Cases, Regulations and Statutes

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

BANKRUPTCY

SALE OF CHAPTER 12 ESTATE PROPERTY. The Chapter 12 debtor’s plan provided for payment of federal taxes by surrendering to the IRS eight parcels of land. The plan also provided that all federal and state tax claims which arose from the transfer of the property to the IRS were treated as general unsecured claims not entitled to priority under Section 507. The eight parcels were sold, resulting in substantial taxable capital gains tax. The debtor argued that, under Section 1222(a)(2)(A), the capital gains tax was a claim of the Chapter 12 estate. The IRS argued that Section 1222(a)(2)(A) did not apply to post-petition sales of the debtor’s property. The Bankruptcy Court and the District Court reviewed the three cases which had ruled on the issue, In re Knudsen, 356 B.R. 480 (Bankr. N.D. Iowa 2006), aff’d, 389 B.R. 643, 680-81 (N.D. Iowa 2008), aff’d, 581 F.3d 696 (8th Cir. 2009) (ruled for debtor); In re Hall, 376 B.R. 741 (Bankr. D. Ariz. 2007), rev’d, 393 B.R. 857, 862 (D. Ariz. 2008) (ruled for debtor on appeal); and In re Schilke, 379 B.R. 899 (Bankr. D. Neb. 2007), aff’d, 2008 U.S. Dist. LEXIS 68176 (D. Neb. 2008), aff’d, 581 F.3d 696 (8th Cir. 2009) (ruled for debtor), and followed them in holding that capital gains taxes resulting from post-petition sales of a Chapter 12 debtor’s property were administrative expenses entitled to application of Section 1222(a)(2)(A). On appeal the appellate court reversed, holding that, because no taxable estate was created in Chapter 12, the taxes from the sale of the debtor’s property were not a claim against the estate. In re Dawes, 2011-1 U.S. Tax Cas. (CCH) ¶ 50,454 (10th Cir. 2011), rev’g, 2009-1 U.S. Tax Cas. (CCH) ¶ 50,280 (D. Kan. 2009), aff’d, 2008 Bankr. LEXIS 362 (Bankr. D. Kan. 2008).

FEDERAL ESTATE AND GIFT TAXATION

CHARITABLE DEDUCTION. The decedent had created a trust which became irrevocable on the decedent’s death. The trust provided for payment of the medical expenses of a certain person during life, with the remainder to be paid to a foundation at that person’s death. The estate petitioned a court to reform the trust to meet the requirements of a charitable remainder annuity trust. The new trust would annually distribute a percentage of the original trust, dividing the annuity between the person and the foundation, with the remainder passing to the foundation. The distribution formula was determined by an expert’s appraisal of the value of the person’s estimated medical costs. The IRS ruled that the reformation was qualified so that the estate would be allowed a charitable deduction for the remainder interest to the foundation, if the trust otherwise qualified as a charitable remainder annuity trust. Ltr. Rul. 201125007, Feb. 16, 2011.

DISCLAIMERS. The decedent owned an interest in a trust established by the decedent’s predeceased spouse. The trust was funded with an IRA and two retirement accounts from which automatic quarterly payments were received, based on the required minimum distributions (RMD) received by the predeceased spouse. After the decedent’s death one quarterly RMD payment was received before the executrix filed a disclaimer of a portion of the decedent’s interests in the trust. The IRS ruled that the disclaimer was qualified and that the disclaimer was effective for all but the RMD already received. Ltr. Rul. 201125009, March 10, 2011.

GENERATION-SKIPPING TRANSFERS. The taxpayers, husband and wife, created an irrevocable trust for their three children and grandchildren and transferred stock
to the trust. The taxpayers hired a tax accountant to file gift tax returns and treated each transfer as a joint gift. Sometime after the return was filed, the taxpayers learned from another accountant that I.R.C. § 2632(c) automatically allocated the taxpayers’ GST exemption to the transfers. The taxpayers sought an extension of time to file the election out of the allocation of the GST exemption. The IRS granted the extension. Ltr. Rul. 201124006, March 4, 2011.

