8-29-2008

Cases, Regulations, and Statutes

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the demutualization process was based on having paid premiums on an insurance policy so it followed that the shares should have some income tax basis.

The United States Court of Federal Claims, in deciding the case,\(^8\) stated that “... the opinion rendered by plaintiff’s valuation expert that the value of the ownership rights was not discernible” was supported by the record which led the court to conclude that this was an appropriate case for application of the “open transaction” doctrine by which taxpayers could treat amounts received as return of basis until the basis was exhausted, with the remaining amounts subject to income tax. The problem with that outcome is that the court provided no guidance as to how the income tax basis amount should be determined.

That virtually assures an appeal in the case and, in all likelihood, further litigation.

The “open transaction” doctrine

As is well known, the “open transaction” doctrine, which arose in the U.S. Supreme Court case of *Burnet v. Logan* in 1931,\(^9\) has been roundly criticized by the courts and limited repeatedly in its application.\(^10\) Although the court in Fisher declared that the case should not be read as a “... revivification of the “open transaction” doctrine” but “an unusual and unique result,”\(^11\) the application of the doctrine can only be termed an ill-fitting solution to a difficult, but not impossible, judicial problem. The inapplicability of *Burnet v. Logan*\(^12\) starts with the observation that there was never a question of the taxpayer’s income tax basis in that case (*Burnet v. Logan*).\(^13\) The key question was how much the taxpayer would realize in the future because the buyer’s promise to pay could not be ascertained. The court simply held that the taxpayer should not be taxed until there was certainty of gain. Yet in *Fisher*\(^14\) the focus was entirely on basis. That raises the question of whether the “open transaction” theory should have played any role in the case.

**Taxpayer action needed**

For those selling demutualization-based securities with the gain reported within the last three years, it is necessary to file a claim for refund or a protective claim in order to take advantage of the court’s order to grant a refund to the taxpayers in *Fisher*.

**FOOTNOTES**


2. 2008-2 U.S. Tax Cas. (CCH) ¶ 50,481 (Fed. Cl. 2008).


7. *Id.*


13. *Id.*

The court also rejected any indication that the debtor operated an illegal pyramid or “Ponzi” scheme in using subsequent investments to pay returns for earlier investments. The court noted that the debtor invested and lost substantial personal funds and effort in the venture and the debtor made no personal use of the invested funds. The investors also sought nondischARGEability under Section 523(a)(4) for breach of fiduciary duty. The court held that no fiduciary duty was created by the investments in the venture because no trust relationship was established prior to the investments. The court held that the investors’ claims were dischargeable. *In re Hampton*, 2008 Bankr. LEXIS 1943 (Bankr. D. Kan. 2008).

**FEDERAL TAX**

**DISCHARGE INJUNCTION.** The debtor filed several bankruptcy cases which were dismissed but filed a final Chapter 7 case which was completed. The debtor thought that the federal tax claims were discharged but the prior bankruptcy cases tolled the three year period of Sections 523(a)(1)(A) and 507(a)(8) sufficiently such that the taxes were not discharged. However, the discharge injunction under Section 524(a) was in effect. The IRS made several attempts to collect the nondischarged taxes by attachments, liens and levies. The taxpayer alleged that the improper collection efforts cost the taxpayer the loss of a job and emotional distress. The court noted that the IRS had a policy of determining the Sections 523(a)(1)(A) and 507(a)(8) three year period using a set calculation of three years plus six months. However, after the decision in *Young v. United States*, 535 U.S. 43 (2002), the IRS was required to use the guidelines expressed in that case. The court held that the IRS was liable for actual damages for collection efforts made after Young but not for collection efforts made before Young. The court denied an award of punitive damages because the IRS did not waive its governmental immunity. *Distad v. United States*, 2008-2 U.S. Tax Cas. (CCH) ¶ 50,500 (Bankr. D. Utah 2008).

**FEDERAL AGRICULTURAL PROGRAMS**

**FOOD SAFETY.** The FDA has adopted as final regulations amending the food additive regulations to provide for the safe use of ionizing radiation for control of food-borne pathogens, and extension of shelf-life, in fresh iceberg lettuce and fresh spinach at a dose up to 4.0 kiloGray. This action is a partial response to a petition filed by the National Food Processors Association on behalf of the Food Irradiation Coalition. *73 Fed. Reg. 49593* (Aug. 22, 2008).

