



Agricultural Law Press

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Agricultural Law Digest

Volume 14, No 13

July 11, 2003

ISSN 1051-2780

Developments in CRP Payment Reporting

— by Neil E. Harl*

With more than 35,000,000 acres currently enrolled in the Conservation Reserve Program,¹ any change in the income tax or self-employment tax treatment of CRP payments is of widespread interest and concern.² A Chief Counsel's letter ruling³ has injected uncertainty and concern as to how CRP payments are to be reported for self-employment tax purposes.⁴

The 2003 ruling

The Chief Counsel's ruling, CCA Ltr. Rul. 200325002,⁵ involved two fact situations—

In one, the taxpayer, who was engaged in the trade or business of farming, bid land into the Conservation Reserve Program. The payments were reported on Schedule E with no self-employment paid. The ruling states that the payments should have been reported on Schedule F with the 15.3 percent self-employment tax paid.

In the other situation, the taxpayer, who was not engaged in the trade or business of farming, acquired land that had already been bid into the Conservation Reserve Program. The taxpayer reported the payments on Form 4835, the form for reporting income and expenses by non-material participation landlords, under a share lease. The ruling states that the payments should have been reported on a Schedule F and the self-employment tax paid.

Thus, in both fact situations, the landowner's activities were considered to amount to material participation. The ruling concludes that CRP payments are income from farming and are not considered rental income.

Earlier authority

The first authority on handling CRP payments, aside from some letters,⁶ was a private letter ruling issued in 1988.⁷ In the facts of that ruling a retired landowner had bid farmland into the CRP after first terminating the lease with a tenant. The ruling stated that the landowner's activities did not constitute material participation and no self-employment tax was due.⁸ That ruling appears to be inconsistent with the 2003 ruling⁹ which implies that even retired landowners would have self-employment income to report from CRP payments.

A 1996 Tax Court case, *Ray v. Commissioner*,¹⁰ involved a taxpayer engaged in farming who had purchased farmland which had been bid into the CRP program. The court found that there was a "direct nexus" between the CRP land and the farming business.

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Therefore, the CRP payments were subject to self-employment tax. That case left open the possibility that CRP land held as an investment and not part of a farming business or bearing a direct nexus to a farming operation would not be subject to self-employment tax. A 1998 Tax Court case, *Hasbrouck v. Commissioner*,¹¹ harmonizes with the *Ray* decision¹² in that participation in the CRP program and receipt of CRP payments did not establish that the taxpayers were actively engaged in the trade or business of farming. The 2003 ruling, by contrast, holds that personal effort in discharging the obligations under a CRP contract essentially amounted to material participation.

Another 1998 Tax Court case, *Wuebker v. Commissioner*,¹³ held that CRP payments are rental payments and are not subject to self-employment tax. However, that case was reversed by the Sixth Circuit Court of Appeals in 2000.¹⁴

The language in the 2003 ruling clearly implies that landowner participation in other land-idling programs would be subject to the same treatment. That could well include the Conservation Reserve Enhancement Program,¹⁵ the Wetlands Reserve Program,¹⁶ the Emergency Conservation Program,¹⁷ the Emergency Watershed Protection Program,¹⁸ the Conservation Security Program,¹⁹ and the Grasslands Reserve Program.²⁰

What lies ahead

The 2003 Chief Counsel's letter ruling will likely provide momentum for the drive to make all CRP payments exempt from self-employment tax. The first proposals were introduced in 2000²¹ with another introduced in 2001²² and the latest introduced in 2003.²³ To date, none has passed. The current proposal, S. 665, failed to make it into the 2003 tax bill that was signed on May 28, 2003.

In the meantime, it is likely that there will be more litigation over the issue. The issue is a long way from being settled.

FOOTNOTES

- ¹ 16 U.S.C. § 3831, added by Pub. L. No. 99-198, Sec. 1231, 99 Stat. 1508 (1985).
- ² See generally, 4 Harl, *Agricultural Law* § 27.03[4][e] (2003); 11 Harl, *Agricultural Law App.* 91A-28 (2003); Harl, *Agricultural Law Manual* §§ 4.02[1][e], 10.03[3][f] (2003). See also Harl, "Big News on CRP Payments: *Wuebker*

Reversed," 11 *Agric. L. Dig.* 41 (2000); Harl, "SE Tax on CRP Payments," 9 *Agric. L. Dig.* 109 (1998); Harl, "Reporting CRP Payments," 7 *Agric. L. Dig.* 165 (1996).