The taxpayer created an irrevocable trust for a spouse and their three children and made several transfers to the trust. The taxpayer also created a second trust for the three children. The taxpayer hired a tax professional to file gift tax returns and treated each transfer as a joint gift with the spouse except for transfers to the first trust because the spouse was a grantee. The gift tax returns failed to allocate the taxpayer’s and spouse’s GST exemptions to the gifts. The taxpayers sought and were granted an extension of time to allocate their GST exemptions to the gifts. Ltr. Rul. 201125016, March 15, 2011.

IRA. The decedent had owned an IRA which had the decedent’s estate as the reminder beneficiary. The decedent’s will passed the IRA to a marital trust in which the surviving spouse was a beneficiary and co-trustee and had the power to require distribution of assets. The IRS ruled that the IRA would not be treated as an inherited IRA, the surviving spouse could rollover the IRA assets to an IRA owned by the spouse and the IRA was included in taxable income of the spouse. Ltr. Rul. 201125047, March 31, 2011.

INSTALLMENT PAYMENT OF ESTATE TAX. Quoted because of its length, the following is an IRS internal e-mail: “First I am assuming your taxpayer is not abroad. Second, I do not concur that the taxpayer’s attempted election comes under the automatic 6-mos. extension provision (section 301.9100-2(b)). The taxpayer did not file its return or request the election within 6 months of the due date of the return if you don’t take into account extensions. The taxpayer would have to qualify for 9100 relief under 301.9100-3, which is not that easy to do. I do agree that the election to use installments under section 6166 is the type of election that could be extended under the general provisions of 9100 though.” CCA 201125019, May 12, 2011.

VALUATION. The decedent owned an interest in a limited partnership which owned and operated timber land. In determining the value of the decedent’s interest, the court used both the cashflow method and asset method. The court gave the cashflow valuation a weight of 75 percent and the asset method a weight of 25 percent because the court found that the partnership was unlikely to sell its underlying assets. The court allowed a discount for lack of marketability and control but only as to the cashflow valuation because the lack of marketability and control would not affect the value of the decedent’s interest as to asset sales. Estate of Giustina v. Comm’r, T.C. Memo. 2011-141.

The decedent owned a 15 percent interest in a media corporation and claimed a discounted valuation for the interest as part of the estate. The court accepted a cashflow-based valuation method because there were no comparable corporations to use for valuation comparisons. The court also allowed a 23 percent discount for a minority interest and a 31 percent discount for lack of marketability. Estate of Gallagher v. Comm’r, T.C. Memo. 2011-148.

FEDERAL INCOME TAXATION

ANNUITY. In Conway v. Comm’r, 111 T.C. 350 (1998), acq., 1999-2 C.B. xvi, the Tax Court held that the direct exchange by an insurance company of a portion of an existing annuity contract to an unrelated insurance company for a new annuity contract was a tax-free exchange under I.R.C. § 1035, referred to as a “partial exchange.” The IRS acquiesced in Conway v. Commissioner, 1999-2 C.B.xvi. In Notice 2003-51, 2003-2 C.B. 362, the IRS provided interim guidance on partial exchanges, stating that the IRS will consider all the facts and circumstances to determine whether a partial exchange and a subsequent withdrawal from, or surrender of, either the surviving annuity contract or the new annuity contract within 24 months of the date on which the partial exchange was completed should be treated as an integrated transaction, and thus whether the two contracts should be viewed as a single contract to determine the tax treatment of a surrender or withdrawal under I.R.C. § 72(e). If however, a taxpayer could demonstrate that one of the conditions of I.R.C. § 72(q)(2), or any other similar life event, such as a divorce or the loss of employment, occurred between the partial exchange and the surrender or distribution, and that the surrender or distribution was not contemplated at the time of the partial exchange, the taxpayer would not be treated as having entered into the surrender or distribution for tax avoidance purposes. The IRS issued a revenue procedure adopting the provisions of Notice 2003-51. Rev. Proc. 2008-24, 2008-1 C.B. 684. The IRS has now issued a new revenue procedure modifying Rev. Proc. 2008-24. The 12-month period referred to in section 4.01(a) of Rev. Proc. 2008-24 is reduced to 180 days. The rule requiring that one of the enumerated I.R.C. § 72(q) conditions be met (or that a similar life event occur) is eliminated. The limitations on amounts withdrawn from or received under an annuity contract involved in a partial exchange do not apply to amounts received as an annuity for a period of 10 years or more or during one or more lives. The automatic characterization of a transfer as either a tax-free exchange under I.R.C. § 1035 or a distribution taxable under I.R.C. § 72(e) followed by a payment for a second contract is eliminated. Under this approach, if a direct transfer of a portion of the cash surrender value of an existing annuity contract for a second annuity contract does not meet the 180-day test described above, the IRS will apply general tax principles to determine the substance, and hence the treatment, of the transfer. Rev. Proc. 2011-38, I.R.B. 2011-30.