**FRUIT MARKETING ORDERS.** The AMS has adopted as final regulations amending the general regulations for federal fruit, vegetable and nut marketing agreements and marketing orders by establishing supplemental rules of practice for amendatory formal rulemaking proceedings in accordance with section 1504 of the Food, Conservation, and Energy Act of 2008 (2008 Farm Bill). The supplemental rules of practice add procedures to the rulemaking process relating to amendments to fruit, vegetable and nut marketing agreements and marketing orders; authorize the USDA to impose assessments on affected industries to supplement funds necessary to improve or expedite an amendatory hearing process; and authorize the use of informal rulemaking to amend such agreements and orders. Section 1504 of the 2008 Farm Bill also applies to amendments of federal milk marketing agreements and orders. The supplemental rules of practice for federal milk marketing agreements and orders are addressed in a separate rulemaking document. *73 Fed. Reg. 49307* (Aug. 21, 2008).

**MILK.** The AMS has adopted as final regulations amending the general regulations for federal milk marketing agreements and marketing orders by establishing supplemental rules of practice for amendatory formal rulemaking proceedings in accordance with section 1504 of the Food, Conservation and Energy Act of 2008 (2008 Farm Bill). This rule provides for supplemental guidelines, time periods and procedures for amending federal milk marketing agreements and orders; authorizes the use of informal rulemaking to amend such agreements and orders; and establishes provisions that permit the USDA to impose assessments on pooled milk under a federal milk marketing agreement or order to fund expedited amendatory formal rulemaking. *73 Fed. Reg. 49085* (Aug. 20, 2008).

**FEDERAL ESTATE AND GIFT TAXATION**

**DISCLAIMERS.** The decedent and surviving spouse had owned two joint brokerage accounts. The decedent had made all contributions to the first account and the decedent and spouse had each made half of the contributions to the second account. After the death of the decedent, the accounts were transferred to the name of the surviving spouse. The spouse received some income funds from the first account and authorized the purchase of securities in the second account. The spouse then transferred both accounts to the decedent’s estate and disclaimed any interest in the first account, less the amount received as income, and one-half of the interest in the second account, less the value of the securities purchased. The IRS ruled that the disclaimers were qualified because the mere change of title was insufficient to be an acceptance of the benefits of the accounts. The disclaimers did not apply to the income received from the first account or the securities purchased after the death of the decedent. *Ltr. Rul. 200832018*, March 17, 2008.

**GENERATION SKIPPING TRANSFERS.** A testamentary trust was established by the decedent, which was funded solely with stock in a closely-held corporation. The surviving spouse was the current income beneficiary with the decedent’s four children and remainder beneficiaries. After the sale of the stock, the children petitioned for a division of the trust into four separate trusts, representing each child’s interest in the
trust. Each trust had the same terms as the original trust, except the remainder beneficiary was one of the children. The IRS ruled that the division of the trust did not result in the trust becoming subject to GSTT. Ltr. Rul. 200832020, March 28, 2008.

SPECIAL USE VALUATION. The IRS has issued the 2008 list of average annual effective interest rates charged on new loans by the Farm Credit Bank system to be used in computing the value of real property for special use valuation purposes for deaths in 2008:

<table>
<thead>
<tr>
<th>District</th>
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<td>AgFirst, FCB</td>
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<tr>
<td>U.S. AgBank, FCB</td>
<td>6.09</td>
</tr>
</tbody>
</table>

The taxpayers formed a limited liability company through which they bought and sold stocks. The taxpayers made the mark-to-market election and claimed capital losses from the which they bought and sold stocks. The taxpayers made the mark-to-market election and claimed capital losses from the

ACCOUNTING METHOD. The IRS has issued a revised revenue procedure for automatic consent of the IRS for certain changes in accounting methods. In most situations, a completed and filed current Form 3115, Application for Change in Accounting Method, will serve as the application for consent to change accounting methods. The new procedure generally applies to applications to change accounting methods that are filed on or after August 18, 2008, for a year of change ending on or after December 31, 2007. Rev. Proc. 2002-9, 2002-1 CB 327, is superseded. Rev. Proc. 2008-52, I.R.B. 2008-36.