³ CCA Ltr. Rul. 200325002, May 29, 2003.

⁴ I.R.C. § 1402(a).

⁵ May 29, 2003.

⁶ The Associate Chief Counsel, Technical, of IRS in 1987 stated that where a farm operator or owner is materially participating in the farming operation, CRP payments constitute receipts from farm operations which are includible in net earnings from self-employment. Letter from Peter K. Scott, Associate Chief Counsel, Technical, March 10, 1987.

⁷ Ltr. Rul. 8822064, March 7, 1988.

⁸ *Id.*

⁹ CCA Ltr. Rul. 200325002, May 29, 2003.

¹⁰ T.C. Memo. 1996-436.

¹¹ T.C. Memo. 1998-249.

¹² *Ray v. Comm'r*, T.C. Memo. 1996-436.

¹³ 110 T.C. 431 (1998).

¹⁴ *Commissioner v. Wuebker*, 205 F.3d 897 (6th Cir. 2000). See also Harl, "Big News on CRP Payments: *Wuebker* Reversed," 11 *Agric. L. Dig.* 41 (2000)

¹⁵ 7 C.F.R. Pt. 1410.

¹⁶ 7 C.F.R. Pt. 1467.

¹⁷ 7 C.F.R. §§ 701.46-701.59.

¹⁸ 7 C.F.R. Pt. 624.

¹⁹ Farm Security and Rural Investment Act of 2002, Pub. L. No. 107-171, Sec. 2001, 116 Stat. 134 (2002).

²⁰ Farm Security and Rural Investment Act of 2002, Pub. L. No. 107-171, Sec. 1401, 116 Stat. 134 (2002).

²¹ S. 2422, S. 2344, H.R. 4212, 106th Cong., 2d Sess. (2000).

²² S. 315, 107th Cong., 1st Sess. (2001).

²³ S. 665, S. 1316, 108th Cong., 1st Sess. (2003).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

CLARIFICATION

In the June 13, 2003 issue of the *Digest*, on page 90, we stated that "... dividends from domestic corporations (either C or S corporations) ... are generally taxed at the same rates as net long-term capital gain ..." under the 2003 Act. It is important to note that the term "dividend" is defined in I.R.C. § 316 with reference to distributions from earnings and profits. See I.R.C. § 1368(c) for a discussion of distributions to shareholders of S corporations with accumulated earnings and profits and the extent to which the distributions may be dividends.

BANKRUPTCY

GENERAL-ALM § 13.03.*

ESTATE PROPERTY. The debtors were sugar beets farmers and had granted a security interest in their crops to a creditor in exchange for operating loans. In 2000 and 2001 the beet crops were damaged by drift from application of herbicide on neighboring

federal land. The debtors filed for bankruptcy in early 2002 before Congress passed an appropriation of funds to be used to compensate farmers with crops damaged by the herbicide applications. The debtors received compensation under this program and the creditor sought to include the funds under its security interest in the debtors' crops. The court held that, because no compensation program or funds existed prior to the bankruptcy filing, the federal compensation was not bankruptcy estate property and not subject to the creditor's crop lien. The creditor also sought to include the compensation payments as collateral in that the payments were the proceeds of the collateral crops. The court held that it was bound by the precedent of *In re Schmitz*, 270 F.3d 1254 (9th Cir. 2001), that government payments received for the inability to produce crops were not proceeds of the crops. *In re Stallings*, 290 B.R. 777 (Bankr. D. Idaho 2003).

FEDERAL TAX-ALM § 13.03.*

REFUNDS. The debtor filed a separate Chapter 11 bankruptcy petition along with chapter 11 petitions by two companies owned by the debtor. The debtor and spouse filed joint returns for 1999 and 2000 and each return claimed a refund. The spouse did not have any income for those tax years; however, the spouse filed a claim that one-half of each refund was the spouse's separate property and not part of the debtor's bankruptcy estate. The court noted that in cases in which the spouse was entitled to one-half of the refund, the state was a community property state. In this case, New Jersey is not a community property state and spouses do not automatically have an interest in the other spouse's property. The spouse also argued that, because the spouse would be jointly liable for any tax due, the spouse was entitled to one-half of the refund. The court noted that the spouse's liability for the tax was not certain and that liability for a tax did not create a property interest in the refund. The court held that the refunds were bankruptcy estate property. *In re Howell*, 2003-2 U.S. Tax Cas. (CCH) ¶ 50,545 (Bankr. D. N.J. 2003).

