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Cases, Regulations, and Statutes

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to be considered a trade or business. For a lessee who is the sole employee of the entity as lessee, the task of resisting an I.R.S. assertion of trade or business status for the lessee is the most difficult. Certainly anyone leasing personal property — or even real property — to a lessee for which they are rendering services should use care to develop the strongest possible case for passive investor status rather than trade or business status. That means the lease should be drafted to place responsibility for maintenance and repair on the lessee, for example, and the lessee should avoid involvement as lessee in management or decision making relative to the property under the lease.

FOOTNOTES

1 T.C. Memo. 1989-357.
2 Id.
3 I.R.C. § 1402(a).
4 I.R.C. § 1402(b).
5 I.R.C. § 1402(a)(1).
6 I.R.C. § 1402(a).
7 Id.
8 Id.
9 I.R.C. § 1402(a)(1).
11 Id.
12 I.R.C. § 1402(a)(1).
13 I.R.C. § 1402(a).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

EXEMPTIONS. The debtor claimed as a business homestead property leased to the debtor's wholly-owned corporation. The court held that the debtor was allowed a business homestead exemption in the property. In re John Taylor Co., 935 F.2d 75 (5th Cir. 1991).

The debtor claimed a rural homestead exemption for two lots of land in a rural subdivision located outside a city limits. The lots were contiguous except that a county road by easement passed over the line between the lots. The court held that the debtor was entitled to a rural homestead exemption because the subdivision did not have the characteristics (no local government, businesses or schools) of a city, town or village. Both lots were included in the exemption because the lots were contiguous except for the road and the debtor treated the properties as one. In re Weaver, 128 B.R. 234 (Bankr. W.D. Ark. 1991).

Although the debtors signed an agreement with the trustee that the debtors' interests in an ERISA-qualified retirement plan were estate property and not exempt, the employer and plan administrator argued that the interests were exempt under Missouri law. The court held that the Missouri exemption for retirement plans was pre-empted by ERISA. In re Carver, 128 B.R. 239 (Bankr. W.D. Mo. 1990).

The trustee filed an objection to the debtor's claimed exemption of an interest in a pension plan. The objection was denied because the trustee failed to file the proof of service. The trustee filed a second objection, with proof of service, after the date for filing objections. The bankruptcy court had allowed the late objection, holding that the objection related back to the timely first objection. The district court held that the second objection did not relate back and was untimely. The case did not raise the issue of whether the exemption would be allowed even without a proper objection as was discussed in a couple of recent cases. (See In re Peterson, 920 F.2d 1389 (8th Cir. 1990) p. 47 supra and In re Kazi, 125 B.R. 981 (Bankr. S.D. Ill. 1991) p. 99 supra) Nuttleman v. Myers, 128 B.R. 254 (D. Neb. 1991).

The debtor had filed a Chapter 13 case in which the plan was confirmed. The debtor had claimed as exempt interests in two IRA's. The debtor converted the case to Chapter 7 and the trustee objected to the exemptions for the interests in the IRA's, arguing that a recent state case had declared the exemptions unconstitutional. The court held that the debtor was not entitled to the exemptions because as of the date of the conversion, the exemptions were not allowed. In re Marcus, 128 B.R. 294 (Bankr. D. Colo. 1991).

The debtor claimed the Massachusetts $100,000 exemption for a homestead with a fair market value of $140,000 and $50,000 of equity, with the intent to avoid liens against the home. A creditor with a lien against the home argued that the exemption be applied to the fair market value of the home before deducting any liens against the home. The court held that the exemption applied to the debtor's equity and that liens could be avoided to the extent the debtor's exemption would be impaired. In re Giarrizzo, 128 B.R. 321 (Bankr. D. Mass. 1991).

The debtor claimed an exemption, under Ohio law, of a homestead and sought avoidance of a lien impairing the exemption. The lien creditor had obtained relief from the stay to proceed to foreclosure on the home. The court held that the homestead exemption does not arise until execution, attachment or sale of the residence and that the lien may not be avoided until one of those actions has been taken. However, because an attempt to avoid a lien at the time of sale would be difficult, the court held that upon the filing of the praecipe for issuance of the order for the sale, the debtor may file for lien avoidance. In re Cardwell, 128 B.R. 427 (Bankr. S.D. Ohio 1991).

