CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

ANIMALS

HORSES. The plaintiffs were injured when their car struck two horses owned by the defendant. The horses had escaped a fenced area on the defendant's property. The plaintiffs sued in negligence for failure to maintain properly the fences to prevent the horses from escaping. The defendant argued that the Iowa Legislature had repealed Iowa Code Chapter 169B which required livestock to be fenced in by owners and there was no duty at common law to fence in the horses. The trial court had granted the defendant's motion to dismiss on these grounds. The appellate court agreed that the "fencing in" statute had been repealed in 1994 and that no common law duty to fence in horses existed. However, the court cited *Flesch v. Schlue, 191 N.W. 63 (1922),* which held, prior to enactment of the statute, that a livestock owner owed a duty of ordinary care to prevent livestock from wandering on to highways. The court characterized the statute as providing a presumption of negligence where livestock is not fenced in, and, as such, only supplemented the case law in effect. The court noted cases in other jurisdictions consistent with a duty of ordinary care by livestock owners. Therefore, the court held that the dismissal of the case was improper and remanded the case for trial. **Klobnak v. Wildwood Hills, Inc., 688 N.W.2d 799 (Iowa 2004)**.

BANKRUPTCY

FEDERAL TAXATION

PENALTIES. Under I.R.C. § 6658(a) no addition to tax under I.R.C. §§ 6651 (failure to file return or pay tax), 6654, 6655 (failure to pay estimated taxes) is to be made for a period during a pending bankruptcy case. The IRS has issued guidance for the definition of a pending bankruptcy case. Generally, a bankruptcy case is pending from the date of the petition to the closing of the case by the court. The discharge of the debtor is not sufficient to end the case for this purpose if the payment continues to be administered under court supervision. However, once the case is closed, the case is no longer pending even if payments continue to be made by the debtor under the bankruptcy plan. In addition, a case is no longer pending once the court dismisses the case for failure of the debtor to complete the plan requirements. **Rev. Rul. 2005-9, I.R.B. 2005-6, 470**.

FEDERAL AGRICULTURAL PROGRAMS

BRUCELLOSIS. The APHIS has adopted as final regulations adding Arkansas, Louisiana and Michigan to the list of validated brucellosis-free states. **70 Fed. Reg. 7839 (Feb. 16, 2005)**.

FARM LABOR. The National Agricultural Statistics Service has issued farm employment figures as of January 2005. There were 749,000 hired workers on the nation's farms and ranches the week of January 9-15, 2005, down 12 percent from a year ago. Of these hired workers, 574,000 workers were hired directly by farm operators. Agricultural service employees on farms and ranches made up the remaining 175,000 workers. Farm operators paid their hired workers an average wage of $9.81 per hour during the January 2005 reference week, up 40 cents from a year earlier. Field workers received an average of $8.73 per hour, up 34 cents from January 2004, and livestock workers earned $9.19 per hour compared with $8.83 a year earlier. □The field and livestock worker combined wage rate, at $8.91 per hour, was up 36 cents from last year. The number of hours worked in a week averaged 36.8 hours for hired workers during the survey week, down 3 percent from a year ago. All NASS reports are available free of charge on the internet. For access, go to the NASS Home Page at: http:/www.usda.gov/nass. **Sp Sy 8 (02-05)**.

PERISHABLE AGRICULTURAL COMMODITIES ACT. The debtor was a grocery and general merchandise wholesaler who had purchased canned goods and frozen potatoes from creditor in the bankruptcy case. The creditors argued that the debtor's failure to pay for the goods created a PACA trust which was not included in the bankruptcy estate. The debtor argued that canned goods were not perishable agricultural commodities covered by PACA and that no resulting trust was created. The court agreed with the debtor that canned goods were not perishable agricultural commodities covered by PACA in that the canning process removed one of the purposes of PACA to protect sellers of commodities with a short shelf life. In addition, the statutory definition of perishable agricultural commodity in 7 U.S.C. § 499o did not including canning in the processes which did not change the nature of the commodity. The court held that the sale of the canned commodities did not give rise to a PACA trust to cover the debtor's failure to pay for the goods. ***In re* Fleming Companies, Inc., 316 B.R. 809 (D. Del. 2004)**.

