Agricultural Law Update

VOLUME 14, NUMBER 5, WHOLE NUMBER 162 MARCH 1997

Official publication of the American Agricultural Law Association

INSIDE

Solicitation of articles: All AALA members are invited to submit articles to the Update. Please include copies of decisions and legislation with the article. To avoid duplication of effort, please notify the Editor of your proposed article.

IN FUTURE ISSUES

- Competing visions of rural property rights

When does ten percent mean ten percent?

For the past several years, there has been a controversy concerning the interpretation of 28 U.S.C. § 586(e), the statutory provision that governs Chapter 12 trustee compensation. This subsection places an upper limit on trustee compensation based on the Executive Schedule for level 5 government employees, and, up to this maximum, provides for the trustee to receive a percentage fee based on the "payments made under the plan" of the debtor. 28 U.S.C. § 586(e)(1)(A). In the bankruptcy of a family farmer, the percentage fee is not to exceed ten percent with regard to payments up to $450,000 and three percent of payments above $450,000. 28 U.S.C. § 586(e)(1)(B). It further provides that the trustee "shall collect such percentage fee from all payments received by such individual under plans ... for which the individual serves as standing trustee." 28 U.S.C. § 586(e)(2).

The controversy centers on the question: ten percent of what? The U.S. Trustee (UST) has taken the position that trustees are entitled not only to ten percent of the payments made to creditors, generally interpreted to mean "payments under the plan," but also to ten percent of their own fee, i.e., ten percent of all payments made to them, including the percentage payment made for the trustee's fee. Bankruptcy and district court cases that have considered this argument have reached conflicting results. *See e.g.*, *In re Edge*, 122 B.R. 219, 221 (D. Vt. 1990); *In re Weaver*, 118 B.R. 730 (Bankr. D. Neb. 1990).

The Tenth Circuit Court of Appeals adopted the UST position in *In re BDT Farms, Inc.*, 21 F.3d 1019 (10th Cir. 1994). It based its analysis on *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-43 (1984). It first considered whether the statutory language at issue was ambiguous, and finding that it was, it then considered whether the government's position was permissible. *BDT Farms*, 21 F.3d at 1021. Citing *Chevron* for the principle that the court must defer to an agency's reasonable interpretation of an ambiguous statute, the Tenth Circuit court found the UST interpretation to be permissible and thus, deferred to it. This decision was discussed in the article, *When is Ten Percent Not Ten Percent: Deference Strikes Again*, Agricultural Law Update 6 (August 1994).

The Eighth Circuit Court of Appeals recently addressed this issue and rejected the holding of *BDT Farms*. *Pelofsky v. Wallace*, 102 F.2d 350 (8th Cir. 1996). In so doing, it affirmed the district and bankruptcy court holdings that restricted the trustee to a fee capped at ten percent of the plan payments.

The bankruptcy court in *Wallace* rejected *BDT Farm's* deference to the UST's interpretation of the statute. It found that deference was not due because the statute was not ambiguous. *In re Wallace*, 167 B.R. 531, 533 (Bankr. E.D. Mo. 1994).

Continued on page 2

NGFA formally petitions CFTC to lift ban on ag trade options

The NGFA on January 30, 1997 filed a formal petition with the Commodity Futures Trading Commission to lift the ban on the use of agricultural trade options.

The petition calls on the CFTC to complete its rulemaking, initiated in 1991, by adopting amendments to existing regulations that would permit trade options on agricultural commodities to the same extent as currently permitted for non-agricultural commodities.

The CFTC in 1991 proposed to amend its rules governing trade options that would have placed trade options for agricultural commodities on the same footing as non-agricultural trade options. While the CFTC accepted comments on its proposal, a final rule never was issued. The rulemaking, however, never was closed.

The NGFA believes that now may be an opportune time to complete the 1991 rulemaking. First, the CFTC currently is at its fully authorized level of five commissioners (for much of the time since 1991 it was not), and a majority of the current commissioners appear to favor providing more market-based risk-management tools

Continued on page 2

Alternatively, the court found that the even if the statute were ambiguous, the UST's position would be impermissible. The court held that the fee that the UST requested amounted to an 11.11% fee, a direct violation of the 10% "maximum allowable percentage" set forth in the statute. *Id.* The *Wallace* district court affirmed the bankruptcy court. *Pelofsky v. Wallace*, 197 B.R. 82 (E.D. Mo. 1995).

Upon de novo review, the Eighth Circuit initially agreed with *BDT Farms* and found the relevant statutory language to be ambiguous. *Pelofsky v. Wallace*, 102 F.3d at 355. However, it agreed with the lower courts in finding that the UST's interpretation of this language was unreasonable, and thus was not entitled to deference. *Id.* Although the court could not find any legislative history on point, it stated that it did not believe "that the drafters envisioned that a farmer would be told to disregard common sense and economic reality and accept the UST assertion that a fee of $1,111.11 on a plan payment of $10,000.00 is a 10% fee, not an 11.11% fee." *Id.*

Moreover, the court noted that it shared the concern that "a family farmer attempting to reorganize might find it difficult to understand why a trustee should collect a fee for 'merely receiving its paycheck.'" *Id.* (citing *In re Wallace*, 167 B.R. at 534; *In re Westpfahl*, 168 B.R. 337, 366 (Bankr. C.D. Ill. 1994).