SALE OF ESTATE PROPERTY. The debtor owned a residence with the nondebtor spouse as tenants by the entirety and the trustee sought court approval for the sale of the debtor's interest to the nondebtor spouse for the fair market value of the debtor's interest, as an entirety interest in the property. The sole creditor objected to the sale by claiming that the sale would remove estate property
for less value than would be otherwise available to the creditor. The court held that the sale would not result in less property for the creditor because the creditor could not force partition of the property because the harm to the nondebtor spouse’s interest would exceed the benefit to the bankruptcy estate or the creditor. The court noted that the nondebtor spouse had contributed to the cost of the residence, the spouse would recognize $20,000 tax liability from a partition and the spouse would not be able to purchase another residence in the community, an Orthodox Jewish neighborhood close to a synagogue. In re Waxman, 128 B.R. 49 (Bankr. E.D. N.Y. 1991).

CHAPTER 12

CONVERSION. The debtors had filed for Chapter 13 two weeks before enactment of Chapter 12 and sought avoidance of a lien as a preferential transfer. The lien was avoided but the debtors then sought conversion to Chapter 12. The bankruptcy court would not allow conversion but allowed the debtors to dismiss the Chapter 13 case and refile for Chapter 12. The filing of the Chapter 12 petition, however, was more than 90 days after the attachment of the avoided lien and the creditor argued that the lien could no longer be avoided as a preferential transfer. The district court affirmed the conversion tactic and held that the lien remained avoided under the equity jurisdiction of Section 349. The appellate court held that the conversion tactic was improper and that the debtor should have the advantage of the Chapter 12 filing and the avoidance of the lien. The court held that the lien was no longer avoidable as a preferential transfer because the lien attached more than 90 days before the Chapter 12 filing. Matter of Sadler, 935 F.2d 918 (7th Cir. 1991).

FEDERAL TAXATION

ALLOCATION OF PLAN PAYMENTS. The debtor’s Chapter 11 liquidating plan provided for payments of principal of unpaid withholding taxes before payment of penalties and interest. The court held that the debtor may not force allocation of tax payments in a Chapter 11 liquidating plan. In re Kare Kemical, Inc., 935 F.2d 243 (11th Cir. 1991), rev’g, 90-1 U.S.T.C. ¶ 50,044 (S.D. Fla. 1989).

After the debtor’s Chapter 11 plan had been substantially performed, the debtor sought an order requiring the IRS to apply tax payments first to trust fund claims. The IRS argued that Section 1101(2)(A) prevented late modification of plans after substantial performance. The court held that a court order allocation of plan payments of taxes was not a modification of the plan but an assertion of the court’s continuing authority to supervise the plan. United States v. APT Industries, Inc., 128 B.R. 145 (W.D. N.C. 1991).

AUTOMATIC STAY. The debtor had filed a bankruptcy case with a former spouse but was dismissed from that case. The debtor commenced a new bankruptcy case and during that case the IRS improperly withheld income tax refunds due to the debtor, resulting from a computer error which continued to link the debtor with the previous case. The IRS had not filed any claim in the current case and asserted no claims against the debtor or the debtor’s estate. The debtor sought compensatory and punitive damages against the IRS for repeated violations of the automatic stay. The court held that the IRS had not waived immunity under Section 106 because the IRS had not filed a claim and had no claim against the debtor or the debtor’s estate. Matter of Cowart, 128 B.R. 492 (Bankr. S.D. Ga. 1990).

TAXABLE YEAR ELECTION. An involuntary Chapter 11 case was filed against the debtor and an order for relief was entered. The debtor filed an election to close the taxable year as of the day before the order for relief was granted. The election was filed within four and one-half months after the close of the short taxable year but more than four and one-half months after the involuntary petition was filed. The IRS argued that the date of the involuntary petition was the commencement of the case. The court held that the commencement of an involuntary case is the date the order for relief is made. In re Kreidle, 91-2 U.S. Tax Cas. (CCH) ¶ 50,371 (Bankr. D. Colo. 1991).