BUSINESS EXPENSES. The taxpayer was an accountant and photographer who claimed deductions for a wide variety of business expenses; however, the taxpayer was unable to provide adequate records to support the expenses by amount or nature. The court upheld the IRS denial of the deductions for lack of

**CAPITAL GAINS.** Over approximately 26 years, the taxpayer, a carpenter/contractor bought and sold 16 parcels of real property. The taxpayer would buy unimproved land, build a single-family residence thereon, and immediately sell the improved property. The taxpayer also bought and sold unimproved land. The taxpayer bought unimproved land and constructed multifamily housing thereon or bought land improved with multifamily housing and improved the housing. The taxpayer did not immediately sell the multifamily housing properties but kept them for rental income. The case involved the character of the gain from the sale of three lots. The court found that the taxpayer originally purchased the lots as part of a larger parcel which was intended for development to create rental income and that the sale of the three lots was not part of a trade or business of buying and selling property. Therefore, the court held that the gain from the sales was capital gain. Gardner v. Comm’r, T.C. Memo. 2011-137.

**CHARITABLE DEDUCTION.** The taxpayer owned two buildings which were subject to the Historic Landmark and Historic Preservation Act of 1978. The taxpayer transferred facade conservation easements to a non-profit corporation which held and enforced conservation easements. The easements prohibited any modification of the facades and required maintenance to preserve the facades. The court held that the easements were eligible for the charitable deduction because the easement transferred qualified property interests and had value, based on the increased financial burdens on the donor. Simmons v. Comm’r, 2011-2 U.S. Tax Cas. (CCH) ¶ 50,469 (D.C. Cir. 2011), aff’d, T.C. Memo. 2009-208.

The taxpayers purchased a parcel of land which they intended to develop into two residential properties. The properties did not have access to a road and the taxpayers sought an easement over a portion of county park land. After negotiations, the parties reached a settlement agreement in August 2004 in which the taxpayers paid the county for an access easement and agreed to donate to the county a conservation easement over one-half of the property, essentially prohibiting the development of one-half of the parcel. The settlement agreement did not finalize the transaction because the county had to obtain approval from several agencies in order to sell park land. The final approval was obtained and a letter sent to the taxpayers in December 2006 to that effect. The taxpayers claimed a charitable deduction in 2004, attaching the settlement agreement and Form 8283, Noncash Charitable Contributions, which contained the claimed appraised value, although without the signature of an appraiser or a representative of the county. The court held that the settlement did not constitute an acknowledgement of the donation by the county because it did not identify a final transaction. The letter in 2006 also did not constitute an acknowledgement because it was not issued in 2004 and did not state that the county did not provide any goods or services in consideration for the transfer of the conservation easement. DiDinato v. Comm’r, T.C. Memo. 2011-153.

**COURT AWARDS AND SETTLEMENTS.** The taxpayers, husband and wife, filed suit against the Farm Service Agency for race discrimination in failing to approve farm operating loans. The parties reached a settlement and the taxpayers received payments for lost profits. The taxpayers did not include the settlement proceeds in income but did not identify any exception available for such exclusion. The court held that the settlement proceeds were taxable income. The court also upheld denial of deductions for farm expenses for lack of substantiation and because the expenses were already deducted from the settlement. The holding was affirmed by the appellate court in a decision designated as not for publication. Estate of Martin v. Comm’r, 2011-1 U.S. Tax Cas. (CCH) ¶ 50,447 (9th Cir. 2011), aff’d, T.C. Memo. 2008-208.

