11 *Id*., Sec. 5.01. The original of the Form 3115 must be filed with: Office of Associate Chief Counsel (Domestic); Commissioner of Internal Revenue; ATTN: CC:DOM:P&SI:6; Room 5112; P.O. Box 7604; Ben Franklin Station; Washington, DC 20044.

12 Rev. Proc. 96-31, supra note 5, Sec. 5.01(1).

13 *Id*., Sec. 5.01(2).

14 *Id*., Sec. 5.01(3).

15 *Id*., Sec. 5.04(3).

16 *Id*., Sec. 5.05.

17 Rev. Proc. 96-31, *supra* n. 5, Sec. 7. The depreciation adjustment to basis is the amount allowable, not the amount claimed. Brock v. Comm'r, T.C. Memo. 1994-177 (calculation of gain on foreclosure sale of rental property).

18 See I.R.C. § 167.

19 Rev. Proc. 96-31, *supra* n. 5, Sec. 7.02.

20 See I.R.C. § 168.

21 I.R.C. § 168(a).

22 I.R.C. § 168(g). See Rev. Proc. 96-31, *supra* n. 5, Sec. 7.03.

23 Rev. Proc. 96-31, *supra* n. 5, Sec. 7.04.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-*ALM* § 13.03.*

AVOIDABLE LIENS. The debtor, a ranch partnership, purchased cattle from a dealer on installment, with the debtor granting the dealer a purchase money security interest in the cattle. The security interest was later amended because of a change in the brand on the cattle. The dealer filed the security interest with the Secretary of State instead of the proper place in the county recorder's office. The debtor later borrowed funds from a bank and granted the bank a security interest in all livestock. The bank searched the state and county records and discovered the dealer's security interest at the state office but not the county office. Although the bank could have obtained a copy of the security interest from the state, the bank did not ask for a copy. The dealer obtained a court order to turn over 195 cows and 25 heifers within 90 days before the Chapter 12 bankruptcy filing. The debtor-in-possession sought to avoid the dealer's security interest in the cattle as unperfected and to avoid the court order transferring the cattle to the dealer. The court held that the security interest was not perfected because it was not filed with the county recorder; therefore, the debtor-in-possession could avoid the security interest. The dealer argued that the court-ordered transfer of the cattle was not preferential because of the new value given for the order in that the dealer had allowed a hearing to continue in exchange for the transfer order. The court held that the court-ordered transfer was an avoidable transfer because the hearing delay was not sufficient new value for the transfer. The bank sought to have its security interest given first priority in the cattle after the avoidance. The court held that, because the bank had knowledge of the dealer's security interest, even though improperly filed, the bank could not assert a priority security interest; therefore, the debtor-in-possession had a priority security interest in the cattle by means of the avoidance of the dealer's security interest. ***In re* Double J Cattle Co., 203 B.R. 484 (D. Wyo. 1995)**.

EXEMPTIONS

CASH. The debtor claimed cash on hand as exempt tangible personal property under Ind. Code § 34-2-28-1(a)(2). The trustee objected, arguing that money was an intangible subject to exemption only under Ind. Code § 34-2-28-1(a)(3). The court reviewed Indiana law and held that cash was tangible personal property when held by the debtor and eligible for exemption as tangible property. **Levin v. Dare, 203 B.R. 137 (S.D. Ind. 1996)**.

CHAPTER 12-*ALM* § 13.03[8].*

DISCHARGE. The debtor had granted a second mortgage to the FmHA (now FSA) on real property. The FmHA's lien was divided into a secured claim and unsecured claim in the bankruptcy case, based on the fair market value of the property at the confirmation of the plan. After the plan payments were completed, the FmHA objected to the payments on the unsecured claim and received additional payments in settlement of that claim. The debtor was granted a discharge and the case was closed. The debtor later died and the debtor's estate sold the property for substantially more than the value used in the bankruptcy case. The FmHA argued that it retained a lien against the property for the portion of the unsecured claim not paid in the bankruptcy case. The FmHA cited *Dewsnup v. Timm, 502 U.S. 410 (1992)* in support of its argument that its lien was not "stripped" as to the unsecured portion. The court held that *Dewsnup* did not apply to Chapter 12 cases where the "stripping" of liens was allowed by Section 1222(b)(2); therefore, at the discharge of the debtor, the FmHA lien was extinguished. The appellate court affirmed, noting that the Chapter 12 plan specifically provided for extinguishment of the FmHA lien upon payment of all plan secured and unsecured claims. **Harmon v. U.S., 101 F.3d 574 (8th Cir. 1996), *aff'g*, 184 B.R. 352 (D. S.D. 1995)**.

