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Cases, Regulations and Statutes

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Restrictive agreements in partnership documents

If the only purpose behind the formation of a family limited partnership is to depress asset values, with nothing of substance changed as a result of the formation, any restrictions imposed by the partnership agreement are likely to be disregarded.\(^1\) The Internal Revenue Service evaluates such transactions in light of whether the arrangement—(1) was a device to transfer property to a family member for less than adequate consideration and (2) was not the result of arm's length negotiation having a valid business purpose.\(^2\)

Discounts based on restrictive agreements have been allowed in the past.\(^3\) However, enactment of the "freeze" rules in 1990\(^4\) has called that line of cases into question.\(^5\) In a 1999 Tax Court case,\(^6\) the court refused to approve a scheme whereby the use of "assignee interests" were used to transfer interests to children to get around the provision of I.R.C. § 2704(b).\(^7\) The court did, in that case, agree that the partnership agreements did not contain an "applicable restriction" within the meaning of I.R.C. § 2704(b) on the grounds that the provision was no more restrictive than state law. Accordingly, a discount for lack of liquidity could be used in computing the value of partnership interests transferred for federal gift tax purposes.\(^8\)

Conclusion

There is little doubt that IRS has their eye on family limited partnerships. Certainly any use of the concept should be accompanied by a showing of ample business reason for the transaction and should involve a careful assessment of the limitations in I.R.C. § 2704(b).

FOOTNOTES
2. See, e.g., Estate of Watts v. Comm'r, T.C. Memo. 1985-595 (35 percent discount of 15 percent partnership interest for non marketability for federal estate tax purposes).
4. Estate of Watts v. Comm'r, n. 2 *supra*.
5. See Estate of Murphy v. Comm'r, T.C. Memo. 1990-472.
8. *Id*.
10. *Id*.
12. *Id*.
16. *Id*.
21. I.R.C. § 2704(b); Treas. Reg. § 25.2704-1(b)(1). See Ltr. Rul. 9735003, May 8, 1997 (restrictions imposed in family limited partnership failed to satisfy I.R.C. § 2704(b) exceptions); FSA Ltr. Rul. 9919009, Jan. 13, 1999 (partnership agreement provisions preventing liquidation were an "applicable restriction" under I.R.C. § 2704(b) which was disregarded in valuing transferred partnership interests to extent more restrictive than limitations under state partnership law; 45 percent discount in family limited partnership disallowed).
23. *Id*.
24. *Id*.

CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr.

ANIMALS

**HORSES.** The plaintiff's vehicle struck the defendant's horse on a public street. The horse had escaped a fenced enclosure. The horse was kept in the limits of a municipality which had an ordinance which required owners of animals to keep their animals physically confined or restrained. The plaintiff argued that the ordinance created a strict liability for owners of animals. The court held that the ordinance did not create a strict liability standard but only established a claim for negligence per se for violation of the ordinance. *Lui v. Barnhart*, 987 P.2d 942 (Colo. Ct. App. 1999).

**BANKRUPTCY**

**CHAPTER 12-ALM § 13.03.**

**ELIGIBILITY.** The debtors, husband and wife, had been engaged in farming for over 15 years and owned as much as 360 acres on which they operated a cow/calf operation and grew crops. Because of financial difficulties from weather
The debtors sought a ruling that the IRS had to at least consider the offer, although the debtors acknowledged that the IRS could not be forced to accept any offer in compromise. The court held that the IRS policy violated Section 525(a) as discriminating against bankruptcy filers merely because they filed for bankruptcy and ordered the IRS to consider the debtors’ offer in compromise under the standards in I.R.C. §§ 7121, 7122. In re Mills, 240 B.R. 689 (Bankr. S.D. W.Va. 1999).

SECURED CLAIMS. The debtor’s Chapter 13 plan listed a claim for federal taxes as unsecured but also provided that any liens would be extinguished upon payments under the plan. The plan also discounted the tax claim for the amount of dischargeable taxes. The plan was confirmed without objection by the IRS. The IRS filed a secured tax claim which was not provided for in the plan. After the debtor made the payments under the plan, the IRS sought enforcement of its liens and the debtor objected. The court held that the debtor could not alter the nature of the tax claim merely by characterizing the tax claim as unsecured in the plan. Because the secured tax claim was nondischargeable, the liens survived and remained enforceable after the bankruptcy case. In re Deutchman, 192 F.3d 457 (4th Cir. 1999).

