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Cases, Regulations, and Statutes

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5. In the case of a perishable agricultural commodity or peanuts, is exclusively produced in the U.S.

The rules do not apply to a covered commodity if the commodity is prepared or served in a food service establishment and offered for sale or sold at the food service establishment in normal retail quantities or served to consumers at the food service establishment. **Act Sec. 10816, adding Secs. 281 and 282 to the Agricultural Marketing Act of 1946.**

Financing statements. The legislation makes numerous changes in Sec. 1324 of the Food Security Act of 1985 relative to financing statements. **Act Sec. 10604, amending Secs. 1324(c)(4), 1324(e) and 1324(g)(2)(A) of the Food Security Act of 1985.**

CONSTRUCTIVE RECEIPT OF PROGRAM PAYMENTS. In the discussion in the last Digest issue, page 83 supra, on **Direct Payments,** disregard the last sentence and replace it with the following:

Similar legislation was passed in 1999 (Pub. L. 106-170). The 2002 Act in an attempt to avoid the constructive receipt of income referred to Pub. L. 106-170 but not to Pub. L. 105-277. The Senate Committee believes the present language is adequate and this author is now inclined to agree. Income under the 2002 Act will be reportable into income in the year of receipt.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

FEDERAL AGRICULTURAL PROGRAMS

COTTON. The CCC has requested proposals from federally recognized Indian tribes, states, units of local government, and nongovernmental organizations to cooperate in the acquisition of conservation easements or other interests in farms and ranches as part of the Farmland Protection Program. Eligible land includes farm and ranch land that has prime, unique, or other productive soil, or that contains historical or archaeological resources. These lands must also be subject to a pending offer from eligible entities for the purpose of protecting topsoil by limiting conversion of that land to nonagricultural uses. **67 Fed. Reg. 37756 (May 30, 2002)**.

FEDERAL ESTATE AND GIFT TAX

GIFTS. The taxpayer owned a 1 percent interest in an LLC taxed as a partnership. The taxpayer acquired an additional 19 percent interest in the LLC on one day and transferred the interest to a generation-skipping trust the next day along with the 1 percent interest to a family trust. The taxpayer filed a gift tax return and identified the LLC, the type of interest conveyed and the claimed value of the interests. The IRS claimed that the gifts were substantially undervalued. In a Chief Counsel Advice letter, the IRS ruled that the substantial undervaluing of the gift and the failure to provide sufficient information about the value of the LLC and the nature of the interests conveyed were sufficient omissions to allow avoidance of the statute of limitations on the gifts. **CCA Ltr. Rul. 200221010, Feb. 12, 2002**.

IRA. The decedent owned an IRA at death and the IRA passed to the estate. The IRS ruled that the amount in the decedent's IRA, less any nondeductible contributions, would be income in respect of decedent to the estate, and that this amount would be considered as gross income permanently set aside which is deductible by the estate in the year of receipt under I.R.C. § 642(c)(2). **Ltr. Rul. 200221011, Feb. 12, 2002**.

FEDERAL INCOME TAXATION

BAD DEBT. The taxpayers, husband and wife, were shareholders in an S corporation which owned and operated a used car dealership. The taxpayers contributed money to the corporation for operating funds and to purchase inventory. The contributions were treated as loans on the corporation's books. However, no promissory notes were executed, no repayment schedule was set and no interest was set or paid. The corporation could not obtain financing from independent lenders without personal guarantees from the taxpayers. The corporation eventually terminated without paying back $700,000 of the contributions and the taxpayers claimed that amount as a bad debt deduction. The court held that the contributions were capital contributions and not loans; therefore, the contributions were not eligible for the bad debt deduction. **Dunnegan v. Comm'r, T.C. Memo. 2002-119**.

C CORPORATIONS—ALM § 7.02.*

EMPLOYEE. The taxpayer was a professional corporation owned by a dentist and the dentist's spouse who worked for the corporation. The dentist provided management services for the corporation in addition to dental services and the wife was a dental hygienist. The corporation paid the dentist a management fee as an independent contractor but did not pay any wages or withhold employment taxes. The taxpayer argued that the corporate form should be ignored and it should be treated as a sole proprietorship which would not be considered the employer of the dentist. The court held that the corporate form could not be ignored because the dentist did not treat the corporation as a mere agent of the dentist and the corporation performed business services for over 30 years. **Katz v. Comm'r, T.C. Memo. 2002-118**.