FEDERAL AGRICULTURAL PROGRAMS

CROP INSURANCE. The FCIC has adopted as final regulations which (1) add provisions for the insurance of Kamut and buckwheat, (2) include additional insurance benefits, clarify existing policy provisions to better meet the needs of the insured, and improve actuarial soundness, and (3) restrict the effect of the Small Grains Crop Insurance Provisions and the Wheat Crop Insurance Winter Coverage Endorsement to the 2000 and prior crop years. **65 Fed. Reg. 21144 (April 20, 2000).**

The FCIC has adopted as final regulations which make a producer ineligible for various FSA administered programs if the producer is found to have engaged in crop insurance fraud. The list includes, but is not limited to, benefits under:

(1) Title V of the FCIA.

(2) The Agricultural Market Transition Act (7 U.S.C. § 7201 *et seq.*), including the Noninsured Crop Disaster Assistance Program under section 196 of that Act (7 U.S.C. § 7333).

(3) The Agricultural Act of 1949 (7 U.S.C. § 1421 *et seq.*).

(4) The Commodity Credit Corporation Charter Act (15 U.S.C. § 714 *et seq.*).

(5) The Agricultural Adjustment Act of 1938 (7 U.S.C. § 1281 *et seq.*).

(6) Title XII of the Food Security Act of 1985 (16 U.S.C. § 3801 *et seq.*).

(7) Any law that provides assistance to a producer of an agricultural commodity affected by a crop loss or a decline in prices of agricultural commodities. **68 Fed. Reg. 39447 (July 2, 2003).**

DISASTER ASSISTANCE. The CCC has adopted as final regulations implementing portions of the Agricultural Assistance Act of 2003 to provide crop-loss disaster assistance for producers who suffered 2001 or 2002 crop losses and to establish a Livestock Assistance Program. These rules implement provisions of the Consolidated Appropriations Resolution, 2003, that add the commodities crambe and sesame seed to the list of commodities eligible for CCC direct and counter-cyclical payments and marketing assistance loans and that provide that popcorn planted acreage is to be considered corn for determining corn crop acreage bases and yields. **68 Fed. Reg. 37936 (June 26, 2003).**

EXOTIC NEWCASTLE DISEASE. The APHIS has issued interim regulations amending the Exotic Newcastle disease regulations by removing Dona Ana, Luna, and Otero Counties, NM, Hudspeth County, TX, and portions of El Paso County, TX, from the list of quarantined areas prohibiting or restricting the movement of birds, poultry, products, and materials that could spread Exotic Newcastle disease from the quarantined area. **68 Fed. Reg. 34779 (June 11, 2003).**

TOBACCO. The USDA has adopted a final regulations setting the national marketing quotas and national support price for Flue-cured (types 11-14) tobacco as follows:

Crop Year	Quota	Support Level
2000	543.0 million pounds	164.0 cents per pound
2001	548.9 million pounds	166.0 cents per pound
2002	582.0 million pounds	165.4 cents per pound

68 Fed. Reg. 34777 (June 11, 2003).

FEDERAL ESTATE AND GIFT TAX

IRA. The taxpayer was the surviving spouse of a decedent who had owned an interest in an IRA. The surviving spouse received the funds in the IRA and rolled them over to an IRA owned by the taxpayer. The taxpayer established a trust for the taxpayer's child as the primary beneficiary of the IRA upon the death of the taxpayer. That child also became the designated representative of the taxpayer as to the IRA with power over the administration of the IRA but without any authority to change

the terms of the IRA. The IRS ruled that the formation of the IRA did not result in a taxable gift and the designated representative did not have a general power of appointment over the IRA. **Ltr. Rul. 200324018, Feb. 24, 2003.**