The taxpayers purchased a truck with a loan. The taxpayers then entered into a “lease” with a trucking company, under which the lease payments were identical to the quarterly loan payments due on the truck. The taxpayers did not receive any other payments from the trucking company. The taxpayers claimed expenses for the use of the truck which resulted in net losses for the tax years involved. The court disallowed the deductions because the taxpayers’ truck leasing activity was not a trade or business. The lease was characterized as a financing accommodation by the taxpayers for the lessor’s purchase of the truck. Doyle v. Comm’r, T.C. Summary Op. 2008-107.

CHARITABLE DEDUCTION. The IRS has issued proposed regulations providing guidance concerning substantiation and reporting requirements for cash and noncash charitable contributions under I.R.C. § 170. 73 Fed. Reg. 45908 (Aug. 7, 2008).

DEPENDENTS. The taxpayer had two children who lived with their mother in another residence. Under a child support order, the taxpayer could claim one child as a dependent. The order also required both parents to sign a Form 8332, Release of Claim to Exemption for child of Divorced or Separated Parents for each child. However, the taxpayer claimed the second child as a dependent, and not the first, even though the mother had not signed a Form 8332 for the second child. The case does not explain why the taxpayer claimed the second child as a dependent and not the first. The court held that, without the filing of a signed Form 8332, the second child was not a qualifying dependent and the taxpayer was not allowed a dependent deduction for that child or the child tax credit based on that child. Walker v. Comm’r, T.C. Memo. 2008-191.

DOMESTIC PRODUCTION DEDUCTION. The taxpayer was a utility which was prevented from claiming the domestic production deduction because of no federal tax liability due to net operating loss carryover. In state regulatory proceedings, the taxpayer’s income was determined without regard to NOLs; therefore, the taxpayer’s income for determining utility rates was calculated using the domestic production deduction. The taxpayer sought a ruling that the different treatment under federal tax rules and state regulatory rules violated the normalization accounting provisions. The IRS ruled that the
normalization provisions applied only to accounting differences caused by tax effects similar to accelerated depreciation; therefore, the differing treatment to the domestic production deduction did not violate the normalization provisions. Ltr. Rul. 200833014, May 13, 2008.

EMPLOYMENT TAXES. The taxpayers owned and operated a business which manufactured and sold nutritional products for pigs and cattle. The business employed sales representatives which it treated as independent contractors and did not withhold federal employment taxes. The taxpayer argued that it met the safe harbor provisions of I.R.C. § 3401(note) in that it consistently treated the sales people as independent contractors and had a reasonable basis for such treatment. The IRS sought summary judgment on the issue. The court held that the determination of a reasonable basis for the treatment was a factual issue not proper for summary judgment and denied the motion. United States v. Porter, 2008-2 U.S. Tax Cas. (CCH) ¶ 50,479 (S.D. Iowa 2008).

The plaintiff worked as an hourly employee of the defendant manufacturing company and claimed 99 deductions on the plaintiff’s Form W-4, Employee Withholding Allowance Certificate. The IRS contacted the defendant and instructed the defendant to ignore the claimed deductions and treat the plaintiff as having one exemption. The plaintiff filed a pro se suit for improper collection of employment taxes. The plaintiff claimed that the defendant failed to establish an employment relationship by filing notice with the IRS. The court noted that such a filing was voluntary and not mandatory. However, the court also noted that the withholding of federal employment taxes was mandatory. The defendant’s motion to dismiss was granted because the plaintiff failed to show any authority for the law suit and because any objection to the withholding system was properly brought against the United States. Nino v. Ford Motor Co., 2008-2 U.S. Tax Cas. (CCH) ¶ 50,497 (E.D. Mich. 2008).

HOBBY LOSSES. The IRS has published a Fact Sheet discussing some of the issues involved in the proper claiming of deductions where a business activity could be characterized as a hobby, resulting in disallowance of deduction in excess of revenue from the activity. Although the information is useful, the reported cases, see Harl, Agricultural Law, § 30.06 (2008), involve a substantial amount of factual issues and place emphasis on the treatment of the activity as a business, especially as to bookkeeping which must provide sufficient data to analyze the profitability of the activity. In addition, much emphasis is placed on the taxpayers’ actual use of the data to improve the profitability of the activity. Most of the Fact Sheet is quoted here:

“Is your hobby really an activity engaged in for profit?