The court found further support for rejecting the UST interpretation in its previous decision in *In re Wagner*. *Pelofsky v. Wallace*, 102 F.3d at 355-6 (citing *Wagner*, 36 F.3d 723 (8th Cir. 1994). In *Wagner*, the court ruled that certain direct payments made by the debtor to his/her creditors were not subject to the trustee's percentage fee. In addition to deciding the central issue of the case, i.e., the direct payment issue, however, the court in *Wagner* addressed a mootness argument raised by the debtors. The debtors argued that because they had already received their discharge, the issue of the trustee's fee was moot. The Eighth Circuit rejected this argument, stating that a discharge only affected the "debts provided for by the plan." *Id.* (citing 36 F.3d at 726; 11 U.S.C. § 1228(a)). According to *Wagner*, the "[t]rustee's fees are not 'debts provided for by the plan' but are fees levied for services provided for in administering the plan." *Id.* This finding supports the argument that the trustee's fees are not payments "under the plan" for purposes of computing the ten percent fee under 28 U.S.C. § 586. *Id.* at 356.

For these reasons, the court held that the trustee's fee should be assessed solely against payments made under the plan and not assessed against his or her own fees. *Id.*

—*Susan A. Schneider, Hastings, MN*

Agricultural Law Update

VOL. 14, NO. 5, WHOLE NO. 162 March 1997

AALA Editor ....Linda Grim McCormick
Rt. 2, Box 292A, 2816 C.R. 163
Alvin, TX 77511
Phone/FAX: (281) 388-0155
E-mail: hcxb52a@prodigy.com

For AALA membership information, contact William P. Babione, Office of the Executive Director, Robert A. Leflar Law Center, University of Arkansas, Fayetteville, AR 72701

Agricultural Law Update is published by the American Agricultural Law Association, Publication office: Maynard Printing, Inc., 219 New York Ave., Des Moines, IA 50313. All rights reserved. First class postage paid at Des Moines, IA 50313.

AG TRADE OPTIONS/Continued from page 1

for use by agricultural producers. Second, the CFTC has continued to solicit input on the use of agricultural trade options following issuance of the 1991 proposal. A major public discussion—*Chairman's Roundtable on the Prohibition of Agricultural Trade Options*—was hosted by the CFTC in December, 1995. Third, the changes to agricultural policy contained in the 1996 farm act make it even more important to producers to manage their own risk and seek a greater share of income from markets. This adds further support for amending the CFTC's rules to permit the development and use of agricultural trade options.

The NGFA asked the CFTC to promptly lift the ban on the use of agricultural trade options given the substantial record already compiled by the agency. The NGFA's position is that lifting the ban would enhance the ability of the cash grain industry to offer producers additional pricing and risk-management tools.

The NGFA asked the CFTC to adopt the amendments proposed in 1991. Among other things, the proposals:

• would permit the use of agricultural trade options where the "*commodity options offered by a person which has a reasonable basis to believe that the option is offered to a producer, processor, or commercial use of, or a merchant handling, the commodity which is the subject of the commodity option transaction, or the products or by-products thereof, and that such producer, processor, commercial user or merchant is offered or enters into the commodity option transaction solely for purposes related to its business as such.*" Importantly, under this proposal, companies doing business with producers would need to take steps to ensure that such off-exchange transactions fit within the exemption, which would be subject to CFTC oversight;

• would **not** exempt parties from complying with CFTC regulations that expressly prohibit unlawful representations and fraud in connection with offering commodity option transactions;

• would create a regulatory exemption for agricultural trade options. However, the CFTC would have jurisdiction over transactions to determine: (1) whether a particular transaction fits within the exemption; and (2) whether the regulatory provisions prohibiting unlawful representations and fraud may have been violated. This contrasts with the self-executing provisions of the Commodity Exchange Act governing unregulated cash forward contracts, where the CFTC does not have jurisdiction.

In its petition, the NGFA asked the CFTC to clarify that so-called revenue-assurance contracts could lawfully be entered into between producers and grain buyers in the cash marketplace if the CFTC approves the NGFA's petition to lift the ban on agricultural trade options. CFTC Commissioner Joseph B. Dial, in a January 5 speech at the 1997 American Farm Bureau Federation's annual convention, described revenue-assurance contracts as follows:

> Producers can use this type of contract to overcome low yields and/or prices and achieve a guaranteed level of revenue. This approach involves an input vendor who will pay part of the producer's premium cost to secure revenue or in some instances the company will enter into a contractual arrangement with the producer that will guarantee revenue on a per acre basis. The genesis of revenue assurance is found in the need for the private sector to fill the gap left by a reduction in the government financial safety net.

Continued on page 3

Agricultural law bibliography

Biotechnology

Angelo, *Genetically Engineered Plant Pesticides: Recent Developments in the EPA's Regulation of Biotechnology*, 7 U. Fla. J.L. & Pub. Pol'y 257-303 (1996).

Comment, *The FDA and the Biotechnology Industry: a Symbiotic Relationship?* 71 Wash. L. Rev. 821-844 (1996).

Malinowski, *Globalization of Biotechnology and the Public Health Challenges Accompanying It*, 60 Alb. L. Rev. 119-169 (1996).

Cooperatives

Organizational issues

Baumel & Lasley, *On Edge over Hedge: Hedge-to-Arrive Contracts Represent Ethics Crisis for Farmer Co-ops*, 63 Rural Coop. 6-9 (July/August 1996).

Corporate farming

Note, *The Missouri Anti-Corporate Farming Act: Reconciling the Interests of the Independent Farmer and the Corporate Farm*, 64 U. Mo. K.C. L. Rev. 835-860 (1996).

Environmental issues

Comment, *The Eight Million Little Pigs—a Cautionary Tale: Statutory and Regulatory Responses to Concentrated Hog Farming*, 31 Wake Forest L. Rev. 851-883 (1996).

