Agricultural Law Update

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"To have doubted one's own first principles, is the mark of a civilized man."

—Oliver Wendell Holmes

More Trouble for "flat storage"

In general, storage facilities are not eligible for investment tax credit if classified as "a building or its structural components" but are eligible if for "the bulk storage of fungible commodities" in connection with manufacturing, production or extraction activities or of furnishing "transportation, communications, electrical energy, gas, water or sewage disposal services." Eligibility of so-called "flat storage" for investment tax credit has been a major issue in recent years.

In *LaVerne Schenk*, T.C. Memo. 1980-531, a steel structure used to store grain but adaptable to other uses—notably machinery storage—failed to qualify. The walls were not reinforced, the doors were equipment size, walls were insulated, the roof contained skylights, a workbench was added after initial construction and several items of equipment were stored inside the structure when the examining agent viewed the facility.

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OSHA promulgates hazard communication rule; proposes grain handling facility rule

While 29 C.F.R.§ 1928 contains all OSHA standards applicable to agricultural operations (ROPS for tractors, and standards for farm machinery — full text; labor camps, anhydrous ammonia, pulpwood logging and slow-moving vechicles — by reference), and while OSHA agricultural operations are those "integrally related" to the growing of crops and raising of livestock *(Secretary v. Darragh Co., 80 OSANRC 93/A2* (1980)), there are many operations classed for OSHA purposes as general industrial which are part of agriculture in a popular nonlegal sense. Feed mills and country elevators are two examples.

Hazard communication rule. A final rule appeared at 48 Fed. Reg. 53289 (Nov. 25, 1983) (to be codified at 29 C.F.R.§ 1910.1200). The intent is to ensure that all employees in the manufacturing sector, Standard Industrial Classification [SIC] Codes 20 through 39, are appraised of chemical hazards in their work via container labeling, safety data sheets and employee training. Feed mills and certain other mills fall within SIC Code 20. Various effective dates are invloved, with all stand-ards to be complied with by May 25, 1986.State laws on the subject are preempted.

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Deductibility of amounts allocated to crops on purchase of farm

Two items of authority, *Ltr. Rul. 8350002, August 8, 1983,* and *GCM 39096, July 15, 1983,* were published in late 1983 on the issue of how a purchaser of a farm should handle growing crops acquired with the land. GCM's (General Counsel's Memoranda) have only recently become available and provide an indication of how the General Counsel of IRS views particular issues.

In the facts of the ruling, a cash basis taxpayer had purchased a farm under land contract and claimed an income tax dedcution for the amount of the purchase price allocated by the purchaser to the growing crops. The crops were about four-fifth's grown at the time of the purchase.

The ruling and the GCM take the position that no deduction is claimable and, instead, the portion of the purchase price allocable to the growing crops would offset the selling price for the crops when sold. Thus, Treas. Reg.§ 1162-12(a) which, as a general rule, permits a current income tax deduction for expenditures by a farmer on the cash method of accounting including "...the cost of seeds and young plants....," is not applicable. Instead, Treas. Reg.§ 1.61-4(a) applies which requires the cost of items acquired for sale to be carried by the taxpayer until the item is sold with the cost offsetting the selling price in the year of sale. This is the rule governing the sale of purchased livestock (and other items purchased for eventual sale).

(continued on page 3)

MORE TROUBLE

CONTINUED FROM PAGE 1

The release of *G.C.M. 39098,* July 6, 1983, adds to the concerns about the eligibility of storage facilities for investment tax credit where the facility is adaptable to other uses. The IRS position is based largely on *A. C. Monk & Co. v. United States,* 686 F.2nd 1058 (4th Cir. 1982), which held that a tobacco storage room did not qualify as a storage facility for purposes of investment tax credit. The court indicated that if a storage facility was adaptable to other uses, investment tax credit could not be claimed.

In the facts of the GCM (which was not published until early 1984), a flat storage facility failed to meet the eligibility requirements for investment tax credit. The structure had the following features—

> "The structure is 200 feet long and 70 feet wide with two large sliding doors at each end. The structure encloses a flat, unobstructed concrete floor. The side walls are reinforced concrete from the base to a height of 5 feet with steel siding extending 22 feet from the top of the concrete to the roof. A beam is in place under the roof to support a device used to unload the grain."

