Agricultural Law Press

Publisher/Editor

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Agricultural Law Digest

Volume 30, No. 15 August 9, 2019 ISSN 1051-2780

Chapter 11 Plan Provision for Liquidating Trustee Upheld

-by Robert P. Achenbach, Jr., J.D.

In a recent Chapter 11 bankruptcy case, a partnership debtor attempted to circumvent a negotiated liquidation in case of a potential plan default but was defeated by established bankruptcy and federal tax provisions. One can imagine that the creditors were placated by the Chapter 11 plan liquidation provision, and the court refused to allow the debtor to use legal maneuvers to pull the negotiated "rug" out from under the creditors.

***In re Schroeder Bros. Farms of Camp Douglas LLP*[1]**

The debtor was a limited liability partnership (LLP) which was taxed as a partnership and which owned and operated a dairy farm but had to file for Chapter 11 because the debtor's liabilities exceeded the limit ($4,411,400 in 2016 through 2019) for Chapter 12 eligibility.1[Section 101(18)(B).] The debtor's plan was confirmed and included a "liquidation provision" which provided that, if the debtor defaulted on required plan payments, the Committee of Unsecured Creditors (the Committee) could petition for appointment of a liquidating trustee after giving the debtor 30 days notice of the default. The debtor did default on plan payments and the committee filed a motion for appointment of the liquidating trustee.

Proposed Solution #1. The debtor objected to the motion on the grounds that any sale of assets would create substantial capital gains tax, sufficient to render the bankruptcy estate insolvent. To solve this problem, the debtor proposed to convert the case to Chapter 12 to take advantage of Section 1232 which allows Chapter 12 debtors to sell farm property and treat the capital gains as an unsecured claim of the estate.[2] Because the plan payments had reduced the debtor's debts, the debtor was now eligible for Chapter 12, at least under the debt limit requirements.

The Committee argued that a conversion to Chapter 12 was not possible because the eligibility of the debtor for Chapter 12 is determined at the date of the original petition in the case, not the date of the conversion. Section 1112(f) prohibits the conversion of a Chapter 11 case to another chapter unless the debtor is qualified for the new chapter. Although a conversion order constitutes an order for relief for the new chapter filing, under Section 348(a) the conversion ". . . does not effect a change in the date of the filing of the petition, the commencement of the case, or the order for relief."[3] Thus, the court held that because the debtor was not eligible for Chapter 12 on the original date of the petition, the debtor could not later convert to Chapter 12.

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In addition, the court noted that Section 1232 would not help the debtor because, as a partnership, all income and deductions flow through to the partners and would not affect the financial status of the partnership in bankruptcy. This issue raises the second proposed solution.

Proposed Solution #2. To remove the partnership problem, the debtor proposed to make the election under Treas. Reg. § 301.7701-1(c) to be taxed as a corporation and removing the pass-through of the capital gains. The court agreed that the debtor was eligible for the election but raised the issue as to whether the election would violate the absolute priority rule of Section 1129(b)(2)(B).[4]

The absolute priority rule provides that a plan is not fair and equitable to a class of unsecured creditors if a junior creditor, including the debtor, receives or retains any interest in bankruptcy estate property and the unsecured creditors receive less than full payment for their claims.[5]

The court cited *In re Perez*[6]that the absolute priority rule prohibits "the bankruptcy court from approving a plan that gives the holder of a claim anything at all unless all objecting classes senior to him have been paid in full." In this case, the court found that allowing the election to corporation status would be unfair to unsecured creditors in that the effect of the election would remove assets which would be available to the unsecured credits while leaving the partners no longer directly taxed on the capital gains. The court noted that the debtor and creditors had negotiated the liquidation provision and had sufficient notice of the ramifications of a default by the debtor.

Appointment of the Trustee

The debtor also challenged the authority of the court to appoint a trustee. Section 1104(a) authorizes a court to appoint a trustee "for cause, including fraud, dishonesty, incompetence, or mismanagement" or "if such appointment is in the interests of creditors . . .." A court may appoint a trustee under Section 1104(a) only after commencement of the case and before confirmation of the plan. Here the plan was confirmed prior to the arise of the default and application of the liquidating agreement. However, the court noted that Section 1123 authorizes provisions in a plan permitting the appointment of a trustee.