Note, *Just What is a Concentrated Animal Feeding Operation Under the Clean Water Act? (Concerned Area Residents for the Environment v. Southview Farm, 34 F.3d 114, 2d Cir. 1994, cert. denied, 115 S. Ct. 1793, 1995)*, 60 Alb. L. Rev. 239-265 (1996).

Recent development, *Animal Feeding Lot Operation is Point Source Not Subject to Agricultural Exemption Under Clean Water Act. (Concerned Area Residents for the Environment v. Southview Farm, 34 F.3d 114, 2d Cir. 1994)*, 5 U. Balt. J. Envtl. L. 124-128 (1995).

Farm labor

General & social welfare

Noble, *Erosion of Agricultural Labor Exemptions in Employment Law: Recent Developments Relevant to Arkansas*, 1996 Ark. L. Notes 71-85.

Farmers Home Administration

Hayes, *The Government Changes the Rules Mid-Game: An Explanation of the Credit Provisions of the FAIR Act—Part Two: Preservation Loan Servicing Program and Inventory Property Changes*, 11 Farmers' Legal Action Rep. 26-33 (No. 1 & 2, 1996).

Roth, *The Government Changes the Rules Mid-Game: An Explanation of the Credit Provisions of the FAIR Act—Part One: Direct Loan and Primary Loan Servicing Program Changes*, 11 Farmers' Legal Action Rep. 3-25 (No. 1 & 2, 1996).

Food and drug law

Gillan, *Laying Ax to the Delaney Clause: Reform of the Zero-tolerance Standard For Carcinogenic Food Additives*, 5 U. Balt. J. Envtl. L. 14-51 (1995).

Forestry

Brennan & Clifford, *Standing, Ripeness, and Forest Plan Appeals*, 17 Pub. Land & Resources L. Rev. 125-151 (1996).

Comment, *The 1995 Salvage Timber Sales Rider: a Recipe For Environmental Devastation*, 5 Dick. J. Envtl. & Pol'y 419-439 (1996).

Comment, *Logging Without Laws: the 1995 Salvage Logging Rider Radically Changes Policy and the Rule of Law in the Forests*, 9 Tul. Envtl. L.J. 447-482 (1996).

Gippert & DeWitte, *The Nature of Land and Resource Management Planning Under the National Forestry Management Act*, 3 Envtl. Law. 149-208 (1996).

Hunting, recreation & wildlife

Comment, *The Right to Hunt in the Twenty-first Century: Can the Public Trust Doctrine Save an American Tradition?*, 27 Pac. L.J. 1235-1287 (1996).

Sherr, *Does the Federal Anti-Crime Bill's Hunter Harassment Provision Violate the First Amendment or If an Animal Rights Protester Falls Down in the Woods and a Hunter Hears, is it a Federal Crime?* 11 J. Nat. Resources & Envtl. L. 119-133 (1995-96).

International trade

Comment, *Unlocking the Japanese Rice Market: How Far Will the Door Be Opened?* 9 Transnational L. 273-293 (1996)

Ellison & Mullin, *Economics and Politics: The Case of Sugar Tariff Reform*, 38 J. L. & Econ. 335-366 (1995).

Luna, *"Agricultural Underdogs" and International Agreements: the Legal Context of Agricultural Workers Within the Rural Economy*, 26 N.M. L. Rev. 9-56 (1996).

Land reform

Valdez, *Land Reform and the Two Faces of Development in Mexico*, 19 Polar 109-120 (No. 2, 1996).

Patents, trademarks & trade secrets

Roberts, *Patenting Plants Around the World*, 18 Eur. Intell. Prop. Rev. 531-536 (1996).

Pesticides

Note, *FIFRA's Preemption of Common Law Tort Actions Involving Genetically Engineered Pesticides*, 38 Ariz. L. Rev. 763-791 (1996).

Public lands

Blumm, *The Case Against Transferring BLM Lands to the States*, 7 Fordham Envtl. L.J. 387-395 (1996).

Feller, *The Comb Wash Case: the Rule of Law Comes to the Public Rangelands*, 17 Pub. Land & Resources L. Rev. 25-54 (1996).

Nolen, *Residents at Risk: Wildlife and the Bureau of Land Management's Planning Process*, 26 Envtl. L. 771-840 (1996).

J. Souder & S. Fairfax, *State Trust Lands: History, Management, and Sustainable Use* (Univ. Press Kansas, 1996) 370 pp.

Taxation

Developments, *Agriculture: 1996*, 49 Tax Law. 1006-1010 (1996).

Torts

Comment, *The Power Line Dilemma: Compensation For Diminished Property Value Caused By Fear of Electromagnetic Fields*, 24 Fla. St. U. L. Rev. 125-160 (1996).

Water rights: agriculturally related

Comment, *Searching for the Public Trust Doctrine in Utah Water Law*, 15 J. Energy Nat. Resources, & Envtl. L. 321-350 (1995).

If you desire a copy of any article or further information, please contact the Law School Library nearest your office.

—Drew L. Kershen, Professor of Law, The University of Oklahoma, Norman, OK

Federal Register in brief

The following is a selection of matters that were published in the *Federal Register* from January 24 to February 13, 1997.

1. Farm Credit Administration; capital adequacy and customer eligibility; final rule. 62 Fed. Reg. 4429.

2. North American Wetlands Conservation Act; request for small grants proposals for 1997; proposals must be postmarked by April 4, 1997. 62 Fed. Reg. 4548.

3. Packers and Stockyards Administration; regulations issued under the PSA; poultry grower contracts; scales; weighing; advance notice of proposed rulemaking; comments due 5/12/97. 62 Fed. Reg. 5935.