FEDERAL AGRICULTURAL PROGRAMS

CROP INSURANCE. The FCIC has adopted as final regulations which amend the Forage Production Crop Insurance Provisions and Forage Seeding Crop Insurance Provisions, and delete Forage Production Winter Coverage Endorsement. The forage policy is revised by: allowing optional units; changing the cancellation and termination dates in California, Nevada and Utah; requiring the insured to report all forage acreage on or before each date specified in the Special Provisions; changing dates when insurance attaches and when insurance ends; extending dates in some counties in California to allow year round coverage; clarifying that insurance is not available for damage or loss of production that occurs after removal from windrow; allowing forage to be direct marketed; and including optional unit procedures in the event of a loss. The forage seeding policy is revised by: adding cancellation and termination dates for California and South Dakota; requiring the insured to report all forage acreage on or before each date specified in the Special Provisions; specifying in all states and in California, unless otherwise specified in the Special Provisions, forage damaged before the final planting date must be replanted to the extent that the forage has less than a 75 percent stand; allowing a replant payment in California, unless otherwise specified in the Special Provisions, on any acreage planted to the insured crop that is damaged by an insurable cause of loss occurring within the insurance period to the extent that less than 75 percent of normal stand remains; allowing increased replanting payments if specified in the Special Provisions; and removing the 10 percent planted acreage requirements. The regulations also restrict the effect of the current Forage Production and Forage Seeding Crop

**FEDERAL ESTATE AND GIFT TAX**

**TAX LIEN.** The taxpayer had received inter vivos real property from a decedent who failed to file or pay gift tax on the transfer. The taxpayer granted a mortgage against the property to finance repairs. The IRS assessed gift tax and filed a lien against the donor's property, the real property involved and the taxpayer's other property. The IRS stated that the mortgage against the donated property had priority over the IRS lien, making the lien against the donated property insufficient to cover the taxes owed. The IRS also stated that the taxpayer was liable for the taxes as the donee if the decedent’s estate could not pay the taxes; therefore, the taxpayer’s property was also subject to the lien. Thus, the IRS held that the lien remained attached to the decedent’s property for the tax owed, the donated property to the extent not covered by the first mortgage and the taxpayer’s property. Ltr. Rul. 200002036, Oct. 6, 2000.

**FEDERAL INCOME TAXATION**

**ALLOCATION OF BASIS.** For multiple asset acquisitions after May 6, 1986, involving "assets which constitute a trade or business", for purposes of determining the transferee's basis in the assets and the gain or loss of the transferor, the consideration received is to be allocated among the acquired assets in the same manner as prescribed in I.R.C. § 338(b)(5). See I.R.C. § 1060(a), (c). Under former Temp. Treas. Reg. § 1.338(b)-2T, basis in multiple asset acquisitions was allocated generally to four classes of assets (1) cash and cash-like items; (2) certificates of deposit, government securities and other marketable stock or securities; (3) all assets not in Class (1), (2) and (4); and (4) intangible assets in the nature of goodwill and going concern value (in that order) in proportion to fair market values. Under final regulations, the fourth class is split into (4) intangibles other than goodwill and going-concern value and (5) goodwill and going-concern value. 65 Fed. Reg. 3820 (Jan. 25, 2000), amending Treas. Reg. § 1.338(b)-2.

**ATTORNEY’S FEES.** The taxpayer had prevailed in a tax case against the IRS concerning valuation of estate property, Estate of Cervin v. Commissioner, 111 F.3d 1252 (5th Cir. 1997). The taxpayer was awarded litigation costs and sought attorney’s fees above the $75 per hour provided by I.R.C. § 7430. The taxpayer argued that special factors existed in the case to justify the higher fee in that (1) the attorney’s special knowledge of federal tax law and state property law and (2) the IRS position in the case was contrary to well-established state law. The court held that the taxpayer was limited to the $75 fee allowance because special legal abilities were not a special factor and egregious conduct by the IRS was not recognized as a special factor. Estate of Cervin v. Comm’r, 2000-1 U.S. Tax Cas. (CCH) ¶ 60,367 (5th Cir. 2000).