WHEAT. The GIPSA is amending the grain standards to change the definition of contrasting classes in Hard Red Winter wheat and Hard Red Spring wheat such that Hard White Wheat is not a contrasting class but is considered as wheat of other classes. GIPSA also is amending the grain standards by adding the sample size used to determine sample grade factors, because the standards should transmit this information. **70 Fed. Reg. 8233 (Feb. 18, 2005)**.

FEDERAL ESTATE AND GIFT TAXATION

CHARITABLE DEDUCTION. The decedent had created a trust which became irrevocable on the decedent's death. The trust was required to make distributions to gift trusts established by the decedent with the remainder to be distributed to a charity. The IRS ruled that the remainder interests passing to the charity were eligible for the charitable deduction because the noncharitable beneficiary interests were severable. **Ltr. Rul. 200505008, Oct. 15, 2004**.

DISCLAIMERS. The decedent's estate included funds in two pension accounts. The decedent's will bequeathed the residue of the estate, which included the pension funds, to two trusts for the benefit of the surviving spouse with remainders to the decedent's children. Within nine months after the decedent's death, the children, through guardians, executed written disclaimers of any interest in the trusts and the residue of the estate. As a result of the disclaimers, the entire estate passed in trust to the surviving spouse. The IRS ruled that the disclaimers were effective and that the trust property was eligible for the marital deduction as QTIP. In addition, the pension funds would be treated as passing directly to the surviving spouse and were eligible for tax-free rollover treatment when transferred to an IRA in the spouse's name. **Ltr. Rul. 200505030, Nov. 12, 2004**.

GIFT. The taxpayer was employed as a manager in a medical business operated by a corporation and was a close personal friend of the owner of the corporation. The taxpayer received bonuses for seven years but did not include the bonuses in income in the last three years. The corporation initially did not include the bonuses in the taxpayer's W-2s but later amended the W-2s to include the bonuses. The taxpayer, however, did not amend the returns for those years to include the bonuses. The taxpayer argued that the bonuses were gifts between close friends, although the employer did not file gift tax returns. The court noted that I.R.C. § 102(c)(1) expressly provides that amounts transferred from an employer to an employee are not eligible to be excluded from income as gifts under I.R.C. § 102(a). The court stated that it was irrelevant whether the bonuses were paid by a close friend because the statute was clear that any employer transfer of funds to an employee was subject to income tax; therefore, the bonuses were includible in the taxpayer's income. **Williams v. Comm'r, 2005-1 U.S. Tax Cas. (CCH) ¶ 50,163 (10th Cir. 2005), *aff'g*, T.C. Memo. 2003-97**.

MARITAL DEDUCTION. The decedent's will bequeathed the decedent's interest in the residence and personal property to the surviving spouse. The residue of the estate passed to the surviving spouse in trust with a bank as trustee. The trust provided that the income and principal of the trust was to be distributed to the surviving spouse, to the extent the surviving spouse and trustee determine are necessary for the spouse's maintenance, education, health or support. The IRS interpreted this as limiting the distribution of income to these specific uses and only with the consent of the trustee. The IRS noted that the limitation was similar to that used to limit a power of appointment so that the power is not considered a general power of appointment. The IRS ruled that the trust property was not eligible for the marital deduction as QTIP because the trust did not provide for distribution of all trust income to the surviving spouse without limitation and did not grant the surviving spouse a general power of appointment over trust property. **Ltr. Rul. 200505022, Nov. 8, 2004)**.

STATUTE OF LIMITATIONS. The decedent's estate had elected special use valuation of estate property and installment payment of estate tax. The estate successfully made early installment payments but failed to fully make later payments, even with extension of time. The estate also sold several parcels of estate property but more than one-third of the property was not sold until a foreclosure was completed against a portion of the property. The IRS was not aware of the foreclosure until it had filed a notice of assessment of all estate taxes in August 1991. The IRS filed suit for collection of taxes in May 2001. The estate argued that the 10-year statute of limitations for collection had expired because the IRS had notice of the transfer of more than one-third of the estate property in 1990, more than 10 years before the filing of the current case. The court held that the IRS did not have notice of the foreclosure sale even as much as two years later; therefore, the statute of limitations did not begin until the IRS gave notice to the estate of the assessment of all estate taxes in 1991. **United States v. Askegard, 2005-1 U.S. Tax Cas. (CCH) ¶ 60,498 (D. Minn. 2005)**.