4. CCC; procurement of processed agricultural commodities for donation under Title II; Pub. L. 480; proposed rule; comments due 4/14/97. 62 Fed. Reg. 6497.

—Linda Grim McCormick, Alvin, TX

AG TRADE OPTIONS/Continued from page 2

Further, the NGFA set forth the following hypothetical transaction as one that clearly would be authorized if the ban on agricultural trade options is lifted:

The contract establishes a minimum contract price determined when the contract is written, and a premium is collected, either at the initiation of the contract, during the life of the contract or, together with the interest accumulated over the life of the contract, at the time of settlement. In return for the premium, the producer has the right to require the merchant to accept delivery of and pay a minimum contract price for the crop. However, the producer may forfeit the premium and seek a higher price for, and deliver, the crop elsewhere.

—David C. Barrett, Jr., Nat. Grain and Feed Association, Washington, DC

Valuation issues continue to predominate in estate and gift tax cases—opportunities for estate planners

By Roger A. McEowen

This article addresses recent developments in the valuation area important to agricultural estates. In recent years, valuation has been one area of estate planning that has provided generous opportunities for planning to achieve significant tax savings. Valuation is the primary issue in estate and gift taxation, and the courts have continued to legitimate techniques that generate significant tax savings through discounts for minority interest position, lack of marketability, and fractional interest.[1] It remains absolutely critical, however, to properly document the basis for any proposed discount, and, in many instances, professional appraisers should be utilized.

Discounts

Perhaps the most significant recent case in the discount area is *Estate of Bonner v. United States.*[2] In *Bonner*, the court held that the decedent's outright ownership of undivided fractional interests in real and personal property did not have to be aggregated with the remaining interests in the same properties that were included in the decedent's estate by reason of I.R.C. § 2044. Thus, even though 100% of the properties was included in the decedent's estate, the interests held outright at death qualified for fractional interest discounts. Consequently, estate planners should be aware of the potential to achieve a discount when funding the marital and nonmarital shares in an agricultural estate if a spouse survives and it is not planned to leave all property outright to the surviving spouse.

At the time of death, the decedent owned a 62.5% interest in 2,107 acres of Texas ranchland, a 50% interest in New Mexico real estate and a 50% interest in a 56-foot pleasure boat. A QTIP trust established under the will of the decedent's predeceased spouse owned the remaining interests.

The estate valued the decedent's 62.5% interest in the ranchland at a 45% discount (below 62.5% of fair market value) based on the fact that it was a fractional undivided interest. The estate also discounted the value of the New Mexico real estate and the boat. The Service disallowed the discounts, claiming instead that the interests held by the QTIP trust merged with the interests held outright by the decedent. As such, 100% of the properties was included in the decedent's gross estate.

The Fifth Circuit Court of Appeals, in reversing the district court,[3] held that a fractional interest discount was available on the basis of the court's 1981 decision in *Estate of Bright v. United States.*[4] The Fifth Circuit, while noting that I.R.C. § 2044 contemplated that QTIP property is to be treated as having passed from the decedent, held that § 2044 does not require the QTIP assets to merge with the assets the decedent owned outright. The court reasoned that the decedent's predeceased spouse could have left the assets in the QTIP to anyone, and neither the decedent nor the decedent's estate had any control over their ultimate disposition. The court also rejected the Service's public policy argument that the decedent should be prevented from using a QTIP to avoid paying taxes on the unified value of the property. Instead, the court noted that the estate of each spouse should be required to pay taxes only on the assets within the control of each spouse. The Fifth Circuit remanded the case to the district court to determine the appropriate discount.[5]

In *Estate of Casey v. Commissioner*,[6] the decedent held a life estate interest in a residence. Certain charities held the remainder. When a maintenance trust began to run out of funds for maintaining the residence, the parties established a liquidating trust to sell the residence and personal property. The estate argued that the decedent's interest in the trust should have been discounted for its minority interest and the interest's lack of marketability. The Service disagreed, arguing instead that the trust was not a trade or business and that a buyer would be concerned only with the delay in liquidating the trust assets before realizing the value of the decedent's interest in money. The court agreed partially, holding that the trust interest could not be discounted as could a minority shareholder's interest, but allowed the discount for the time delay in liquidating the trust assets.

In *Estate of Wheeler v. United States*,[7] the decedent's estate consisted of 50% of the voting stock of a family owned corporation in which the decedent's heirs owned all of the nonvoting stock and the other 50% of the voting stock. Under local law (Texas), a 50% interest in voting stock was insufficient to control corporate affairs. The Service allowed a 25% discount for lack of marketability and argued that the estate should not be given an additional 10% minority discount. The court stated that a minority interest discount is conceptually different from a discount for lack of marketability and that an award of the latter does not preclude application of the former. Thus, the court allowed a 10% minority discount.

In *Estate of McClatchy v. Commissioner*,[8] the decedent owned over two million shares of unregistered voting stock in a closely-held corporation in which the decedent was an affiliate under federal securities law. Sale of the stock during the decedent's life was subject to federal securities law restrictions, but the decedent's estate was not an affiliate to which the restrictions applied. The estate argued that the stock value should be discounted for estate tax purposes because of the restrictions in effect during the decedent's life. The court disagreed, reasoning instead that the valuation was to be determined by reference to the interest that passed because of the decedent's death. Because the stock passed to the estate without the restrictions, a discount was not appropriate.[9]

In *Smith v. United States*,[10] a corporate promissory note issued to the decedent's predeceased spouse was included in the decedent's estate. The note was a private obligation and did not include any protective language found in the publicly issued corporate debt instruments. The note's fair market value was determined by comparing it to similar publicly issued corporate debt instruments. The estate argued that the estate tax valuation should be determined by discounting the note's fair market value to account for the lack of protective documents found in the publicly traded debt instruments. The court agreed and accepted the estate's valuation.

