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Cases, Regulations and Statutes

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In conclusion

The Senate Finance Committee proposals are clearly a step in the direction of making the family-owned business provision workable and a useful tool for farm and ranch estate planning. However, additional changes are needed before practitioners will feel completely comfortable in using the concept.

FOOTNOTES

5 Prop. I.R.C. § 2057(a).
6 I.R.C. § 2033A(a).
7 Prop. I.R.C. § 2057(a)(2).
9 See I.R.C. § 2033A(a).
10 See I.R.C. § 2010(c).
11 See I.R.C. § 1014.
12 See I.R.C. § 1014(b)(9); Treas. Reg. § 1.1014-2(b)(1).
15 I.R.C. § 2032A.
16 See I.R.C. § 2032A(b)(2).
17 See I.R.C. §§ 2033A(e)(2)(D)(ii), 954(c)(1), 542(c)(2), 543(a).
18 See 5 Harl, supra n. 1, § 43.04[2]. See also Letter, Kenneth Kies, Chief of Staff of Joint Committee on Taxation to Sen. Charles Grassley, Nov. 3, 1997.
19 See 5 Harl, supra n. 1, § 43.04[2].
20 See Harl, Kelley and McEowen, supra n. 3, at 117.
21 Prop. I.R.C. § 2057(e)(1).
23 Id.
24 See 5 Harl, supra n. 1, § 43.04[4].
25 The drafters of the IJC letter seemingly did not realize that post-death involvement is evaluated with respect to members of the qualified heir’s family, not members of the decedent’s family. See 5 Harl, supra n. 1, § 43.04[4].
27 I.R.C. § 2033A(f).
28 I.R.C. § 2033A(e)(2)(D).
33 See Harl, Kelley and McEowen, supra n. 3, at 120.
34 See Harl, Kelley and McEowen, supra n. 3, at 121.
35 Id.
38 See Prop. I.R.C. § 2057(b)(1)(D).
40 Mizell v. Comm’r, T.C. Memo. 1995-571.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-ALM § 13.03.*

SHARED APPRECIATION AGREEMENTS. The debtor had borrowed money from the FSA and defaulted on the original loan. As part of a refinancing agreement, the FSA agreed to write down the loan and the debtor agreed to a shared appreciation arrangement under which the FSA would receive a portion of any appreciation in the value of the debtor’s farmland during the period of the loan. The debtor borrowed funds from another creditor and granted a security interest in the same real property. The creditor argued that the creditor’s lien took priority over the shared appreciation agreement. The court held that the shared appreciation agreement was secured by the same security agreement as the loan and had priority over subsequently perfected security interests. The court also held that the shared appreciation agreement was not an executory agreement capable of rejection by the debtor. The court further held that, although the value of the FSA claim under the shared appreciation agreement was not capable of accurate valuation before the end of the loan, the court could make an estimate, with the FSA filing for an adjustment when the loan was terminated. In re Tunnissen, 216 B.R. 834 (Bankr. D. S.D. 1996).

CONTRACTS

BREACH. The plaintiffs sold their dairy farm to their son and daughter-in-law. The sale included a promissory note for
the purchase of the dairy herd and the lease of the facilities and equipment. The plaintiffs co-signed the note and entered into an agreement with the buyers that required the buyers to assign all milk proceeds to the bank for payment on the note and to the plaintiffs for payment of the lease. The agreement also prohibited the buyers from taking any cash advances against the milk proceeds. The buyers sold their milk to the defendant, a local creamery which had the policy of allowing farmers to take cash advances from milk proceeds. The plaintiffs claimed to have informed the defendant about the prohibition against cash advances but the defendant denied this. The defendant allowed the buyers to take cash advances with the result that the buyers did not make loan and lease payments as agreed. The plaintiffs sued the defendant for breach of contract when the buyers defaulted on the loan and lease. The court held that the defendant had no contractual requirement to change its policy of allowing cash advances, because the defendant was not a party to the loan and lease agreements. The court noted that the plaintiffs were aware of the defendant’s policies when the agreements were formed. Veerkamp v. Farmers Co-op Creamery, 573 N.W.2d 715 (Minn. Ct. App. 1998).

