Cases, Regulations and Statutes

Robert P. Achenbach Jr

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

FEDERAL FARM PROGRAMS

ORGANIC FOOD. The AMS has adopted as final regulations, as recommended to the Secretary of Agriculture by the National Organic Standards Board (NOSB) on November 5, 2009, and April 29, 2010, which continue the exemption allowing 12 substances in organic production and handling on the USDA National List of Allowed and Prohibited Substances. 76 Fed. Reg. 46595 (Aug. 3, 2011).

TRANSPORTATION. The APHIS has issued proposed regulations establishing minimum national official identification and documentation requirements for the traceability of livestock moving interstate. Under the proposed rule, unless specifically exempted, livestock belonging to species covered by this rulemaking that are moved interstate would have to be officially identified and accompanied by an interstate certificate of veterinary inspection or other documentation. The proposed regulations specify approved forms of official identification for each species but would allow the livestock covered under this rulemaking to be moved interstate with another form of identification, as agreed upon by animal health officials in the shipping and receiving states or tribes. 76 Fed. Reg. 50082 (Aug. 11, 2011).

FEDERAL ESTATE AND GIFT TAXATION

CREDIT FOR PRIOR ESTATE TAXES. The decedent had two sisters who died before the decedent, one in 1998 and one in 2000. The estate of the first sister passed to the decedent and the second sister, and the estate of the second sister passed to the decedent. The decedent died in 2007 and the executor filed a claim for refund in 2009 based on application of an estate tax credit for the first sister’s estate tax on property passing to the second sister and the decedent and an estate tax credit for the second sister’s estate tax on property passing to the decedent. The decedent’s estate paid no federal estate tax due to deductions for charitable bequests and any refund would have only increased the size of the decedent’s estate and increased the charitable bequests, also resulting in no federal estate tax. The court held that the claim for the estate tax paid by the first sister was dismissed for lack of jurisdiction for failure to file a timely claim, because the estate of the second sister did not file a claim for the estate tax credit. The court also held that the decedent’s estate’s claim was dismissed because the estate had not paid any estate tax. The court noted that, under I.R.C. § 2013(c), the decedent’s estate’s credit is limited to the lesser of: (1) the federal estate tax attributable to the transferred property in the second sister’s estate, or (2) the federal estate tax attributable to the transferred property in the decedent’s estate. Because the decedent’s estate tax liability was zero, the maximum credit the estate was entitled to was zero. Miglio v. United States, 2011-2 U.S. Tax Cas. (CCH) ¶ 60,622 (N.D. Ill. 2011).

GENERATION SKIPPING TRANSFERS. The grantor had established a trust for three grandchildren prior to September 25, 1985. The trustee and representatives of the children obtained a court order splitting the trust into three equal subtrusts, one for each child. The IRS ruled that the splitting of the trust did not subject it to GSTT. Ltr. Rul. 201131014, April 19, 2011.

MARITAL DEDUCTION. The decedent’s estate provided for a marital trust for the surviving spouse and directed that the trust be funded with either (a) the minimum amount necessary as the federal estate tax marital deduction in the decedent’s estate to reduce the federal estate tax due by reason of the decedent’s death to the lowest possible amount, and (b) the minimum amount necessary as the estate tax marital deduction in the decedent’s estate under the state death tax laws to reduce the state death taxes due by reason of the decedent’s death to the lowest possible amount. The marital trust fund was funded with the (b) amount because no federal estate tax was owed. The estate tax return was prepared by an accountant who included the marital trust property as QTIP election property. The estate sought a ruling that the election would be disregarded for purposes of the surviving spouse’s estate. The IRS ruled that the QTIP election was disregarded because the marital deduction was not required to reduce federal estate taxes. Ltr. Rul. 201131011, April 20, 2011.