TRUSTEE LIABILITY. The Chapter 7 trustee filed the income tax return for the debtor corporation six months late and requested the expedited audit procedure of Section 505(b). The IRS did not respond within the time limits of Section 505 but later assessed penalties and interest for the late filing of the return. The court held that because the IRS did not timely respond to the expedited audit request, the IRS was barred from assessing any penalties or interest. In re Carie Corp., 128 B.R. 266 (D. Alaska 1989).

FEDERAL AGRICULTURAL PROGRAMS

BORROWER’S RIGHTS. The debtors entered into an agreement with the defendant bank to deed farmland to the bank and to lease the land back to the debtors for two years. The agreement reserved all rights of the debtors under the Agricultural Credit Act of 1987. The bank had the land appraised in three tracts and offered the tracts for sale at the appraised value to the debtors who presented a counteroffer which was refused. Two of the tracts were sold to third parties for more than the appraised value and the debtors argued that the sale of the two tracts violated the agreement and the Agricultural Credit Act of 1987. The court held that the division of the farmland into three tracts did not violate the 1987 Act and the sale of the two tracts on different terms than were offered to the debtors who presented a counteroffer which was refused. K Lazy K Ranch, Inc. v. Farm Credit Bank of Omaha, 127 B.R. 1014 (D. S.D. 1991).

The debtors sought an injunction to prohibit a farm credit bank from selling farm land transferred to the bank under a bankruptcy case agreement. The debtors alleged that the sale would violate the debtors’ right of first refusal under the Agricultural Credit Act of 1987. The court held that the 1987 Act did not provide a private right of action to enforce the right of first refusal. In re Jarrett Ranches,

In response to the plaintiff's action to foreclose on farmland as collateral for the defendant's loan, the defendants argued that the plaintiff was required to participate in mediation before bringing a foreclosure action. The court held that under 7 U.S.C. §§ 5101-5106, mediation was not required before foreclosure could be allowed. Federal Land Bank v. Northcutt, 811 P.2d 1368 (Okla. Ct. App. 1991).

PRICE SUPPORT AND PRODUCTION ADJUSTMENT PROGRAMS. The CCC has issued proposed rules concerning the eligibility of landlords for production adjustment programs. The proposed rules clarify the CCC definition of cash and share leases. A lease is considered a cash lease if the landowner receives a sum certain cash payment or specified quantity of the crop. A lease is a share lease if the landowner receives a specific share of the crop or a specified share of the proceeds of a crop. For leases with a combination of the above characteristics, a cash lease results if the cash payment exceeds one-half of the landowner's total expected return or the expected share amount if the lease provides for payment of the larger of a specified cash amount or a specified share. Otherwise, for mixed leases, the lease is a share lease. 56 Fed. Reg. 40272, (Aug. 14, 1991), amending 7 C.F.R. § 1413.111(b).

The CCC has issued proposed regulations making discretionary determinations under FACTA 1990: (1) advance deficiency payments for 1992-1995 wheat, feed grains, upland cotton and rice will be 40 percent of the projected payment rate, with no advance payments for ELS cotton; (2) no change in the types of crops which may be planted on flex acres; (3) planting of oats on wheat or feed grains ACR will not be allowed for 1992; and (4) planting of conserving crops on ACR will not be allowed for 1992. 56 Fed. Reg. 41082, (Aug. 19, 1991).

WETLANDS. The SCS in conjunction with the Environmental Protection Agency, the Department of Defense and the Department of the Interior has issued proposed revisions to the "Federal Manual for Identifying Defense and the Department of the Interior has issued proposed rules concerning the eligibility of landlords for production adjustment programs. The proposed rules clarify the CCC definition of cash and share leases. A lease is considered a cash lease if the landowner receives a sum certain cash payment or specified quantity of the crop. A lease is a share lease if the landowner receives a specific share of the crop or a specified share of the proceeds of a crop. For leases with a combination of the above characteristics, a cash lease results if the cash payment exceeds one-half of the landowner's total expected return or the expected share amount if the lease provides for payment of the larger of a specified cash amount or a specified share. Otherwise, for mixed leases, the lease is a share lease. 56 Fed. Reg. 40272, (Aug. 14, 1991), amending 7 C.F.R. § 1413.111(b).