In *Krapf v. United States*,[11] the taxpayer donated 26,000 shares of stock to a university in 1976 and valued the shares at $10 each for federal income tax charitable deduction purposes. The gifted stock represented 32.5% of all outstanding shares. The Service deemed the stock worthless and disallowed the deductions. The company lost a major contract four months after the gifts and, as a result, went bankrupt.

Roger A. McEowen is Assistant Professor of Agricultural Economics and Extension Specialist, Agricultural Law and Policy, Kansas State University, Manhattan, Kansas and is a member of the Kansas and Nebraska Bars.

The trial court used evidence of post-gift transactions to determine the value of the stock on the date of the gift. This approach resulted in a value of $4.34 for each share of gifted stock. On appeal, the Federal Circuit also used subsequent events to prove the value of the gift, but remanded the case because the trial court's valuation was not based on the evidence and was too speculative. On remand, the court valued the gifted stock at $2.46 per share based on an adjusted net worth analysis with a 33% discount for the taxpayer's minority interest. The value of intangibles was not included for lack of evidence of their values, and the price determined by a buy-sell agreement was ignored because of no evidence that the agreement was executed.

In *Estate of Scanlan v. Commissioner*,[12] the decedent died owning an undivided 50% community interest in a closely-held corporation. The decedent's spouse made gifts of corporate voting stock approximately three months before the decedent's death, for which the decedent and spouse elected split gift treatment. The gifted stock was valued at approximately $35 per share on the decedent's Form 709. The decedent's stock interest was also valued at approximately $35 per share on the decedent's estate tax return. The gifts were valued based on a corporate valuation report prepared by a professional investment banking firm, and the estate tax value was arrived at by a similar valuation report which included a 35% discount for minority interest and lack of marketability.

Approximately one year after the decedent's death, the corporation solicited offers to purchase all of the corporate stock or assets. An offer was received to buy all of the corporate stock for $75.16 per share. In accordance with the corporate redemption agreement, nonfamily member shareholders were required to sell their shares back to the corporation at $75.16 per share. Based on this redemption price, the Service determined that each share of the corporate voting stock was worth $72.15 as of the date of the decedent's death. The Service then discounted this value by an arbitrary 4% figure to account for the decedent's minority interest in the company.

The court rejected both the estate's and the Service's values. The court opined that the estate's expert was unpersuasive and that the expert had arbitrarily applied a 35% marketability discount to the decedent's share. The estate's expert did not, in the court's opinion, adequately discuss the publicly traded companies which he compared to the decedent's corporation, and did not set forth their age, business, or product line with any specificity. The expert also made no mention of a hypothetical buyer or seller. The Service provided no expert, and the court found incredible the Service's argument that a 4% discount adequately reflected a lack of marketability and minority discount for the decedent's stock. As such, the court held that the value of the decedent's stock at the time of death was $50.51 per share. The court arrived at this value by starting with the redemption price of $75.16 per share and reducing it by a 30% discount for lack of marketability and minority interest.[13]

In *Estate of Wright v. Commissioner*,[14] the valuation methods and opinions of an estate's experts regarding the value of closely-held bank stock were held to be more correct than those of the Service's expert. The decedent owned 23.8 % of stock in a corporation that wholly owned a bank corporation. The stock had previously sold for $50/share, but the estate argued that putting all of the shares on the market at the same time would reduce the price to $38/share. The Service valued each share at $67 after adding a control premium to the $50/share sale price. The court established a figure of $45 per share because the large block of stock would be difficult to sell at full price and because the bank was in excellent financial shape. The court rejected as implausible the Service's argument that a control premium should apply on the basis that a single investor might purchase the estate's large minority interest and use that stock block to acquire a controlling interest.

Miscellaneous valuation developments

In *Estate of Lloyd v. Commissioner*,[15] the decedent owned 50% of a trust which owned two parcels of rural land zoned as residential. Upon the decedent's death, the estate argued that the land should be valued as residential property because the highest and best use of the land was for residential purposes and because the land was zoned residential. The estate also argued that any attempt to rezone the land for commercial purposes would be difficult. The court rejected the estate's arguments and held that the evidence demonstrated that local development was commercial and that a rezoning could be easily obtained. As such, the fair market value would be determined on the basis of the commercial use value of the property.

In *Wrona v. United States*,[16] the decedent owned a 67% leasehold interest in a parking garage. The executors valued the leasehold for estate tax purposes based on a pending offer to purchase the leasehold. The sale fell through and the leasehold was sold to the decedent's son for much less than the estate tax value. The executors sought to amend the estate tax return to decrease the value. The trial court denied the lower value and the appellate court affirmed.

In re Taylor,[17] the donor gifted several parcels of land to the taxpayer and retained a life estate in each parcel. The Service used several sales of comparable nearby land to value the gifts. The taxpayer's appraiser claimed that no comparable sales were available and used an income-producing approach to value the parcels. However, both parties agreed that a comparable sales approach would produce the most accurate valuation. The court held that the Service's value was to be used to value the gifts.