COURT AWARDS AND SETTLEMENTS. The taxpayer was employed as a gas station attendant and claimed to be injured while working. After the taxpayer's employment was terminated the taxpayer filed a suit against the employer for wrongful discharge, intimidation, coercion, and harassment in violation of Fla. Stat. Ann. § 440.205. The parties settled for $5,000 which the taxpayer did not include in income. The court held that the settlement proceeds were includible in gross income because the suit did not involve any claims for personal injury. **Reid v. Comm'r, T.C. Summary Op. 2002-55**.

The taxpayers were defrauded by an insurance agent who sold them health insurance for their daughter and claimed that the daughter's existing medical condition was covered by the insurance. The taxpayers sued the insurance company for breach of contract when the company refused to pay any claims because of the pre-existing medical condition. The parties settled and the taxpayers excluded the proceeds from income. The court held that the proceeds were gross income because the claim against the insurance company did not include any claim for personal injuries. **Ervin v. Comm'r, T.C. Memo. 2002-134**.

DEPRECIATION. The IRS has published a supplement to Form 946, "How to Depreciate Property" for use in preparing 2001 returns. As for the additional depreciation allowance authorized by the law enacted this past March, the IRS states the following on the ordering issue concerning section 179: "The allowance is an additional deduction of 30% of the property's depreciable basis. To figure the depreciable basis, you must first multiply the property's cost or other basis by the percentage of business/investment use and then reduce that amount by any section 179 deduction. . . ." Thus, it looks like the IRS is following the Joint Committee on Taxation interpretation. The IRS provides the following example: "On November 1, 2001, you bought and placed in service in your business qualified property that cost $100,000. You choose to deduct $24,000 of the property's cost as a section 179 deduction. You use the remaining $76,000 of cost to figure your special depreciation allowance of $22,800 ($76,000 x 30%). You use the remaining $53,200 of cost to figure your regular depreciation deduction for 2001 and later years." See also Harl, "Additional Guidance on the 30 Percent Depreciation Allowance, p. 73 *supra*.

DISASTER PAYMENTS. On May 7, 2002, the president determined that certain areas in Kentucky were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of severe storms, tornadoes and flooding on April 27, 2002. **FEMA-1414-DR**. Accordingly, a taxpayer who sustained a loss attributable to these disasters may deduct the loss on his or her 2001 federal income tax return.

EARNED INCOME CREDIT. The taxpayer was the sole wage earner in a household which included the taxpayer's mother and two siblings. The taxpayer provided all support for the household and provided various parenting services for the younger siblings. The court held that the taxpayer was eligible for the earned income credit with the two siblings as qualifying children because the taxpayer cared for the siblings in a parental capacity. **Barajas v. Comm'r, T.C. Summary Op. 2002-59**.

EDUCATOR'S EXPENSE DEDUCTION. Eligible educators are eligible, under I.R.C. § 62, in 2002 and thereafter for a deduction of up to $250 for costs incurred for books and classroom supplies. The IRS has issued advice that educators should maintain accurate records and receipts of those costs to substantiate the deduction. **IR-2002-65**.

EMPLOYEE BENEFITS. The IRS has ruled that for purposes of the requirements for the exclusion from gross income of group health coverage for cafeteria plans, contributions used to purchase group health coverage under I.R.C. § 125 are not includible in the gross income of an employee solely because a plan uses an automatic enrollment process in which the employee's salary is reduced each year to pay a portion of the group health coverage unless the employee affirmatively elects cash. Contributions used to purchase group health coverage under Section 125 are not includible in the gross income of the employee to the extent that an employee can elect cash. The IRS also ruled that the lack of a choice between cash and a qualified benefit for employees does not affect whether the plan satisfies the requirements for the I.R.C. § 106(a) exclusion from gross income. **Rev. Rul. 2002-27, I.R.B. 2002-20, 925**.

HOBBY LOSSES. The taxpayer was a college professor and bred Appaloosa horses on a farm. The court held that the activity was not engaged in for profit because (1) the taxpayer did not keep sufficient records to form a business plan to make the operation profitable; (2) the taxpayer did not have expertise in operating a profitable breeding operation; (3) although the taxpayer spent considerable time at the activity, much of it was for pleasure; (4) the breeding activity did not appreciate in value; (5) the taxpayer did not have success at other similar activities; (6) the activity had only losses; (7) the losses offset income from other sources; and (8) the taxpayer's principal interest in the activity was pleasure since the activity was not profitable. **Harrington v. Comm'r, T.C. Summary Op. 2002-58**.