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FEDERAL ESTATE AND GIFT TAX

ADMINISTRATIVE EXPENSES. The decedent's estate included an operating hotel which was continued by the estate executor for almost two years before the hotel was sold. The executor sought an administrative deduction for the ordinary and necessary business expenses of operating the hotel during the estate operation. The IRS ruled that the expenses went beyond the settling of the estate affairs and were not deductible as administrative expenses. Ltr. Rul. 9132003, April 29, 1991.

ALLOCATION OF TAXES. The decedent's will directed that the executrix should pay all estate taxes "without regard to whether such taxes be payable by my estate or by any beneficiary." Under Indiana law, unless the will otherwise directs, estate taxes are not to be paid from property eligible for a charitable, marital or other deduction. The court held that the will overrode the Indiana apportionment statute and provided for equal apportionment of estate taxes against all property, thus decreasing the property passing to the surviving spouse eligible for the marital deduction. Ransburg v. U.S., 91-2 U.S. Tax Cas. (CCH) § 60,081 (S.D. Ind. 1991), aff'g on point on rehearing, 90-2 U.S. Tax Cas. (CCH) ¶ 60,052 (S.D. Ind. 1990).

BELOW MARKET INTEREST RATE LOANS. The donors sold their farm land to their children under a 30 year contract at 6 percent interest. The IRS argued that the market rate of interest of 11 percent caused a gift of the difference in the interest rates. The donors argued that I.R.C. § 483 applied to allow the 6 percent interest. The court held that section 483 did not apply to federal gift tax law and that the IRS rate would be used to determine the imputed interest and value of the gift. The case is not in accord with Ballard v. Comm'r, 854 F.2d 185 (7th Cir. 1988). Krabbenhoft v. Comm'r, 91-2 U.S. Tax Cas. (CCH) § 60,080 (8th Cir. 1991), aff'g, 94 T.C. 887 (1990).

INCOME IN RESPECT OF DECEDENT. The decedent received an interest in an IRA owned by a predeceased person. Under the IRA provisions, if the decedent died before all funds were distributed, the remaining amounts were to be distributed to third parties. Upon the decedent's death, the executor sought contribution for the federal and state estate taxes attributable to the IRA amounts included in the decedent's estate. The surviving beneficiaries made the payments by directing the IRA trustee to distribute funds to the decedent's estate. The IRS ruled that the payments to the estate were income in respect of decedent. Ltr. Rul. 9132021, May 2, 1991.

MARITAL DEDUCTION. The decedent's surviving spouse and children were residuary beneficiaries under the decedent's will. Under a settlement agreement, the amount to be distributed to the children was established in an attempt to discern the real intent of the decedent. The court held that the amounts passing to the children under the settlement agreement did not pass first to the surviving spouse so as to be includible in the marital deduction share. Est. of Ransburg v. U.S., 91-2 U.S. Tax Cas. (CCH) § 60,081 (S.D. Ind. 1991), rev'g on point on rehearing, 90-2 U.S. Tax Cas. (CCH) ¶ 60,052 (S.D. Ind. 1990).

TRANSFERS WITH RETAINED INTERESTS. The decedent owned unimproved rural land, one-half as beneficiary of a trust for life and one-half in fee. The decedent created a partnership and contributed the decedent's one-half fee interest in the land to the partnership and transferred general and limited partnership interests to the decedent's children and grandchildren. In a subsequent year, the decedent transferred more partnership interests to the same partners. The partnership attempted to sell the land as residential development but was unable to do so by the decedent's death because of zoning restrictions. The IRS ruled that because the decedent owed the other partners the
fiduciary duty of a general partner, the transfers of the partnership interests were gifts of present interests. Also because of this fiduciary duty, the decedent's management control was not a retained interest in the transferred partnership interest such as to include them in the decedent's estate under Section 2036. **Ltr. Rul. 9131006, April 30, 1991.**