The court cited *In re Ionosphere Clubs, Inc*.[7] for four factors to use in determining whether an appointment of a trustee is in the best interests of creditors: "(i) the trustworthiness of the debtor; (ii) the debtor in possession's past and present performance and prospects for the debtor's rehabilitation; (iii) the confidence-or lack thereof-of the business community and of creditors in present management; and (iv) the benefits derived by the appointment of a trustee, balanced against the cost of the appointment." Thus, the court found that the appointment of a liquidating trustee was in the best interests of the debtor and creditors, particularly because the parties had negotiated this solution for a plan default, indicating that the creditors found this procedure to be in their best interests.

In Conclusion

The case does not discuss why the debtor choose Chapter 11 instead of taking steps to qualify for Chapter 12, but the debtors default was blamed on deteriorating market conditions and that cause would arise in either Chapter 11 or 12. Plus the existence of the liquidating provision for the trustee demonstrated that the debtors and creditors were aware of the potential for the confirmed plan to fail. Thus, the attempt to circumvent the liquidating provision through legal maneuvers was insufficient to overcome the economic hazards of dairy farming.

ENDNOTES

[1] 2019 Bankr. LEXIS 1705 (Bankr. W.D. Wis. 2019).

[2] See Harl and Achenbach, *Agricultural Law*, § 39.04[4][b] (2019).

[3] See, e.g., *In re* Campbell, 313 B.R. 871 (Bankr. 10th Cir. 2004); *In re* Ash, 539 B.R. 807 (Bankr. E.D. Tenn. 2015).

[4] Note that Chapter 12 does not contain the same "cram-down" provision as in Chapter 11, although Chapter 12 has its own cram-down rule. Likewise, there is no absolute priority rule in Chapter 12.

[5] See Harl and Achenbach, *Agricultural Law*, § 120.05[5][g] (2019).

[6] 30 F.3d 1209, 1214 (9th Cir. 1994).

[7] 113 B.R. 164 (Bankr. S.D. N.Y. 1990).

CASES, RULINGS, REGULATIONS AND STATUTES

FEDERAL ESTATE AND GIFT TAXATION

DISCLAIMERS. The taxpayer was the income beneficiary of three trusts. The taxpayer utilized the disclaimer provisions expressly provided in the three trusts and disclaimed the life estates. At the time the taxpayer executed the disclaimers, the taxpayer had been medically diagnosed as suffering from cancer, was in hospice care and had a medical prognosis of at least a 50 percent probability that the taxpayer would die within one year. However, the taxpayer died five days later. The disclaimer constituted completed gifts to the owners of the remainder interests in the trusts. The executors of the taxpayer's estate sought a ruling as to the applicable actuarial factor to be used in valuing the disclaimers of the life estates. Treas. Reg. § 25.2512-5(a) provides that, except as otherwise provided in Treas. Reg. §§ 25.2512-5(b) and 25.7520-3(b), the fair market value of annuities, unitrust interests, life estates, terms of years, remainders, and reversions transferred by gift, is the present value of the interests

determined under Treas. Reg. § 25.2512-5(d). Treas. Reg. § 25.7520-3(b)(3) provides that except as provided in Treas. Reg. § 25.7520-3(b)(3)(ii), the mortality component prescribed under I.R.C. § 7520 may not be used to determine the present value of an annuity, income interest, remainder interest, or reversionary interest if an individual who is a measuring life dies or is terminally ill at the time the gift is completed. For purposes of this paragraph, an individual who is known to have an incurable illness or other deteriorating physical condition is considered terminally ill if there is at least a 50 percent probability that the individual will die within one year. The IRS ruled that, because the taxpayer was terminally ill within the meaning of Treas. Reg. § 25.7520-3(b)(3) at the time of the gifts, the mortality component prescribed under I.R.C. § 7520 for ordinary life estate interests may not be used to determine the present value of the life estate interests disclaimed by the taxpayer. The IRS ruled that an actuarial factor of 0.00043 must be used in valuing the gifts. **Ltr. Rul. 2019028003, March 28, 2019**.