A point to not is that the revenue ruling mentioned in the GCM has not, as yet, been issued. The GCM can be viewed as an indication that IRS has not abandoned the "reasonably adaptable" test and may well rule specifically in the flat storage area. *LaVerne Schenk, supra,* has already raised warnings about eligibility of flat storage for investment tax credit if the facility is reasonably adaptable to other uses.

—Neil E. Harl

Rural electric cooperative's wholesale rates subject to state public service commission

In *Arkansas Electric Cooperative Corporation v. Arkansas Public Service Commission,* 52 U.S.L.W. 4549 (1983), the Supreme Court upheld the assertion of the Arkansas Public Service Commission (PSC) that the Commission has jurisdiction over the wholesale rates charged by the Arkansas Electric Cooperative Corporation (AECC). The Arkansas PSC had entered an order asserting jurisdiction over the rates charged by AECC, a customer-owned rural power cooperative established with loan funds from the federal Rural Electrification Administration (REA), in 1979. AECC contested the order arguing that the PSC's assertion of jurisdiction was offensive to both the supremacy clause and the commerce clause of the U.S. Constitution. The Court disagreed and found the state regulation of the cooperative's wholesale electric rates to be within the scope of legitimate local public interests that could be regulated by the state PSC and held that the burden imposed on interstate commerce was not excessive in relation to the putative local benefits.

AECC's sole members and primary customers were seventeen smaller rural electric cooperatives who sold the power to individual customers. In the absence of any retail electric rates, AECC had not been regulated by the Arkansas PSC prior to 1979. The wholesale electricity rates were also not within the jurisdiction of the Federal Energy Regulatory Commission (successor of the Federal Power Commission) under the Federal Power Act since AECC was a rural power cooperative under the supervision of the REA. Thus, the cooperative had not been subject to any exacting state or federal rate regulation prior to the Arkansas PSC's assertion of jurisdiction in 1979.

The Supreme Court was presented two major issues by the cooperative and amicus curiae; whether there was federal preemption of state regulation and whether the PSC's regulation interfered with or imposed a burden on interstate commerce. The Federal Power Commission had determined in 1967 that the Federal Power Act did not include jurisdiction over rural power cooperatives. The Federal Power Act also did not infer that the rates of such cooperatives should be left unregulated so there was no preemption by the Act. The legislative history of the Rural Electrification Act indicated that the REA would operate within the constraints of existing state rate regulations. Since the regulation instituted by the Arkansas PSC did not conflict with the federal regulations governing REA cooperatives, the Court found no preemption by the Rural Electrification Act.

The issue of whether the PSC regulation burdened interstate commerce presented the Court with a choice of either following the mechanical wholesale/retail test set out in *Public Utilities Commission v. Attleboro Steam & Electric Company,* 273 U.S. 83 (1927), or the balance-of-interests test approved by more recent commerce clause cases. The Court rejected the *Attleboro* wholesale/retail line in favor of the balance-of-interests test and found that the unburdensome Arkansas PSC regulation to be within legitimate local public interests. Thus state public service commissions may regulate the wholesale rates established by rural power cooperatives that are supervised by the Rural Electrification Administration.

— Terence J. Centner

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Gift of real property — annual exclusion

An attempt to make use of the annual gift tax exclusion in each of several years was foiled by the I.R.S. in *Rev. Rul. 77-299, 1977-2 C.B. 343.* That was the plan whereby the donor transferred the real property by deed in exchange for a series on noninterest bearing notes that matured in succeeding years. As the notes matured, they were forgiven. The taxpayer wanted to treat the forgiveness of each note as a separate gift that qualified for the annual exclusion in the year of the forgiveness. The I.R.S. ruled that the donor's intent to forgive the notes as they came due meant that the entire transfer was a gift subject to gift taxes in the year of the transfer.

