buyer, having reasonable knowledge of the relevant facts, would take some account of the tax consequences of contingent built-in capital gains on the sole asset of the corporation at issue in making a sound valuation of the property." The appellate court rejected the argument that, where no corporate liquidation was planned, any capital gains liability was too speculative. **Eisenberg v. Comm'r, 98-2 U.S. Tax Cas. (CCH) ¶ 60,322 (2d Cir. 1998), *rev'g and rem'g*, T.C. Memo. 1997-483**.

# FEDERAL INCOME TAXATION

**AUDITS**. The IRS has issued a "Market Segment Specialization Program Training Guide, Hardwood Timber Industry, General Program Examination." The guide is used by IRS agents as a reference tool for audits. **IRPO ¶ 206,501**.

The IRS has issued a "Market Segment Specialization Program Training Guide--Farming, Specific Income Issues and Farm Cooperatives." The guide is used by IRS agents as a reference tool for audits. The guide provides information on unreported income, gross v. net proceeds, government farm programs, cooperatives, livestock, and row crops. **IRPO ¶ 204,581**.

**CORPORATIONS-*ALM* § 7.02.***

REORGANIZATIONS. *Rev. Rul. 70-225, 1970-1 C.B. 80, as modified by Rev. Rul. 98-27, I.R.B. 1998-22, 4,* addressed a distribution of the stock of a newly formed controlled corporation followed by an acquisition of the stock of the controlled corporation. The IRS has announced that *Rev. Rul. 70-225* is no longer determinative following enactment of Section 1012 of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788, 914-18 as amended in Sec. 6010(c) of the Tax Technical Corrections Act of 1998, Pub. L. No. 105-206, 112 Stat. 790, 813-14, which modified certain provisions in I.R.C. §§ 351, 355, and 368. **Rev. Rul. 98-44, I.R.B. 1998-__, __**.

**COURT AWARDS AND SETTLEMENTS**. The taxpayers had sued a doctor for medical malpractice and obtained a jury award which included pre-judgment interest. During the appeal process, the parties executed a settlement agreement for an amount larger than the jury award but less than the total award with interest. The taxpayers excluded the entire settlement proceeds as payment for personal injuries. The court held that, where a judgment has been obtained and the judgment contained an award of pre-judgment interest, a pro rata portion of a settlement must be allocated to pre-judgment interest. The court held that pre-judgment interest was not part of the “damages” received for personal injuries and was included in the taxpayers’ income. **Rozpad v. Comm’r, 98-2 U.S. Tax Cas. (CCH) ¶ 50,672 (1st Cir. 1998)**.

**ENVIRONMENTAL CLEANUP COSTS**. The IRS has issued a revenue procedure providing procedures for taxpayers to make the election under I.R.C. § 198 to deduct any qualified environmental remediation expenditure (QERE). A "qualified environmental remediation expenditure" is any expenditure that is otherwise chargeable to the capital account and that is paid or incurred in connection with the abatement or control of hazardous substances as a qualified contaminated site. However, under I.R.C. § 198(b)(2) a QERE does not include any expenditure for property subject to an allowance for depreciation, except that the portion of the allowance for depreciation of such property that is otherwise allocated to a qualified contaminated site is treated as a QERE. **Rev. Proc. 98-47, I.R.B. 1998-__, __**.

**HOBBY LOSSES-*ALM* § 4.05[1].*** The taxpayer was a dentist and purchased a farm to operate an Arabian horse breeding activity. The activity produced seven straight years of losses; however, the court held that the activity was operated with the intent to make a profit, based on the following factors: (1) the taxpayer maintained complete and accurate financial and breeding records; (2) the taxpayer had a business plan to develop the activity into a profitable business and modified the plan to reduce expenses; (3) a separate bank account was maintained; (4) the horses were actively marketed; (5) the taxpayer sought expert advice on horse breeding and farm management; (6) the taxpayer put much hard work and long hours into the activity and seldom used the horses for personal pleasure; and (7) most of the losses resulted from unforeseen circumstances beyond the taxpayer’s control and the losses were decreasing. **Morley v. Comm’r, T.C. Memo. 1998-312**.