In Tech. Adv. Memo. 9637006,[18] the executor filed the federal estate tax return for the decedent's estate and elected to value the assets on the alternate valuation date, six months after the date of death. One of the estate assets consisted of the right to receive annual lottery payments for 16 years. The decedent died before receiving the first payment which was received within the alternate valuation period. As of the date of the decedent's death, the applicable federal rate was 8.4%, and at the alternate valuation date six months later, the applicable federal rate was 9.4%. The estate valued the decedent's interest in the lottery payments as of the date of death, but adjusted this value by using the factor based on the applicable federal rate of 9.4%. The Service ruled that the lottery winnings represented the right to receive a fixed dollar amount annually for a defined period of time and constituted an interest whose value is effected by mere lapse of time. However, the Service ruled that a change in interest rates is not a change due to a mere lapse of time and that the estate had properly valued the interest as of the date of the decedent's death with the adjustment for the difference in its value as of the alternate valuation date because of the change in the applicable federal rate. In essence, this means that lottery winnings should be valued in the same manner as an annuity.

In *Estate of Williamson v. Commissioner*,[19] the Service issued a statutory notice of deficiency to the decedent's estate more than three years after the estate tax return was filed. Attached to the Form 709 was a request for an extension of time with an explanatory statement that because of a dispute with the surviving spouse, the estate was unable to list and value the items of the estate. This, the court held, gave the service adequate notification of the estate's failure to itemize and value specific items of the decedent's gross estate. As such, the six-year statute of limitations applicable to

Continued on page 6

an estate tax return that omits items from the gross estate exceeding 25% of the gross estate reported on the estate tax return did not control.[20]

[1]Discounts may also be available for state restrictions on land use. For example, in *Estate of Luton v. Commissioner*, T.C. Memo. 1994-539, *supp. by* T.C. Memo. 1996-181, the decedent's estate included a 78% interest in the common stock of a corporation that owned a 1,300 acre ranch, a one-third interest in a closely-held corporation which owned wetlands used for hunting, and 41.8% of a liquidating trust. The court rejected the estate's liquidation valuation and comparative property valuation of the ranch and wetlands because the properties were not for sale and the comparable properties used were not sufficiently similar. The corporation was valued using the value of the corporation's assets less a 20% discount for lack of marketability, based on the illiquid nature of the assets caused by the state restrictions.

The estate was allowed a 20% discount for minority interest and a 15% discount for lack of marketability, in part because of the land use restrictions. The value of the interest in the liquidating trust was discounted 10% for lack of marketability, but the court did not allow any discount for minority interest because minority interest holders were protected by the trustee's fiduciary duty. The supplemental ruling in early 1996 involved the stipulation which determined the effect on stock valuation of a loan from a related corporation.

[2]84 F.3d 196 (5th Cir. 1996). Another significant recent case was *Estate of Hoover v. Commissioner*, 69 F.3d 1044 (10th Cir. 1995). In *Hoover*, the decedent held a 26% interest in a New Mexico ranching partnership as a limited partner. The estate first discounted the decedent's interest to reflect the decedent's minority position. From this discounted value, the executor further reduced the taxable estate by making a special use value election. The Tax Court denied the minority interest discount on the basis of its holding in *Estate of Maddox v. Commissioner*, 93 T.C. 228 (1989). In *Maddox*, the decedent owned a 35.5% interest in an incorporated family farm which qualified for special use valuation. The Tax Court held that the "use value" of the shares included in the gross estate was not the "fair market value" of the shares, and that the estate was not entitled to a minority interest discount that would otherwise be available in determining "fair market value." Consequently, the court held that the estate was entitled to utilize a minority interest discount or a special use valuation election, but denied the estate the ability to reduce further the value of property included in the estate at use value by a discount. The Tenth Circuit Court of Appeals reversed the Tax Court and allowed the estate to utilize both a minority interest discount and a special use valuation election on the qualified property.

[3]The opinion of the United States district court for the Southern District of Texas was unreported.

[4]619 F.2d 407 (5th Cir. 1981). In *Bright*, the decedent held a 27.5% interest in an asset as executor of his deceased wife's estate and a 27.5% in the same asset in his individual capacity. The Service argued that the estate tax value of the decedent's interest should be determined as though the decedent held a single 55% controlling interest, with that value then being cut in half. The Fifth Circuit rejected this approach based on the willing buyer, willing seller definition of fair market value, stressing instead that the "willing seller" is not the estate itself, but a hypothetical seller.

[5]While the estate apparently was only seeking a discount for the interests the decedent held outright, the Fifth Circuit's reasoning would appear to support a discount for the assets held in the QTIP trust. The discount should be available regardless of whether the individuals ultimately receiving the QTIP assets are the same persons inheriting the assets held by the decedent. Under the court's reasoning, the valuation is made as of the moment of death and must be measured by the interest that passes, as contrasted with the interest held by the individual before death or the interest held by the legatee after death.

The Service is challenging *Bonner*. The Service has consistently taken the view that aggregation is required in determining estate tax value in factual situations similar to *Bonner*. In Priv. Ltr. Rul. 9608001 (Aug. 18, 1995), the Service concluded that a partnership interest included in an estate under I.R.C. § 2044 had to be aggregated with an interest in the same partnership held through a revocable trust. The Service also reached the same result for stock held outright and stock of the same company held by a QTIP trust in Priv. Ltr. Rul. 9550002 (Aug. 31, 1995). In a ruling that involved a set of facts very similar to *Estate of Bonner*, the Service ruled that undivided interests in real estate included under I.R.C. § 2044 aggregated with undivided interests included under I.R.C. § 2033 (see, Priv Ltr. Rul. 9140002 (Jun. 18, 1991)).

[6]T.C.Memo. 1996-156.

[7]96-1 U.S.T.C. (CCH) ¶60,226 (W.D. Tex. 1995).

[8]106 T.C. No. 9 (1996).