IRA. The taxpayer owned an IRA and was jailed for failure to pay child support and alimony. The taxpayer decided to get out of jail by making a payment by withdrawing money from the IRA but did not include the distribution in income. The court held that the limited exception for withdrawals forced by the government, including an IRS levy, did not apply and required the taxpayer to include the distribution in income and pay the early withdrawal penalty. **Baas v. Comm'r, T.C. Memo. 2002-130**.

LETTER RULINGS. The IRS has issued a revenue procedure which provides for a pilot program that will test whether the process for issuing Technical Advice Memoranda (TAMs) can be streamlined. The new advice will be known as a Technical Expedited Advice Memorandum (TEAM) and during the TEAM pilot program, only issues under the jurisdiction of the Associate Chief Counsel (Income Tax & Accounting) will be eligible for a TEAM. The purpose of the new TEAM pilot program is to expedite certain aspects of the TAM process and to eliminate certain requirements (taxpayer and field agreement on facts) that may delay or frustrate the process. Accordingly, the Office of Chief Counsel will provide an answer even if the taxpayer and the field disagree on the facts. The Office of Chief

Counsel, in appropriate circumstances, may issue two separate answers: one based on the field's factual submission and the other based on the taxpayer's. **Rev. Proc. 2002-30, I.R.B. 2002-__**.

NET OPERATING LOSSES. The Job Creation and Worker Assistance Act of 2002 added I.R.C. § 172(b)(1)(H) which provides a five-year carryback period for net operating losses (NOLs) for any taxable year ending during 2001 and 2002. *Pub. L. No. 107-147, § 102(a), 116 Stat. 21 (2002)*. The IRS has issued a revenue procedure which provides qualifying taxpayers who filed returns for a taxable year ending during 2001 and 2002 without taking advantage of the new five-year carryback with a limited opportunity to do so and to apply for a tentative carryback adjustment if they file an application on or before October 31, 2002. The revenue procedure allows taxpayers that incurred an NOL in a taxable year ending during 2001 or 2002 and elected under Section 172(b)(3) to forgo the NOL carryback period to revoke their elections in order to apply the five-year carryback period. The revenue procedure also allows such taxpayers, as well as taxpayers who used a two-year carryback period for an NOL in a taxable year ending during 2001 or 2002, to file an application for a tentative carryback adjustment under I.R.C. § 6411(a) based on a five-year NOL carryback period even if the 12-month period for filing such an application has expired. A revocation and/or application for tentative carryback adjustment under this revenue procedure must be made on or before October 31, 2002. The revenue procedure allows taxpayers that filed returns for a taxable year ending in 2001 or 2002, and who neither elected to forgo the carryback period, nor used the two-year carryback period, to elect to relinquish the five-year carryback period (and thereby retain the ability to use the two-year carryback period) if they act on or before October 31, 2002. **Rev. Proc. 2002-40, I.R.B. 2002-23**.

PARSONAGE EXCLUSION. The Congress passed and the President signed the Clergy Housing Allowance Clarification Act of 2002, Pub. L. No. 107-181, which provides that ministers may deduct the fair market value of their homes from their church income, including costs incurred for furniture and utilities. See McEowen, The Parsonage Exclusion – First Amendment Concerns?" p. 75 *supra*.

PASSIVE ACTIVITY LOSSES. The taxpayers, husband and wife, owned a condominium which was rented to third parties through a management company. The management company handled all of the administration and maintenance of the unit except for two weeks per year that the taxpayers claimed to spend on maintaining the unit. The court held that the taxpayers did not materially participate in the operation of the condominium because the taxpayers spent less than 100 hours annually on the operation of the unit. **Patterson v. Comm'r, T.C. Summary Op. 2002-57**.

PENSION PLANS. The IRS has issued a revenue procedure which provides that qualified retirement plans generally must be amended by the end of the first plan year beginning on or after January 1, 2003 to the extent necessary to comply with final and temporary regulations under I.R.C. § 401(a)(9), relating to required minimum distributions. The revenue procedure contains model plan amendments that sponsors of master and prototype volume submitter and individually designed plans may adopt to satisfy this requirement. The revenue procedure also provides that determination letter applications filed on or after the first day of the 2003 plan year will be reviewed with respect to whether the form of the plan satisfies the requirements of the final and temporary regulations under I.R.C. § 401(a)(9). **Rev. Proc. 2002-29, I.R.B. 2002-__.**

RETURNS. The IRS has announced that it is providing relief from interest and penalties to various taxpayers affected by the September 11, 2001, terrorist attacks who previously received extra time in which to file returns or pay taxes. Generally, taxpayers will not owe interest or penalties for the amount of time that the IRS earlier extended their filing or payment deadline, and the IRS will refund such amounts to affected taxpayers who have already paid them. The relief is provided under a new authority granted to the IRS by the Victims of Terrorism Tax Relief Act of 2001 (Pub. L. No. 107-134). **Notice 2002-40, I.R.B. 2002-24**.