INSTALLMENT PAYMENT OF ESTATE TAX. The decedent's estate included a revocable grantor trust which held shares in a closely-held corporation with six operating units. The estate sought a ruling that four of the units (numbers 2, 3, 5 and 6) had activities which constituted "carrying on of a trade or business" for purposes of the election to pay federal estate tax in installments. Under I.R.C. § 6166(a)(1), if the value of an interest in a closely held business that is included in determining the gross estate of a decedent exceeds 35 percent of the adjusted gross estate, the estate may elect to pay all or part of the estate tax liability in two or more (but not exceeding ten) equal installments. Pursuant to I.R.C. § 6166(b)(1) an "interest in a closely held business" is defined, in relevant part, as stock in a corporation carrying on a trade or business if 20 percent or more of the value of voting stock of the corporation is included in the gross estate, or the corporation has 45 or fewer shareholders. *Rev. Rul. 2006-34, 2006-1 C.B. 1171* contains a non-exclusive list of factors that are relevant in determining whether real property and other interests are interests in a closely held business for purposes of Section 6166: the amount of time the corporation's employees devoted to the trade or business; whether an office was maintained from which the activities of the corporation were conducted and whether the corporation maintained regular business hours for that purpose; the extent to which the corporation's employees were actively involved in finding new tenants and negotiating and executing leases; the extent to which the corporation's employees provided services beyond the mere furnishing of leased premises; the extent to which the corporation's employees personally arranged for, performed, or supervised repairs and the maintenance of property (whether or not performed by independent contractors); and the extent to which the corporation's employees handled tenant repair requests and complaints. Unit 2: Unit 2 was responsible for providing re-marketing, management and support services regarding equipment owned by Unit 1 and equipment owned by outside lessors. Unit 2 had full-time-equivalent employees that were involved in management, support, re-marketing, sale and re-lease of the equipment at several locations. Most lessees and customers were secured through direct activities of Unit 2, and the repair of equipment was either arranged for, performed by, or supervised by an employee of Unit 2. The IRS ruled that the activities of Unit 2 constituted an active trade or business for purposes of Section 6166. Unit 3 was similar to Unit 2 and, additionally, its employees hired and supervised independent contractors for substantial repairs and capital improvements, and services such as snow removal, landscaping, security, janitorial, and cafeteria services. The IRS ruled that the activities of Unit 3 constituted an active trade or business for purposes of Section 6166. Unit 5: Unit 5 involved non-owner employees of the corporation actively overseeing construction of the subject properties and actively supervising the actions of another independent company. The IRS ruled that the activities of Unit 5 constituted an active trade or business for purposes of Section 6166. Unit 6: Unit 6 hired another company owned by the corporation to manage and operate a hotel, using employees of Unit 6. The IRS ruled that the activities of Unit 6 constituted an active trade or business for purposes of Section 6166. **Ltr. Rul. 201928007, April 12, 2019**.

TRUSTS. The estate filed its federal income tax return on a fiscal year basis and made a distribution within the first 65 days of the fiscal year, intending to have the distribution considered to be paid or credited on the last day of the fiscal year under I.R.C. § 663(b). Due to inadvertence, the Section 663(b) election was not timely filed. I.R.C. § 663(b)(1) provides that in general, if within the first 65 days of any taxable year of an estate or a trust, an amount is properly paid or credited, such amount shall be considered paid or credited on the last day of the preceding taxable year. I.R.C. § 663(b)(2) provides that I.R.C. § 663(b)(1) shall apply with respect to any taxable year of an estate or a trust only if the executor of such estate or the fiduciary of such trust elects, in such manner and at such time as provided by regulations. Treas. Reg. § 1.663(b)-2(a)(1) provides that if a trust return is required to be filed for the taxable year of the trust for which the election is made, the election shall be made in the appropriate place on such return and shall be made not later than the time prescribed by law for filing such return (including extensions thereof). Such election shall become irrevocable after the last day prescribed for making it. The IRS granted an extension of time for the estate to make the Section 663(b) election. **Ltr. Rul. 201928010, March 26, 2019**.

FEDERAL FARM PROGRAMS

EMERGENCY CONSERVATION PROGRAM. Section 2403 of the 2018 Farm Bill (Pub. L. No. 115–334) made changes to the Emergency Conservation Program (ECP) provisions by adding wildfires as an eligible natural disaster for which payments may be provided to eligible producers. The FSA has issued proposed regulations which include the 2018 Farm Bill change plus other changes including: adding an additional category to natural disasters to be consistent with the changes to the ECP provisions;

making a portion of the cost-share payments for the repair or replacement of fencing available to eligible producers prior to the producer carrying out the repair or replacement; increasing the maximum payment amount a producer can receive under ECP; establishing a maximum payment percentage that a producer who is a socially disadvantaged or beginning farmer or rancher may receive; and making minor technical changes to the existing ECP and regulations. **84 Fed. Reg. 32839 (July 10, 2019)**.