**BUSINESS EXPENSES.** The IRS has adopted as final regulations governing the substantiation requirements for certain business expenses. I.R.C. § 274(d) disallows a trade or business deduction under I.R.C. § 162 for any traveling (including meals and lodging), entertainment, gift, or listed property expense, unless the taxpayer substantiates the elements of the expense by adequate records or by sufficient evidence. Under Treas. Reg. § 1.274-5(c), a taxpayer must maintain two types of records to satisfy the “adequate records” requirement: (1) a summary of expenses (account book, diary, log, statement of expense, trip sheets, or other similar record), sometimes called an expense account or expense voucher, and (2) documentary evidence (such as receipts or paid bills). Together, these records must establish the elements of amount, time, place, and business purpose (and for gifts and entertainment, business relationship of recipient or persons entertained) for each expenditure or use. Treas. Reg. § 1.274-5(c)(2)(iii) generally requires that a taxpayer have a receipt or other documentary evidence to substantiate (1) any expenditure for lodging and (2) any other expenditure of $75 or more. This change is applicable to both deductions and reimbursement arrangements. 65 Fed. Reg. 4121 (Jan. 26, 2000).

**CHARITABLE DEDUCTION.** The taxpayer claimed a deduction for contributions to a “church” which was removed from the list of organizations qualified under I.R.C. § 170(c)(2). The taxpayer argued that the organization was a church and was not required to meet the requirements of Section 170(c)(2). The court held that the only exemption for churches was the requirement for a formal application for Section 170(c)(2) status. Once the IRS determines that an organization does not comply with Section 170(c)(2), the burden of proof of eligibility is on the taxpayer. The court held that the taxpayer failed to provide any evidence of the organization’s eligibility or even that the contributions were made. Taylor v. Comm’r, T.C. Memo. 2000-17.

**CORPORATIONS**

**REORGANIZATION.** The IRS has issued a revenue ruling on “type A” reorganizations. In the first set of facts, a target corporation transferred some of its assets and liabilities to an acquiring corporation, retained the remainder of its assets and liabilities, and remained in existence following the transaction. The target corporation's shareholders received stock in the acquiring corporation in exchange for part of their target corporation stock and they retained their remaining target corporation stock. The transaction qualified as a merger under state X corporate law. In the second situation, a target corporation transferred some of its assets and liabilities to each of two acquiring corporations. The target corporation liquidated and the target corporation's shareholders received stock in each of the two acquiring corporations in exchange for their target corporation stock. The transaction qualified as a merger under state X corporate law. The IRS ruled that neither merger qualified as a reorganization under I.R.C. § 368(a)(1)(A) (“type A”). In the first situation, the acquired corporation did not liquidate as
required for a “type A” reorganization. In the second situation, the acquired corporation’s assets and liabilities were acquired by more than one corporation as required for a “type A” reorganization. Rev. Rul. 2000-5, I.R.B. 2000-__.

COURT AWARDS AND SETTLEMENTS. The taxpayers received a personal injury judgment which included interest. A portion of the interest award was paid to the taxpayers’ attorneys as part of the contingency fee arrangement. The taxpayers argued that (1) all of the interest was excluded from income because the interest was part of the damages for personal injury, (2) the prejudgment interest was excludable as damages, or (3) the interest paid to the attorneys was excludible as earned by the attorneys. The District Court, citing Kovacs v. Commissioner, 25 F.3d 1048 (6th Cir. 1994) (unpublished), aff’g, 100 T.C. 124 (1993), cert. denied, 513 U.S. 963 (1994), rejected all of these arguments, holding that the interest was included in income as an award not received on account of personal injury. The appellate court reversed, holding with the taxpayer’s third argument that the amount paid to the attorneys was not income to the taxpayer but was income to the attorneys only. Estate of Clarks v. United States, 2000-1 U.S. Tax Cas. (CCH) ¶ 50,158 (6th Cir. 2000), rev’g, 98-2 U.S. Tax Cas. (CCH) ¶ 50,868 (E.D. Mich. 1998).