**INVOLUNTARY CONVERSIONS**. The taxpayer operated a citrus tree nursery. The trees were destroyed in 1985 as part of a state citrus canker eradication program and the taxpayer received $32,000 in compensation for the destroyed trees. The taxpayer did not claim the proceeds as income on the 1985 return and did not make the election for deferral of gain under I.R.C. § 1033. The state established a reimbursement program and the taxpayer applied for additional compensation. The taxpayer received $1.3 million in 1992 in additional compensation for the destroyed trees, with $500,000 designated as interest. The taxpayer used the proceeds to purchase other farm land, a house and a vacation. None of the proceeds was used to purchase new trees. The taxpayer claimed only the interest payment as “other income” and did not include the rest of the settlement in income. Again, no election under I.R.C. § 1033 was made. The taxpayer argued that, because the gain was realized in two separate payments, the taxpayer was entitled to two separate periods in which to make the Section 1033 election. The court held that the statute did not provide for more than one two year period for purchase of replacement property; therefore, the second payment did not start a new two year replacement period. Because the replacement property was purchased more than two years after the original compensation award payment, no deferral of gain was allowed. The court noted that the taxpayer could have made the election with the first payment and sought an extension of the two year replacement period to allow the taxpayer to take advantage of the deferral when the second payment was received. The court also held that the farm land, house and vacation were not eligible replacement property for the destroyed citrus trees. ***In re* Mahon, 98-2 U.S. Tax Cas. (CCH) ¶ 50,684 (Bankr. M.D. Fla. 1998)**.

**PENSION PLANS**. For plans beginning in August 1998, the weighted average is 6.51 percent with the permissible range of 5.86 to 6.90 percent (90 to 109 percent permissable range) and 5.86 to 7168 percent (90 to 110 percent permissable range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). **Notice 98-44, I.R.B. 1998-__, __**.

**RENTAL ACTIVITY**. The taxpayer was hired by movie production companies to provide carpentry services. As part of the compensation, the taxpayer charged actual expenses, including rental of the taxpayer’s tools. The taxpayer claimed all of the expenses on Schedule C as business expenses, resulting in a net loss. The expenses included car and truck use, legal and professional fees, office expenses, supplies, taxes and licenses, meals and entertainment, equipment rental, home office, location travel, telephone and union dues. The IRS argued alternatively (1) the taxpayer’s leasing of the tools was a passive activity, disallowing losses or (2) the expenses were reimbursed employee expenses, deductible only on Schedule A. The court held that the leasing of the tools was not a passive activity because the tools were a necessary part of the services provided by the taxpayer. The court also held that the taxpayer materially participated in the activity because the taxpayer provided services in conjunction with the tool leasing. However, the court held that only the car and truck, equipment rental, and location travel expenses pertained to the equipment leasing activity and were deductible on Schedule C. The remaining expenses were reimbursed employee expenses deductible on Schedule A. **Welch v. Comm’r, T.C. Memo. 1998-310**.

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**RETURNS**. Under the Taxpayer Bill of Rights 2, Pub. L. No. 104-168, § 1210, 110 Stat. 1452 (1996) the "timely mailing as timely filing/paying" rule of I.R.C. § 7502(a) can be met by using designated private delivery service instead of the U.S. Postal Service. The IRS has announced that the designation of four private delivery services in *Notice 97-50, I.R.B. 1997-37, 21* remains unchanged. The designation of private delivery services is made annually on or before September 1 of each year. **Notice 98-47, I.R.B. 1998-__**.

The IRS has announced publication of revised Form 943A, Agricultural Employer's Record of Federal Tax Liability. The form is available by phone at 1-800-829-3676 or on the internet at http://www.ire.ustreas.gov.

**TRUSTS**. The taxpayer was a nurse anesthetist and formed a trust to receive a share in a partnership which had another anesthetist as a partner. Although the taxpayer performed the medical services, the amounts distributed by the partnership were placed in the trust's bank account. The taxpayer, however, had control over the funds in the partnership and had control over the trust bank account. The trust did not file income tax returns or pay any tax on the partnership distributions. The court held that the taxpayer was liable for the tax on the partnership distributions because the amounts were paid to the taxpayer, the taxpayer had control over the funds at all times, and the amounts resulted from the services provided to the partnership by the taxpayer. The appellate decision is designated as not for publication. **Estrada v. Comm'r, 98-2 U.S. Tax Cas. (CCH) ¶ 50,660 (9th Cir. 1998),** ***aff'g,*** **T.C. Memo. 1997-180**.