FRUITS AND VEGETABLES. The AMS has adopted as final regulations which remove seven voluntary U.S. grade standards and one consumer standard for fresh fruits and vegetables as part of the USDA's work to eliminate regulations that are outdated, unnecessary, ineffective, or impose costs that exceed benefits. The affected fruits and vegetables are cantaloups, celery, Persian limes, peaches, apricots, nectarines and honey dew melons. The consumer standard for celery stalks is also being removed. None of the eight voluntary standards removed from the CFR are related to a current, active marketing order, import regulation, or export act. The cost of printing these eight standards in the CFR annually exceeds the benefits of further inclusion in the CFR. These voluntary standards and all subsequent revisions or new standards for these products will be available in a separate publication. The standards for the affected commodities will continue to be administered by the AMS Specialty Crops Inspection Division and catalogued using the existing numbering system for voluntary standards. **84 Fed. Reg. 33827 (July 16, 2019)**.

FEDERAL INCOME TAXATION

ACCOUNTING METHOD. The IRS has adopted as final regulations removing Treas. Reg. § 1.451-5, and its cross-references, relating to the treatment of advance payments for goods and long-term contracts under I.R.C. § 451. Treas. Reg. § 1.451-5 generally allowed accrual method taxpayers to defer the inclusion of income for advance payments for goods until the taxable year in which they were properly included in income under the taxpayer's method of accounting for federal income tax purposes if that method resulted in the advance payments being included in gross income no later than when the advance payments were recognized in gross receipts under the taxpayer's method of accounting for financial reporting purposes. Section 13221 of TCJA 2017, Pub. L. No. 115-97 (2017), amended I.R.C. § 451 by redesignating I.R.C. §§ 451(b) through (i) as (d) through (k) and adding new subsections (b) and (c). New I.R.C. § 451(c) generally requires an accrual method taxpayer that receives any advance payment described in I.R.C. § 451(c)(4) during the taxable year to include the advance payment in income in the taxable year of receipt or make an election to: (1) include any portion of the advance payment in income in the taxable year of receipt to the extent required under new I.R.C. § 451(b); and (2) include the remaining portion of the advance payment in income in the following taxable year. New I.R.C. § 451(c) and its election to defer advance payments override the deferral method provided by §1.451-5. **T.D. 9870, 84 Fed. Reg. 33691 (July 15, 2019)**.

DEPENDENTS. The taxpayer had one minor son by the taxpayer and the taxpayer's former spouse. The taxpayer's divorce decree included negotiated child custody and support terms. The decree established the child's primary residence with the spouse and that the taxpayer could claim the child as a dependent on even-numbered years and could claim the child as a dependent on odd-numbered years if the taxpayer was current on child support obligations and the spouse's income was less than $15,000. The spouse agreed to execute form 8832 or similar written declaration to provide for the dependency claim by the taxpayer. For 2015, the taxpayer claimed the child as a dependent on the return, elected head of household status, and claimed a dependency exemption deduction, the child tax credit, and the earned income tax credit. The taxpayer did not include Form 8332 or a similar written declaration with the 2015 return. The former spouse also claimed the child on the spouse's 2015 return and did not timely execute Form 8332 or a similar written declaration. However, the former spouse did execute the Form 8832 after the IRS assessed the taxpayer a deficiency based on denial of the dependency exemption, the head of household status, the child tax credit and the earned income tax credit, all of which were dependent upon taxpayer being able to declare the child as a dependent. For a noncustodial parent to claim a qualifying child as a dependent under I.R.C. § 152(e)(2), the custodial parent must sign a written declaration, usually on Form 8832, stating that he or she will not claim the child as a dependent and (2) the noncustodial parent must attach that declaration to his or her return. Treas. Reg. § 1.152-4 does not explicitly allow (or prohibit) Form 8332 or a similar written declaration to be submitted during examination or with an amended return. The court noted that a Prop. Treas. Reg. § 1.152-5(e)(2)(i) explicitly permits a noncustodial parent to submit Form 8332 or a similar written declaration during examination or with an amended return but only if the custodial parent either did not claim the dependency exemption or filed an amended return removing the claim to the dependency exemption. The court held that, because the taxpayer met neither of the current or proposed regulations, the IRS properly denied the dependency exemption, the head of household status, the child tax credit and the earned income tax credit. **Demar v. Comm'r, T.C. Memo. 91**.