Estate planners assumed that *Rev. Rul. 77-299* did not mean that a series of gifts of real property would be lumped together for gift tax purposes. The I.R.S. has affirmed that assumption in *Rev. Rul. 83-180, I.R.B. 1983-50, 4.* In that ruling, the donor made gifts of three acres, two acres and five acres in succeeding years. The value of the gift each year exactly equaled the annual exclusion. The I.R.S. ruled that each of the gifts qualified for the annual exclusion in the year it was given.

—Philip E. Harris

DEDUCTIBILITY
CONTINUED FROM PAGE 1

The major difference in outcome is *when* the tax benefit is obtained for the amount allocated to the crops. By the taxpayer's view, the benefit would be obtained in the year the land was purchased. By the IRS view, the tax benefit would be delayed until the year the crops were sold.

If the crops are to be fed to livestock, the IRS position is less strong. An argument could be made that a deduction should be allowable just as a deduction would be allowed a cash method of accounting taxpayer who purchases grain to be fed to livestock.

In *Kermit Uecker,* 81 T. C. No. 63 (1983), one of the issues was the deductibility of $40,000 allocated to existing forage on purchase of a ranch. IRS disallowed the deduction and the Tax Court held that the taxpayer failed to prove that the portion of the purchase price at issue was properly allocated to the existing forage.

— Neil E. Harl

No energy credit on grain bins

IRS has ruled in *Ltr. Rul. 8346002,* July 20, 1983, that a steel grain drying bin (with drying floor) is not eligible for the business energy credit. The question was whether the bin was eligible for the credit on the ground that the air used to dry the grain was naturally heated by solar energy. The ruling points out that, for the energy credit to be available in the case of solar energy, there must be — (1) a solar collector, (2) an energy storage system and (3) a heat exchanger.

—Neil E. Harl

Remaindermen's mortgage not deductible by life tenant's estate

In *Estate of Theis,* 81 T.C. ______, No. 45 (October 17, 1983) the decedent had given away a remainder interest and retained a life estate in some property. The remaindermen mortgaged their interest in the property. The life tenant was secondarily liable or the loan secured by the mortgage. The property was included in the decedent's gross estate because of the retained life interest. The estate was not allowed to deduct the mortgage on the property because the remaindermen were primarily liable for the mortgage, appeared to be solvent and continued to make the payments on the mortgage. Furthermore, no claim had been made against the estate to pay the mortgage.

—Philip E. Harris

Use of unified credit does not start the statute of limitations

Section 2504(c) of the Internal Revenue Code sets a limitation on the period of time in which the value of a gift may be changed for purposes of calculating the gift tax due on subsequent gifts. The limit is the same as the time allowed for assessing a gift tax on the original gift. That period is generally three years after the gift tax return was filed. I.R.C. §6501(a).

The I.R.S. has ruled in Rev. Rul. 84-11, 1984-3 I.R.B. 11 that the use of a taxpayer's unified credit does not start the limitation period running. In that ruling, a taxpayer made a gift in 1977 and reported the value of the gift as $123,000 on a timely filed gift tax return. In 1982, the taxpayer made a gift of $230,000.

The gift taxes due on the 1982 gift are affected by the 1977 gift because the unified credit otherwise available in 1982 will be reduced by the amount of the 1977 taxable gift. Rev. Rul. 84-11 holds that since no gift taxes were due in 1977 (because the unified credit offset all of the tentative tax) the statute of limitations under I.R.C. §2504(c) did not start to run. Therefore, the 1977 gift can be revalued by the I.R.S. for purposes of determining the amount of unified credit that is absorbed by the 1977 gift.

The revenue ruling points out that I.R.C. §6501 bars an assessment of additional taxes on the 1977 gift. Therefore, the revaluation of the 1977 gift can do no more harm to the taxpayer than fully using up the unified credit that was available in 1977.

Rev. Rul. 84-11 was preceded by two other I.R.S. rulings that indicated a consistent position. In Rev. Rul. 79-398, 1979-2 C.B. 338, the I.R.S. ruled that a taxpayer does not have the option to *not* use the unified credit. In that ruling, the taxpayer had made a gift conditioned on the donee paying the gift tax. The donor did not want the donee to get the benefit of the donor's unified credit and therefore argued that the credit could be saved for future transfers.