PLAN. The debtors' Chapter 12 plan provided for payment of a secured claim owed to a Farm Credit Bank over the life of the plan at 7.5 percent interest. The original loan had an interest rate of 8.75 percent. The Bankruptcy Court did not confirm the plan because the interest rate was less than the prime rate plus 1.5 percent for the risk factor, given the debtor's poor repayment history. The appellate courts affirmed the Bankruptcy Court decision. The court rejected the debtors' argument that the interest rate could not exceed the contract rate and held that the rate was to equal the rate the bank would charge for lending the same amount as would be received from a foreclosure of the debt, i.e. a market rate of interest. **Koopmans v. Farm Credit Services, 102 F.3d 874 (7th Cir. 1996), *aff'g*, 196 B.R. 425 (N.D. Ind. 1996)**.

TRUSTEE FEES. The debtor's Chapter 12 plan provided for a trustee's fee of 10 percent of the payments to be made to the creditors. The trustee objected to the plan, arguing that the fee was to be applied to the payments made to the trustee, resulting in a 11.11 percent charge against the payments to be made to the creditors. The court held that the statutory fee of 10 percent was unambiguous and was limited to 10 percent of the property to be paid to the creditors. The court reasoned that, because the statute assessed the fee against "the payments made under the plan" and because only the trustee makes the plan payments, the fee could not be assessed to payments made to the trustee by the debtor. ***In re* Wallace, 102 F.3d 350 (8th Cir. 1996), *aff'g*, 197 B.R. 82 (E.D. Mo. 1996), *aff'g*, 167 B.R. 531 (Bankr. E.D. Mo. 1994)**.

FEDERAL TAXATION-*ALM* § 13.03[7].*

AUTOMATIC STAY. This case involved two bankruptcy cases. In the first case, the debtor filed for Chapter 13 and included federal income tax refunds in the fund for payment of creditors, but after the case commenced, the IRS refused to pay the refunds and allowed an administrative offset in favor of the Bureau of Child Support Enforcement. In the second case, the facts were similar except the offset was to the U.S. Department of Education. In both cases, the IRS was not a creditor and did not receive notice of the bankruptcy filing. The court held that the offsets violated the automatic stay but refused to award damages because the violations were not willful in that the IRS did not receive notice of the filing. ***In re* Lafanette, 97-1 U.S. Tax Cas. (CCH) ¶ 50,124 (Bankr. W.D. La. 1997)**.

CLAIMS. The debtor's Chapter 13 plan provided for 100 percent payment of *allowed* secured claims. The IRS filed a claim for taxes, listing a portion of the claim as secured, a portion as priority unsecured and a portion as general unsecured. The IRS had filed a tax lien against the debtor's property pre-petition which was junior to a mortgage on the debtor's residence. The debtor's residence was worth less than the total amount owed on the mortgage and tax lien. Three years after confirmation of the plan, the debtor moved to reduce the secured portion of the IRS claim to the amount of the value of the residence above the mortgage debt. The court held that the modification of the IRS claim was allowed because the plan provided for payment of allowed claims and a secured claim was allowed only to the extent of the value of the collateral. ***In re* Strong, 203 B.R. 105 (Bankr. N.D. Ill. 1996)**.

DISCHARGE. The debtor had petitioned the Tax Court to challenge a deficiency notice from the IRS which included a penalty for fraud. The Tax Court case resulted in a grant of summary judgment to the IRS because the debtor failed to file answers to the IRS claims. The Tax Court ruling included a specific finding of fraud by the debtor in filing false W-E forms. The debtor then filed for Chapter 7 and the IRS sought to have the deficiency declared nondischargeable under Section 523(a)(1). The debtor argued that the Tax Court decision was not applicable to the dischargeability of the tax claim because the Bankruptcy Court had exclusive jurisdiction over determining the tax claim. The court held that it did not have exclusive jurisdiction over tax claims and that the Tax Court ruling was entitled to res judicata as to the element of fraud by the debtor; therefore, the tax claim was not dischargeable. ***In re* Palmer, 203 B.R. 460 (D. Mont. 1996)**.