RESCISSON. The plaintiff operated a horse auction and as part of that auction, maintained a voluntary repository of medical information about horses to be sold. The information was placed in the repository only as a complimentary service to sellers and prospective buyers. The sale contracts expressly disclaimed any warranty by the plaintiff as to the medical information. The defendant sought to obtain medical information on a horse but could not obtain it because of misfiling by the plaintiff’s staff. The defendant decided to bid on the horse anyway and made the successful bid. The defendant then had the medical records obtained and discovered flaws in the horse’s legs. The defendant refused to pay for the horse and the plaintiff sued on the contract. The defendant acknowledged that the sales contract disclaimed all warranties for the sale and that alone would prevent the rescission of the contract based on the horse’s condition. However, the defendant argued that the plaintiff was negligent in operating the medical repository and that negligence allowed the defendant to rescind the contract. The court held that even if the plaintiff was negligent, the operation of the repository was not the cause of the horse’s condition. The defendant took the risk of bidding on the horse without seeing the medical records which the defendant knew existed. The court held that it was the defendant’s own decision to purchase the horse that caused the problem. Keeneland Ass’n, Inc. v. Hollendorfer, 986 F. Supp. 1070 (E.D. Ky. 1997).

ENVIRONMENT

UNDERGROUND STORAGE TANKS. The defendant had purchased property which contained an underground petroleum storage tank. The defendant did not use the tank but also did not close the tank and have the soil tested for contamination, as was required by Iowa law. The defendant sold a portion of the land to the plaintiff but stated on a disclosure statement that there were no underground tanks on the property. The defendant claimed that the known tank was not on the plaintiff’s portion of the property, but the fact issue was not resolved as a matter of law. The state Department of Natural Resources (DNR) notified the parties that there were actually two underground tanks, the soil was contaminated, the tanks needed to be removed and the soil had to be cleaned. The plaintiff sued for breach of contract and negligence and received a jury verdict for $50,000. The court upheld the verdict, holding that the defendant owed a duty to the plaintiff to disclose the existence of the known tank as a defect of the property and because the underground tanks did not comply with state law and regulations. The court also held that the contract was breached because the defendant failed to disclose the existence of the tank on the disclosure statement. Timm v. Clement, 574 N.W.2d 368 (Iowa Ct. App. 1997).

FEDERAL AGRICULTURAL PROGRAMS

PACKERS AND STOCKYARDS ACT. The respondent was a livestock auction company subject to the PSA. The evidence showed that a disabled cow was delivered to the company and left to die in an area with no food or water on a day when the temperature exceeded 100 degrees. The company did nothing until a passerby complained and then the company only contacted an officer of the state animal services division to destroy the cow. The company argued that the GSPSA had no jurisdiction over the incident because the company did nothing which injured livestock commerce. Although the Judicial Officer ruled that the PSA covered abuse of animals as an unfair or unreasonable practice, the JO ruled that the abuse in this case was insufficient to warrant any sanction. The JO noted that no injury occurred except to the cow. The JO also vacated the ALJ civil penalty because no evidence was presented as to the gravity of the offense, the size of the company’s business, and the effect of the penalty on the ability of the company to conduct its business. Note: The Farm Sanctuary organization was formed to reduce the incidents of livestock abuse at stockyards by providing care for “downed” cows and other “unmarketable” animals. In re Arizona Livestock Auction, Inc., 55 Agic. Dec. 1121 (1996).