**FEDERAL INCOME TAXATION**

**AT RISK.** The taxpayer partnership owned barges operated on the Mississippi river by a corporation comprised of the partners of the barge owning partnership as shareholders. In the years the partnership has a loss from the barge operation, the corporation paid the partnership expenses to the extent of the losses, including debt service on the loans made to acquire the barges. The amounts so paid were charged against an "affiliate account." The IRS ruled that the arrangement was a management contract and the partners could not include the amount in the affiliate account as amounts at-risk in the partnership. **Ltr. Rul. 9132004, April 30, 1991.**

**COOPERATIVES.** An exempt farm cooperative was required to make an emergency purchase of normally member-produced crops from a nonmember producer in another country in order to fulfill pre-existing orders. The IRS ruled that, under Rev. Rul. 69-222, 1969-1 C.B. 161, the emergency purchase to fulfill pre-existing orders would not change the cooperative's exempt status. **Ltr. Rul. 9132028, May 13, 1991.**

**DEPRECIATION.** A rancher claimed depreciation and investment tax credit from the purchase of cattle by one corporation owned by the rancher to another corporation owned by the rancher. The court denied the deductions and credits from the sale because the taxpayer failed to produce evidence of a sale transaction. **Johnson v. Comm'r, T.C. Memo. 1991-346.**

**DISCHARGE OF INDEBTEDNESS.** In a case which illustrates the danger of selling assets before filing Chapter 7 bankruptcy, a farm debtor was held to have recognized gain from the pre-bankruptcy sale of farm equipment with the proceeds used to reduce debt secured by the equipment. Thus, the debtor was personally liable for the federal income tax on the gain. The court held that I.R.C. § 108 (nonrecognition of discharge of indebtedness income) did not apply because indebtedness was not forgiven but only reduced by the amount of proceeds generated by the sale of the equipment. [Had the debtor disposed of the equipment after filing of bankruptcy, gain from the sale or transfer to the secured creditor would be recognized by the bankruptcy estate. See Harl, Agricultural Law, § 39.02 (1991),] In re Brubeck, 91-2 U.S.Tax Cas. (CCH) ¶ 50,364 (S.D. Ind. 1991), aff'g, 90-1 U.S.Tax Cas. (CCH) ¶ 50,046 (Bankr. S.D. Ind. 1989).

**FAMILY ESTATE TRUSTS.** The defendants sold trust packages under which personal assets were transferred to domestic trusts owned by foreign trusts used to evade income tax on personal income. The defendants were convicted of conspiring to defraud the United States and appealed the conviction, arguing that the convictions were not supported by the evidence. The court held that the defendants' appearances at the sales seminars, preparation of income tax forms and service as trustees for the sham trusts were sufficient evidence to link the defendants to the conspiracy. **United States v. Tranakos, 911 F.2d 1422 (10th Cir. 1990).**

**IRA'S.** The taxpayer withdrew amounts from three IRA's for use to pay tax liability of the taxpayer's former spouse according to the divorce decree. The court held that the amounts withdrawn were includible in the taxpayer's gross income because neither the IRA's nor the funds were transferred to the former spouse and the former spouse's tax liability became the taxpayer's under the divorce decree. **Harris v. Comm'r, T.C. Memo. 1991-375.**

**INVESTMENT TAX CREDIT.** A partnership operating an ethanol distillation plant was not allowed investment tax credit for the facility until the taxable year the facility could produce the intended product. **Valley Natural Fuels v. Comm'r, T.C. Memo. 1991-341.**

The taxpayers were denied investment tax credit for rehabilitation expenses for a certified historic building where the total expenses did not exceed the total basis of the building. The court rejected the taxpayer's attempt to separate the expenses for the first floor which exceeded the first floor's share of the building's basis. **Alexander v. Comm'r, 97 T.C. No. 15 (1991).**

**INVOLUNTARY CONVERSION.** The taxpayer owned timberland which received damage from hurricane Hugo. The taxpayer realized gain from dead and damaged timber under Section 631(a) and (b) and from sales. The taxpayer used the proceeds of the damaged timber for reforestation expenses, including the replanting of trees and the repairing of drains, fences and timberland roads. The IRS ruled that the gains realized from Sections 631(a) and (b) and sales resulted from an involuntary conversion and the reforestation expenses constituted replacement property resulting in no tax liability if made within the time limitations of Section 1033(a)(2)(B). **Ltr. Rul. 9131034, May 3, 1991.**