REFUND. The decedent died in 1999 and the plaintiff became executor of the estate. In 1999 the plaintiff obtained from an accountant an estimate of the estate tax owed, added a 10 percent “cushion” and submitted the payment of $435,000 to the IRS with a Form 4768 request for an extension of time to file the estate tax return. The IRS granted an extension until November 1999. The plaintiff did not file an estate tax return until 2006 after notification from the IRS that a return was overdue. The estate tax listed on the return was for $323,140 and the return requested a refund of the overpayment. The IRS denied the refund because the refund claim was made more than three years after the initial payment. The plaintiff argued that the initial payment was a deposit; therefore, no limitation period applied as to making a refund claim. The court stated that prior decisions in the Federal Circuit have held that relevant factors governing whether a payment is a deposit include: (1) whether the tax has been assessed by the IRS prior to the remittance; (2) whether the remittance is “disorderly,” i.e. made without careful consideration of the potential tax liability; (3) whether the taxpayer contests liability; (4) whether the taxpayer...
indicates to the IRS that the remittance is a deposit; (5) whether the IRS viewed the remittance as a deposit; and (6) whether the remittance was made when payment was due and submitted with a request for an extension of time within which to file a return. In this case the court held that the payment was not a deposit because (1) the payment was not disorderly in that the payment was based on a professional estimate of the tax plus a cushion in case of errors; (2) the payment was not made under objection to the estate’s liability for the taxes; (3) the plaintiff did not call the payment as deposit; (4) the IRS never treated the payment as a deposit; and (5) the payment was made with a request for an extension of time to file the return. Finally, the court noted that the plaintiff did not follow the procedures of Rev. Proc. 84-58, 1984-2 C.B. 501, for submission of a deposit. Boesnel v. United States, 2011-2 U.S. Tax Cas. (CCH) ¶ 60,624 (Fed. Cl. 2011).

SPECIAL USE VALUATION. The IRS has issued the 2010 and 2011 lists of average annual effective interest rates charged on new loans by the Farm Credit Bank system to be used in computing the value of real property for special use valuation purposes for deaths in 2010 and 2011:

<table>
<thead>
<tr>
<th>District</th>
<th>Interest rate 2010</th>
<th>Interest rate 2011</th>
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<tbody>
<tr>
<td>AgFirst</td>
<td>7.48</td>
<td>6.97</td>
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<tr>
<td>AgriBank</td>
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<td>6.12</td>
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<tr>
<td>CoBank</td>
<td>6.07</td>
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<tr>
<td>Texas</td>
<td>6.45</td>
<td>6.04</td>
</tr>
<tr>
<td>U.S. AgBank</td>
<td>6.15</td>
<td>5.88</td>
</tr>
</tbody>
</table>

AgFirst, AgriBank, CoBank, Texas, and U.S. AgBank conduct business in the following States:

- AgFirst: Delaware, District of Columbia, Florida, Georgia, Maryland, North Carolina, Pennsylvania, South Carolina, Virginia, West Virginia
- AgriBank: Arkansas, Illinois, Indiana, Iowa, Kentucky, Michigan, Minnesota, Missouri, Nebraska, North Dakota, Ohio, South Dakota, Tennessee, Wisconsin, Wyoming
- Texas: Alabama, Louisiana, Mississippi, Texas
- U.S. AgBank: Arizona, California, Colorado, Hawaii, Kansas, Nebraska, New Mexico, Oklahoma, Utah


VALUATION. The IRS has adopted as final regulations relating to the use of actuarial tables in valuing annuities, interests for life or terms of years, and remainder or reversionary interests. The regulations contain the new actuarial tables for transfers with valuation dates after May 1, 2009. These regulations will affect the valuation of inter vivos and testamentary transfers of interest for deaths in 2010 and 2011. 76 Fed. Reg. 49570 (Aug. 10, 2011).

FEDERAL INCOME TAXATION

BUSINESS EXPENSES. The taxpayer owned several real estate properties, one used for a recreational vehicle park and two properties which were to be developed and sold; however, no sales were made. The taxpayer filed two Schedules E and claimed business deductions on Schedule C. The court disallowed most of the business expense deductions for lack of substantiation or clear business purpose, primarily because the real estate activities were held to not be an active trade or business. The allowed deductions were held to be claimed only on the Schedules E. Ortega v. Comm’r, T.C. Memo. 2011-179.

BUSINESS INCOME. The taxpayers operated a residential satellite TV installation business. The taxpayers’ installers received payments directly from customers which they were allowed to keep as partial compensation for their services. The taxpayers did not report this income nor claim any compensation expense deduction for the same amounts. The court held that the taxpayers were required to report these payments as business income but were also allowed an offsetting deduction for a compensation expense. Lua v. Comm’r, T.C. Memo. 2011-192.

CORPORATIONS.