PERISHABLE AGRICULTURAL COMMODITIES ACT. The petitioner was a PACA licensed produce broker. The ALJ had found that the petitioner had failed to timely pay 66 sellers for 345 lots of produce worth over $1 million. The ALJ also found that the petitioner had made payment for that produce by the time of the PACA violation hearing but the petitioner had accumulated another $1 million in debts. The ALJ ruled, and the JO concurred, that the petitioner had committed frequent and flagrant violations of PACA in failing to timely pay for produce. The petitioner’s license was revoked as the sanction. The petitioner appealed, arguing that the evidence was insufficient to support the findings of the ALJ and JO. In particular, the petitioner argued that the use of invoices to show delivery and payment dates was not reliable. The appellate court held that, although the invoices were not sufficient to accurately determine the actual
delivery and payment dates, the invoices were sufficient to show that the payments were untimely made, especially since the petitioner presented no evidence to contradict the invoices. The court also upheld the sanction, given the findings of repeated and flagrant violations of PACA. The court held that the mitigating effect of the petitioner’s paying of the produce sellers was offset by the continuing delay in making payments to recent sellers. The petitioner also raised the point that many produce sellers would suffer loss of business from the license revocation. The court held that the effect on sellers was part of the legislative decision to impose sanctions for violations of PACA. Havana Potatoes of New York Corp. v. United States, 136 F.3d 89 (2d Cir. 1997), aff’d, 55 Agric. Dec. 1234 (1996).

FEDERAL ESTATE AND GIFT TAX

GIFT. After the taxpayers were married, the wife received shares of stock in a brokerage account as a gift from her grandfather. The taxpayers depleted the stock by drawing on the account and eventually sold the stock. The grandfather made two more transfers of stock to the account. When that stock was sold, the taxpayers claimed the capital gains based on a tax basis equal to the fair market value of the stock at the time of the transfer. The taxpayers claimed that the stock transfer was a loan of the stock and not a gift, which would allow only a tax basis equal to the basis in the hands of his grandfather at the time of the transfer. The court held that the transfer was a loan, based on the following factors: (1) no schedule of repayments or amortization; (2) the loans were repayable only at the will of the grandfather; (3) no interest schedule of repayments or amortization; (2) the loans were repayable only at the will of the grandfather; (3) no interest was charged or paid; (4) no security was given or required; (5) no repayments were made or demanded; (6) the taxpayers had no ability to repay the loans; and (7) the taxpayers did not report any loan forgiveness as discharge of indebtedness income. Vinikoor v. Comm’r, T.C. Memo. 1998-152.

JOINT TENANCY PROPERTY. The decedent and surviving spouse held commercial and residential property as joint tenants. Under California law, property acquired by married persons is deemed community property unless title is taken as joint tenants. The surviving spouse obtained a court ruling that the properties were held as community property. The court held that the properties were held as community property if the owners demonstrate that the intent was to hold the property as community property. The court stated that the state court ruling was insufficient by itself to prove the owners’ intent to hold the properties as community property. In addition, the court held that the spouse failed otherwise to prove that the mutual intent of the decedent and spouse was to hold the property as community property. The court held that the property was held by the decedent as joint tenancy property. The decedent’s estate claimed a 15 percent minority interest discount in the value of the decedent’s interests in the properties. The court held that a fractional interest discount is not allowed for joint tenancy property, but that the value of the entire property is included less the contributions made by the surviving joint tenant. Dr. Neil Harl will publish an article on this case in a future issue of the Digest. Estate of Young v. Comm’r, 110 T.C. No. 24 (1998).

PENSION PLAN. The decedent owned an interest in a qualified pension plan. Because of a will contest, a temporary administrator was appointed by the probate court. The administrator requested distributions from the pension plan and received several payments. Some of the payments were used to pay administrative expenses. The IRS argued that the plan payments were taxable to the estate. The court held that the plan payments were included in estate income because the estate received the funds without condition and made use of the funds. Estate of Machat v. Comm’r, T.C. Memo. 1998-154.