FAMILY-OWNED BUSINESS DEDUCTION. The decedent's estate included stock in a corporation which passed under the will to the decedent's children. The estate elected to treat the stock as QFOBI under I.R.C. § 2057 and claimed the maximum deduction. The estate needed money to pay the estate tax and caused the corporation to redeem one-third of the stock. The IRS ruled that the redemption did not affect the estate's eligibility for the FOBD and did not constitute a disposition causing imposition of additional estate tax. **Rev. Rul. 2003-61, I.R.B. 2003-24.**

MARITAL DEDUCTION. The decedent's will provided for the passing of the residuary estate to two marital trusts which were eligible for the QTIP election. The QTIP election was made on the timely filed estate tax return but the stated value of the property passing to the trusts on the return was less than the actual fair market value. If the correct value was used, the estate would not have any estate tax liability and sought a ruling as to how to proceed. The IRS ruled that the estate's representative should file a supplemental Form 706 prior to the deadline for claiming a credit or refund. The supplemental Form 706 should supply the correct description of the trust for which the QTIP election was made and report the full value of the property subject to the QTIP election. **Ltr. Rul. 200323010, Feb. 19, 2003.**

The decedent's will created a marital trust for the surviving spouse. The surviving spouse was to receive payments from the property of the trust "as she needs." The trust was silent as to the use of the remainder of the net income from the trust. The court held that the trust was not QTIP because the surviving spouse was not required to receive all net income from the trust. The estate had argued that the decedent's previous wills had included language that the surviving spouse receive all income from the trust and these previous wills evidenced a strong intent of the decedent to have the trust qualify for the marital deduction. The court provided a long and detailed account of the decedent's deliberations with attorneys and accountants over estate planning and noted that the decedent had expressed more concern over other aspects of the estate plan than saving taxes. The court also noted that, although the earlier wills had all included language providing for full payment of trust income to the spouse, the final will had removed that language. **Estate of Aronson v. Comm'r, T.C. Memo. 2003-189.**

VALUATION OF STOCK. The decedent owned 20 percent of the stock in a family-owned corporation which manufactured boats. The stock was owned through a family limited partnership of which the decedent owned a 99 percent limited partnership share. The court held that the income approach was the best method for valuing the corporation because it was a long-established, financially successful, operating company. The court also held that the stock value was entitled to a 30 percent discount for lack of marketability and minority interest. **Estate of Deputy v. Comm'r, T.C. Memo. 2003-176.**

FEDERAL INCOME TAXATION

ABANDONMENT. The taxpayer and the taxpayer's brother had purchased a gasoline and diesel fuel distributing facility. The taxpayer attempted to sell the property but could not because the property was contaminated and subject to a state cleanup order. The taxpayer transferred all interest in the facility to the brother and claimed a deduction for an abandonment loss. The court held that the property was not abandoned by the taxpayer and was not eligible for the abandonment loss deduction. The appellate court affirmed in a decision designated as not for publication. **Tsakopoulos v. Comm'r, 2003-1 U.S. Tax Cas. (CCH) ¶ 50,513 (9th Cir. 2003), aff'g, T.C. Memo. 2002-8.**

ACCOUNTING METHOD. The taxpayer was a glass manufacturer and depreciated tin used in the manufacturing process. The IRS determined that the tin was not a depreciable asset but was a cost of producing the glass. The IRS claimed that the change from depreciation to current cost deduction was a change in accounting method, requiring an adjustment under I.R.C. § 481. The court held that the required change in deducting the cost of the tin was not a change in accounting method but was only a change in the determination of the useful life of the tin; therefore, no income adjustment was required. **O'Shaughnessy v. Comm'r, 2003-1 U.S. Tax Cas. (CCH) ¶ 50,522 (8th Cir. 2003), rev'g, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,235 (D.C. Minn. 2002).**

BAD DEBTS. On the taxpayers' 1999 income tax return, the taxpayers claimed a bad debt deduction for unpaid fees for services and for other debts listed in a 1998 bankruptcy petition. The court held that the debts for the service fees were not eligible for the bad debt deduction because the fees were not included in income when earned. The court disallowed the other bad debt deduction because the underlying debts were deemed worthless prior to 1999. **Crosson v. Comm'r, T.C. Memo. 2003-170.**

BUSINESS EXPENSES. The taxpayer was an attorney who operated the business with a professional corporation. As part of contingent fee arrangements with clients, the taxpayer provided litigation costs which were reimbursed only if the client's litigation was successful. The taxpayer claimed a business expense deduction for the advanced litigation costs which had not been repaid at the end of the tax year because the litigation was still pending. The court held that the advanced litigation costs were in the nature of a loan to the clients and could not be claimed as an expense deduction until the litigation was concluded. **Merritt v. Comm'r, T.C. Memo. 2003-187.**

C CORPORATIONS.