**PREPRODUCTION EXPENSES.** The IRS has issued proposed rules governing the capitalization of preproduction interest on all real property (includes crops with a preproductive period of more than two years) and personal property with a class life of 20 years or more, an estimated preproduction period of more than two years, or an estimated production period of more than one year and an estimated cost of production of more than $1 million. The amount of interest required to be capitalized is to be determined under the cost avoidance method. The proposed rules are effective for taxable years beginning after the rules become final. **56 Fed. Reg. 40815 (Aug. 16, 1991), adding Prop. Treas. Reg. §§ 1.263A(f)-1 through 1.263A(f)-9.**

**PARTNERSHIPS**

**LIABILITIES.** The IRS has issued proposed regulations to replace the temporary regulations concerning the allocation of recourse and nonrecourse partnership liabilities
among the partners. Under the proposed regulations, a partnership liability is considered a recourse liability as to a partner if the partner bears the economic risk for the liability, including under a constructive liquidation analysis. A constructive liquidation involves an analysis of the partner's share of the liability in the event of a liquidation of the partnership in which, under the partnership agreement, the partner would be required to pay the liability. A constructive liquidation includes liquidation of the partnership, worthlessness of all partnership assets, taxable disposal of all partnership assets, allocation of partnership tax items to the partners, and immediate payment of partnership liabilities. Prop. Treas. Reg. § 1.752-2(b). Nonrecourse liabilities are to be allocated first according to the partners' share of minimum or taxable gain. Prop. Treas. Reg. § 1.752-3(a). Economic risk also exists where a partner assumes liability for a partnership obligation so that the partnership may obtain the obligation, the partner's assumption removes the lender's risk for the partnership obligation, and the partner assumes the risk for the obligation with the intent to allow other partners to include the obligation in their bases in the partnership. Prop. Treas. Reg. § 1.752-2(j)(2). If the partner pledges property with an ascertainable fair market value, the value of that property must be recomputed over the life of the partnership obligation, but if the market value of the pledged property is not readily ascertainable, the fair market value of the property is to be determined only as of the time of the pledge. Prop. Treas. Reg. § 1.752-2(h). If more than 25 percent of the interest accruing on a partnership obligation is guaranteed by partners, the guarantors will be considered to bear the economic risk of the present value of the guaranteed interest payments. Prop. Treas. Reg. § 1.752-2(e). A partner with 10 percent or less of an interest in partnership tax items is not considered at risk as to partnership nonrecourse obligations. Prop. Treas. Reg. § 1.752-2(d). 56 Fed. Reg. 37083 (Aug. 2, 1991).

LOSS. A limited partner abandoned an interest in a partnership after the partnership's main asset, a motion picture, was acquired by the executive producer. The court held that the taxpayer could claim an ordinary loss for the interest where the partnership had no liabilities at the time of the abandonment. Citron v. Comm'r, 97 T.C. No. 12 (1991).

RETIREMENT PLANS. The IRS has issued procedures for a mass submitter or sponsoring organization to obtain an opinion letter for a prototype simplified employee pension agreement that provides for contributions pursuant to an employee's election under Section 408(k)(6). The revenue procedure contains a model agreement and two other formats for sponsors to use to add elective deferral provisions to existing prototype SEP's. Rev. Proc. 91-44, I.R.B. 1991-31, 25.

The self-employed taxpayer was not allowed a deduction for contributions to a defined benefit plan where the taxpayer failed to show that the trust agreement to adopt the plan was in existence in the taxable year the deduction was claimed. Attardo v. Comm'r, T.C. Memo. 1991-357.


S CORPORATIONS

ADMINISTRATIVE ADJUSTMENTS. The S corporation tax matters partner (TMP) timely filed a petition for readjustment in response to an IRS final S corporation administrative adjustment. The court assessed penalties for delay against the TMP because the TMP failed to appear at the trial, respond to court orders or substantiate the claims in the petition. The court did not assess the penalties against the other shareholders who did not take part in the proceedings. Rollercade, Inc. v. Comm'r, 97 T.C. No. 8 (1991).