SPECIAL USE VALUATION-ALM § 5.03[2]. The IRS has issued the 1998 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:

<table>
<thead>
<tr>
<th>District</th>
<th>Interest rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Columbia</td>
<td>9.32</td>
</tr>
<tr>
<td>Omaha</td>
<td>8.17</td>
</tr>
<tr>
<td>Sacramento</td>
<td>8.38</td>
</tr>
<tr>
<td>St. Paul</td>
<td>8.28</td>
</tr>
<tr>
<td>Spokane</td>
<td>8.22</td>
</tr>
<tr>
<td>Springfield</td>
<td>8.74</td>
</tr>
<tr>
<td>Texas</td>
<td>8.19</td>
</tr>
<tr>
<td>Wichita</td>
<td>8.27</td>
</tr>
</tbody>
</table>


FEDERAL INCOME TAXATION

BAD DEBTS. The taxpayer had guaranteed a loan obligation of a partnership and was required to pay the loan when the partnership defaulted. The court held that, because the guarantee was a nonbusiness bad debt under Treas. Reg. § 1.166-9(b), the bad debt could not be characterized as a business bad debt. Parekh v. Comm’r, T.C. Memo. 1998-151.

BUSINESS EXPENSES-ALM § 4.02. The taxpayer operated a horse and dog breeding business but failed to keep any records of the separate expenses of the business to support the adjusted basis of the business property. The IRS had audited the taxpayer and reconstructed the allowable deductions and income from indirect records such as bank accounts and estimated personal expenses. The court upheld the IRS determinations because the taxpayer failed to provide any records or other evidence to rebut the IRS determinations. The appellate court affirmed in a decision designated as not for publication. Fisher v. Comm’r, 98-1 U.S. Tax Cas. (CCH) ¶ 50,370 (4th Cir. 1998), aff’d, T.C. Memo. 1997-225.

COMPUTERS. The taxpayer was a real estate sales agent and purchased a computer for use in the business. The taxpayer claimed the computer as a business expense on Schedule C but did not make the Section 179 expense method election on Form 4562. The court held that, because the taxpayer failed to make the proper election for the computer expense, the taxpayer was not entitled to any
determination for the computer expense. Fors v. Comm’r, T.C. Memo. 1998-158.

CORPORATIONS-ALM § 7.02.*

CONTRIBUTIONS. The taxpayer was the sole shareholder of a corporation and was required by state law to increase the capital in the corporation. The taxpayer contributed real property to the corporation which assumed the taxpayer’s liabilities. The liabilities exceeded the taxpayer’s basis in the property which otherwise would have caused the recognition of gain to the extent of the excess liability assumed. In order to avoid this gain recognition, the taxpayer also contributed a promissory note to the corporation for an amount sufficient to increase the taxpayer’s basis above the amount of liabilities assumed. The note was in writing, had a market rate of interest and had a fixed term. The court also found that the taxpayer was creditworthy and could repay the loan. The IRS argued that the indebtedness was not sufficient to create basis in that the taxpayer had complete control over whether the corporation would ever enforce the debt. The IRS pointed out that no payments had been made on the debt for two years but the corporation had not sought acceleration of the debt. In addition, no security was given for the note. The three judge panel held that the note was bona fide indebtedness with sufficient potential obligation of the taxpayer. The court emphasized the potential liability of the taxpayer in effect the corporation declared bankruptcy in that the creditors could look to the taxpayer for payment of corporate debts. As the dissent warns, the holding opens the door for “paper” construction of shareholder basis so long as the shareholder jumps through all the hoops of creating the debt. Dr. Neil Harli will publish an article on this case in a future issue of the Digest. Peracchi v. Comm’r, 98-1 U.S. Tax Cas. (CCH) ¶ 50,374 (9th Cir. 1998), rev’g, T.C. Memo. 1996-191.

