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Publisher/Editor
Robert P. Achenbach, Jr.
Contributing Editor
Dr. Neil E. Harl, Esq.
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Co-Ownership Discounts: Fifth Circuit Says IRS Position Not "Substantially Justified"

-by Neil E. Harl*

Until 1989, the Tax Court had rejected co-ownership or "fractionalization" discounts to real property values[1] although interests in real estate held as community property had been eligible for discount for non-marketability of the decedent's fractional interest.[2] However, a 1989 case, *Estate of Youle v. Commissioner*,[3] allowed a discount of 12 ½ percent for tenancy in common ownership. That case has been followed by about 20 cases allowing discounts of 10 to 60 percent.[4] For real property other than timberland, a discount of 20 percent has been considered as relatively safe.[5]

The IRS position

Throughout the 25 years during which the co-ownership discount has been litigated, the Internal Revenue Service has never waivered from its position that any discount should be limited to the costs of partitioning the property.[6] The Service position has been that the issue of a discount was a question of fact.

The latest chapter

In the latest round of developments in the long-running saga of co-ownership discounts, the Internal Revenue Service position that co-ownership discounts should be limited to the costs of partitioning the property was dealt a serious blow by the Fifth Circuit Court of Appeals[7] which found that the Internal Revenue Service had failed to meet its burden of proving that its position on co-ownership or fractionalization discounts "was substantially justified."[8] The court decision thus cleared the way for litigation costs to be charged to IRS although the case was remanded to the Tax Court to determine if the estate's claim for attorneys' fees was unreasonable.[9]

The case had involved a long-running dispute between the estate and IRS over discounts. The estate had argued initially for a discount of 25 percent on 16 non-contiguous tracts of timberland in Louisiana.[10] The IRS countered that any discount should be limited to the costs of partitioning the property.[11] In the process of negotiating with the Service, the estate ratcheted the discount claim up from 25 percent to 50 percent, later from 50 to 60 percent and finally from 60 to 90 percent.[12]

The Tax Court approved a 55 percent discount for the non-controlling interests and an additional five percent discount because of the "peculiar circumstances with respect to the decedent's remaining family members."[13] That apparently was with reference to the estate's assertion that any partition would be ". . . vigorously resisted by the remaining

* Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.

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co-owners."[14] But the Tax Court rejected a claim for litigation costs and found the IRS position was substantially justified.

As is well known, the Fifth Circuit Court of Appeals is known to provide a friendly forum to taxpayers. The question, notwithstanding that fact, is whether the decision in *Baird v. Commissioner*[15] will lead to a relaxation in the IRS position on co-ownership discounts.

FOOTNOTES

[1] Estate of Pudim v. Comm'r, T.C. Memo. 1982-606; Estate of Clapp v. Comm'r, T.C. Memo. 1983-721; Estate of McMullen v. Comm'r, T.C. Memo. 1988-500 (value of decedent's one-half interest in trust property not discounted as fractional share when trust property to be sold as entire fee simple property interests).

[2] Propstra v. United States, 680 F.2d 1248 (9th Cir. 1982). But see Estate of Haydel v. Comm'r, T.C. Memo. 1991-507 (no discount allowed where pre-trial stipulation set values of property interests).

[3] T.C. Memo. 1989-138.

[4] See, e.g., Estate of Cervin v. Comm'r, T.C. Memo. 1994-550, *rev'd on another issue*, 111 F.3d 1252 (5th Cir. 1997) (20 percent discount allowed for 50 percent interest in farm and homestead); Estate of Pillsbury v. Comm'r, T.C. Memo. 1992-425 (15 percent discount allowed for undivided 77 percent and 50 percent interests in real estate); Estate of Baird v. Comm'r, T.C. Memo. 2001-258, (60 percent fractional share discount allowed for timber property in trust). See generally 5 Harl, *Agricultural Law* § 43.02[2] (2005); Harl, *Agricultural Law Manual* § 5.02[1] (2005). See also Harl, "Co-Ownership Discounts: A New Direction?" 11 *Agric. L. Dig*. 25 (2000).