DISASTER LOSSES. On May 25, 2019, the President determined that certain areas in Oklahoma were eligible for assistance from the government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act (42 U.S.C. § 5121) as a result of flooding which began on May 7, 2019. **FEMA-3411-EM**. On May 29, 2019, the President determined that certain areas in Louisiana were eligible for assistance from the government under the Act as a result of flooding which began on May 10, 2019. **FEMA-3413-EM**. On May 30, 2019, the President determined that certain areas in Arkansas were eligible for assistance from the government under the Act as

a result of severe storms and flooding which began on May 21, 2019. **FEMA-3414-EM**. On June 1, 2019, the President determined that certain areas in Oklahoma were eligible for assistance from the government under the Act as a result of severe storms, tornadoes and flooding which began on May 7, 2019. **FEMA-4438-DR**. On June 7, 2019, the President determined that certain areas in Louisiana were eligible for assistance from the government under the Act as a result of severe storms and tornadoes which began on April 24, 2019. **FEMA-4439-DR**. On June 7, 2019, the President determined that certain areas in South Dakota were eligible for assistance from the government under the Act as a result of severe winter storm and flooding which began on March 13, 2019. **FEMA-4440-DR**. On June 8, 2019, the President determined that certain areas in Arkansas were eligible for assistance from the government under the Act as a result of severe storms and flooding which began on May 21, 2019. **FEMA-4441-DR**. On June 12, 2019, the President determined that certain areas in Minnesota were eligible for assistance from the government under the Act as a result of a severe winter storm and flooding which began on March 12, 2019. **FEMA-4442-DR**. On June 12, 2019, the President determined that certain areas in Idaho were eligible for assistance from the government under the Act as a result of severe storms, flooding which began on April 13, 2019. **FEMA-4443-DR**. On June 12, 2019, the President determined that certain areas in North Dakota were eligible for assistance from the government under the Act as a result of flooding which began on March 21, 2019. **FEMA-4444-DR**. Accordingly, taxpayers in these areas may deduct the losses on their 2018 or 2019 federal income tax returns. See I.R.C. § 165(i).

HOBBY LOSSES. The taxpayers, husband and wife, began their thoroughbred horse breeding and racing activity in 1985. The activity reported only losses until terminated in 2014. The IRS audited the taxpayers' 2010, 2011 and 2012 returns and disallowed deduction related to the activity in those years. During those years, the husband was employed full time as a programmer and the wife was disabled. Also during those years, the taxpayers did not breed, race or sell any of their horses. The taxpayers did not own a farm and their horses were maintained and trained at farms owned by others. I.R.C. § 183 disallows deductions against other income for losses in excess of revenues from activities not engaged in for profit. Treas. Reg. § 1.183-2 provides nine factors to be used to determine whether an activity is engaged in for profit: (1) the manner in which the taxpayer carried on the activity; (2) the expertise of the taxpayer or advisers; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that the assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or loss with respect to the activity; (7) the amount of occasional profits earned, if any; (8) the financial status of the taxpayer; and (9) whether elements of personal pleasure or recreation were involved. The court held that the taxpayers did not operate the horse activity with the intent to make a profit because (1) although the taxpayers maintained some records of the activity, the records were insufficient for evaluating the economic performance of their horses; the taxpayers did not race the horses; and did not run a consistent and concentrated advertising program; (2) although the wife had some experience with working with horses, neither taxpayer had experience in operating a profit horse activity and did not seek advice on how to profitably run such an activity; (3) the taxpayers did not spend any substantial amount of time on the activity; (4) although there was some evidence that the taxpayers' horses had appreciated in value, such appreciation was far less than the losses incurred; (5) the activity incurred only losses; (6) the activity had no profitable years; (7) the losses offset income from other sources; and (8) the wife received substantial personal pleasure from the activity. The fifth factor of Treas. Reg. § 1.183-2 was found to be neutral. **Donoghue v. Comm'r, T.C. Memo. 2019-71**.

INFORMATION RETURNS. The taxpayer was a lender who had sent presale notices of repossession of collateral the taxpayer borrowers. The borrowers filed a class action lawsuit claiming that the presale notices were defective. The parties reached a settlement in the case with some discharge of indebtednss involved. I.R.C. § 6050P requires that an applicable entity report any discharges (in whole or in part) of indebtedness of any person in excess of $600.00. The report is to include the name, address and taxpayer identification number of each person whose indebtedness is discharged, the date of the discharge and the amount of indebtedness discharged. Treas. Reg. § 1.6050P-1(b)(2) provides that a discharge of indebtedness occurs if one of eight "identifiable events" that the regulation defines takes place. In this ruling two of the events were discussed: (1) an identifiable event exists when the applicable financial entity and debtor agree to discharge the indebtedness for less than full consideration and (2) a discharge of indebtedness exists where a creditor discontinues collection activity pursuant to a decision by the creditor or a defined policy of the creditor. In the first case, the IRS found that the entry of judgment which incorporated the settlement of the parties was an identifiable event. The IRS also found that the cancellation of indebtedness was not a result of any defined policy or business practice of the taxpayer, but rather a decision to discontinue collection action as part of settling the litigation. Thus, the cancellation of indebtedness in the settlement was not an identifiable event. Because at least one identifiable event of discharge of indebtedness occurred, the taxpayer is subject to the reporting requirements under I.R.C. § 6050 P. **Ltr. Rul. 201927005, April 5, 2019**.