SAFE HARBOR INTEREST RATES

June 2002

	Annual	Semi-annual	Quarterly	Monthly
		Short-term		
AFR	2.91	2.89	2.88	2.87
110 percent AFR	3.21	3.18	3.17	3.16
120 percent AFR	3.50	3.47	3.46	3.45
		Mid-term		
AFR	4.74	4.69	4.66	4.64
110 percent AFR	5.23	5.16	5.13	5.11
120 percent AFR	5.71	5.63	5.59	5.57
		Long-term		
AFR	5.70	5.62	5.58	5.56
110 percent AFR	6.28	6.18	6.13	6.10
120 percent AFR	6.85	6.74	6.68	6.65

Rev. Rul. 2002-36, I.R.B. 2002-24.

SALE OF RESIDENCE. The taxpayers, husband and wife, owned a residence and purchased another parcel of property. The taxpayer eventually moved to the new property and placed the old residence for sale. The old residence did not sell and the taxpayers decided to renovate the property to make it more attractive to buyers. After the renovation, the property was again offered for sale and sold quickly. The taxpayers sought tax advice from a tax accountant who advised that the taxpayers could claim a business loss deduction on the property as rental property. The court held that the property was never converted to rental use; therefore, no business deduction could be claimed for the loss on the sale. The court did not uphold assessment of the I.R.C. § 6662(a) accuracy penalty because the taxpayers relied on professional advice in claiming the deduction. **Turner v. Comm'r, T.C. Summary Op. 2002-60**.

THEFT LOSS. The taxpayer rented an apartment building to a nonprofit organization which used the building for a homeless shelter. The property was returned to the taxpayer in 1996 and the taxpayer discovered that all the appliances and plumbing fixtures were removed. The taxpayer lost the property to foreclosure in 1997. The taxpayer claimed a theft loss in 1997, arguing that the loss occurred when the title to the building was lost. The court held that the theft loss deduction had to be claimed in 1996, the year the theft loss was discovered. **Waters v. Comm'r, T.C. Summary Op. 2002-62**.

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AGRICULTURAL TAX AND LAW SEMINARS

by Neil E. Harl and Roger A. McEowen

August 13-16, 2002 Holiday Inn I-25, Fort Collins, CO
September 24-27, 2002 Interstate Holiday Inn, Grand Island, NE

For our west coast subscribers: Plans are underway for a two-day seminar in the Palm Springs, CA area on October 17-18, 2002 on Farm & Ranch Income Tax and Farm & Ranch Estate and Business Planning. Mark your calendars and watch this space for details.

Come join us for expert and practical seminars on the essential aspects of agricultural tax and law. Gain insight and understanding from two of the nation's top agricultural tax and law instructors.

The seminar are held on Tuesday, Wednesday, Thursday, and Friday. Registrants may attend one, two, three or all four days, with separate pricing for each combination. On Tuesday, Dr. Harl will speak about farm and ranch income tax. On Wednesday, Dr. Harl will cover farm and ranch estate planning. On Thursday, Roger McEowen will cover farm and ranch business planning. **NEW THIS YEAR**: On Friday, Roger McEowen will cover agricultural contracts. Your registration fee includes comprehensive annotated seminar materials for the days attended which will be updated just prior to the seminar. The seminar materials will also be available on CD-ROM for a small additional charge.

Here are some of the major topics to be covered:

• Income tax aspects of property transfer, including income in respect of decedent, installment sales, private annuities, self-canceling installment notes, and part gift/part sale transactions.

• Taxation of debt, taxation of bankruptcy, the latest on SE tax of rental of land to a family-owned entity; income averaging; earned income credit; commodity futures transactions; paying wages in kind; new depreciation rules.

• Farm estate planning, including 15-year installment payment of federal estate tax, co-ownership discounts, alternate valuation date, special use valuation, family-owned business deduction (FOBD), marital deduction planning, disclaimers, planning to minimize tax over deaths of both spouses, trusts, and generation skipping transfer tax.

• Gifts and federal gift tax, including problems with future interests, handling estate freezes, and "hidden" gifts.

• Organizing the farm business--one entity or two, corporations, general and limited partnerships and limited liability companies.

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Registration brochures will be mailed in June and July. However, complete information and a registration form are available now on our web site at http://www.agrilawpress.com. For more information, call Robert Achenbach at 1-541-302-1958, or e-mail to **robert@agrilawpress.com**