COVENANT NOT TO COMPETE. The taxpayer was an S corporation engaged in the business of providing consulting and management services to insolvent companies. One of the founders was an employee who owned 23 percent of the outstanding stock. The employee entered into an agreement to have the corporation purchase the employee’s share in the corporation. The agreement contained a covenant not to compete for 12 months. The corporation claimed deductions for the value of covenant not to compete, amortized over the 12 months of the covenant’s existence. The IRS determined that the covenant was an amortizable I.R.C. § 197 intangible, amortizable by the corporation over fifteen years (beginning with the month of acquisition) and not over the duration of the covenant. The corporation argued that, in order for the covenant to be Section 197 property, all or a substantial portion of the corporation’s stock had to be transferred. The court held that Section 197 did not require all or a substantial portion of a corporation’s stock be transferred in order for the covenant to be Section 197 property. Therefore, the transfer of the 23 percent interest was sufficient for Section 197 to apply to require the amortization of the value of the covenant over 15 years. Recovery Group, Inc. v. Comm’r, 2011-2 U.S. Tax Cas. (CCH) ¶ 50,541 (1st Cir. 2011), aff’d, T.C. Memo. 2010-76.

REORGANIZATIONS. The IRS has adopted as final regulations relating to the methods of accounting, including the inventory methods, to be used by corporations that acquire the assets of other corporations in certain corporate reorganizations and tax-free liquidations. 76 Fed. Reg. 45673 (Aug. 1, 2011).

COURT AWARDS AND SETTLEMENTS. The taxpayer sued a former employer for sexual harassment, failure to prevent sexual harassment, disability discrimination, failure to prevent discrimination, intentional infliction of emotional distress, and other causes of action. The taxpayer had claimed that the employer’s actions had resulted in emotional stress for which
the taxpayer had received counseling. The parties reached a settlement agreement in which the taxpayer received payments for attorney’s fee, back pay and physical injury caused by emotional stress. The taxpayer did not report the payment for emotional stress in gross income. The court held that the emotional distress payment was not excludible because there were no physical injuries involved. McGowen v. Comm’r, T.C. Memo. 2011-186.

DEPRECIATION. The taxpayer was a limited liability company which elected to be taxed as a partnership. The taxpayer did not claim the additional first year depreciation for all classes of property placed in service by the taxpayer during the taxable year. However, the taxpayer failed to attach the election statement to its federal tax return for the taxable year with respect to all classes of qualified property. The accounting firm that was retained by the taxpayer to assist in preparing its federal partnership tax return for the taxable year failed to inform the taxpayer of the election statement. IRS granted an extension of time to properly make the election. Ltr. Rul. 201130002, April 19, 2011.

EMBEZZLED FUNDS. The taxpayer was convicted of embezzling funds from an employer. The taxpayer had used some of the funds to support a separate corporation’s grocery store business in which the taxpayer served as president. The taxpayer argued that the embezzled funds were not income to the taxpayer but were income to the grocery store corporation because the funds were used in that business and obtained by an officer of that corporation. The court held that the embezzled funds were income to the taxpayer personally because the taxpayer performed the embezzlement. Wood v. Comm’r, T.C. Memo. 2011-190.

HOBBY LOSSES. The taxpayers, husband and wife, operated a horse breeding activity from 2000 to 2009. The husband was employed as a successful business manager and the wife was a nurse. The wife obtained a college degree in horse breeding and management and performed most of the duties directly with the horses and the husband managed the business end of the operation. The IRS disallowed deductions in excess of income for 2005 and 2006 on the grounds that the activity was not operated with the intent to make a profit. The court held that the taxpayers did operate the horse breeding activity with the intent to make a profit because (1) the activity was operated in a business-like manner with separate bank account, horse management software, development of a business plan and adjusting the activity to make it more profitable, and accurate books; (2) the wife had expertise in horse management and the husband had expertise in managing a business; (3) the wife expended significant amounts of time on the activity; (4) the taxpayers reasonably expected the value of the horses to appreciate; (5) the years of losses occurred during the normal start-up time for horse activities; (6) the taxpayers did not receive personal pleasure from the horse activity; and (7) the taxpayers terminated the activity later when it became clear that they would not make any profits. Blackwell v. Comm’r, T.C. Memo. 2011-188.

INVESTMENT INTEREST. The taxpayer purchased a residence by borrowing from a brokerage and pledging corporate stock as collateral. The loan was repaid with the proceeds of a loan from a mortgage company. The taxpayer claimed the interest on the brokerage loan as investment interest, arguing that the interest character was determined by the type of collateral used. The court held that the interest was personal residence mortgage interest based on the use of the proceeds of the loan. Ellington v. Comm’r, T.C. Memo. 2011-193.