**DISASTER LOSSES.** On June 6, 2011, the President determined that certain areas in Oklahoma are eligible for assistance from the government under the Disaster Relief and Emergency Assistance Act (42 U.S.C. § 5121) as a result of severe storms, flooding, tornadoes and straight-line winds, which began on May 22, 2011 FEMA-1989-DR. On June 7, 2011, the President determined that certain areas in Minnesota are eligible for assistance from the government under the Act as a result of severe storms and tornadoes which began on May 21, 2011. FEMA-1990-DR. On June 7, 2011, the President determined that certain areas in Illinois are eligible for assistance from the government under the Act as a result of severe storms and flooding which began on April 19, 2011. FEMA-1991-DR. On June 10, 2011, the President determined that certain areas in Alaska are eligible for assistance from the government under the Act as a result of an ice jam and flooding which began on May 8, 2011. FEMA-1992-DR. On June 10, 2011, the President determined that certain areas in New York are eligible for assistance from the government under the Act as a result of severe storms, flooding and tornadoes which began on April 26, 2011. FEMA-1993-DR. On June 15, 2011, the President determined that certain areas in Massachusetts are eligible for assistance from the government under the Act as a result of severe storms and tornadoes which began on June 1, 2011. FEMA-1994-DR. On June 15, 2011, the President determined that certain areas in Vermont are eligible for assistance from the government under the Act as a result of severe storms and flooding which began on April 23, 2011. FEMA-1995-DR. On June 17, 2011, the President determined that certain areas in Montana are eligible for assistance from the government under the Act as a result of severe storms and flooding which began on April 4, 2011. FEMA-1996-DR. Accordingly, taxpayers in the areas may deduct the losses on their 2010 federal income tax returns. See I.R.C. § 165(i).

**DISCHARGE OF INDEBTEDNESS.** The taxpayer settled a credit card debt for less than the outstanding balance but did not include the discharged amount in taxable income. The taxpayer argued that the debt was contested and the payment was determined after resolution of the contest. The taxpayer provided evidence of letters sent to the credit card company complaining about the excessive amount of interest charged and paid. However, there was no evidence that the taxpayer challenged the
original debt incurred on the credit card account. The court held that the discharged debt was taxable income because the taxpayer did not contest the original debt but questioned only the interest charged. The court also held that the failure of the taxpayer to receive a Form 1099-C from the credit card company did not affect the taxation of the discharged debt because the taxpayer should have known that the discharge of indebtedness occurred.


INNOCENT SPOUSE RELIEF. During a year when the taxpayer and spouse were married, the spouse received a distribution from the spouse’s pension plan. Although the funds were placed in a joint account, the taxpayer claimed to not know about the distribution. The distributed funds were not claimed as income. After the couple divorced, the IRS assessed taxes for the year of the distribution arising from the distribution being included in taxable income. The taxpayer sought innocent spouse relief from these taxes. The court held that, because the taxpayer did not have knowledge of the distribution, innocent spouse relief was granted. Richard v. Comm’r, T.C. Memo. 2011-144.

MILEAGE DEDUCTION. The IRS has announced an increase in the standard mileage rate for the second half of 2011 to 55.5 cents per mile for business use and 23.5 cents per mile for medical and moving expense purposes, incurred on or after July 1, 2011. The mileage rate of 14 cents per mile for charitable use was not changed because it is set by statute. Ann. 2011-40, I.R.B. 2011-29, modifying Notice 2010-88, 2010-2 C.B. 882.

PARTNERSHIPS.