The taxpayer received a personal injury jury verdict award. A portion of the award was paid by the defendant’s insurance and a portion was paid by a state professional agency. A portion of the proceeds was prejudgment interest required by state law. The court held that the prejudgment interest amounts were included in gross income. Greer v. Comm’r, T.C. Memo. 2000-25.

INNOCENT SPOUSE DEFENSE. The IRS has issued a revenue procedure providing guidance for individuals seeking equitable relief from joint tax liabilities under the innocent spouse provisions of I.R.C. §§ 66(c), 6015(f). The guidance enumerates the threshold conditions that must be satisfied for any request for equitable relief to be considered. Sets forth the criteria under which relief will ordinarily be granted and includes a partial list of factors that are to be considered in determining whether it would be inequitable to hold a requesting spouse liable for a deficiency or for an unpaid liability that was properly reported. The procedures apply to any spouse who requests relief from liabilities arising from the operation of community property law or from liabilities that were unpaid on, or arose after, July 22, 1998. Rev. Proc. 2000-15, I.R.B. 2000-__.

PARTNERSHIPS-ALM § 7.03.*


PASSIVE INCOME. The taxpayer was required to supply a letter of credit to support underwriting of risk. The taxpayer provided securities to the bank as collateral for the letter of credit. The letter of credit was drawn upon and the bank required the sale of some of the securities. The IRS ruled that the gain from the sale of the securities was nonpassive portfolio income. FSA Ltr. Rul. 200002015, Oct. 12, 1999.

PENSION PLANS. In a revenue ruling, a newly hired or current employee could elect to receive an amount in cash or have the amount contributed by the employer to a profit-sharing plan. The IRS ruled that the employer contributions made on the employee’s behalf to the plan in lieu of receipt of cash compensation will not fail to be considered elective contributions, within the meaning of Treas. Reg. § 1.401(k)-1(g)(3), made under a qualified cash deferred arrangement, within the meaning of I.R.C. § 401(k), merely because the contributions are made pursuant to an arrangement under which a fixed percentage of the employee’s compensation is contributed to the plan, unless the employee affirmatively elects to receive the amount in cash. Rev. Rul. 2000-8, I.R.B. 2000-__.

The IRS has released a revenue procedure which revises and combines the IRS’s master and prototype and regional prototype plan programs into a unified program for the preapproval of pension, profit-sharing, and annuity plans. The procedure opens the unified program, on April 7, 2000, for mass submitter plans and May 8, 2000, for non-mass submitter plans, to allow sponsors to obtain opinion letters relating to the qualification of their plans that take into account all of the changes in the qualification requirements made by the Uruguay Round Agreements Act (Pub. L. No. 103-465), the Small Business Job Protection Act of 1996 (Pub. L. No. 104-188), the Taxpayer Relief Act of 1997 (Pub. L. No. 105-34), and the IRS Restructuring and Reform Act of 1998 (Pub. L. No. 105-206). Rev. Proc. 2000-20, I.R.B. 2000-__.

S CORPORATIONS-ALM § 7.02[3][c].*

DISCHARGE OF INDEBTEDNESS. The taxpayer was the sole shareholder of an S corporation. The corporation realized discharge of indebtedness income (DII) in a bankruptcy case and excluded the income under the bankruptcy exception of I.R.C. § 108(a). The taxpayer increased the basis of the taxpayer’s stock by the amount of discharge of indebtedness income realized by the corporation. The court held, as the Tax Court has done since Nelson v. Comm’r, 110 T.C. 114 (1998), that the taxpayer could not pass-through the S corporation’s discharge of indebtedness income where the income was excluded from income under one of the Section 108 exceptions. The appellate court agreed that the DII had to be used to offset the other tax attributes, in this case net operating losses, of the corporation. However, the court held that the taxpayer’s basis in the corporation was increased by the amount of DII and could be used to offset future losses of the corporation. The court noted that, after the facts in this case, the IRS had issued proposed regulations which adopt the holding in Nelson, but the court did not rule on the regulations. Witzel v. Comm’r, 2000-1 U.S. Tax Cas. (CCH) ¶ 50,165 (7th Cir. 2000), affg in part, T.C. Memo. 1999-64.