INNOCENT SPOUSE RELIEF. The taxpayer and former spouse separated in 2007 but filed joint returns for 2008 and 2010. In 2008, the taxpayer received a social security disability payment and in 2010, the taxpayer received another similar payment. In 2008 the social security payment was not reported. In 2010, the payment was included but the couple underpaid their tax liability. The couple were divorced in 2011 and the divorce decree provided that the former spouse was solely liable for the 2008 and 2010 tax liabilities. In 2014, the taxpayer filed for relief from joint and several liability from the 2008 and 2010 taxes but was denied as to the 2008 taxes and approved for partial relief from the 2010 liability. The taxpayer claimed spousal abuse during the marriage. The court held that taxpayer did not

satisfy the statutory requirements for relief under I.R.C. §6015(b) and (c) for 2008 and 2010 because the taxpayer failed to show that the request for relief was filed less than two years after the commencement of collection action by the IRS. Therefore, the taxpayer's sole avenue for relief is the provision for equitable relief under I.R.C. § 6015(f). *Rev. Proc. 2013-34, I.R.B. 2013-43, 397* lists seven threshold conditions that must be met for a requesting spouse to be eligible for equitable relief under I.R.C. § 6015(f), including the requirement that the income from which the tax liability arises be attributable (in full or in part) to the non-requesting spouse. This requirement is subject to five exceptions, including one for abuse. The exception for abuse applies where the requesting spouse establishes that (1) the requesting spouse was a victim of abuse, and (2) because of that abuse, and for fear of the non-requesting spouse's retaliation, the requesting spouse was unable to challenge the treatment of any items on the joint return or to question the payment of any amount due. The court found that the tax liabilities for which the IRS denied relief were attributable to the taxpayer's social security payments; therefore, unless the taxpayer proved spousal abuse that was sufficient to prevent the taxpayer from challenging the erroneous returns as to the payments, relief was properly denied. The court found that the taxpayer failed to provide any evidence of spousal abuse, noting that the taxpayer and former spouse were separated at the time of both returns and the taxpayer admitted that the taxpayer believed the social security payments were not taxable in both years. The court held that the IRS properly denied innocent spouse relief. **Ogden v. Comm'r, T.C. Memo. 2019-88**.

IRA. The taxpayer owned an IRA and received a distribution on June 25, 2014 which was used to purchase residence while a sale of the taxpayer's prior residence was pending. The taxpayer intended to close the sale of the prior residence in time to redeposit the distributed funds to the IRA with the 60 day rollover period. The sale did close with the 60 days and the taxpayer attempted to redeposit the funds into the IRA; however, the taxpayer received erroneous deposit information for the IRA account advisor and the check was not deposited by the IRA custodian until 62 days after the distribution. I.R.C. § 408(d)(1) provides that any amount distributed from an IRA is includible in gross income by the recipient. Under I.R.C. § 408(d)(3)(A) recipient of an IRA distribution can exclude from gross income any amount paid or distributed from an IRA if the full amount is subsequently rolled over into a qualifying IRA not later than the 60th day after the recipient received the payment or distribution. The taxpayer argued that (1) the rollover was not recorded as timely because of a bookkeeping error by the IRA custodian and (2) the taxpayer was entitled to a hardship waiver under I.R.C. § 408(d)(3)(I). The court found that the untimely rollover was caused by a bookkeeping error by the IRA account advisor which failed to promptly deposit the funds with the IRA custodian. Although this finding was sufficient for the court to rule that the taxpayer met the rollover period, the court also looked at the taxpayer's eligibility for a waiver. *Rev. Proc. 2003-16, 2003-1 C.B. 359* provides guidance about hardship waivers under I.R.C. § 408(d)(3)(I) in that an automatic hardship waiver ". . . is granted only: (1) if the funds are deposited into an eligible retirement plan within 1 year from the beginning of the 60-day rollover period; and (2) if the financial institution had deposited the funds as instructed, it would have been a valid rollover." The court found that the IRA account advisor was at fault for the delay in the deposit of the funds back into the IRA. Thus, the court held that the taxpayer was eligible for the rollover exception under either the bookkeeper and waiver exceptions. **Burack v. Comm'r, T.C. Memo. 2019-83**.