ADMINISTRATIVE ADJUSTMENTS. The taxpayer was a partnership which sold partnership property. The partnership overstated the partnership’s basis in the property, resulting in an understatement of taxable income from the sale. More than three years and less than six years after the filing of the tax return for the year of the sale, the IRS filed a final partnership administrative adjustment which resulted from a reduction of the partnership’s basis in the property sold. The taxpayer sought summary judgment because the FPAA was filed more than three years after the filing of the return. The IRS argued that the six year limitation applied because the return understated taxable income. The Tax Court held that the six year limitation did not apply because the overstatement of basis was not an understatement of receipt of income. In 2010, the IRS adopted final regulations which stated: “an understatement of gross income resulting from an overstatement of unrecovered cost or other basis constitutes an omission from gross income for purposes of 6501(e)(1)(A).” Treas. Reg. §301.6229(c)(2)-1(a)(1)(iii). On a petition for rehearing, the Tax Court refused to vacate that first decision on the basis of new IRS regulations. See Intermountain Insurance Service of Vail, LLP v. Comm’r, 134 T.C. 211 (2010). On appeal the appellate court reversed, holding that the regulations were a reasonable interpretation of the statute and could be applied retroactively to impose the six year statute of limitation. Intermountain Insurance Service of Vail, LLP v. Comm’r, 2011-2 U.S. Tax Cas. (CCH) ¶ 50,468 (D.C. Cir. 2011), rev’d, T.C. Memo. 2009-195.

PASSIVE ACTIVITY LOSSES. The taxpayer was in a real property business as defined by I.R.C. § 469 and was eligible to make the election under I.R.C. § 469(e)(7)(B) to treat all interest in rental real estate as a single rental real estate activity. However, the taxpayer failed to make the election on the taxpayer’s tax return. The IRS granted the taxpayer a 120 day extension of time to make the election. Ltr. Rul. 201125002, March 18, 2011.

PENALTIES. The taxpayer had died in 2006 without filing returns for 2004 and 2005 or payment of estimated or final taxes. The IRS made tax assessments based on a substitute return for 2005. The estate provided no excuses for the failure to pay estimated taxes, file the return or make any tax payment; therefore, the court held that the IRS properly assessed penalties for failure to pay estimated taxes, failure to file a return and failure to pay taxes. Block v. Comm’r, T.C. Memo. 2011-145.

RETURNS. The IRS has adopted as final regulations relating to the automatic extensions of time to file returns for partnership, trust, and estate taxpayers, and automatic extensions of time for filing returns for pension excise taxes. 76 Fed. Reg. 36996 (June 24, 2011), adding Treas. Reg. § 1.6081-2.

S CORPORATIONS

EMPLOYEE STOCK OWNERSHIP PLANS. The taxpayer was an S corporation and the sole member of an LLC. The taxpayer established an ESOP within the meaning of I.R.C. § 4975(e)(7). The assets of the ESOP consisted primarily of shares of the taxpayer’s stock. The taxpayer represented that it had a single class of common stock with a combination of voting power and dividend rights that was the greatest of any class of common stock of any member of the taxpayer’s controlled group. The LLC did not make an election under Treas. Reg. § 301.7701-3(a) to be taxed as a corporation. The IRS ruled that the common stock of the taxpayer satisfied the definition of “employer securities” as that term is defined under I.R.C. § 409(1) with respect to employees of the LLC. Ltr. Rul. 201124030, March 22, 2011.

PASSIVE INVESTMENT INCOME. The taxpayer was an S corporation which owned and leased commercial real estate. The taxpayer’s shareholders provided services in the leasing of the property, including inspecting, maintaining, and repairing the building, including the roofs, external walls, windows, floors, foundations, guttering and downspouts, plumbing, sidewalks, curbs, drainage ditches, air conditioning and heating units, and security and fire alarm systems; providing waste disposal; and performing safety inspections. The IRS ruled that the rental income from the property was not passive investment income. Ltr. Rul. 201125012, March 14, 2011; Ltr. Rul. 201125012, March 14, 2011.

TAX RETURN PREPARERS. The IRS has announced a reminder as to PTIN requirements for return preparers on the “Tax Professionals” page of its website (http://www.irs.gov/taxpros/article/0,,id=221009,00.html) that PTINs obtained or refreshed for the 2011 filing season will expire on December 31, 2011. Renewal will be available in October 2011. Preparers who applied for their PTINs on paper will be able to renew either online or on paper. Paper renewal will take four to six weeks to process. PTINs must be renewed before January 1, 2012. The IRS also announced that the second phase of the paid preparer...
oversight program will begin in the fall of 2011. The competency exam will be available at that time. Return preparers who pass the exam will become IRS Registered Tax Return Preparers. In addition, while IRS Registered Tax Return Preparers must take continuing education annually, the start date for continuing education courses has not yet been determined.