DISTRIBUTIONS. The taxpayer corporation owned a subsidiary corporation which operated a business different from the taxpayer's business. In order to allow each corporation to focus on its separate business, the taxpayer corporation distributed its stock in the subsidiary to the subsidiary in a distribution meeting the requirements of I.R.C. § 355. The IRS ruled that the distribution would meet the business purpose

requirement of Treas. Reg. § 1.355-2(b). **Rev. Rul. 2003-74, I.R.B. 2003-__.**

The taxpayer corporation owned a subsidiary corporation which operated a business different from the taxpayer's business. In order to allow each corporation to obtain sufficient funding from loans, the taxpayer decided to distribute its stock in the subsidiary to the subsidiary in a distribution meeting the requirements of I.R.C. § 355. The IRS ruled that the distribution would meet the business purpose requirement of Treas. Reg. § 1.355-2(b). **Rev. Rul. 2003-75, I.R.B. 2003-__.**

COST-SHARING PAYMENTS. The IRS has determined that all or a portion of cost-share payments received under the Conservation Reserve Program (CRP) is eligible for exclusion from gross income to the extent permitted by I.R.C. § 126. **Rev. Rul. 2003-59, I.R.B. 2003-24, 1014.**

COURT AWARDS AND SETTLEMENTS. The taxpayer had filed a lawsuit against an employer for sexual harassment under state law and an award of damages for "damages for mental anguish, humiliation, embarrassment, and loss of benefits and other economic advantages of employment." The parties reached a settlement and the settlement amount, less the attorneys' fees, was excluded from income. The court held that the claims for emotional distress did not qualify as personal injuries; therefore, the settlement was taxable income. The court denied a reduction of the taxable portion of the settlement for the taxpayer's court costs and medical expenses. **Shultz v. Comm'r, T.C. Memo. 2003-173.**

The taxpayer sued a credit card company for harm to the taxpayer's credit reputation, resulting from a disputed credit card balance which the credit card company reported as defaulted. The parties reached a settlement for a \$5,000 payment to the taxpayer and the settlement did not allocate the payment to any specific claim or damages. The court held that the payment was included in taxable income because the taxpayer had not made any claim for physical injuries and the settlement agreement did not allocate any portion of the payment for physical injuries. **Henderson v. Comm'r, T.C. Memo. 2003-168.**

DEPRECIATION. Rev. Proc. 2002-33, I.R.B. 2003-20, 963 provided additional time for certain taxpayers who filed their 2000 or 2001 federal tax return before June 1, 2002, to (1) claim the 30 percent additional first year depreciation provided by I.R.C. §§ 168(k)(1) and 1400L(b) for a class of property that is qualified property or qualified New York Liberty Zone property placed in service after September 10, 2001, during the 2000 or 2001 taxable year, (2) elect the increased I.R.C. § 179 amount provided by I.R.C. § 1400L(f) for I.R.C. § 179 property that is Liberty Zone property placed in service by the taxpayer after September 10, 2001, during the 2000 or 2001 taxable year, and (3) depreciate under I.R.C. § 168 Liberty Zone leasehold improvement property placed in service by the taxpayer after September 10, 2001, during the 2000 or 2001 taxable year, as 5-year property using the straight-line method of depreciation. Rev. Proc. 2002-33 also explained how taxpayers may make the election provided by I.R.C. §§

168(k)(2)(C)(iii) and 1400L(b)(2)(C)(iv) not to deduct the 30 percent additional first year depreciation for any class of property that is qualified property or Liberty Zone property placed in service after September 10, 2001. Special provisions, including a deemed election, were provided for taxpayers that filed their 2000 or 2001 federal tax return before June 1, 2002. The IRS has learned that some taxpayers were unaware of the relief provided by Rev. Proc. 2002-33 or were precluded from the relief because their federal tax returns for the taxable year that included September 11, 2001, were filed on or after June 1, 2002. The IRS has extended the relief provided in Rev. Proc. 2002-33 to any taxpayer that timely filed its federal tax return for the taxable year that included September 11, 2001. **Rev. Proc. 2003-50, I.R.B. 2003-__.**