LIFE INSURANCE. The taxpayer had purchased a life insurance policy on the taxpayer’s life. Over the next 27 years, the taxpayer borrowed funds against the cash value of the policy. At the policy’s maturity date, the policy terminated and the insurance company paid the taxpayer the difference between the cash value and the outstanding loans. The insurance company issued a Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., for the difference between the cash value at maturity and the taxpayer’s investment in the policy. The taxpayer did not report this amount as income and the IRS assessed a deficiency. The taxpayer claimed that taxes were paid on all distributions but failed to provide evidence to support this claim. The court held that the payment of the loan balance constituted payment of the insurance proceeds to the taxpayer; thus, the taxpayer was liable for tax on the insurance proceeds less any contributions made by the taxpayer. Ledger v. Comm’r, T.C. Memo. 2011-183.

PARTNERSHIPS

ASSESSMENTS. A petition for review has been filed with the U.S. Supreme Court in the following case. The taxpayer was a partner in 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 because of the basis overstatement. The court held that the six year limitation did not apply because the overstatement of basis was not an understatement of receipt of income. Home Concrete & Supply, LLC v. United States, 634 F.3d 249 (4th Cir. 2011), rev’d, 2009-2 U.S. Tax Cas. (CCH) ¶ 50,794 (E.D. N.C. 2009).

PASSIVE ACTIVITY LOSSES. The taxpayer was in a real property business as defined by I.R.C. § 469 and was qualified under I.R.C. § 469(c)(7)(B) to make an election to treat all interests in rental real estate as a single rental real estate activity. However, the taxpayer filed the income tax return for one year without the statement required by Treas. Reg. § 1.469-9(g)(3). The IRS granted an extension of time to file the election as provided in Treas. Reg. § 1.469-9(g)(3). Ltr. Rul. 201131002, April 12, 2011.
PENSION PLANS. For plans beginning in August 2011 for purposes of determining the full funding limitation under I.R.C. § 412(c)(7), the 30-year Treasury securities annual interest rate for this period is 4.26 percent, the corporate bond weighted average is 5.94 percent, and the 90 percent to 100 percent permissible range is 5.35 percent to 5.94 percent. Notice 2011-67, I.R.B. 2011-34.

RETURNS. The IRS has published information about filing an amended return. Taxpayers should file an amended return if a filing status, dependents, total income, deductions or credits were reported incorrectly. Taxpayers do not need to amend their tax return. The IRS usually corrects math errors or requests missing forms – such as W-2s or schedules – when processing an original return. In these instances, do not file an amended return. Use Form 1040X, Amended U.S. Individual Income Tax Return, to amend a previously filed Form 1040, 1040A or 1040EZ. Make sure to check the box for the year of the return being amended on the Form 1040X. Amended tax returns cannot be filed electronically. If a taxpayer is amending more than one year’s tax return, prepare a 1040X for each return and mail them in separate envelopes to the appropriate IRS processing center. The Form 1040X has three columns. Column A shows original figures from the original return (if however, the return was previously amended or adjusted by IRS, use the adjusted figures). Column C shows the corrected figures. The difference between Column A and C is shown in Column B. There is an area on the back of the form to explain the specific changes and the reason for the change. If the changes involve other schedules or forms, attach them to the Form 1040X. If a taxpayer is filing to claim an additional refund, the taxpayer should wait until the taxpayer has received the original refund before filing Form 1040X. The taxpayer may cash that check while waiting for any additional refund. If the taxpayer owes additional tax, the taxpayer should file Form 1040X and pay the tax as soon as possible to limit interest and penalty charges. Generally, to claim a refund, a taxpayer must file Form 1040X within three years from the date the taxpayer filed the original return or within two years from the date the taxpayer paid the tax, whichever is later. Normal processing time for amended returns is 8 to 12 weeks. IRS Summertime Tax Tip 2011-12.

S CORPORATIONS

DISTRIBUTIONS TO SHAREHOLDERS. The taxpayer had been the sole owner of an S corporation and transferred by gift 95 percent to the taxpayer’s son on December 31 prior to the tax year involved. The taxpayer filed a gift tax return which identified the December 31 gift. During the tax year, the taxpayer received distributions from the corporation and the IRS assessed a deficiency based on characterizing those distributions as capital gains to the extent the distributions exceeded the taxpayer’s basis in the remaining 5 percent interest in the corporation. The taxpayer attempted to argue that the transfer of stock was part sale and part gift but the court held that the evidence demonstrated that the entire transfer was a gift as declared in the gift tax return. Therefore, the court upheld the IRS assessment based on the amount of the distributions in excess of the taxpayer’s basis as capital gains. Miller v. Comm’r, T.C. Memo. 2011-189.