TRANSFEREE LIABILITY. The taxpayer was a beneficiary of the decedent's estate. The estate failed to file an estate tax return or pay federal estate taxes. A new estate administrator was appointed who sued the former executors for mismanagement of the estate. The IRS assessed estate taxes of over $8 million, including penalties and interest, and assessed some of those taxes against the taxpayer on the basis of transferee liability to the extent the taxpayer had received estate property. The taxpayer acknowledged transferee liability for the taxpayer's share of taxes but argued that the taxpayer was liable only for the interest which accrued from the date notice of the liability was filed with the taxpayer. The court held that, under I.R.C. § 6901(a), a transferee's tax liability was to be treated the same as the underlying estate's tax liability with interest assessed from the date the taxes were due. **Saigh v. Comm'r, T.C. Memo. 2005-20**.

TRUSTS. The taxpayer was the sole beneficiary of a trust established by a parent. The trust had income for one tax year and distributed most of the income to the taxpayer, although the trust was required to distribute all income to the taxpayer. The taxpayer did not include any of the trust income in taxable income. The court held that, because all income was required to be distributed, the taxpayer had to include all trust income in the taxpayer's personal taxable income. **Myers v. Comm'r, T.C. Summary Op. 2005-15**.

FEDERAL INCOME TAXATION

CAPITAL ASSETS. The taxpayer had worked as an independent contractor insurance agent for a company. Under the agent agreement, the taxpayer received commissions for existing and continuing insurance contracts acquired and administered by the taxpayer. The taxpayer retired in 1996 and transferred all insurance records to the company which entered into an agreement with a new agent. The taxpayer sold the taxpayer's business property and equipment to the new agent and the employees continued with the new agent. The taxpayer received commission payments during the next three years based on insurance contracts obtained by the taxpayer prior to retirement. The taxpayer initially included these payments in income on tax returns but later filed amended returns which claimed the payments as long-term capital gains income. The taxpayer argued that the payments were the result of the sale of intangible assets, goodwill and going concern value, to the new agent and were entitled to capital gains treatment. The court held that the payments did not result from the sale of goodwill and going concern to the new agent because (1) the payment came from the insurance company and were based on past services of the taxpayer and (2) under the agent agreement, all the goodwill and going concern value belonged to the insurance company. **Jones v. Comm'r, 2005-1 U.S. Tax Cas. (CCH) ¶ 50,174 (S.D. Ala. 2004)**.

COOPERATIVES. The taxpayer was a tax-exempt rural electric cooperative. The cooperative offered satellite-based internet service under an agreement with a national provider of internet services which is also a tax-exempt cooperative. The taxpayer provided dial-up internet service and performed installation, maintenance and billing services. The internet services would be provided on a cooperative basis to existing members and new members. The IRS ruled that the offering of internet services did not affect the tax-exempt status of the taxpayer cooperative. The IRS also ruled that the internet services could be combined with the electrical services for purposes of determining whether 85 percent of the taxpayer's income comes from services to members. **Ltr. Rul. 200504035, Nov. 2, 2004**.

COURT AWARDS AND SETTLEMENTS. The taxpayer was employed with a brokerage firm and resigned in 1993. In 1997 the taxpayer informed the former employer that the taxpayer was a member of a class involved in a class action gender discrimination lawsuit and was entitled to a share of the proceeds of the settlement of that case. The settlement provided payment directly to the taxpayer's lawyers and payment to the taxpayer. A W-2 form was filed for a portion of the settlement and a Form 1099 Misc was filed for the remainder of the settlement. The taxpayer signed a release of all claims against the former employer as part of the settlement. The taxpayer argued that the settlement proceeds were excludible from income because the payments were made in compensation for physical injuries from second-hand smoke during employment. The taxpayer claimed that the second-hand smoke claim was not included in the settlement agreement in order "to protect the employer." However, the taxpayer presented no evidence to support this claim. The court held that, under *Banks v. Comm'r, 125 S. Ct. 826 (2005) see p. 20 supra.*, the portion of the settlement paid to the taxpayer's lawyers was included in the taxpayer's income and deductible as an intemized deduction. The remainder of the settlement proceeds was also included in the taxpayer's income because the proceeds were not paid in compensation for physical injuries. **Valia v. Comm'r, T.C. Summary Op. 2005-17**.