**PROPERTY**

**EASEMENT.** The plaintiff’s and defendant’s properties were originally owned by one owner. The original owner sold the defendant’s portion and granted the buyer an easement for a road over the north edge of the remaining property. The buyer of the defendant’s property used the land for hunting but sold the land to someone who used the land as a fish hatchery. Subsequent owners, including the defendant continued to operate a fish hatchery on the land, resulting in some commercial traffic on the easement road. The defendant changed the use to outdoor events, such as weddings and obtained a county permit to hold additional events each year. Although the individual events had high traffic, the annual traffic was about the same as when the property was used as a fish hatchery. The plaintiff sued based on the argument that the new use exceeded the easement terms. The court noted that the original easement grant contained no restrictions on the use of the road and that the annual use of the road had not increased; therefore, the court upheld the trial court’s ruling in favor of the defendant. **Wilson & Son Ranch, LLC v. Hintz, 2011 Wash. App. LEXIS 1435 (Wash. Ct. App. 2011).**

**SECURED TRANSACTIONS**

**LIVESTOCK LIEN.** The plaintiff and defendant had a relationship for several years, during which the defendant moved cattle and horses to the plaintiff’s ranch. After the relationship soured, the defendant moved away but left the livestock on the plaintiff’s ranch without provision for payment of their care. The plaintiff filed suit to perfect a lien, under Ariz. Code § 3-1295, for the cost of the care of the livestock. The court held that in order for a lien to arise for care of livestock, an express or implied agreement needs to be shown. Because the plaintiff could not show any agreement to have the defendant pay for the plaintiff’s care of the livestock, no lien could arise. **Donaldson v. McNew, 2011 Ariz. App. Unpub. LEXIS 843 (Ariz. Ct. App. 2011).**

**IN THE NEWS**

**TAX RETURN PREPARERS.** CCH has reported that an IRS official announced that the IRS will not give taxpayers the option to direct a portion of their refund to pay tax return preparers. David R. Williams, the director of the IRS’s Return Preparer Office, stated that the IRS will not “pursue this concept at this time.” In August 2010, the IRS had announced that it would consider allowing taxpayers to direct a portion of their refunds to pay tax return preparers, possibly beginning by the 2012 filing season, **IR-2010-89.** This earlier announcement accompanied the IRS’s termination of the “debt indicator” program. Banks and return preparers used the IRS’s debt indicators to determine whether a taxpayer was entitled to a tax refund and, therefore, was a candidate for a refund anticipation loan (RAL). RALs were often marketed to taxpayers who did not have funds to pay their return-preparation fees and who used RALs to pay those fees, the IRS noted. In his latest statement, made at the IRS’s Tax Forum in Atlanta, Williams said that the IRS explored the refund option concept with consumer advocates, industry groups and others. The Service “heard a variety of views, some supporting the additional option for consumers, with others raising operational and/or policy concerns.” In view of this feedback and the priorities and resources available to the IRS for the 2012 filing season, the IRS decided not to pursue the concept at this time. Williams did not describe the concerns expressed to the IRS. **By Brant Goldwyn, CCH News Staff**

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- Soil and water conservation expenditures
- Fertilizer deduction election
- Farm lease deductions
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- Paying wages in kind

Sale of Property
- Income in respect of decedent
- Sale of farm residence
- Installment sale including related party rules
- Sale and gift combined.

Like-Kind Exchanges
- Requirements for like-kind exchanges
- What is “like-kind” for realty
- Partitioning property

Taxation of Debt
- Turnover of property to creditors
- Discharge of indebtedness

Second day

**FARM ESTATE AND BUSINESS PLANNING**

New Legislation

The Liquidity Problem

Property Held in Co-ownership
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- Traps in severing joint tenancies
- Joint tenancy and probate avoidance
- Joint tenancy ownership of personal property
- Other problems of property ownership

Federal Estate Tax
- The gross estate
- Special use valuation
- Property included in the gross estate
- Basis calculations under uniform basis rules
- Valuing growing crops
- Claiming deductions from the gross estate
- Marital and charitable deductions
- Generation-skipping transfer tax, including later GST consequences for transfers in 2010
- Taxable estate
- The unified credit and other credits
- Unified estate and gift tax rates
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