In LR 8132011, April 24, 1981, the taxpayer filed a gift tax return showing a tentative tax liability of $10,538. She elected to use $10,537 of her unified credit and paid $1.00 of gift tax. The taxpayer argued that the use of her unified credit was a payment of gift tax sufficient to start the statute of limitations under §2504(c). In the alternative, she argued that the payment of $1.00 in taxes triggered the statute of limitations. The I.R.S. followed Rev. Rul. 79-398 and ruled that the taxpayer did not have the option to not use $1.00 of her unified credit. Therefore, her voluntary payment of that amount did not start the statute of limitations. Furthermore, the application of the unified credit is not a payment of tax and does not start the statute of limitations.

Given this position of the I.R.S. very few taxpayers will be able to use I.R.C. §2504(c) to set the value of gifts. Only those who make gifts in excess of the unified credit exemption equivalent ($325,000 in 1984; $400,000 in 1985; $500,000 in 1986; and $600,000 in 1987 and thereafter) will be able to pay a gift tax that will trigger the statute of limitations.

— Philip E. Harris

Freezes

Although some of the pressure is off estate freezes with recent plateauing and declines in farm land values, interest continues for holders of larger estates. In a recently published General Counsel's Memorandum, IRS examined a freeze involving a family held corporation. The transaction was designed to shift the future equity growth of the corporation from the major shareholders of the older generation to the minority shareholders of the younger generation. It involved an exchange of common stock for common and preferred by the older shareholders and an exchange of voting common stock for voting and nonvoting common stock by the younger shareholders.

The GCM concludes that the transaction qualified as a valid recapitalization with a business purpose. Thus, the transaction could be carried out tax-free.

—Neil E. Harl

Section 337 liquidations

In general, upon sales of assets by a corporation followed by complete liquidation under I.R.C. §337, neither gain nor loss is recognized at the corporate level from the sale or exchange of property within the 12-month period for liquidation following adoption of the plan of liquidation. The shareholders pick up the gain on receipt of the liquidation distribution.

Occasionally, IRS is successful in invoking the assignment of income doctrine. In *Peterson v. United States,* 83-2 U.S.T.C. ¶9103 (8th Cir. 1983), the court upheld application of the assignment of income doctrine involving the sale of matched commodity futures contracts. The amounts were treated as ordinary income to the shareholders.

This is a point to watch in Section 337 liquidations of farm corporations holding commodity futures contracts.

—Neil E. Harl.

Funding marital shares with special use value land

For several years, it's been unclear as to how IRS would view the funding of a marital deduction share in an estate with land under special use valuation. In *Ltr. Rul. 8314005,* December 14, 1982, IRS took the position that special use value property used to satisfy a marital deduction amount could be valued at fair market value if the will or trust specifies that fair market value is to be used. The ruling creates a highly advantageous result for farm estates of substantial size in terms of the federal estate tax burden in the estate of the surviving spouse.

Example (1): K died in 1983 with farmland valued at $1,000,000 and $100,000 in cash. For special use valuation purposes, the land was valued at $400,000 so the gross estate totalled $500,000. K's will provided for a credit shelter trust ($275,000 for a death in 1983). A marital deduction of $225,000 would reduce the federal estate tax liability to zero. K's estate could allocate $225,000 of farmland (using fair market value) to the marital share and $775,000 plus the $100,000 of cash to the nonmarital share. At the later death of the surviving spouse, only the $225,000 of farmland (at whatever value is then appropriate, special use or fair market value) would be included in the surviving spouse's gross estate.

Example (2): Using the same facts as in Example (1), but assuming that the marital deduction is funded with land at special use value, land with a fair market value of $562,500 would be needed to fund a marital deduction of $225,000 (to eliminate the tax at the first death). Thus, at the surviving spouse's death, $562,000 of land would be included in the gross estate.

The major question is whether the position of IRS in *Ltr. Rul. 8314005* will continue to prevail. One point to keep in mind: a funding scheme that involves a pecuniary bequest clause with nonrepresentative allocation of assets may run counter to *Rev. Rul. 64-19,* 1964-1 (pt. 1) C.B. 682, unless the clause specifies use of date of distribution values. A clause using date of distribution values may trigger income tax liability on distribution, however, as to the difference between date of death and date of distribution values.