# PRODUCT LIABILITY

**SPRAYER**. The plaintiff was injured by skin contact with a disinfectant the plaintiff was spraying on hog farrowing crates. The bottle on the sprayer carrying the disinfectant separated from the sprayer and splashed the disinfectant on the plaintiff. The judge gave a jury instruction on the negligence of the plaintiff from failing to read the instructions for application of the disinfectant. The disinfectant instructions stated that the applicant should wear an impervious apron while applying the disinfectant. At trial, inconsistent evidence was presented as to whether the plaintiff was wearing any protective clothing at the time of the accident. The court held that the jury instruction was proper because a fact issue was presented as to whether the plaintiff had followed the directions for wearing protective clothing. **Wolfe v. Gilmour Mfg. Co., 143 F.3d 1122 (8th Cir. 1998)**.

# SECURED TRANSACTIONS

**COOPERATIVE PER UNIT CAPITAL RETAIN CERTIFICATES**. The debtor was a Texas dairy farmer who sold milk to a Kansas dairy processing and marketing cooperative. Part of the milk proceeds was returned to the debtor in per unit capital retain certificates. The certificates were subject to assignment restrictions in the cooperative's bylaws. The debtor gave the certificates to a bank as security for an operating loan and the bankruptcy trustee sought recovery of the certificates as estate property. The trustee argued that the assignment of the certificates to the bank was avoidable because of the assignment restrictions in the cooperative's bylaws. The bank argued that Texas Bus. & Commerce Code § 9.318(d) prevented restrictions on assignment of general intangibles. The court held that the restrictions were enforceable because the restrictions were specifically allowed under the Kansas Cooperative Marketing Act. The court held that the assignment of the certificates to the bank violated the cooperative bylaws and ordered the certificates returned to the bankruptcy estate. ***In re*** **Bonnema, 219 B.R. 951 (Bankr. N.D. Tex. 1998)**.

# CITATION UPDATES

**Holt v. United States, 39 Fed. Cls. 525 (Fed. Cls. 1997)** (estate property basis) see Vol 8, p. 188.

**Peracchi v. Comm'r, 143 F.3d 487 (9th Cir. 1998),** ***rev'g,*** **T.C. Memo. 1996-191** (corporate contributions) see p. 78 *supra*.

**Purdey v. Comm'r, 39 Fed. Cls. 413 (1997)** (hobby losses) see Vol 8, p. 174.

**Weyerhaeuser Co. v. U.S., 39 Fed. Cls. (1997),** ***on rem. from,*** **92 F.3d 1148 (Fed. Cir. 1996), cert. denied, 117 S.Ct. 776 (1997),** ***aff'g in part and rev'g in part,*** **32 Fed. Cl. 80 (1994)** (casualty losses) see Vol 8, p. 173.

# JOURNAL ARTICLES

The Spring 1998 issue of the *Drake Journal of Agricultural Law* contains the following articles:

Abdalla, C. & Becker, J., "Jurisdictional Boundaries: Who Should make the Rules of the Regulatory Game?"

Carpenter, S., "Farm Service Agency Credit Programs and USDA National Appeals Division"

Geyer, L., "The Agricultural Lawyers' Guide to the Internet"

Hamilton, N., "Right-to-Farm Laws Reconsidered…"

McEowen, R., "Recent Caselaw and Legislative Developments Concerning Special Use Valuation of Farm and Ranch Property"

Richardson, J., "How a Sole Practitioner Uses the 'Electronic Office' to Maintain a Competitive Law Practice"

Schneider, S., "The Family Farmer in Bankruptcy: Recent Developments in Chapter 12"

Tanner, G., "Annual Review of Agricultural Law: Commercial Law Developments"

McGaughey, B., "The Role and Responsibility of an Expert Witness"

Tweeten, L., "Food Security and Farmland Preservation"

Note, "The Unconstitutionality of Iowa's Proposed Agricultural Food Products Act and Similar Veggie Libel Laws"

Note, "Deer and Management: A Comprehensive Analysis of Iowa State Hunting Laws and Regulations"

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