PARSONAGE ALLOWANCE. The taxpayer was a pastor of an independent church. In an audit of their 2007, 2008 and 2009 tax returns, the IRS determined that the taxpayer underreported substantial amounts of income. The taxpayer argued that much of the unreported income was a parsonage allowance funded by gifts from the church members. I.R.C § 107(2) provides that a minister does not have to include in gross income "the rental allowance paid to him as part of his compensation, to the extent used by him to rent or provide a home" and may not exceed the fair rental value of the home. Under Treas. Reg. § 1.107-1(c) , the exclusion does not apply to money used for food, domestic help, or expenses of a business or investment property. Treas. Reg. § 1.107-1(b) provides ". . . The term 'rental allowance' means an amount paid to a minister to rent or otherwise provide a home if such amount is designated as rental allowance . . . by the employing church or other qualified organization, or if such amount is designated as rental allowance pursuant to official action taken in advance of such payment by the employing church or other qualified organization . . .. The designation of an amount as rental allowance may be evidenced in an employment contract, in minutes of or in a resolution by a church or other qualified organization or in its budget, or in any other appropriate instrument evidencing such official action." The court found several checks from 2007 that indicated on them that the payment was at least partially intended as a parsonage allowance. For 2008 and 2009, however, the court found little evidence that any of the amounts were designated as a parsonage allowance. However, there was little evidence that any of the amounts from 2007, 2008 or 2009 were actually spent on the taxpayer's housing. In addition, the court found substantial evidence that the parsonage allowance items were paid directly by the church, leaving most of the check payments as useable for non-parsonage expenses. Thus, the court held that the amounts received by the taxpayer were not excludible from taxable income as part of a parsonage allowance because the amounts were not sufficiently designated as such prior to payment. **Brown v. Commissioner, T.C. Memo. 2019-69**.

REPAIRS. The taxpayer owned a 265 acre property which the taxpayer used to grow grapes and leased for horse and cattle grazing. The property was irrigated by a spring line that the taxpayer installed on the property to run water from a natural spring to the grape vines and pastures. The property had several private roads which the taxpayer maintained. The taxpayer hired a contractor to work on the spring line, fences and roads and claimed the expenses for this work as current deductions for the years in which the work was performed. The IRS disallowed most of the deductions, recharacterizing the expenses as capital expenditures to be added to the property basis. I.R.C. § 263(a)(1) requires capitalization of amounts "paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." See also Treas. Reg. § 1.163(a)-3. The court noted that the Tenth Circuit Court of Appeals has

"evolved what may be called the 'one-year' rule of thumb, under which an expenditure should be capitalized if it brings about the acquisition of an asset having a period of useful life in excess of one year or if it secures a like advantage to the taxpayer which has a life of more than one year." In addition, the Tenth Circuit has stated that an "overriding precept that an expenditure made for an item which is part of a 'general plan' of rehabilitation, modernization, and improvement of the property, must be capitalized, even though, standing alone, the item may appropriately be classified as one of repair." See *United States v. Wehrli, 400 F.2d 686 (10th Cir. 1968)*. Because the work in this case was done over several months and the contractor performed work on each project at the same time, the taxpayer presented a worksheet allocating the various work periods to each job. The taxpayer argued that the work was primarily repairs of the spring line, road and fences. However, the Tax Court found that over the time of the work, the entire spring line was replaced with a stronger system, the road work replaced a washed out road and the fence work was required as part of the spring line replacement. The Tax Court held that all of this work was part of a rehabilitation and improvement plan of the taxpayer; therefore, the costs of the work had to be capitalized in the basis of the property and could not be deducted currently. The appellate court affirmed in a decision designated as not for publication. **Wells v. Comm'r, 2019 U.S. App. LEXIS 22053 (10th Cir. 2019), *aff'g* T.C. Memo. 2018-11**.

RETURNS. The IRS has issued draft versions of the 2019 Form 1040 and its numbered schedules, reducing the numbered schedules from six to three. The IRS has also issued a draft of the new 2019 Form 1040-SR to used by taxpayers aged 65 or older. Finally, the IRS has issued a draft of new Form 1099-NEC to be used for reporting non-employee income instead of Form 1099-MISC.