The IRS has announced an automatic extension of time to make the election not to apply the mid-quarter convention rules contained in I.R.C. § 168(d)(3) to property placed in service in the tax year that included September 11, 2001, if the third or fourth quarter of the taxpayer's tax year included September 11, 2001. The extension is available to qualifying taxpayers who filed timely tax returns for the tax year that included September 11, 2001, but failed to make the election. Those taxpayers are granted an automatic extension of time until December 31, 2003, to amend their tax returns for the tax year that included September 11, 2001, and any subsequent tax years, in order to make the election and reflect any necessary adjustments resulting from the election. **Notice 2003-45, I.R.B. 2003-__.**

DISASTER LOSSES. On June 3, 2003, the President determined that certain areas in Mississippi were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of severe storms and tornadoes that began on May 5, 2003. **FEMA-1470-DR.** On June 3, 2003, the President determined that certain areas in Kentucky were eligible for assistance under the Act as a result of severe storms, tornadoes and flooding that began on May 4, 2003. **FEMA-1471-DR.** On June 3, 2003, the President determined that certain areas in Arkansas were eligible for assistance under the Act as a result of severe storms, tornadoes and flooding that began on May 2, 2003. **FEMA-1472-DR.** On June 21, 2003, the President determined that certain areas in West Virginia were eligible for assistance under the Act as a result of severe storms, flooding and landslides that began on June 11, 2003. **FEMA-1474-DR.** **Accordingly,** taxpayers who sustained losses attributable to the disaster may deduct the losses on their 2002 federal income tax returns.

EMPLOYEE BENEFITS. The taxpayer company maintained a plan qualified under I.R.C. § 401(a) that provided retirement benefits for employees. The taxpayer also maintained a health plan for employees, former employees, their spouses, and dependents that is partially paid through a cafeteria plan under I.R.C. § 125 for employees. Under the health plan, former employees could elect to have distributions from the qualified retirement plan applied to pay for the health insurance premiums under the cafeteria plan. The IRS ruled that the amounts distributed from the qualified retirement plan that the distributee elected to have applied to pay health insurance premiums under a cafeteria

plan are includible in the distributee's gross income. The IRS also ruled that the same conclusion applies if amounts distributed from the qualified retirement plan are applied directly to reimburse medical care expenses incurred by a participant in the qualified retirement plan. **Rev. Rul. 2003-62, I.R.B. 2003-25.**

INTEREST RATE. The IRS has announced that, for the period July 1, 2003 through September 30, 2003, the interest rate paid on tax overpayments remains at 5 percent (4 percent in the case of a corporation) and for underpayments at 5 percent. The interest rate for underpayments by large corporations is 7 percent. The overpayment rate for the portion of a corporate overpayment exceeding \$10,000 is 2.5 percent. **Rev. Rul. 2003-63, I.R.B. 2003-25.**

PARTNERSHIPS.

LIABILITIES. The IRS has issued proposed regulations regarding a partnership's assumption of a partner's liabilities in a transaction occurring after October 18, 1999, and before June 24, 2003. Under the proposed regulations, if a partnership assumes a liability of a partner (other than a liability to which I.R.C. § 752(a), (b) apply) in a transaction described in I.R.C. § 721(a), then, after application of I.R.C. § 752(a), (b), the partner's basis in the partnership is reduced (but not below the adjusted value of such interest) by the amount (determined as of the date of the exchange) of the liability. For this purpose, the term liability includes any fixed or contingent obligation to make payment, without regard to whether the obligation is otherwise taken into account for Federal tax purposes. The adjusted value of a partner's interest in a partnership is the fair market value of that interest increased by the partner's share of partnership liabilities under Treas. Reg. §§ 1.752-1 through 1.752-5. The exceptions under I.R.C. § 358(h) applicable to corporate assumptions of shareholder liabilities generally apply for purposes of the proposed regulations. Therefore, a reduction in a partner's basis generally is not required, under these regulations, after an assumption of a liability by a partnership from that partner if: (1) the trade or business with which the liability is associated is transferred to the partnership assuming the liability as part of the transaction, or (2) substantially all of the assets with which the liability is associated are contributed to the partnership assuming the liability. However, in the case of a partnership transaction that is substantially similar to the transactions described in Notice 2000-44, the exception for contributions of "substantially all of the assets with which the liability is associated" does not apply. **68 Fed. Reg. 37414 (June 24, 2003).**