In a similar case, the corporation with DII had no tax attributes to reduce. The court held that the DII became tax-exempt income which passed through to the shareholders which increased the shareholders’ basis and allowed offset
against net operating loss carryovers. The court noted that regulations have been proposed which are contrary to this result, but the regulations were not effective for the tax years involved here. Hogue v. United States, 2000-1 U.S. Tax Cas. (CCH) ¶ 50,149 (D. Or. 2000).


SUBSIDIARIES. The IRS has issued regulations relating to the treatment of corporate subsidiaries of S corporations (QSSS). The regulations interpret the rules added to the Internal Revenue Code by section 1308 of the Small Business Job Protection Act of 1996 (the Act).

Prior law prohibited an S corporation from owning 80 percent or more of the stock of another corporation. The Act repealed I.R.C. § 1362(b)(2)(A), thereby allowing an S corporation to own 80 percent or more of the stock of a C corporation. The Act also added I.R.C. § 1504(b)(8) to prevent an S corporation from joining in the filing of a consolidated return with its affiliated C corporations. A C corporation subsidiary of an S corporation, however, may file a consolidated return with its affiliated C corporations.

Under the regulations, an S corporation makes a QSSS election with respect to an eligible subsidiary by filing a form to be developed by the IRS prior to the time these regulations become final. This changes the temporary election procedure provided in Notice 97-4, I.R.B. 1997-2, 25, which provided that a parent S corporation files a completed Form 966, Corporate Dissolution and Liquidation (with some modifications), to make a QSSS election. Until these regulations are finalized, taxpayers should continue to use the temporary election procedure in Notice 97-4 to make QSSS elections. The regulations also provide that the effective date of a QSSS election may be up to 2 months and 15 days prior to the day the QSSS election is made. This is a slight change from the 75 day retroactive period provided in Notice 97-4, but is consistent with the general time period for making S elections. Unlike the S election, however, a QSSS election does not need to be made within 2 months and 15 days of the beginning of a taxable year. A similar retroactive period is provided for revocations of QSSS status. In addition, a taxpayer may choose a prospective effective date for a QSSS election or revocation, so long as the date selected is not more than 12 months after the date the election or revocation is made. Treas. Reg. § 1.1361-3.

The regulations provide that, when an S corporation makes a valid QSSS election with respect to a subsidiary, the subsidiary is deemed to have liquidated into the parent. The tax treatment of this liquidation, alone or in the context of any larger transaction (for example, a transaction that also includes the acquisition of the subsidiary’s stock), is generally determined under all relevant provisions of the Code and general principles of tax law, including the step transaction doctrine. However, a special transition rule applies to certain elections effective prior to the date that is 60 days after publication of final regulations in the Federal Register. The transition rule indicates the recognition of special concerns that may have arisen as a result of transactions entered into by taxpayers relying on the legislative history to the Act and without applying the step transaction doctrine to the acquisition of the subsidiary’s stock followed by a QSSS election. Treas. Reg. § 1.1361-4.

Special rules may apply when a QSSS election is made following the transfer of one S corporation’s stock to another S corporation. For example, if an S corporation acquires the stock of another S corporation in a transaction in which the acquiring S corporation’s basis in the stock received is determined by reference to the transferor’s basis and makes a QSSS election with respect to the other corporation effective on the day of acquisition, any losses disallowed under section 1366(d) with respect to a former shareholder of the QSSS will be available to that shareholder as a shareholder of the acquiring S corporation. Furthermore, when stock in an S corporation is transferred to another S corporation and a QSSS election is made with respect to the subsidiary effective on the day of acquisition, the S election of the former corporation terminates at the same moment as the QSSS election becomes effective. This rule ensures that the former S corporation is not treated as a C corporation for any period solely because of the transfer. Generally, the regulations treat the liquidation as occurring at the close of the day before the QSSS election is effective. Under this rule, if a parent corporation makes an S election effective on the same date as a QSSS election with respect to a subsidiary, the deemed liquidation occurs at a time when the parent corporation is still a C corporation. A QSSS election satisfies the requirement of adopting a plan of liquidation under section 332. Treas. Reg. § 1.1361-4.