Mortgage indebtedness on special use value land

Since enactment of special use valuation as part of the Tax Reform Act of 1976, a question has been raised as to whether the full amount of mortgage indebtedness could be claimed as a deduction for federal estate tax purposes. IRS had taken the position that indebtedness secured by use value property must be reduced in a manner comparable to the reduction of use value from fair market value. *Ltr. Rul. 8108179,* November 28, 1980; *Ltr. Rul. 8052030,* September 26, 1980. *In Ltr. Rul. 8120017,* February 3, 1981, the secured indebtedness was reduced for purposes of figuring the federal estate tax due but the full amount of the indebtedness was deductible in recapture calculations. The rulings did not have a firm statutory base and a number of estates had moved to challenge the IRS position.

In *Rev. Rul. 83-81,* I.R.B. 1983-21, 17, IRS agreed that a mortgage for which the decedent's estate was liable should be fully deductible for federal estate tax purposes if all of the secured property was included in the decedent's gross estate even though the land had been valued under special use valuation. In light of that ruling, it will no longer be so important to pay off mortgage indebtedness before death on land destined for special use valuation.

— Neil E. Harl

Disappearing value

Ltr. Rul. 8401006, September 28, 1983, focused upon a novel attempt to influence the value of corporate stock at death. In the facts of the ruling, the decedent held voting preferred stock at death but the voting rights ceased at the decedent's death. The ruling holds that the majority voting power represented by the voting preferred stock must be taken into account for federal estate tax purposes, nonetheless.

—Neil E. Harl

Change in accounting method

Several years ago, IRS amended the regulations to allow 180 days for filing requests for change in accounting method. That change applied to several different types of requests.

In *Rev. Prov. 83-77, I.R.B. 1983-42, 20,* IRS has given a 90 day automatic extension of time (beyond the usual 90 day filing requirement) for about a half dozen requests for change in accounting method including a change in the treatment of Commodity Credit Corporation loans (under I.R.C. §77). To obtain the 90 day extension, simply type or print "Filed Under Rev. Proc. 83-77" at the top of the application.

—Neil E. Harl

Investment tax credit recapture

For almost seven years, a substantial question has existed as to whether investment tax credit would be recaptured on a shift in organizational structure for a farm or ranch business. In *Rev. Rul. 76-514,* 1976-2 C.B. 11, investment tax credit was recaptured on transfer of all assets used in a dental practice to a newly-formed professional corporation except for the building in which the practice was carried on. The building comprised about 30% of the value of all assets used in the practice. The building was retained in individual ownership and rented to the professional corporation. IRS took the position in the ruling that "substantially all" of the assets were not transferred as was required by the regulations to avoid recapture. *Rev. Rul. 76-514* was viewed as a clear threat to situations where farmland was not transferred to newly formed partnerships or corporations.

Three cases in 1981 with similar facts were decided in favor of the taxpayers. In *George Loewen,* 76 T.C. 90 (1981), a Kansas farmer-cattle feeder transferred the machinery, livestock and equipment used in the farm business to a newly formed corporation. The land was retained in individual ownership and rented to the new corporation. The Tax Court held there was no recapture but the holding was weakened by statements of the Tax Court relative to the effect of the Kansas statute limiting land ownership by corporations. About three months later, two cases were decided in the U.S. District Court in the Eastern District of Washington. The cases, *Felgenhaur v. United States,* 81-2 U.S.T.C. ¶ 9532 (E.D. Wash. 1981) and *Ostheller v. United States,* 81-2 U.S.T.C. ¶ 9531 (E.D. Wash. 1981), involved similar facts with incorporation of the farm business but with the land retained in individual ownership and rented to the newly formed corporation. The court held that there was not recapture of investment tax credit in either case.