[5] See, e.g., Estate of Brocato v. Comm'r, T.C. Memo. 1999-424 (20 percent fractional share discount allowed for apartment houses; IRS had argued cost of partitioning as limit to discount). Compare Estate of Busch v. Comm'r, T.C. Memo. 2000-3 (10 percent discount for co-ownership of agricultural land for federal estate tax purposes allowed which was "more than adequate" to cover reasonable costs of partition action; estate had claimed 40 percent discount; all heirs seemingly interested in development of land on edge of city). See Harl, "Co-Ownership Discounts: A New Direction?" 11 *Agric. L. Dig. 25* (2000), where the author opined that the discount represented "an attentiveness to the costs of partitioning beyond that found in earlier cases." 11 *Agric. L. Dig*. 25, 26. In *Estate of Busch,* the estate had sought a 40 percent discount for co-ownership of a 90.74 acre tract of land on the outskirts of Pleasanton, California. The Court rejected the IRS argument that the owners were trying to sell the property and so no discount should be allowed. The land had been owned by the 98 year-old decedent and a trust for the 97 year-old surviving spouse of a deceased brother.

[6] See Ltr. Rul. 199336002, May 28, 1993; Ltr. Rul. 199943003, June 7, 1999.

[7] Estate of Baird v. Comm'r, 2005-2 U.S. Tax Cas. (CCH) ¶ 60,505 (5th Cir. 2005).

[8] *Id.*

[9] *Id.*

[10] *Id.*

[11] *Id.*

[12] *Id.*

[13] *Id.*

[14] *Id.*

[15] 2005-2 U.S. Tax Cas. (CCH) ¶ 60,505 (5th Cir. 2005).

SETTLEMENT REACHED IN SMITHFIELD FOODS CASE

By Roger A. McEowen

The Iowa Attorney General's Office and Smithfield Foods, Inc., including all of its related entities and Murphy Family Farms, L.L.C., and Prestage Stoecker Farms, Inc., its successors, agents and assigns etc… (hereinafter "Smithfield") have agreed to a settlement of the constitutional challenge initiated by Smithfield in Federal District Court for the Southern District of Iowa in April, 2002, Civil No. 4-02-CV-90324-RP-TJS. See also *Smithfield Foods, Inc. et al. v. Miller, 2004 U.S. App. LEXIS 10051 (8th Cir. May 21, 2004), vac'g and rem'g, 241 F. Supp.2d 978 (S.D. Ia. 2003).* See also McEowen & Harl, "Iowa Ban on Packer Ownership of Livestock Ruled Unconstitutional," 14 *Agric. L. Dig.* 17 (2003). This document sets out the major terms of settlement agreement executed between the parties. The entire text of the Agreement will be available on the Iowa Attorney General's web-site: iowaattorneygeneral.org. The major terms of the Settlement Agreement are as follows:

Producer Rights. Smithfield has agreed that its Iowa producers shall have a set of identified producer rights, which include, but are not limited to the following: (1) right to Join an Association; (2) right to be a "whistleblower;" (3) right to use a contract producer lien (Iowa Code §§ 579A, 579B; (4) right to review contracts pursuant to Iowa Code § 202.3; and (5) right to disclose contract terms pursuant to Iowa Code § 202.3

Remedies. Smithfield has agreed that should any Iowa producer suffer damages as a result of a Smithfield's breach of their contract with the Iowa producer or as a result of Smithfield's failure to provide abide by any of the other provisions of the Settlement Agreement, the Iowa producer, as third party beneficiaries of the Settlement Agreement, can bring a civil action for damages, including treble and punitive damages. In addition, if the Iowa producer prevails in the above-referenced civil action, Smithfield will be responsible for the producer's costs and attorney fees in addition to any awarded damages.

Prohibited Company Activities. Smithfield has agreed to refrain from a list of activities that include, but are not limited to the following: (1) taking actions to coerce, intimidate, retaliate against, or discriminate against producers that exercise or attempt to exercise their rights under the Settlement Agreement, including actions affecting the following: (a) execution, termination,

extension, or renewal of an agricultural contract; (b) alter the quality, and/or quantity of delivery times of contract inputs; (c) use the performance of any other contract grower as the basis of the termination, cancellation, or renewal of a production contract or to negatively affect the grower's compensation; or (d) require contract producers to make a capital investment in addition to the capital investment required by the Iowa producer's production contract with Smithfield, unless fair and equitable compensation is paid to the producer in a manner the producer agrees to in writing.