[9]The restrictions would have remained in effect if the property had been gifted. Thus, a discount would have been available for gift tax purposes. This would have resulted in a lower gift tax than estate tax on the same shares. However, this outcome must be balanced against the income tax consequences to the donee beneficiary because of the loss of a stepped-up basis. Also, for gifts of closely-held stock to family members, the special valuation rules of I.R.C. §§ 2701-2704 must be considered.

[10]923 F. Supp. 896 (S.D. Miss. 1996).

[11]35 Fed. Claims 286 (1996), *on rem. from*, 977 F.2d 1454 (Fed. Cir. 1992).

[12]T.C.Memo. 1996-331.

[13]In a later decision, *Estate of Scanlan v. Commissioner*, T.C. Memo. 1996-414, the court rejected the estate's motion for reconsideration. The estate claimed that the court erred because the court concluded that the decedent's shares of stock were marketable, failed to account property for minority and marketability discounts, and did not apply the standards set forth in *Mandelbaum v. Commissioner*, T.C. Memo. 1995-255, *aff'd. without published opinion*, 91 F.3d 124 (3rd Cir. 1996), to determine the marketability discount.

[14]T.C. Memo. 1997-53.

[15]T.C.Memo 1996-30.

[16]96-1 U.S.T.C. (CCH) ¶60,227 (Fed. Cir. 1996).

[17]96-1 U.S.T.C. (CCH) ¶60,229 (Bankr. M.D. Fla. 1996).

[18]May 10, 1996.

[19]T.C. Memo. 1996-426.

[20]*See, e.g.*, I.R.C. § 6501(e)(2).

ILLINOIS DRAINAGE LAW/Cont. from page 7
permit a servient estate owner to obstruct the natural and proper flow of water from a dominant estate to make reasonable use of the servient estate.

The servient estate could not impede the natural flow of surface water from the dominant estate by artificial structures. *People ex rel. Witte v. Big Creek Drainage District No. 2*, 159 Ill. App. 3d 576 (5th Dist. 1987). In the other case, the court said that the servient estate could not obstruct the natural flow of water or otherwise interfere with the dominant estate's drainage rights by artificial means. *Bodenschatz v. Parott*, 153 Ill. App. 3d 1008 (5th Dist. 1987). The court also said that the servient estate owner is not required to improve or aid the natural flow of surface water from the dominant estate.

In *Zimmer v. Village of Willowbrook*, 242 Ill. App. 3d 437 (2nd Dist. 1993), a property owner was allowed to recover money damages against a neighbor resulting from the construction of a pond and culvert on the neighbor's land. This was so even though the property was not adjacent to the neighbor's property. From these four cases, it would appear that an owner of land, whether the owner is of a servient estate or just a neighbor, cannot interfere with the natural flow of water that causes change to the drainage of water or damages to other land.

Dessen v. Jones, 194 Ill. App. 3d 869 (4th Dist. 1990), was another case where the servient estate obstructed the flow from the dominant estate to the damage of the dominant estate. The court held that where the obstruction by the servient estate is at issue, the reasonable use rule is not required to be applied. The appellate court said that although the lower court did not apply the reasonable use doctrine, the court did balance the equities of the situation and did not err in its application of surface water drainage law.

A very comprehensive and instructive opinion is from the Second District Appellate Court in the case of *Dovin v. Winfield Township*, 164 Ill. App. 3d 326 (2nd Dist. 1987). Not only does this opinion give a good history of the drainage law of the state of Illinois, but it is comprehensive in discussing the civil law rule and the good husbandry exception. The case involved an urban setting and the change in the flow of water from the dominant to the servient estate. The court "concluded that the appropriate method of determining whether there is a compensable injury due to an increased flow of water is to determine whether such increased flow is reasonable by balancing the benefit to the dominant estate against the harm done to the servient estate." However, the owner of the dominant estate does not have an unlimited right to increase the amount of water drained from his property. The proper determination is whether the benefit to the dominant estate outweighs the harm done to the servient estate.

In 1869 Illinois adopted the civil law rule of surface water drainage. The first modification came in the agricultural context with the good husbandry exception set forth in *Peck*. Modification then came in the urban situation with the *Templeton* case by adopting a policy of reasonableness of use. The *Templeton* court stated that the policy of reasonableness of use led initially to the good husbandry exception. Although recent cases in the agricultural context continue to use the good husbandry modification and policy of reasonableness of use, in the urban situation the courts seemed to be adopting a more flexible balancing test which weighs the benefits to the dominant estate against the harm done to the servient estate.

—Thomas F. Hartzell, Carthage, Illinois

This article is reprinted with permission from the January 1997 Illinois State Bar Association's Agricultural Law

An overview of Illinois drainage law

Illinois' drainage problems center around the fact that Illinois is a water surplus state. The vast majority of Illinois farmland will grow and yield good crops in most years without irrigation. Although drainage problems arise along Illinois' many rivers and larger streams, many farmers seek to remove water from Illinois flat lands. Next to the rivers and streams, some farmer seek to prevent waters from reaching their fields. Given this diversity, a drainage problem and the solving of that problem will depend upon the facts of the situation.

In *Gillham v. The Madison County Railroad Company*, 49 Ill. 44 (1869), Illinois expressly rejected the common enemy rule of surface water drainage and adopted the civil law rule. The civil law rule, sometimes referred to as the rule of natural drainage, holds that the dominant estate may not interfere with the natural drainage of surface water either by an increase in the flow or a change in the natural course which is detrimental to the servient estate. Modification of the civil law rule came in the agricultural context with the good husbandry exception set forth in *Peck v. Herrington*, 109 Ill. 611 (1884). The dominant estate could increase the flow and volume of surface water onto the servient estate for agricultural purposes as required by good husbandry if done in the natural drainage channel so that the water drains from the dominant estate to the servient estate at the same point as where naturally discharged and the water was not diverted from another watershed. This good husbandry exception was codified in the Drainage Act of 1885, now at Illinois Compiled Statutes, chapter 70, section 605-2-1.