In *Ltr. Rul. 8234080,* May 26, 1982, IRS mentioned *George Loewen* with approval and held that there was no recapture where all assets except land and buildings were transferred to a newly formed corporation. Recently, IRS acquiesced in *George Loewen* (I.R.B. 1983-16, 5) and issued *Rev. Rul. 83-65,* I.R.B. 1983-16, 6. *Rev. Rul 83-65* states that IRS will no longer apply *Rev. Rul. 76-514* and there should be no recapture on investment tax credit if major assets, such as land, are retained and rented to newly formed entities. That outcome clears the way for formation of farm partnerships or corporations with all assets except land transferred so long as the land is rented to the new entity.

— Neil E. Harl

Final regulations for amortization of reforestation expenditures

The I.R.S. released final regulations under I.R.C. §194 which allows a taxpayer to amortize certain reforestation expenditures over an 84 month period. *T.D. 7927* (December 15, 1983). A taxpayer is allowed to amortize up to $10,000 of reforestation expenditures each year. Only expenditures that result in additions to capital accounts after December 31, 1979 are eligible for this special amortization. The reforestation must be for the purpose of producing timber products in commercial quantities (one acre or more).

The period for claiming the amortization deduction begins on the seventh month of the year of the expenditures and ends with the sixth month of the seventh year after the expenditures. Expenditures in excess of $10,000 per year may not be carried to another year. They must be added to the basis of the property. If the property is sold within ten years of the reforestation expenditure, the amortized amount will be subject to recapture under I.R.C. §1245.

—*Philip E. Harris*

Termination of tenancies by the entirety

The Economic Recovery Tax Act of 1981, Pub. L. 97-34 repealed I.R.C. §2515. Under that section, a person who made a gift by transferring property to his or her spouse as a joint tenant or as a tenant by the entirety had two choices with respect to the federal gift tax treatment of the transfer. The donor could treat the transfer as non-spouses were required to treat it. That is, the donor could report the transfer as a gift of one-half of the property. If that was done, the property was thereafter treated as being owned equally by the spouses for federal gift tax purposes. Alternatively, the donor could choose to *not* report the transfer as a gift. If that was done, the property was thereafter treated as being owned equally by the spouses for federal gift tax purposes. Alternatively, the donor could choose to *not* report the transfer as a gift. If that was done, the property was thereafter treated as being owned entirely by the donor for federal gift tax purposes.

The repeal of §2515 removes the option for spouses who create joint tenancies or tenancies by the entirety after 1981. The creation must be treated as a gift if one spouse contributes more to the acquisition than his or her share of the resulting tenancy.

What effect does the repeal of §2515 have on spousal joint tenancies that were created before 1982? If they had been terminated prior to 1982, the gift tax treatment would depend upon whether or not a gift was reported when the tenancy was created. For terminations after 1981, the I.R.S. has ruled in *Rev. Rul. 83-178, I.R.B. 1983-49, 5* that the treatment on creation is irrelevant to the treatment upon termination. The repeal of §2515 is effective for all terminations after 1981. Therefore, each spouse will be treated as owning one-half of the property for federal gift tax purposes (if local law treats them as each owning one-half) regardless of the option chosen by the donor when the tenancy was created before 1982.