“In general, taxpayers may deduct ordinary and necessary expenses for conducting a trade or business or for the production of income. Trade or business activities and activities engaged in for the production of income are activities engaged in for profit.

“The following factors, although not all inclusive, may help you to determine whether your activity is an activity engaged in for profit or a hobby:

• Does the time and effort put into the activity indicate an intention to make a profit?
• Do you depend on income from the activity?
• If there are losses, are they due to circumstances beyond your control or did they occur in the start-up phase of the business?
• Have you changed methods of operation to improve profitability?
• Do you have the knowledge needed to carry on the activity as a successful business?
• Have you made a profit in similar activities in the past?
• Does the activity make a profit in some years?
• Do you expect to make a profit in the future from the appreciation of assets used in the activity?

“An activity is presumed for profit if it makes a profit in at least three of the last five tax years, including the current year (or at least two of the last seven years for activities that consist primarily of breeding, showing, training or racing horses).

“If an activity is not for profit, losses from that activity may not be used to offset other income. An activity produces a loss when related expenses exceed income. The limit on not-for-profit losses applies to individuals, partnerships, estates, trusts, and S corporations. It does not apply to corporations other than S corporations.

What are allowable hobby deductions under IRC 183?

“If your activity is not carried on for profit, allowable deductions cannot exceed the gross receipts for the activity.

“Deductions for hobby activities are claimed as itemized deductions on Schedule A, Form 1040. These deductions must be taken in the following order and only to the extent stated in each of three categories:

• Deductions that a taxpayer may claim for certain personal expenses, such as home mortgage interest and taxes, may be taken in full.
• Deductions that don’t result in an adjustment to the basis of property, such as advertising, insurance premiums and wages, may be taken next, to the extent gross income for the activity is more than the deductions from the first category.
• Deductions that reduce the basis of property, such as depreciation and amortization, are taken last, but only to the extent gross income for the activity is more than the deductions taken in the first two categories.” FS-2008-23.

IRA. The decedent’s estate included an IRA which had a trust as the beneficiary, with the surviving spouse as the trustee with full control over trust assets. Under the terms of the trust, the surviving spouse, as trustee, could distribute the IRA to the surviving spouse. The surviving spouse had the IRA funds distributed to an IRA in the surviving spouse’s name. The IRS ruled that the IRA funds were not an inherited IRA and the rollover of the funds to the spouse’s IRA would not be included in the spouse’s taxable income. Ltr. Rul. 200833028, May 21, 2008.

INNOCENT SPOUSE. The taxpayer and spouse had operated an import business and used company funds to pay personal
expenses. The couple filed joint returns for two years in which no income was reported. The taxpayer was found guilty of tax fraud and evasion for substantial under reporting of taxable income. The taxpayer sought innocent spouse relief which was denied by the IRS. The court found that the taxpayer was personally involved in the business and the filing of the income tax returns and was personally aware of the under reporting of taxable income; therefore, the taxpayer was not entitled to innocent spouse relief which was properly denied by the IRS.  


The taxpayer and former spouse owned a residential rental property and filed joint income tax returns with incorrect information based on the rental income and expenses. The former spouse became addicted to prescription painkillers and was arrested for forging prescriptions. The taxpayer sought innocent spouse relief because the taxpayer claimed that the spouse filled out the income tax return while addicted to the painkillers and falsified the returns. The court found that the taxpayer was personally involved in the rental management and financial records; therefore, the taxpayer was aware, or should have been aware, of the false information on the tax return and was not entitled to innocent spouse relief for the tax deficiencies resulting from the rental. 


MEdICAL EXPENSES. The IRS has issued guidance that a child of divorced or separated parents will be treated as a dependent of both parents for purposes of the exclusion from gross income of certain employer reimbursements of expenses incurred for the medical care of the employee’s child under I.R.C. § 105(b). Under this procedure, the IRS will treat the child as a dependent of both parents for purposes of Code I.R.C. § 105(b). The procedure is effective August 18, 2008, but taxpayers may choose to apply the guidance to any tax year beginning after December 31, 2004, for which a credit or refund can still be claimed under I.R.C. § 6511.  


NEw MARKETs TAX CREDIT. The IRS has issued proposed regulations relating to the new markets tax credit under I.R.C. § 45D revising and clarifying certain rules relating to recapture of the new markets tax credit for certain taxpayers claiming the new markets tax credit. 73 Fed. Reg. 46572 (Aug. 11, 2008).