PASSIVE ACTIVITY LOSSES. The taxpayers were the sole owners of an S corporation which provided concrete pumping services. The taxpayers were employees of the corporation and operated the equipment. The taxpayers leased equipment to the corporation in exchange for lease payments. The leasing activities were reported on Schedule E and reported losses resulting from depreciation of the equipment. The taxpayers argued that the exception of Temp. Treas. Reg. § 1.469-1T(e)(3)(ii)(D) applied because they provided services to the corporation incidental to the leasing of the equipment. The court

held that the losses were passive activity losses which could not be used to offset the taxpayers' other income because the services provided by the taxpayers were not incidental to the leasing activities but were related to the concrete pumping business. **Kessler v. Comm'r, T.C. Memo. 2003-185.**

PENSION PLANS. The taxpayer was an employer which maintained a defined benefit plan qualified under I.R.C. § 401(a), under which benefit accruals were frozen as of December 31, 1996. Under the plan's benefit formula prior to January 1, 1997, a participant received a specified percentage of his or her highest average pay multiplied by the participant's total years of service. The plan provided that each participant became fully vested in his or her accrued benefit after five years of service. The freezing of accruals under the plan caused a partial termination in 1997, so that all participants in the plan became fully vested in their accrued benefits following the freeze. The taxpayer subsequently amended the plan to provide that, as of January 1, 2003, participants in the plan would begin accruing benefits under a different formula. A participant's accrued benefit under the plan, as amended, was the sum of the accrued benefit under the old formula and the accrued benefit under the new formula. The IRS ruled that the freezing of accruals under the qualified retirement plan, so that a partial termination of the plan occurred, did not constitute a plan termination for purposes of determining whether service for the plan sponsor after the plan was established may be disregarded toward vesting if accruals resumed under the plan. Accordingly, all years of service for the plan sponsor following the establishment of the previously frozen plan had to be taken into account for purposes of vesting. The IRS also ruled that, if the accruals were earned under a new plan maintained by the same employer and the new plan was merged with the frozen plan, then this holding also applied, so that, after the merger, service after the frozen plan was established had to be taken into account for purposes of vesting in any benefit accruals under the new plan. **Rev. Rul. 2003-65, I.R.B. 2003-25.**

The taxpayer company had provided a defined benefit plan qualified under I.R.C. § 401(a) but terminated that plan and changed to a new defined contribution plan. The taxpayer satisfied all liabilities of the original plan and transferred over 25 percent of the surplus assets of the original plan to the new plan. The IRS ruled that the transferred assets were not included in the taxpayer's income and were not eligible for a deduction. The surplus assets not transferred were subject to an excise tax under I.R.C. § 4980 and included in the taxpayer's income. **Rev. Rul. 2003-85, I.R.B. 2003-__.**

The IRS has issued a reminder that businesses which provide so-called Master & Prototype plans and Volume Submitter retirement plans must update the plans by September 30, 2003. Employers providing such plans are usually small to midsize businesses, including self-employed persons, such as some doctors and lawyers. Failure to act by the deadline could cost a retirement plan its tax-favored status. Many employers will only need to make sure that they adopt their plan amendments with the IRS by September 30 to keep their plans tax-qualified. Others, however, will also have to file the amendments with

the IRS by September 30 to keep their plans tax qualified. **IR-2003-81.**

RETURNS. The IRS has announced that taxpayers can obtain an employer identification number (EIN) online on the IRS web site at www.irs.gov. In addition, return preparers can obtain EINs for their clients after first obtaining the client's signature on Form SS-4. **IR-2003-77.**