NET OPERATING LOSSES. The debtors had a net operating loss (NOL) for 1990. The debtors filed for Chapter 7 in December 1991 and did not elect to close their tax year effective with the bankruptcy filing. The debtors received a discharge of millions of dollars of debt in March 1992. The debtors filed their 1991 return on April 9, 1993 and claimed the unused NOLs as a deduction against the 1991 income. The debtors argued that, because the bankruptcy estate did not use the NOLs, the NOLs were returned to the debtors at the close of the case. The court held that, upon the filing of the Chapter 7 case, the NOLs passed to the bankruptcy estate because the debtors did not make the election to end their tax year with the filing. The court also held that because the NOLs were part of the bankruptcy estate, the discharge of indebtedness received by the estate reduced the NOLs before the tax attributes of the estate passed to the debtors after discharge. **Kahle v. Comm'r, T.C. Memo. 1997-91**.

REFUND. The debtor filed for Chapter 13 on January 12, 1996 and filed the debtor's 1995 personal income tax return on January 22, 1996. The IRS allowed the refund but refused to pay it to the debtor and offset the refund against the debtor's income tax deficiency for earlier years. The court held that the refund was a pre-petition obligation of the IRS to the debtor and was eligible for the setoff. ***In re* Glenn, 97-1 U.S. Tax Cas. (CCH) ¶ 50,188 (E.D. Pa. 1997), *rev'g*, 96-2 U.S. Tax Cas. (CCH) ¶ 50,447 (Bankr. E.D. Pa. 1996)**.

CONTRACTS

INFECTIOUS DISEASE. The plaintiff was a supplier of breeding pigs and delivered breeder pigs to the defendant under written contracts. The contracts had provisions regarding losses from infectious diseases and required the defendant to isolate all new shipments for 30-60 days in order to receive credit for pigs which had infectious diseases. The contracts limited damages to replacement of pigs lost because of disease. The defendant and plaintiff learned about the outbreak of Porcine Reproductive and Respiratory Syndrome (PRRS) during their contractual relationship. The plaintiff performed tests for the disease and found some pigs testing positively for

PRRS. The defendant did not perform tests on delivered pigs for PRRS until more than a year after the last shipment from the plaintiff. The plaintiff sued for the purchase price of the delivered pigs and the defendant counterclaimed for breach of contract, breach of warranty, negligence and fraud. The defendant sought damages for infection of healthy pigs from PRRS in the pigs shipped by the plaintiff. The plaintiff argued that the contracts expressly limited damages to the loss of value of the pigs delivered. The defendant claimed that the damage limitation portion of the contracts was unconscionable. The court held that the damage limitation provisions were not unconscionable because the defendant was an experienced businessperson and had sufficient knowledge of PRRS and failed to take steps to test the pigs upon delivery. The defendant also claimed that the plaintiff breached express warranties that the delivered pigs were free of infectious diseases and were suitable for breeding when the plaintiff knew from testing that some of its pigs were infected with PRRS and that PRRS affected the breeding ability of pigs. The court noted that the pigs were shipped in compliance with federal and state inspection laws and that the defendant failed to test the animals upon delivery; therefore a question of fact remained as to whether the delivered pigs were actually infected with PRRS. The court also held that the defendant's claims of fraud were insufficient in that the defendant failed to show that the contracts imposed any duty on the plaintiff to advise the defendant as to the proper testing for PRRS. **Pig Imp. Co., Inc. v. Middle States Holding Co., 943 F. Supp. 392 (D. Del. 1996)**.

FEDERAL AGRICULTURAL PROGRAMS

BRUCELLOSIS. The APHIS has adotped as final regulations changing the classification of New Mexico from a Class A to Class Free state. **62 Fed. Reg. 5907 (Feb. 10, 1997)**.

CONSERVATION. The CCC has adopted as final regulations revising the CRP regulations, including the consolidation of all CRP regulations in 7 C.F.R. Part 1410. The new provisions include (1) inclusion of wetlands and acreage enrolled in the Water Bank Program as eligible CRP acres; (2) expansion of the conservation priority areas to include CRP acres, the Wetlands Reserve Program and the Environmental Quality Incentives Program; (3) restriction of the total CRP acres in a state to 10 percent of the total crop land; (4) provisions for an incentive of up to 25 percent of the costs of restoring wetlands; and (5) provisions for incentives to enroll filter strips, riparian buffers, field windbreaks, grass waterways, and EPA acres designated as wellhead protection acres. **62 Fed. Reg. 7601 (Feb. 19, 1997)**.

CROP INSURANCE. The FCIC has adopted as final regulations which include the cranberries endorsement in the Common Crop Insurance Policy and restrict the endorsement provisions to 1997 and earlier crop years. **62 Fed. Reg. 5903 (Feb. 10, 1997)**.