DISASTER LOSSES. On January 21, 2005, the President determined that certain areas in Indiana were eligible for assistance under the Disaster Relief and Emergency Assistance Act (42 USC 5121) as a result of severe winter storms and flooding, which began on January 1, 2005. **FEMA-1573-DR**. On February 8, 2005, the President determined that certain areas in Kansas were eligible for assistance under the Act as a result of severe storms, heavy rains and flooding, which began on January 4, 2005. **FEMA-1579-DR**. Accordingly, taxpayers in the affected areas in Indiana and Kansas who sustained losses may deduct them on their **2004** federal income tax returns. On February 4, 2005, the President determined that certain areas in California were eligible for assistance under the Act as a result of severe storms, flooding and mudslides, which began on December 27, 2004. **FEMA-1577-DR**. On February 8, 2005, the President determined that certain areas in Kentucky were eligible for assistance under the Act as a result of a severe storm which began on December 21, 2004. **FEMA-1578-DR**. Accordingly, taxpayers in the affected areas in California and Kentucky who sustained losses may deduct them on their **2003** federal income tax returns.

EMPLOYEE EXPENSES. The taxpayers, husband and wife, operated a vending machine business and claimed expense deductions for payment of wages to their minor children, ages five and 10. The taxpayers claimed that the children helped in the business by putting candy bars into the machines, sorting the totes full of candy, breaking down the cardboard and sorting out the recyclable products of waste produced by the business, and counting money. The taxpayers testified that the children worked approximately 10 hours per week, although the taxpayer did not provide any written work records. The children were paid by check but the checks were often cashed much later because of a lack of funds in the business account. The funds were not placed in separate accounts for the children but were used by the taxpayers in the business or for personal expenses. The payments were based on an annual salary tailored to avoid requiring the children to file income tax returns. The court held that the taxpayers failed to prove that the wages were an ordinary and necessary business expense. The court also assessed an accuracy-based penalty because the taxpayers failed to keep any records to substantiate the claimed deductions. **Dumond v. Comm'r, T.C. Summary Op. 2005-11**.

HOBBY LOSSES. The taxpayer was a dentist with a full time practice. The taxpayer owned a one and a half acre rural property on which the taxpayer raised and trained horses. The court held that the taxpayer did not operate the farm with the intent to make a profit because (1) the activity was not operated in a business-like manner in that the taxpayer did not keep separate accounts and records, did not prepare financial profit and loss projections, did not prepare a business plan or otherwise analyze the profitability of the activity; (2) the taxpayer did not consult experts to even study materials on breeding horses; (3) although the taxpayer was a successful dentist, the dentist business did not affect the taxpayer's ability to operate a horse breeding activity for profit; (4) the taxpayer spent relatively little time on the horse activity compared to the dentistry practice; (5) the taxpayer made no changes to stop the losses from the activity; and (6) the losses from the horse activity offset substantial income from the dentistry practice. **Giles v. Comm'r, T.C. Memo. 2005-28**.

LIKE-KIND EXCHANGES. The taxpayer corporation had commercial real estate which it wanted to sell, in a tax-free exchange, to a buyer corporation. The taxpayer owned 62 percent of the stock of a third corporation and sought to acquire property owned by the third corporation through a three party exchange. The taxpayer would transfer the property to a qualified intermediary who would first sell the property to the second corporation and use the funds to purchase the third corporation's property to be transferred by exchange to the taxpayer. The court noted that the tax-free exchange rules do not apply to related-party exchanges if a purpose of the exchange was to avoid federal income tax. The court held that the use of a qualified intermediary did not remove application of the related party rule; therefore, if tax avoidance was a purpose of the transaction, the taxpayer could not use the like-kind exchange rules to defer gain on the transactions here. The court held that the taxpayer failed to prove that no tax avoidance purpose existed for the transfers; therefore, the gain from the transactions was taxable. **Teruya Brothers, Ltd. & Subsidiaries v. Comm'r, 124 T.C. No. 4 (2005)**.