PARTNERSHIPS

ELECTION TO ADJUST BASIS. The partnership originally had two members. The partnership interests of the two partners were sold to a single individual but the partnership failed to make the I.R.C. § 754 election to adjust the income tax basis of the partnership. The IRS granted an extension of time to file the election. 


returns. The IRS has issued a revenue procedure setting forth the requirements for using IRS forms to file 2008 information returns, preparing acceptable substitutes of the official forms and using official or acceptable substitute forms to furnish information to recipients. The guidance addresses Forms 1096, W-2G and 1042-S and the 1098, 1099 and 5498 series. Rev. Proc. 2008-33, 2008-2 C.B. 340.

The IRS has issued guidance for bulk requests by tax practitioners concerning clients located in presidentially-declared disaster areas. Practitioners who are located in a presidentially declared disaster area where the IRS has granted a postponement of time to file returns and make tax payments may wish to contact the IRS at 1-866-562-5227 to self identify their clients. Alternatively, they may use the following procedures if they have a large number of clients (ten or more): Prepare a CD with the following information in an Excel spreadsheet: (1) in column A list their client’s TINs; (2) in column B list the first four letters of the client’s last name or the first four letters of the business name, using upper case lettering. Do not use any periods, commas, separators or any additional wording such as “the”, etc. Mail the CD to: Internal Revenue Service, Special Services Section, 1 Independent Drive, Suite 500, Stop 6000, Jacksonville, FL 32202. Be sure to include the Stop “6000” to ensure your request is processed timely. Include a cover letter with the CD requesting relief from penalties and/or interest. The letter should also contain the practitioner’s name and address and a statement that identifies which disaster affected their clients. A copy of the IRS news release may be helpful, but not necessary. IRS Notice, Aug. 12, 2008.

SAFE HARBOR INTEREST RATES

September 2008

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S CORPORATIONS

NUMBER OF SHAREHOLDERS. The IRS has adopted as final regulations governing the definition of family members for purposes of I.R.C. § 1361(c)(1) which allows all family members to be treated as one shareholder for S corporation purposes. Section 403(b) of the Gulf Opportunity Zone Act of 2005 (Pub. L. 109-135) eliminated the requirement of an election in order for a family to be treated as one shareholder, providing instead that members of a family would automatically be treated as one shareholder for purposes of I.R.C. § 1361(b)(1)(A). Although the portions of Notice 2005-91, 2005-2 C.B. 1164, addressing the manner of making the family shareholder election are no longer relevant, the regulations retain the provisions of Notice 2005-91 describing certain entities other than individuals who will be treated as members of the family. The family members are determined by reference to a common ancestor. I.R.C. § 1361(c)(1)(B) defines “members of a family” as a common ancestor, any lineal descendant of the common ancestor, and any spouse or former spouse of the common ancestor or
any such lineal descendant. Adopted and foster children are included among the lineal descendants as described in I.R.C. § 1361(c)(1)(C). An individual is not eligible to be the common ancestor for purposes of this provision if, on the applicable date, the individual is more than six generations removed from the youngest generation of shareholders who would otherwise be members of the family (without regard to the “six generation” test of I.R.C. § 1361(c)(1)(B)(ii)). Section 403(b) of the 2005 Act also changed the applicable date in I.R.C. § 1361(c)(1)(B)(iii) on which a person will be tested for qualification as a “common ancestor” to the latest of (1) the date the subchapter S election is made, (2) the earliest date an individual who is a “member of the family” holds stock in the S corporation, or (3) October 22, 2004. The regulation clarifies that the “six generation” test is applied only at the date specified in I.R.C. § 1361(c)(1)(B)(iii) for determining whether an individual meets the definition of “common ancestor,” and has no continuing significance in limiting the number of generations of a family that may hold stock and be treated as a single shareholder. The regulation provides that there is no adverse consequence to a person being a member of two families. 73 Fed. Reg. 47526 (Aug. 14, 2008).