Following the deemed liquidation, the QSSS is not treated as a separate corporation (except as otherwise provided in the regulations), and all assets, liabilities, and items of income, deduction, and credit are treated as those of the S corporation. Accordingly, all such items must be reported on the S corporation’s return required to be filed under section 6037. A special rule applies for the calculation of these items where either an S corporation or its QSSS is a bank (as defined in section 581). This special rule was first announced in Notice 97-5, 1997-2 I.R.B. 25. Until these regulations are finalized, taxpayers should continue to follow Notice 97-5. Treas. Reg. § 1.1361-4.

The QSSS status of a corporation continues until it terminates. The regulations specify the date of termination for specific terminating events. Section 1361(b)(3)(D) provides that, if a QSSS election terminates, the corporation is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) from the S corporation in exchange for stock of the new corporation immediately before the termination. The tax treatment of this transaction or of a larger transaction that includes this transaction will be determined under the Code and general principles of tax law, including the step transaction doctrine. Examples are provided to illustrate situations in which the formation of the new corporation will qualify as a nonrecognition transaction under section 351. The regulations also provide that, under certain circumstances, relief may be available under the standards established under section 1362(f) for the...
that final regulations are published in the Federal Register.

accrued earnings and profits.

address the allocation of distributions from current or

and profits for those three taxable years. Provisions also

the C corporation bear to the C corporation's total earnings

to the time when the S corporation acquired 80 percent of

earnings and profits for the three taxable years ending prior

profits in the same proportion as the C corporation's active

requirements of section 1504(a)(2) as active earnings and

prior to the time an S corporation held stock meeting the

regulations provide that a C corporation may

to active investment income, all earnings and profits produced by the

derived from activities that would produce passive

corporation's earnings and profits for a taxable year are

less than 10 percent of the C

corporation's gross receipts in the year the earnings and

investment income-producing activities with the

corporation derived from the active conduct of a trade or business. Special rules apply to

dividends distributed by the common parent of a

The regulations also provide rules relating to certain C
corporation subsidiaries held by S corporations. Under section 1362(d)(3)(E), dividends received by an S
corporation from a C corporation in which the S corporation has an 80 percent or greater ownership interest are not

treated as passive investment income for purposes of sections 1362 and 1375 to the extent the dividends are

attributable to the earnings and profits of the C corporation derived from the active conduct of a trade or business. The

regulations provide guidance for attributing dividends to the active conduct of a trade or business. Special rules apply to

dividends distributed by the common parent of a consolidated group. Treas. Reg. § 1.1361-2.

Under the regulations, earnings and profits of a C
corporation derived from the active conduct of a trade or business are the earnings and profits of the corporation derived from activities that would not produce passive

investment income under section 1362(d)(3) if the C corporation were an S corporation. The regulations provide a

safe harbor under which the corporation may determine the amount of the active earnings and profits by comparing the corporation's gross receipts derived from non-passive

investment income-producing activities with the corporation's total gross receipts in the year the earnings and

profits are produced. If less than 10 percent of the C corporation's earnings and profits for a taxable year are

derived from activities that would produce passive investment income, all earnings and profits produced by the
corporation during the taxable year are considered active earnings and profits. Treas. Reg. § 1.1361-2.

The regulations also provide that a C corporation may

treat all earnings and profits accumulated by the corporation prior to the time an S corporation held stock meeting the

requirements of section 1504(a)(2) as active earnings and profits in the same proportion as the C corporation's active

earnings and profits for the three taxable years ending prior to the time when the S corporation acquired 80 percent of

the C corporation bear to the C corporation's total earnings and profits for those three taxable years. Provisions also

address the allocation of distributions from current or accumulated earnings and profits. Treas. Reg. § 1.1361-2.

The regulations are proposed to be effective on the date

that final regulations are published in the Federal Register.

However, the IRS is considering whether certain provisions

should be made retroactive. 65 Fed. Reg. 3843 (Jan. 25, 2000), amending Treas. Reg. § 1.1361-0 et seq.