MOVING EXPENSES. The taxpayer was employed with a company in Reno, Nevada for two years before the taxpayer was transferred to a company warehouse in Los Angeles, California. The company reimbursed the taxpayer for some of the moving expenses for the taxpayer's personal property, the cost of a hotel room for three months, and the cost of the taxpayer's meals for three months. The employer paid third party providers for most of the expenses of moving the taxpayer's property and some of these payments were not reported as income by the taxpayer. The employer also paid the taxpayer an amount which was intended to compensate the taxpayer for any additional taxes resulting from the amounts paid by the employer. The taxpayer claimed moving expenses for moving the property, the hotel room and the meals, except the additional amount for taxes. The court held that, under I.R.C. § 217(b), the cost of the meals was not allowed as a moving expense deduction. In addition, the court held that the costs of hotel rooms was deductible as a moving expense only if incurred while traveling from the old residence to the new residence. Because the cost of the hotel room for three months was incurred while the taxpayer was located at the new employment location, those costs were not deductible as moving expenses. Of the remaining moving costs, the court held that the taxpayer could claim a moving expense deduction only for those costs which were reimbursed by the employer and included in the taxpayer's gross income. The court held that, because the moving expenses were paid directly to third party providers and not included in the taxpayer's gross income, those moving costs were not deductible by the taxpayer. **Bosco v. Comm'r, T.C. Summary Op. 2005-14**.

PASSIVE ACTIVITY LOSSES. The taxpayers, husband and wife, each owned one-half of a corporation which leased a commercial building to several law firms. The corporation was a limited liability company taxed as a partnership. The wife was a lawyer in one of the law firms and the husband was a medical doctor who provided medical consulting services through the corporation for the law firms in addition to the husband's occupation as a university professor. Thus, the corporation engaged in three types of services: leasing office space, providing legal support services and providing medical consulting services. The corporation employed three staff persons to provide the legal support services, including legal research and computer-assisted research, a law library and general maintenance services. The wife was primarily responsible for managing the corporation's services to the tenant law firms. The corporation incurred net operating losses for the tax years involved and claimed the losses as nonpassive activity losses which were passed on to the taxpayers. The IRS cited the wife's substantial income from the practice of law to determine that the wife could not have spent sufficient time on the corporation's business to make the losses nonpassive. The court determined initially that the taxpayers failed to shift the burden of proof on the time spent issue to the IRS because the taxpayers failed to provide the timesheets for the wife's activities with the law firm; thus, the taxpayers were required to provide sufficient evidence to support their claim that the wife's activities with the corporation's business were enough to qualify for an exception to the passive activity rules. The taxpayers argued that the corporation's activities were eligible for the "extraordinary personal services" exception under Treas. Reg. § 1.469-1T(e)(3)(ii)(C). The court cited *Welch v. Comm'r, T.C. Memo. 1998-310* which involved a carpenter who provided construction services for a movie company and also rented equipment to the company. The court in *Welch* held that the rental income was incidental to the provision of services which were the primary motivation for hiring the carpenter; therefore, the rental income was nonpassive under the extraordinary service exception. The court also cited examples in Treas. Reg. § 1.469-1T(e)(3)(v) where tenants leased commercial space primarily for the business services provided instead of primarily to rent the space involved. The court found that the corporation's law firm tenants leased the office space primarily to obtain the legal services of the support staff, law library and the husband's medical consulting firm and not merely to rent office space. The testimony of several tenants demonstrated that the availability of the legal services was a primary factor in leasing the office space in the building. The court held that the rental income was incidental to the extraordinary personal services provided to the tenants and the rental income and operating losses were nonpassive income eligible to offset other income of the taxpayers. Neil Harl will write an article on this case for a future issue of the *Digest*. **Assaf v. Comm'r, T.C. Memo. 2005-14**.

PENSION PLANS. For plans beginning in February 2005 for purposes of determining the full funding limitation under I.R.C. § 412(c)(7), the corporate bond weighted average is 6.07 percent with the permissible range of 5.46 to 6.07 percent (90 to 100 percent permissible range). The 30-year Treasury securities rate for this period is 5.08 percent, the 90 percent to 105 percent permissible range is 4.57 percent to 5.33 percent, and the 90 percent to 110 percent permissible range is 4.57 percent to 5.59 percent. **Notice 2005-19, I.R.B. 2005-9**.