SOCIAL SECURITY TAXES. The taxpayer operated accredited medical residency programs for new doctors who have completed their medical education. The taxpayer withheld and paid FICA taxes on the amounts paid to the medical residents and filed for a refund of those payments, arguing that the medical residents qualified for the student exception under I.R.C. § 3121(b)(10). The trial and appeals courts held that the determination of whether the stipends paid to medical residents were subject to FICA taxes was to be based on the nature of the relationship between the residents and the payor of the stipend. If the relationship was educational, the student exception applied to relieve the stipends from FICA tax. The court held that the medical residents (but not the chief residents who were held to be administrators) were students entitled to the exception because the residents were enrolled in classes and received regular evaluation. Center for Family Medicine v. United States, 2008-2 U.S. Tax Cas. (CCH) 50,488 (D. S.D. 2008).

TAX PROTESTERS. The taxpayer had been assessed an I.R.C. § 6673 penalty by the trial court for making a frivolous argument that the IRS was prohibited from collecting taxes from the taxpayer under the Thirteenth Amendment of the Constitution. The appellate court affirmed the imposition of the penalty in a case designated as not for publication. The case has been appealed to the U.S. Supreme Court. Webster v. Comm’r, 2008-1 U.S. Tax Cas. (CCH) ¶ 50,217 (9th Cir. 2008), aff’g, T.C. Memo. 2006-144.

TRUSTS. The taxpayers established a charitable remainder unitrust which had the taxpayers as income beneficiaries and an undesignated charity as the remainder holder. The taxpayers terminated the trust and distributed to themselves and a charity as remainder holder for both trusts. Each spouse was the current income beneficiary of the CRUT trusts with each spouse as the common ancestor for purposes of split trust provisions in the divorce agreement provided for the trust to be split into two CRUT trusts with each spouse as the current income beneficiary and the charity as remainder holder for both trusts. Each spouse was the surviving beneficiary of the other trust. The IRS ruled that the division did not disqualify either trust as a CRUT and no gain or loss was recognized by the division. Ltr. Rul. 200832021, May 6, 2008.

LIENS. The debtor and a creditor had reached an agreement in a bankruptcy case under which the creditor had the right to sell three parcels of land if the debtor failed to pay a sum certain to the creditor. The agreement prohibited the debtor from placing any lien or encumbrance on the title of the three parcels. The parcels were to be sold one at a time until the sales produced the amount required to be paid by the debtor. When the payment was not made, the creditor auctioned the three parcels, the last two on the same day. The third sale was ruled to be improper because it was made on the same day as the second sale and the third sale had to be redone. Before the third sale could be redone, the debtor filed a Notice of Suit with the county register of deeds, including a notice that the third parcel was subject to a bankruptcy proceeding. The debtor admitted that the Notice would have the effect of clouding the title and making any sale more difficult. The court held that the Notice violated the debtor-creditor agreement and was invalid. In re Rafter Seven Ranches, L.P, 2008 Bankr. LEXIS 1989 (Bankr. D. Kan. 2008).
FARM INCOME TAX, ESTATE AND BUSINESS PLANNING SEMINARS
by Neil E. Harl
January 6-10, 2009
Outrigger Keauhou Beach Resort, Big Island, Hawai’i.

Spend a week in Hawai’i in January 2009 and attend a world-class seminar on Farm Income Tax, Estate and Business Planning by Dr. Neil E. Harl. The seminar is scheduled for January 6-10, 2009 at the spectacular ocean-front Outrigger Keauhou Beach Resort on Keauhou Bay, 12 miles south of the Kona International Airport on the Big Island, Hawai’i.

Seminar sessions run from 8:00 a.m. to 12:00 p.m. each day, Tuesday through Saturday, with a continental breakfast and break refreshments included in the registration fee. Each participant will receive a copy of Dr. Harl’s 400+ page seminar manual Farm Income Tax: Annotated Materials and the 600+ page seminar manual, Farm Estate and Business Planning: Annotated Materials, both of which will be updated just prior to the seminar.

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AALA ANNUAL AGRICULTURAL LAW SYMPOSIUM

The American Agricultural Law Association is holding its 29th Annual Agricultural Law Symposium on October 24 & 25, 2008 at the Marriott Hotel in downtown Minneapolis, MN.

Topics will include annual updates on bankruptcy, income and estate tax, federal farm programs, food safety and environmental law. Special panel presentations are being planned for topics of special interest to Minnesota and Midwest practitioners, as well as panel discussions on national agricultural law topics, including the 2008 Farm Bill.

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