DIVERSION OF CORPORATE FUNDS. The taxpayers, husband and wife, were the sole shareholders of two corporations. The corporations owed the shareholders $550,000 in borrowed funds and $282,000 in invested capital during the three tax years involved. During this time, the wife retained cash from the corporations’ businesses and hid the money in a kitchen drawer. The taxpayers did not report any of these funds as income. During this same time, the corporations had no earnings or profits. The IRS argued that the taxpayers diverted and hid the funds with the intent to evade payment of taxes. The IRS argued that, because the taxpayers did not intend the diverted funds to be payments on the loans or a return of capital, the funds were income to the taxpayers and failure to report the income was actionable evasion of taxes. The trial jury convicted the taxpayers of conspiracy to defraud the United States and tax evasion. The court held with the majority of precedent that, when a corporation has no earnings or profits, funds paid to shareholders are not taxable, at least where the shareholder is owed money by the corporation or has a capital account greater than the amounts paid by the corporation. United States v. D’Agostino, 98-1 U.S. Tax Cas. (CCH) ¶ 50,380 (2d Cir. 1998).

NURSERY TREES. The taxpayers operated a nursery which purchased one to two year old bare root trees for resale at least five years later. The trees were purchased with bare roots because the trees are cheaper to ship in large quantities. The bare root trees, however, required special handling to grow and maintain. The taxpayers grew the trees in soil for at least five years before resale when the trees were sold with soil balls around the roots. The taxpayers purchased new bare root trees each year to replenish the inventory reductions from the sale of grown trees and the loss of trees which did not survive the bare root condition. The taxpayers made a timely election out of I.R.C. § 263A so that the costs of the new trees and the maintenance costs of growing the trees could be deducted currently. Under Treas. Reg. § 1.162-12, a farmer may currently deduct the costs of “seeds and young plants” in the year of purchase if the farmer follows a consistent practice of deducting such costs each year. The auditing revenue agent argued that the bare root trees were not “young plants” for purposes of Treas. Reg. § 1.162-12; therefore, the costs of the trees had to be capitalized. The agent cited Industrial Agrigrowth Consulting Services, Inc. v. Comm’r, T.C. Memo. 1988-382 which held that an ornamental tree nursery had to capitalize the costs of the trees because the trees were not young plants. The IRS distinguished that case from the facts of this ruling by noting that the holding in the case resulted from the failure of the taxpayer to provide information about the maturity or marketability of the trees when purchased. In this ruling, the IRS found that the bare root trees were not marketable without significant special handling and at least five years of growing. The IRS held that the bare root trees were young plants and that the taxpayers could elect to deduct the cost of the trees currently. Ltr. Rul. 9818006, Jan. 6, 1998.

TRAVEL EXPENSES. The taxpayer was a corporation which operated a trucking business. The taxpayer paid its drivers a per diem travel expense of 6 percent of the load revenue for each trip. The drivers were not required to substantiate any travel expenses nor to return any unused amounts. The method of payment did not change if the drivers used the sleeping quarters in the trucks. The evidence showed that drivers could receive different reimbursements for the same trips, just because the value of the load was different. Under Treas. Reg. § 1.62-2(f), employee business expense reimbursements could be excluded from wage income if paid under an accountable plan. In order for reimbursements to be made under an accountable plan, the payments must be made for business-related expenses. Under Treas. Reg. § 1.62-2(d)(3)(i), an expense is not business-related if it is paid whether or not the employee actually incurs the expense. The court held that the 6 percent per diem reimbursements were included in wage income because the amount was paid whether or not the expense was incurred and the calculation of the amount was dependent upon a factor, the trip load revenue, which was not related to the travel expenses. Trucks, Inc. v. United States, 1475 (N.D. Ga. 1997).

**NUISANCE**

LIVESTOCK CONFINEMENT OPERATIONS. Iowa has passed legislation which changes the law to remove protection from nuisance suits from animal feeding operations which (1) unreasonably interfere with another

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*Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.*
comfortable use and enjoyment of property and (2) fail to use existing prudent generally accepted management practices reasonable for the operation. The law dropped previous requirements that the interference be continuous and that the elements be proved by clear and convincing evidence. The new legislation added a provision excepting from right-to-farm protections, any operation in which a “chronic violator” has an interest. The new legislation also dropped the rule that “an animal feeding operation that complies with the requirements of [Iowa Code] Chapter 455B for animal feeding operations shall be deemed to meet any common law requirements regarding the standard of a normal person living in the locality of the operation.” Iowa H.F. 2494, House Amendment 9048, (May __, 1998).