REPAIRS. The taxpayer owned aircraft used in the taxpayer's freight business. The engines on the aircraft were periodically repaired based on actual damage or scheduled maintenance required either by the engine manufacturer or by federal regulations. The court held that the costs of the aircraft engine maintenance were currently deductible as repairs. See Harl, "Repair or Capitalize Expenditures," 14 *Agric. L. Dig*. 177 (2003). **FedEx Corp. v. United States, 2005-1 U.S. Tax Cas. (CCH) ¶ 50,186 (6th Cir. 2005), *aff'g*, 291 F. Supp.2d 699 (W.D. Tenn. 2003)**.

RETURNS. The IRS has issued a reminder to taxpayers in Connecticut that returns without payments are to be sent to the Kansas City, MO service center and returns with payments are to be sent to the St. Louis, Mo center. Taxpayers in Virginia without payments are to be sent to the Fresno, CA service center. Returns from Arizona, Utah and Virginia with payments are to be sent to the San Francisco, CA center. **IR-2005-16**.

The IRS has published Publication 946, How to Depreciate Property, to its website, www.irs.ustreas.gov/formspubs/index.html, in the Forms & Pubs section. The publication, which is to be used when preparing 2004 returns, addresses how to recover the cost of business or income-producing property through deductions for depreciation (i.e. the depreciation allowance, the special Liberty Zone depreciation allowance and deductions under the Modified Accelerated Cost Recovery System). In addition, it explains how to take an I.R.C. § 179 deduction instead of a depreciation deduction for certain properties, how to figure depreciation and how to fill out Form 4562, Depreciation and Amortization.

SAFE HARBOR INTEREST RATES
March 2005

	Annual	Semi-annual	Quarterly	Monthly
		Short-term		
AFR	3.08	3.06	3.05	3.04
110 percent AFR	3.40	3.37	3.36	3.35
120 percent AFR	3.70	3.67	3.65	3.64
		Mid-term		
AFR	3.83	3.79	3.77	3.76
110 percent AFR	4.21	4.17	4.15	4.13
120 percent AFR	4.60	4.55	4.52	4.51
		Long-term		
AFR	4.52	4.47	4.45	4.43
110 percent AFR	4.98	4.92	4.89	4.87
120 percent AFR	5.43	5.36	5.32	5.30

Rev. Rul. 2005-13, I.R.B. 2005-10.

SALE OF RESIDENCE. The IRS has issued an updated version of Rev. Proc. 2005-14, discussed in Harl, "Section 121 Exclusion and Like-Kind Exchange on Same Property?" p. 17 *supra*.

The taxpayer was employed as a police officer. Shortly after purchasing a new condominium residence, the taxpayer was assigned to a police dog unit which required the taxpayer to keep a dog at the residence. Because the condominium association prohibited dogs, the taxpayer sold the condominium before the taxpayer had lived in the residence for two years. The taxpayer purchased a single-family home at which the dog could be kept. The IRS ruled that the sale of the original residence was caused by unforeseen circumstances and the taxpayer could exclude gain up to the limited exclusion amount. The limited exclusion amount was the full exclusion amount multiplied by the percentage of two years the original residence was owned before the sale. **Ltr. Rul. 200504012, Oct. 14, 2004**.

TRANSFEREE LIABILITY. The taxpayer's were the three children of a parent who owned a farm and adjacent rural homestead. As a result of a divorce decree, the parent was required to pay the former spouse the value of one-half of the farm or to sell the farm and pay the former spouse from the proceeds. The parent failed to make the payment and incurred unpaid mortgage payments and taxes on the property. In addition, the parent incurred unpaid income tax liabilities. In an attempt to satisfy the divorce decree and remove the property from the reach of the IRS, the parent sold the parent's interest in the properties to the taxpayers for less than the fair market value of the property, with an interest the farm transferred to the former spouse. The taxpayers and former spouse sold a portion of the farm to third parties, resulting in the full payment of the former spouse's divorce claim. After the transfer to the taxpayers and former spouse, the parent was insolvent due to the unpaid taxes. The court found that the taxpayers had paid only a fraction of the fair market value of the property, the property was conveyed to remove it from levy by the IRS which held a preexisting claim, and the parent was made insolvent by

Agricultural Law Press
P.O. Box 50703 Eugene, OR 97405

the transfer. The court held that the taxpayers were liable as transferees of a fraudulent transfer for the unpaid taxes plus interest and penalties. **Suchar v. Comm'r, T.C. Memo 2005-23**.