Iowa Producer's Ability to Organize. Smithfield has agreed that if its Iowa producers organize or adopt a collective bargaining unit, Smithfield will not retaliate against such growers. In addition, Smithfield will refrain from any anti-trust or restraint-of-trade litigation against such growers and Smithfield agrees to negotiate in good faith with any such grower organization.

Environmental Program. Smithfield has agreed to fund and participate in an environmental program at Iowa State University that will train Smithfield's Iowa Producer's in the best environmental practices. Funding levels are set at $ 100,000.00/ year.

Smithfield/Lueter Scholarship Fund at Iowa State University. Smithfield has agreed to continue to fund the above-referenced scholarship program for an additional four years at $60,000.00/ year.

Iowa Plants. Smithfield has agreed that it has every intention to keep its Iowa plants and its plant in Sioux Falls, south Dakota in operation. Should said intentions change, Smithfield will provide 90 days notice to the Iowa Attorney General's Office.

Market Access. Smithfield has agreed that for two years following the execution of this agreement 25 percent of the swine slaughtered at its Iowa facilities and in its plant in Sioux Falls, South Dakota will be purchased from non-Smithfield sellers. The Iowa Attorney General's Office has agreed that, given Smithfield's compliance with the terms of this Settlement Agreement, it will not pursue enforcement of Iowa Code § 202B.201 against Smithfield. The parties to the Settlement agreement have agreed that the agreement shall be in effect for 10 years from the date of execution.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

BANKRUPTCY

GENERAL

DISCHARGE. The debtor had a contract with a creditor to purchase weener pigs at monthly intervals. Two of the batches of pigs were infected with a virus and the debtor withheld payment of two subsequent batches in order to force the creditor to discuss the infected batches. The parties failed to agree on liability and the creditor filed suit for payment. An arbitrator ruled in the creditor's favor and the debtor filed for bankruptcy before the creditor could obtain a judgment on the arbitrator's decision. The creditor sought to have the arbitrator's award declared nondischargeable under Section 523(a)(6) for willful and malicious injury by the creditor of a creditor's interest. The creditor alleged that the debtor acted with fraudulent intent when the debtor accepted the second two batches with the intent not to pay for them. The court held that the debtor did not have the intent to defraud the creditor but was merely seeking a method of negotiating a settlement for the infected pigs. The court found that the parties did not engage in a series of separate purchases but had a long term, multi-delivery contract over which the debtor had made the required payments. **Gehl v. Land O'Lakes Feed, LLC, 325 B.R. 269 (Bankr. N.D. Iowa 2005)**.

EXEMPTIONS.

HOUSEHOLD GOODS. The Chapter 7 debtor claimed an exemption as household goods, under Section 523(d)(3), for a shotgun, pistol, rifles, and fishing equipment. The court rejected the test that firearms were per se not household goods. The court adopted the "functional-nexus" analysis for determining the nature of property in the hands of the debtor. Under this test, household goods included personal property used to support and facilitate daily life in the residence. Under this standard, the court held that the burden was on the objecting creditor to provide evidence that the claimed exempt property was not used by the debtor for daily life in the residence; therefore, the exemptions were allowed. ***In re* Andershonis, 324 B.R. 247 (Bankr. M.D. Penn. 2005)**.

FEDERAL TAX

AUTOMATIC STAY. The Chapter 13 debtor listed an unsecured priority claim for federal taxes and provided for payment of the taxes in the confirmed plan. The IRS filed a motion for relief from the automatic stay in order to offset a portion of its claim by retaining a tax refund due to the debtor. The court held that the IRS was not entitled to relief from the automatic stay merely because it had a right of setoff of the tax refund, but that relief required some proof of a cause which furthered the purposes of bankruptcy. Because the IRS provided no cause for relief from the automatic stay except its right of setoff, the court held that no relief would be granted in that the requested relief would put the IRS in a better position than other similar claims in the Chapter 13 plan. ***In re* Shultz, 325 B.R. 197 (Bankr. N.D. Ohio 2005)**.

DISCHARGE. The debtor sought a ruling that taxes due more than six years before the filing of the Chapter 7 petition were dischargeable. The court granted dismissal for the IRS for failure of the debtor to state a claim for which relief may be granted, because the debtor failed to provide any allegations of material elements of a cause of action. ***In re* Rowe, 2005-2 U.S. Tax Cas. (CCH) ¶ 50,551 (Bankr. N.D. Ohio 2005)**.