CLASS OF STOCK. The IRS has issued proposed rules replacing previously issued proposed regulations (see 1 Agric. Law Dig. 205(1990)) concerning the one class of stock requirement for S corporation status. Under the proposed regulations, a corporation has more than one class of stock if the outstanding shares do not confer identical rights to distributions and liquidation proceeds, including distributions that vary with respect to timing or amount. Prop. Treas. Reg. § 1.1361-1(l)(1). Thus, if all shares of stock of an S corporation have identical rights to distribution and liquidation proceeds, the corporation may have voting and nonvoting common stock, a class of stock which may vote only on certain issues, irrevocable proxy agreements or groups of shares that differ with respect to rights to elect members of the board of directors.

The definition of distribution includes all definitions under the Code and general principles of federal tax law. The determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is based on the articles of incorporation, bylaws, applicable state law and any binding agreements relating to distribution or liquidation, referred to as "governing provisions." Prop. Treas. Reg. § 1.1361-1(l)(2). A routine commercial contractual arrangement such as a lease, employment or loan agreement, is not considered to be a governing provision unless entered into to circumvent the one class of stock requirement. The regulations specify several exceptions-

- Agreements to redeem or purchase stock at death, disability or termination of employment are disregarded in determining whether a corporation's outstanding shares of stock confer identical distribution and liquidation rights. Prop. Treas. Reg. § 1.1361-1(l)(2)(iii).
- Rights under bona fide buy-sell agreements and restrictions on transferability of stock are not considered to create a second class of stock unless the agreement is used to circumvent the one class of stock requirement and the agreement sets a purchase price significantly different from the fair market value of the stock. Prop. Treas. Reg. § 1.1361-1(l)(2)(iii).

Outstanding stock does not include nonvested stock unless the shareholder elects under Section 83(b) and does not include deferred compensation arrangements which involve property not subject to Section 83. Prop. Treas. Reg. § 1.1361-1(b)(3),(4). Differences in voting rights and
restrictions on transferability of stock are not considered to create a second class of stock unless the agreement is used to circumvent the one class of stock requirement and the agreement sets a purchase price significantly different from the fair market value of the stock. Prop. Treas. Reg. § 1.1361-1(l)(2).

A debt obligation, regardless of designation, is not considered a second class of stock unless (1) the debt constitutes equity or otherwise results in the owner being treated as an owner of stock under general principles of federal tax law and (2) the debt is used to contravene the shareholders' rights to distribution or liquidation proceeds or to contravene the limitation on the number of shareholders. Prop. Treas. Reg. § 1.1361-1(l)(4)(ii). Straight debt will not be treated as a second class of stock, even if it would be treated as equity, if the debt is supported by a written unconditional promise to pay on demand or a specified date a sum certain and (1) the interest rate and payment are not contingent on corporation profits, corporation discretion or similar factors; (2) the debt cannot be converted into stock; and (3) the creditor is an individual, estate or trust described in Section 1361(e)(2). Prop. Treas. Reg. § 1.1361-1(l)(5). Obligations which originally qualified as straight debt cease to so qualify if the obligations are materially modified so that it no longer meets the definition of straight debt or are transferred to a non-eligible shareholder. Prop. Treas. Reg. § 1.1361-1(l)(5)(iii). If a C corporation has outstanding an obligation that satisfies the definition of straight debt but that may be considered equity under general principles of federal tax law, the obligation is not treated as a second class of stock if the C corporation converts to S corporation status. Prop. Treas. Reg. § 1.1361-1(l)(5)(v). In addition, the conversion to S corporation status is not treated as an exchange of debt for stock.

The proposed regulations contain safe harbors for obligations issued by a corporation-

- Unwritten advances from a shareholder not exceeding $10,000 in the aggregate at any time, treated as debt by the parties and are expected to be repaid within a reasonable time are not treated as a second class of stock. Prop. Treas. Reg. § 1.1361-1(l)(4)(ii)(B)(1).
- Proportionately held obligations are not treated as a second class of stock. Prop. Treas. Reg. § 1.1361-1(l)(4)(ii)(B)(2). Proportionately held obligations are any class of obligation which are considered to be equity under general principles of tax law but are owned solely by the owners of, and in the same proportions as, the outstanding stock of the corporation. The regulations note that obligation owned by the sole shareholder of a corporation are always held proportionately.