WATER LAW

ARKANSAS RIVER COMPACT. Case summary by Roger A. McEowen. In 1949, Kansas and Colorado entered into the Arkansas River Compact. However, the Compact did not end disagreements concerning the equitable distribution of the river's upper waters. In 1985, Kansas claimed that Colorado had violated the Compact by drilling new irrigation wells that "materially depleted" the river water otherwise available for use by Kansas water users. A Special Master found that Colorado had unlawfully depleted the river in violation of the Compact and the Supreme Court agreed, remanding the case for remedies. The Special Master recommended that Colorado pay Kansas damages, divided the water losses into six categories with damages calculated differently for each category, and recommended that Kansas be awarded prejudgment interest on damages for losses incurred from 1969 through 1994 (the judgment's date). The Supreme Court adopted the recommendations, but held that prejudgment interest would run from 1985 instead of 1969. The Special Master subsequently filed another report attempting to resolve the remaining issues. The Special Master recommended that no river master be appointed, that prejudgment interest be granted only from the date the complaint was filed, that a 10-year measurement period be established to determine Colorado's future compliance with the Compact and to determination by the Colorado Water Court of water replacement credits to be applied toward Colorado's obligations. Kansas objected to the recommendations. The Supreme Court held that the appointment of a river master was not warranted because disputes could also require policy-oriented decisionmaking directly related to legal issues, and that arbitration under the compact was a viable alternative for technical disputes. The Court also agreed with the Special Master that limiting prejudgment interest from the date of the complaint, and only to damages incurred after that date, was appropriate. Also, the Court agreed with the Special Master's proposed 10-year measurement period because the use of a complex computer model to measure water depletion required a substantial measurement period to avoid significant inaccuracies which would occur with shorter periods, and Kansas's right to contest adverse decisions of the Colorado Water Court was adequately preserved. **Kansas v. Colorado, 125 S. Ct. 526 (2004)**.

GROUND WATER. Case summary by Roger A. McEowen. In a decision that is likely to intensify the water-rights debate in Nebraska, the Nebraska Supreme Court held that a western Nebraska ranch that has surface water rights (dating to 1954) to Pumpkin Creek could sue irrigators who pump from the ground for taking too much water and drying up the stream. The case represents the first time the Court has been confronted with the question of whether a surface water appropriator may bring a common law claim against the user of hydrologically connected ground water. Nebraska law ignores the hydrological fact that groundwater and surface water are linked and the law establishes two separate systems for allocating stream flows and groundwater. Under the Nebraska Constitution and statutory law, stream flows are allocated by priority in time (prior appropriation doctrine), but groundwater is governed by the common law rule of reasonableness and the Ground Water Management and Protection Act (GWMPA). The ranch claimed that water pumped from neighboring wells caused Pumpkin Creek to be dry, thereby preventing the ranch from irrigating crops and providing water for livestock. While the Court held that the doctrine of prior appropriation did not apply to groundwater even though groundwater and surface water are hydrologically connected, and that the common law claim of conversion did not apply because the right to appropriate surface water does not involve ownership of property that can be converted, the Court held that it would recognize a common law claim for interference with surface water by the user of hydrologically connected groundwater. In so holding, the Court determined that common law claims were not abrogated by the GWMPA and that state law did not allow state natural resource districts (the regulatory body governing groundwater) to award monetary damages. The Court noted that the common law should acknowledge and attempt to balance the competing equities of groundwater users and surface water appropriators. Under the test established by the Court, the withdrawal of groundwater must have a direct and substantial effect upon a watercourse or lake and unreasonably cause harm to a person entitled to the use of its water. The Court reversed the trial court's opinion in favor of the groundwater irrigators and remanded the case to the trial court for a trial on the merits. **Spear T Ranch, Inc. v. Knaub, et al., 269 Neb. 177 (2005)**.