—*Philip E. Harris*

OSHA

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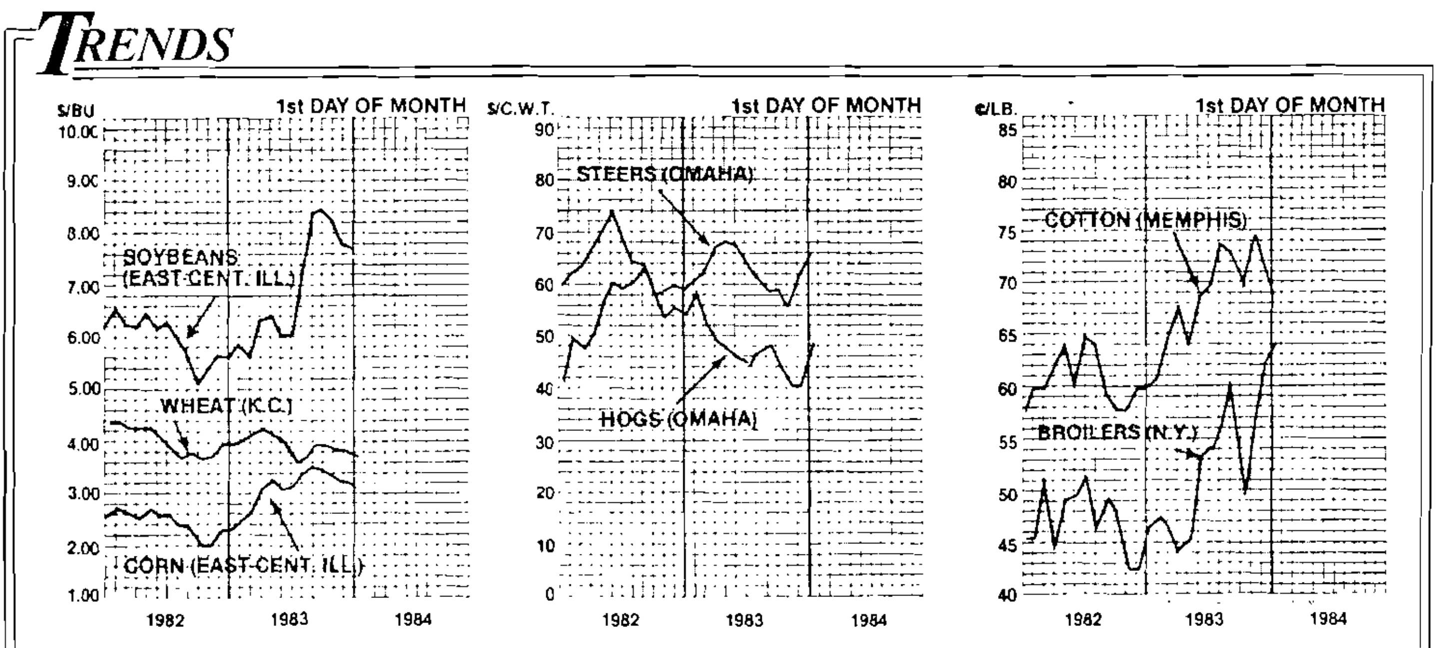
Grain handling facilities proposed rule. The proposed rule and explanatory materials appear at *49 Fed. Reg. 996* (Jan. 6, 1984). Comments and requests for a hearing must be postmarked by March 9, 1984. Telephone contact: James F. Foster, 292-523-8151. The proposed standards include requirements for the control of fires, grain dust explosions and other employee safety hazards associated with grain handling facilities. Specific standards deal with entry by employees into bins, silos and tanks. If promulgated, the standards will apply to grain elevators, dust pelletizing plants, feed mills and certain aother mills — large and small. Note that the mills are in SIC Code 20, while grain elevators and storage facilities are in SIC Code 42. The proposed standards would not apply to seed plants or to already regulated oil extraction facilities. Caveat: there is already regulation. *Farmers Cooperative Grain and Supply Co., 1982 OSHA ¶ 26, 301* (Rev. Comm. 1982), sustained a charge that grain elevator dust accumulations violated existing OSHA general housekeeping regulations at 29 C.F.R.§ *1910.22(a)(1)*. *Donovan v. Missouri Farmers Assoc., 674 F. 2d 690* (8th Cir. 1982), found a violation of the general duty clause in the failure to provide safety belts and lifelines to employees working in the elevator's pit area.

—*Donald B. Pedersen*

TRENDS



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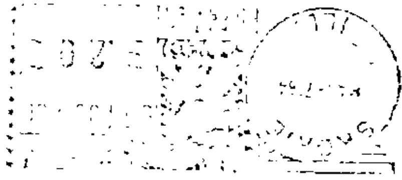

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AMERICAN AGRICULTURAL LAW ASSOCIATION NEWS

1984 AALA Membership Dues

Membership dues for 1984 are now payable. Despite higher publication costs, our dues have not been increased for 1984. Regular membership dues are $25.00; regular sustaining member, $50.00; student member, $5.00; institutional member, $100.00.

AALA plans to publish a 1984 directory. When you remit your 1984 dues, please be sure to inform us about any changes in the data (business address, telephone number and areas of professional interest, in particular) you included on the 1983 member information form.

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