An option to purchase stock is treated as a second class of stock if the option is substantially certain to be exercised and (1) the option has a strike price substantially below the fair market value of the stock on the date the option was issued, (2) the option is transferred to a nonshareholder, or (3) the option is materially modified. Prop. Treas. Reg. § 1.1361-1(l)(4)(iii). Exceptions to this rule are made for options issued to (1) persons engaged in the lending business for the purpose of a commercially reasonable loan to the corporation and (2) employees or independent contractors in connection with the performance of services and the option is not transferable. A safe harbor for options is allowed for options with a strike price at least 90 percent of the fair market value of the underlying stock on the date the option is issued.

A corporation electing S corporation status loses its S corporation status as of the date the corporation is treated as having more than one class of stock. Prop. Treas. Reg. § 1.1361-1(l)(6).


UNDISTRIBUTED INCOME. The court held that a shareholder of an S corporation was liable for tax on the shareholder's share of corporate taxable income whether or not the shareholder received the income from the corporation. Knott v. Comm'r, T.C. Memo. 1991-352.

TAX LIEN. The taxpayers owned a homestead as joint tenants when the one spouse incurred employment tax liability which remained unpaid. The IRS sought payment of the taxes through sale of the homestead which was transferred entirely to the nondebtor spouse for less than adequate consideration. The court found the conveyance to be a fraudulent transfer conveyance because it caused the debtor spouse to be insolvent. The court held that the IRS could sell the homestead under the four factors enumerated in United States v. Rodgers, 461 U.S. 677 (1983). First, the sale of the debtor's partial interest would not produce an adequate price; second the couple attempted to avoid the consequences of the tax liability by the transfer to the nondebtor spouse; third, the costs to the nondebtor spouse would not be significantly greater than any other forced sale; and fourth, the debtor and nondebtor spouses have equal interests in the homestead. United States v. Bierbrauer, 936 F.2d 373 (8th Cir. 1991).

WITHHOLDING TAXES. The IRS has issued guidance for reporting requirements where third parties are deemed employers under Temp. Treas. Reg. § 32.1(e)(3), making the third party liable for withholding and payment of employment taxes unless the third party transfers liability to the employer. Notice 91-25, I.R.B. 1991-31, 14.

In the next issue:
"Making Valid Disclaimers"
by Neil E. Harl
MORTGAGES

MODIFICATION. The plaintiffs sold their farm to a third party and took a mortgage for the amount owed; however, the buyer did not assume the plaintiff's first mortgage on the property. The buyer later resold the farm to the defendants who renegotiated the mortgage to allow the plaintiffs only the right to recover the property without any personal liability by the buyers on the mortgage. After the buyer sought to return the property to the plaintiffs, the plaintiffs brought an action for foreclosure and a deficiency judgment. The plaintiffs argued that the renegotiated mortgage was signed under duress because the plaintiffs were still liable under their own mortgage on the property. The court held that no duress occurred because the property was worth more than all indebtedness at the time of the renegotiation and the buyers merely asserted their rights that existed. The court also found consideration for the renegotiated mortgage in that the plaintiffs were relieved of the necessity of being forced to take back the property. Isaak v. Idaho First Nat'l Bank, 812 P.2d 295 (Idaho App. 1990).

STATE REGULATION OF AGRICULTURE

WETLANDS. The plaintiff constructed a pond by excavation in the midst of some wetlands and later filled the pond back in. The Massachusetts Department of Environmental Quality Engineering fined the plaintiff $75,000, under 310 Code Mass. Regs. § 10.04, for filling a pond which was "man-made by impoundment." The court held that the plaintiff's pond was not made by impoundment, which did not include excavation. Warcewicz v. Dept. of Env. Protection, 574 N.E.2d 364 (Mass. 1991).

CITATION UPDATES