The IRS has announced the revision of Form 8873, Extraterritorial Income Exclusion, and its instructions. The 2000 and 2001 Forms 8873 contained an error in the computation of the extraterritorial income exclusion (net of disallowed deductions) shown on line 55 of the form in certain instances in which a taxpayer used the foreign sale and leasing income method. This error may have led some taxpayers that used the foreign sale and leasing income method to claim excessive extraterritorial income exclusions for tax years 2000 and 2001. Compared to the 2000 and 2001 Forms 8873, the 2002 Form 8873 has been revised as follows: line 46 has been modified; lines 52 through 54 have been deleted; and line 55 has been redesignated as line 52 and modified to reflect the deletion of lines 52 through 54. As a result, the 2002 Form 8873 reflects the correct calculation of the extraterritorial income exclusion (net of disallowed deductions) on line 52 regardless of whether the taxpayer uses the foreign trade income, foreign trading gross receipts, or foreign sale and leasing income method to calculate the amount entered on line 45. **Ann. 2003-47, I.R.B. 2003-__.**

REVENUE RULINGS. The IRS has issued a list of revenue rulings and revenue procedures which are obsolete, although they have not been revoked or repealed. **Rev. Rul. 2003-67, I.R.B. 2003-26.**

SAFE HARBOR INTEREST RATES

July 2003

	Annual	Semi-annual	Quarterly	Monthly
Short-term				
AFR	1.23	1.23	1.23	1.23
110 percent AFR	1.35	1.35	1.35	1.35
120 percent AFR	1.49	1.48	1.48	1.48
Mid-term				
AFR	2.55	2.53	2.52	2.52
110 percent AFR	2.80	2.78	2.77	2.76
120 percent AFR	3.06	3.04	3.03	3.02
Long-term				
AFR	4.17	4.13	4.11	4.09
110 percent AFR	4.59	4.54	4.51	4.50
120 percent AFR	5.02	4.96	4.93	4.91

Rev. Rul. 2003-71, I.R.B. 2003-27.

STATE REGULATION OF AGRICULTURE

MILK. The plaintiffs were Nevada dairy producers who sold milk to California processors. The plaintiffs challenged application of the California milk price stabilization program to them as violating the Commerce Clause of the U.S. Constitution.

The Circuit Court held that the case was governed by the holding of *Shamrock Farms Co. v. Veneman*, 146 F.3d 1177 (9th Cir. 1998), which held that the California program was immunized from Commerce Clause challenges by Section 144 of the 1996 Farm Bill. The plaintiffs also alleged that the program violated the Equal Protection Clause but the court held that the issue was insufficiently pled because the petition failed to allege facts to demonstrate that the classifications of producers are arbitrary or that they are not rationally related to legitimate state interests. On appeal, the U.S. Supreme Court reversed, holding that the 1996 Farm Bill provision applied only to California laws affecting the composition and labeling of milk products and did not specifically immunize California laws on pricing from Commerce Clause scrutiny. The Supreme Court also reversed on the Equal Protection Clause issue because the California law did not include an express statement as to the basis for disparate treatment of nonresident producers. The court did not rule on the merit of either issue. **Hillside Dairy, Inc. v. Lyons**, 539 U.S. __ (2003), *rev'g and rem'g sub. nom.*, **Ponderosa Dairy v. Lyons**, 259 F.3d 1148 (9th Cir. 2001).

CITATION UPDATES

Raymond v. United States, 247 F. Supp.2d 548 (D. Vt. 2002) (court awards and settlements) see p. 21 *supra*.

IN THE NEWS

COUNTRY-OF-ORIGIN LABELING. The House Appropriations Committee has passed the agriculture spending bill for fiscal 2004 with language that prevents the USDA from using 2004 funds to implement the 2002 farm bill's mandatory country of origin labeling (COOL) provision. The rule is scheduled to take effect in the fall of 2004. The Bush administration says it will carry out the law. USDA officials plan to propose rules for mandatory labeling in September and finalize them in April 2004, according to a Reuters report. In testimony before the House Ag Committee Thursday, Colorado Farm Bureau President Alan Foutz reaffirmed Farm Bureau's support for COOL, which the group believes can be implemented "in a fair manner to all producers without large costs and burdensome paperwork requirements." He said the groups' members are willing to do the extra work to put in place a process verification system, and argued a voluntary program would be ineffective. Grocers and foodmakers, however, called for repeal of the law saying it would disrupt the food chain and drive down farm-gate prices. See also, McEowen, "Country of Origin Labeling" 14 *Agric. L. Dig.* 65 (2003). **Ag Online.**



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October 23, 2003: "Farm & Ranch Income Tax"

by Neil E. Harl

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by Roger A. McEowen

Spa Resort, Palm Springs, CA

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