SECURED TRANSACTIONS

ATTACHMENT. The debtor had granted a security interest to the plaintiff Farm Credit Bank in existing farm equipment and after-acquired property. The debtor purchased two pickup trucks, using a loan from the defendant bank and granting the bank a security interest in the trucks. Neither lender perfected its security interest in the trucks by noting their liens on the certificates of title. After the debtor defaulted on the truck loans, the trucks were sold at auction and the issue in the case was which unperfected lien had priority. Since neither lien was perfected, the priority was to be determined by the order in which the liens attached to the collateral, under S.D. C.L. § 57A-9-312(5)(b). Under the law governing attachment, S.D. C.L. § 57A-9-203, a lien does not attach unless the parties have signed a security agreement which identifies the collateral. Although the plaintiff’s security agreement listed several trucks owned by the debtor at that time and included after-acquired property, the court held that, because the security agreement did not specifically list the trucks, the plaintiff’s security interest did not attach to the trucks. The court noted that an exception for replacement collateral did not apply because the debtor did not use the proceeds of listed collateral to purchase the two trucks. The case is interesting in that there is no discussion, as there has been in other cases of after-acquired collateral, of whether the after-acquired property clause was sufficient to put a subsequent creditor on notice of the security interest. The holding in this case may indicate that after-acquired farm equipment clauses may rarely be sufficient to cause attachment in after-acquired property because the clauses can rarely specifically identify future purchases. Creditors should use caution in relying on after-acquired property clauses, at least in South Dakota. Farm Credit Services v. First State Bank, 575 N.W.2d 250 (S.D. 1998).

STATE REGULATION OF AGRICULTURE

LIVESTOCK CONFINEMENT OPERATIONS. Kansas has passed new legislation increasing to 5,000 feet the distance between new swine feeding facilities and any habitable structure or park. The law affects facilities with more than 3,725 animal units which apply for construction permits after February 28, 1998. The law also requires manure management plans for new and existing facilities with 1,000 or more animal units. If manure is to be applied to land, the facility is required to submit a nutrient utilization plan which includes soil tests and manure nutrient analysis. The new legislation also changed allowable seepage rates from lagoons. Swine facilities with 1,000 or more animal units are required to submit odor control plans in order to receive a new or expansion construction permit. The Kansas Depart. of Health and Environment is authorized to require the planting of trees to help control odor. Kansas H.B. 2950.

In response to Goodell v. Humboldt County, (see 9 Agric. L. Dig. 39 supra) the Iowa legislature has passed legislation prohibiting counties from adopting legislation regulating conditions or activities involving animal production, care, feeding or housing, unless expressly authorized by state law.

The new legislation also prohibits the construction or expansion of an animal feeding operation within 100 feet of a road, street or bridge maintained by a political subdivision, unless permanent vegetation with a mature height of at least 20 feet is planted between the facility and the thoroughfare. The new law prohibits construction of an animal feeding operation within 500 feet of a major water source or within 200 feet from other watercourses. Similarly, the legislation prohibits the diversion, expansion or construction of major water sources or other watercourses within the above distances from an animal feeding operation.

The new legislation prohibits the application of liquid manure from a confinement feeding operation on land within 750 feet of (1) a residence not owned by the owner of the land, (2) a commercial enterprise, (3) a religious or educational institution, or (4) a public use area, unless a waiver is obtained. Application is allowed within 250 feet of the above properties for manure incorporated in the soil within 24 hours, manure from small animal feeding operations, and spray irrigation application of not more than 25 pounds per square inch. The legislation also increased or retained the required distances between various kinds and sizes of animal feeding structures and the above properties, constructed or expanded after the effective date of the legislation.

The new legislation also provides a procedure for complaints, investigation and enforcement actions against animal feeding operations. The actions may be commenced through the county board of supervisors or the DNR. Iowa H.F. 2494, House Amendment 9048, (May __, 1998).

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