FOSTER CARE PAYMENTS. The taxpayer was an S corporation which provided adult foster care and adult day care training. The taxpayer received payments from the state for providing these services and passed these payments through to the taxpayer’s owner who provided the services, after subtracting expenses. The IRS ruled that the foster care payments were not income under I.R.C. § 131 to the taxpayer’s owner. Ltr. Rul. 201131007, April 21, 2011.

SALE OF PROPERTY. The taxpayers owned a property on which the taxpayers operated a towing business and on which was the taxpayers’ residence. The taxpayer sought to sell the entire property but initially only rented the towing business part of the property to unrelated people who continued to use the property as a towing business. The taxpayers were forced to sell a right-of-way easement to the county for a road. The taxpayers continued to use the house as their residence until the whole property, subject to the easement, was sold to the tenants. The taxpayers provided sufficient evidence to support their allocation of the sale proceeds between the business and residential portions of the property. The court held that the sale proceeds allocated to the business property were capital gain. The court held that the grant of the easement was treated as a sale and the tax character of the proceeds could be allocated between the business and residential property because the easement affected both parts of the property. The proceeds allocated to the residence were eligible for the exclusion under I.R.C. § 121(a). Wickersham v. Comm’r, T.C. Memo. 2011-178.

START-UP EXPENSES. In 2004 the taxpayer began activities for a real estate investment business. In 2004 the taxpayer, registered a business name, opened a separate bank account for the business, obtained an employer identification number from the IRS and obtained a credit card for the business. The taxpayer made several attempts to purchase property during the year but failed to purchase anything until December 30. The taxpayer did not find a tenant for the property until sometime in 2005. The taxpayer claimed business deductions on the 2004 return for marketing, travel, equipment and training. The court held that the taxpayer’s activities in 2004 did not constitute an active trade or business until the property was purchased and held out for rent. Therefore, the 2004 expenses were start-up expenses under I.R.C. § 195. The appellate court affirmed in a decision designated as not for publication. Woody v. Comm’r, 2011-2 U.S. Tax Cas. (CCH) § 50,555 (D.C. Cir. 2011), aff’g, T.C. Memo. 2009-93.

THEFT LOSS. The taxpayers, husband and wife, lost their home through a foreclosure. Although the taxpayers made many attempts to have the foreclosure declared illegal, they failed to have any charges brought against the mortgage company. The taxpayers claimed a theft loss deduction on the 2004 return for theft of the property. The court held that the theft loss deduction was not allowed because no illegal action was shown by the taxpayers to have occurred by the foreclosure. Nagel v. Comm’r, T.C. Memo. 2011-184.

TRUSTS. The taxpayer created a qualified personal residence trust under which the taxpayer retained a term interest to possess and occupy the trust’s residence. The trust originally
provided that, at the end of the term, the trust benefits passed to the taxpayer’s children. The taxpayer and children obtained a modification of the trust agreement to provide (1) the children would have a power to appoint an equal share of the trust corpus to themselves or to provide a further term interest in the residence as a gift to the taxpayer. The IRS ruled that, if the modification language followed the sample language of Rev. Proc. 2003-42, 2003-1 CB 993, the modifications did not disqualify the trust for special valuation status under I.R.C. § 2702. Ltr. Rul. 201131006, April 13, 2011.

IN THE NEWS

REGISTERED TAX RETURN PREPARERS. The IRS has updated its on-line frequently asked questions about supervised preparers and preparers of non-Form 1040 series returns. The IRS reminded supervised preparers and non-Form 1040 series preparers that they must obtain or renew a preparer tax identification number (PTIN). However, supervised preparers and non-Form 1040 series preparers are exempt from competency testing and continuing education courses required for registered tax return preparers. As part of its enhanced oversight of return preparers, the IRS has mandated that all individuals who prepare federal tax returns for compensation must obtain or renew a PTIN (T.D. 9527, TAXDAY, 2011/06/01, I.4). Preparers who are not certified public accountants (CPAs), enrolled agents (EAs) or attorneys will be required to successfully pass a competency examination and complete continuing education courses. Preparers who are treated as supervised preparers or who do not prepare Form 1040 series returns are also exempt from testing and continuing education. The IRS issued Notice 2011-6, 2011-1 C.B. 315, explaining who is exempt from competency testing and continuing education because they are supervised preparers or if they do not prepare Form 1040 series returns (TAXDAY, 2010/12/31, I.1). On its website, the IRS explained that supervised preparers for purposes of the exemption from competency testing and continuing education are:

(1) Individuals who do not sign, and are not required to sign, tax returns as a paid return preparer but are:
(a) Employed by attorney or CPA firms; or
(b) Employed by other recognized firms that are at least 80 percent owned by attorneys, CPAs, or EAs; and
(2) Who are supervised by an attorney, CPA, EA, enrolled retirement plan agent or enrolled actuary who signs the returns prepared by the supervised preparer as the paid tax return preparer. Competency testing, the IRS explained, will initially be limited to individual income tax returns (Form 1040 series returns and accompanying schedules). Therefore, preparers of non-Form 1040 series returns will be exempt from competency testing and continuing education at this time. A non-Form 1040 series preparer is an individual who does not prepare, or assist in the preparation of, any Form 1040 series tax return or claim for refund, except a Form 1040-PR or Form 1040-SS, for compensation. The IRS explained on its website that non-Form 1040 series preparers may: (1) sign any tax return they prepare or assist in preparing; and (2) represent taxpayers before revenue agents, customer service representatives, or similar officers and employees of the IRS (including the Taxpayer Advocate Service) during an examination if the individual signed the tax return or claim for refund for the tax year under examination. By George L. Yaksick, Jr., Federal Tax Day - Current, I.3, “IRS Updates FAQs About Supervised Preparers and Non-Form 1040 Series Preparers,” (Aug. 8, 2011)

FARM ESTATE AND BUSINESS PLANNING

by Neil E. Harl

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- **September 15-16, 2011, Sioux Falls, SD**
  - Ramkota Hotel, 3200 W. Maple St., Sioux Falls, SD 57107 ph. 605-336-0650

The topics include:

<table>
<thead>
<tr>
<th>First day</th>
<th>Second day</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>FARM INCOME TAX</strong></td>
<td><strong>FARM ESTATE AND BUSINESS PLANNING</strong></td>
</tr>
<tr>
<td><strong>New Legislation</strong></td>
<td><strong>New Legislation</strong></td>
</tr>
<tr>
<td>Reporting Farm Income</td>
<td>Property Held in Co-ownership</td>
</tr>
<tr>
<td>- Leasing land to family entity</td>
<td>- Federal estate tax treatment of joint tenancy</td>
</tr>
<tr>
<td>- Items purchased for resale</td>
<td>- Traps in severing joint tenancies</td>
</tr>
<tr>
<td>- Items raised for sale</td>
<td>- Joint tenancy and probate avoidance</td>
</tr>
<tr>
<td>- Crop insurance proceeds</td>
<td>- Joint tenancy ownership of personal property</td>
</tr>
<tr>
<td>- Sales of diseased livestock</td>
<td>- Other problems of property ownership</td>
</tr>
<tr>
<td>- Gains and losses from commodity futures</td>
<td></td>
</tr>
<tr>
<td><strong>Sale of Property</strong></td>
<td><strong>Federal Estate Tax</strong></td>
</tr>
<tr>
<td>- Income in respect of decedent</td>
<td>- The gross estate</td>
</tr>
<tr>
<td>- Sale of farm residence</td>
<td>- Special use valuation</td>
</tr>
<tr>
<td>- Installation sale including related party rules</td>
<td>- Property included in the gross estate</td>
</tr>
<tr>
<td>- Sale and gift combined.</td>
<td>- Basis calculations under uniform basis rules</td>
</tr>
<tr>
<td><strong>Like-Kind Exchanges</strong></td>
<td>- Valuing growing crops</td>
</tr>
<tr>
<td>- Requirements for like-kind exchanges</td>
<td>- Claiming deductions from the gross estate</td>
</tr>
<tr>
<td>- What is “like-kind” for realty</td>
<td>- Marital and charitable deductions</td>
</tr>
<tr>
<td>- Partitioning property</td>
<td>- Generation-skipping transfer tax, including</td>
</tr>
<tr>
<td></td>
<td>later GST consequences for transfers in 2010</td>
</tr>
<tr>
<td></td>
<td>- Taxable estate</td>
</tr>
</tbody>
</table>

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