Prior to 1974, surface water drainage cases mostly dealt with the development of the dominant estate for agricultural purposes. In 1974, *Templeton v. Huss*, 57 Ill. 2d 134, was decided by the Illinois Supreme Court. The dominant estate was converted from farmland to a residential subdivision. The ground was graded and paved, houses constructed and other artificial improvements made. The servient estate alleged that this conversion increased both the amount and rate of surface water runoff. The trial court found that there was no diversion from another watershed and entered judgment for the dominant estate, defendant. The appellate court affirmed. The Illinois Supreme Court reversed and remanded, holding that the dominant estate may not increase the flow of surface water, "regardless of whether it was caused by diversion from another watershed" or by artificial construction, onto the servient estate "beyond a range consistent with the policy of reasonableness of use." *Templeton* at 141. In adopting a policy of reasonableness of use in the urban development setting, the court made reference that the policy of reasonableness of use led initially to the good husbandry exception.

Before *Templeton*, water cases involved water draining across the surface, lateral drainage flow. *Templeton* involved interference with lateral drainage and natural seepage. As waters flow across the land, some water naturally seeps into the ground. Thus, seepage is part of natural drainage. Paved streets and artificial construction interferes with the lateral flow and prevents seepage. The *Templeton* court established a principle that preventing unreasonable changes in the natural lateral drainage flow should also apply to unreasonable interference with natural seepage. *Templeton* at 141.

The *Templeton* court was not concerned with the watershed from which the water came or if it entered the servient land at a point different from the natural entry point. Whether the increased flow of water was caused by diversion from another watershed or the same watershed, the policy of reasonableness of use applied. It can be argued that diversion from another watershed was irrelevant on appeal because plaintiff's count alleging diversion from another watershed was not appealed. By exclusively mentioning diversion from another watershed, the *Templeton* court meant that the reasonableness of use principle should apply where urban development interfered with the lateral drainage, seepage, or diversion from the same or a different watershed.

Prior to *Templeton*, it was reasonable to allow an increased flow of water to help the development of the dominant estate and make it more productive. *Templeton* extended this policy to urban development. A more flexible rule that balances the interest of all parties was implemented. However, the *Templeton* court failed to set out the factors to be weighed and clear guidelines for proper application. The court did prohibit "unlimited right to increase the rate or amount of surface water runoff and unreasonable development." *Templeton* at 141.

In an agricultural setting, the appellate courts have continued to allow increases in the quantity and velocity of surface water drainage. *Lindberg v. Lennenager*, 73 Ill. App. 3d 623 (3rd Dist. 1979); *Ehrhart v. Reid*, 73 Ill. App. 3d 824 (3rd Dist. 1979); and *Callahan v. Rickey*, 93 Ill. App. 3d 916 (3rd Dist. 1979). The benefit to the dominant estate must be reasonable in its extent. The diversion of water can be from plowing a furrow between farmlands, construction of a ditch, or a grass waterway. However, the direction of the water flow must not change. "The evidence indicates that the direction of the dead furrow was consistent with the natural contours of the land, merely facilitating the flow of water into the ditch...." *Callahan* at 169. *Templeton* made it explicit that "reasonable development" can occur for agricultural purposes. *Templeton* at 141.

The cases citing *Templeton* in the urban context implement the policy of reasonableness of use by balancing the interest of all parties. Servient land owners must accept water from the dominant estate and cannot construct a dam or close a tile to harm the dominant estate. *Brown v. Ponton*, 80 Ill. App. 3d 1069 (3rd Dist. 1980). A city cannot construct a sewer system which floods residents' basements. *Powell v. Village of Mt. Zion*, 88 Ill. App. 3d 406 (4th Dist. 1980). In *Delano v. Collins*, 49 Ill. App. 3d 791 (1977), a dominant estate owner was allowed to improve his real estate even though it caused a change in the drainage patterns. *Templeton's* policy of reasonableness of use is to be applied where municipal improvements increase waters on the servient estate by diverting the natural flow. *Starcevich v. City of Farmington*, 110 Ill. App. 3d 1074 (3rd Dist. 1982).

In *Firestone v. Fritz*, 119 Ill. App. 3d 685 (2nd Dist. 1983), the owner of the dominant estate changed the natural course of water within the boundaries of his own land. The court held that the dominant estate owner must have the water pass from his land upon the land of the servient state at the precise place where the water would naturally do so. Interference with natural drainage was limited to that which was incidental to a reasonable development of the dominant estate.

Three cases from the Illinois Appellate Fifth District concern the servient estate artificially affecting the natural flow of surface water. *Mileur v. McBride*, 147 Ill. App. 3d 755 (5th Dist. 1986), involved the rights of the owner of the dominant estate to continue to discharge water in the natural course of drainage over the servient estate. The servient estate owner obstructed the flow of water by raising the levy on his land. The dominant estate owner sought monetary damages. The *Mileur* court stated that Illinois followed the civil law rule of surface water drainage and that the owner of the servient estate has no right to stop or impede the natural flow of the surface water. The civil law rule has two exceptions. One is for railroads and the other is the "good husbandry" rule. The *Mileur* court concluded that there was no precedent to

Continued on page 6