SAFE HARBOR INTEREST RATES

February 2000

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Section 1361(b)(3)(D) provides that a corporation whose

QSSS election has terminated (or a successor corporation) may not make an S election or have a QSSS election made with respect to it for five taxable years following the termination without the consent of the Secretary. The

regulations provide that, without requesting the Secretary's consent, a corporation may make an election to be treated as an S corporation or may have a QSSS election made with respect to it before the expiration of the five-year period under certain circumstances. Consent is not required if an otherwise valid S election or QSSS election is made for the former QSSS (or its successor corporation) effective immediately following the disposition of its stock. Thus, the regulations allow corporations to move freely between QSSS and S corporation status, provided there is no intervening period for which the corporation is treated as a C corporation. Treas. Reg. § 1.1361-5.

The regulations also provide rules relating to certain C corporation subsidiaries held by S corporations. Under section 1362(d)(3)(E), dividends received by an S corporation from a C corporation in which the S corporation has an 80 percent or greater ownership interest are not treated as passive investment income for purposes of sections 1362 and 1375 to the extent the dividends are attributable to the earnings and profits of the C corporation derived from the active conduct of a trade or business. The regulations provide guidance for attributing dividends to the active conduct of a trade or business. Special rules apply to dividends distributed by the common parent of a consolidated group. Treas. Reg. § 1.1361-2.

Under the regulations, earnings and profits of a C corporation derived from the active conduct of a trade or business are the earnings and profits of the corporation derived from activities that would not produce passive investment income under section 1362(d)(3) if the C corporation were an S corporation. The regulations provide a safe harbor under which the corporation may determine the amount of the active earnings and profits by comparing the corporation's gross receipts derived from non-passive investment income-producing activities with the corporation's total gross receipts in the year the earnings and profits are produced. If less than 10 percent of the C corporation's earnings and profits for a taxable year are derived from activities that would produce passive investment income, all earnings and profits produced by the corporation during the taxable year are considered active earnings and profits. Treas. Reg. § 1.1361-2.

The regulations also provide that a C corporation may treat all earnings and profits accumulated by the corporation prior to the time an S corporation held stock meeting the requirements of section 1504(a)(2) as active earnings and profits in the same proportion as the C corporation's active earnings and profits for the three taxable years ending prior to the time when the S corporation acquired 80 percent of the C corporation bear to the C corporation's total earnings and profits for those three taxable years. Provisions also address the allocation of distributions from current or accumulated earnings and profits. Treas. Reg. § 1.1361-2.

The regulations are proposed to be effective on the date that final regulations are published in the Federal Register.

However, the IRS is considering whether certain provisions should be made retroactive. 65 Fed. Reg. 3843 (Jan. 25, 2000), amending Treas. Reg. § 1.1361-0 et seq.

SAFE HARBOR INTEREST RATES

February 2000

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Mid-term

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Long-term

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<tr>
<td>120 percent AFR</td>
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<td>7.99</td>
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SECTION 105 PLANS. The taxpayers. Husband and wife established a Section 105 employee medical expenses reimbursement plan on December 16, 1993. The plan provided for a retroactive effective date of January 1, 1993. The taxpayers signed an employment agreement which made the wife the employee of the business and covered by the plan. The court held that reimbursements made to the wife for medical expenses prior to December 16, 1993 were included in the wife’s income. Although the parties raised the issue, the court delayed a ruling on whether the insurance premiums paid for the wife were also included in income, until the parties presented sufficient evidence. Wollenburg v. United States, 2000-1 U.S. Tax Cas. (CCH) ¶ 50,156 (D. Neb. 1999).

WORKERS’ COMPENSATION

AGRICULTURAL LABOR. The defendant had constructed and operated a dairy in which the plaintiff was employed. During the construction of the dairy, the defendant obtained workers’ compensation insurance but did not file an election to be covered by the workers’ compensation statute. After the dairy was completed, the defendant let the insurance lapse. The plaintiff was injured in an accident after the lapse of the policy and sought a ruling that the defendant’s purchase of the workers’ compensation insurance was an election to be covered by the statute. The court held that the purchase of workers’ compensation insurance alone was insufficient to elect to be covered by the act because the statute, Kan. Stat. Supp. 44-505, required a written statement of election to be filed with the state director. Rivera v. Cimarron Dairy, 988 P.2d 235 (Kan. 1999).
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&

SEMINAR IN NEW MEXICO

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by Neil E. Harl and Roger A. McEowen

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