SAFE HARBOR INTEREST RATES
August 2019

	Annual	Semi-annual	Quarterly	Monthly
		Short-term		
AFR	1.91	1.90	1.90	1.89
110 percent AFR	2.10	2.09	2.08	2.08
120 percent AFR	2.29	2.28	2.27	2.27
		Mid-term		
AFR	1.87	1.86	1.86	1.85
110 percent AFR	2.06	2.05	2.04	2.04
120 percent AFR	2.24	2.23	2.22	2.22
		Long-term		
AFR	2.33	2.32	2.31	2.31
110 percent AFR	2.57	2.55	2.54	2.54
120 percent AFR	2.80	2.78	2.77	2.76

Rev. Rul. 2019-17, I.R.B. 2019-32.

TRUSTS. Spouse 1 created and funded Trust 1, a grantor trust under I.R.C. § 675(4). As a grantor trust, the grantor, Spouse 1, is treated as the owner of the assets, the trust is disregarded as a separate tax entity, and all income is taxed to the grantor. See *Rev. Rul. 85-13, 1985-1 C.B. 184*. Spouse 2 created and funded Trust 2, a grantor trust under I.R.C. § 675(4). As a grantor trust, the grantor, Spouse 2, is treated as the owner of the assets, the trust is disregarded as a separate tax entity, and all income is taxed to the grantor. *Rev. Rul. 85-13*. Spouse 1 sold a limited partnership interest in a partnership to Trust 2. In addition, the trustees of Trust 1 sold a limited partnership interest in a partnership to Trust 2. 1041(a)(1) of the Code provides that no gain or loss shall be recognized on a transfer of property from an individual to a spouse. I.R.C. § 1041(b) provides that, in the case of any transfer described in I.R.C. § 1041(a), the property shall be treated as acquired by the transferee by gift, and the basis of the transferee in the property shall be the adjusted basis of the transferor. The IRS ruled that , because Trust 1 is a grantor trust, assets sold by Trust 1 will be treated for federal tax purposes as sold by Spouse 1. In addition, because Trust 2 is a grantor trust, assets purchased from Spouse 1 and Trust 1 will be treated for federal tax purposes as purchased by Spouse 2. **Ltr. Rul. 201927003, April 5, 2019**.

VETERANS' BENEFITS. The IRS has published information for veterans who received disability severance payments after 1991 and claimed it as income. Veterans should take action soon if they received a notice (letters 6060-A and 6060-D) and have not already filed Form 1040X, *Amended U.S. Individual Income Tax Return*, to claim a refund or credit of the overpayment attributable to the disability severance payment. The Combat-Injured Veterans Tax Fairness Act of 2016 provides that most veterans who received a one-time, lump-sum, disability severance payment when they separated from military service are entitled to a refund if that payment was claimed as income. The payment must have been received after Jan. 17, 1991, and before Jan. 1, 2017. Eligible veterans should have received a mailed notice from the Department of Defense (DoD) in July of 2018 explaining how to claim their tax refunds. Deadlines are soon approaching as the time available for claiming these tax refunds is limited to one year from the date of the Department of Defense notice, three years after the due date for filing the original return for the year the disability severance payment was made, or two years after tax was paid for the year the disability severance payment was made. Because taxpayers can usually only claim tax refunds within three years from the due date of the return, this alternative time frame is especially important since some of the claims may be for refunds of taxes paid as far back as 1991. There are two options for claiming the tax refund. *Option 1*: File a claim based on the actual amount of the tax overpayment attributable to your lump sum disability severance payment, or *Option 2*: Choose to claim the standard refund amount listed below that corresponds to the year the disability severance payment was made. Veterans should write "Disability Severance Payment" on Form 1040X, line 15, and enter the standard refund amount listed below on line 15, column B, and on line 22, leaving the remaining lines blank. Veterans can also submit a claim based on the actual amount of their disability severance payment by completing Form 1040X and carefully following the instructions. An original return is not necessary if the information for that tax year available. Veterans without the required information to complete the Form 1040X can request a transcript online at IRS.gov/transcript. The standard refund amounts are: $1,750 for tax years 1991 - 2005; $2,400 for tax years 2006 - 2010; $3,200 for tax years 2011 - 2016. The DoD notice includes the following instructions: Complete and file IRS Form 1040X, Amended U.S. Individual Income Tax Return, for the tax year the disability severance payment was made; Write either "Veteran Disability Severance" or "St. Clair Claim" across the top of the front page of the Form 1040X; All amended returns are filed on paper, so veterans should mail their completed Form 1040X, with a copy of the DoD letter, to: Internal Revenue Service, 333 W. Pershing Street, Stop 6503, P5, Kansas City, MO 64108. If the veteran no longer has or did not receive the DoD notice, the veteran should contact the Department of Veterans Affairs to obtain the required documentation. **IR 2019-125**.

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