The FCIC has adopted as final regulations which include the dry beans endorsement in the Common Crop Insurance Policy and restrict the endorsement provisions to 1997 and earlier crop years. **62 Fed. Reg. 6099 (Feb. 11, 1997)**.

The FCIC has issued proposed regulations which include the fresh plum endorsement in the Common Crop Insurance Policy and restrict the endorsement provisions to 1997 and earlier crop years. **62 Fed. Reg. 6134 (Feb. 11, 1997)**.

The FCIC has adopted as final regulations which include the ELS cotton endorsement in the Common Crop Insurance Policy and restrict the endorsement provisions to 1997 and earlier crop years. **62 Fed. Reg. 6703 (Feb. 13, 1997)**.

The FCIC has issued proposed regulations which include the onion endorsement in the Common Crop Insurance Policy and restrict the endorsement provisions to 1997 and earlier crop years. **62 Fed. Reg. 6739 (Feb. 13, 1997)**.

DISASTER PAYMENTS. The plaintiff was a farmer who grew basil in 1993 and arugula in 1994. In 1993, the plaintiff suffered crop loses and applied for disaster payments. The county committee made an initial determination of crop yields and payment rate but later modified the determination to lower substantially both figures. In 1994, the plaintiff also suffered disaster losses and applied for disaster benefits. Again the county committee made an initial determination of yield and payment rates but later substantially lowered both figures. The plaintiff challenged the committee's modifications as not authorized by statute and as arbitrary and capricious. The court held that the modification of yield and payment rates was within the power of the county committee. However, the court remanded the case to the CCC because the county committee provided no factual basis on the record for the initial determinations nor for the modifications; therefore, the court could not determine whether the initial rates or the modifications were arbitrary. **Guy v. Glickman, 945 F. Supp. 324 (D. D.C. 1996)**.

GRAIN STANDARDS. The Grain Inspection, Packers and Stockyards Administration has adopted as final regulations removing the voluntary U.S. grade standards for Beans, Whole Dry Peas, Split Peas, and Lentils from the Code of Federal Regulations. The voluntary standards and all subsequent revisions or new standards will be made available in a separate publication, and will appear as notices in the Federal Register for public comment. **62 Fed. Reg. 6705 (Feb. 13, 1997)**.

MEAT AND POULTRY INSPECTION. The plaintiffs were poultry consumers who challenged regulations promulgated under the Poultry Products Inspection Act, 21 U.S.C. § 451 *et seq*. The plaintiffs argued that the differences between the poultry regulations and regulations promulgated under the Federal Meat Inspection Act, 21 U.S.C. § 601 *et seq*., as to the allowance of more than zero percent tolerance for process defects in poultry and the allowance of water washing contaminated carcasses. Under the red meat regulations, a zero tolerance for process defects was required and contaminated carcasses had to be trimmed. The Secretary argued that the regulations were enforcement decisions which were unreviewable by the courts, under *Heckler v. Chaney, 470 U.S. 821 (1985)*. The court held that the regulations were interpretative of the underlying law and were reviewable by the courts. The court remanded the case for trial, holding that the two basic acts were substantially similar enough to bring into question the validity of issuing different standards for contamination of poultry and red meat products. **Kenney v. Glickman, 96 F.3d 1118 (8th Cir. 1996)**.

WETLANDS. The plaintiff was a farmer who participated in the federal price support and production adjustment programs in 1988 and 1989. In 1980, the plaintiff haddug two "dugouts" in the middle of a field. In 1989, the plaintiff filled in the holes. The ASCS (now FSA) determined that the land around the dugouts was wetland and that the plaintiff had filled in a portion of the surrounding land and planted an agricultural crop on the land in violation of the swampbuster provisions, 16 U.S.C. § 3801(a)(4)(A). The plaintiff generally attacked the ASCS ruling as arbitrary and capricious but the court held that the ruling was based on substantial evidence of soil tests and aerial photographs. The court specifically ruled that the filling in of the dugouts in 1989 was not a continuation of the original digging of the dugouts in 1980; therefore, the conversion did not commence prior to 1985. **Downer v. United States, 97 F.3d 999 (8th Cir. 1996)**.

FEDERAL ESTATE AND GIFT TAX

CHARITABLE DEDUCTION. The taxpayer formed a charitable remainder unitrust. The trust agreement granted the taxpayer as co-trustee the power to change the charitable beneficiary. The IRS ruled that the power to change the charitable beneficiary did not disqualify the trust for the charitable deduction. **Ltr. Rul. 9707027, Nov. 19, 1996**.

DISCLAIMERS-*ALM* § 5.02[6].* The decedent's spouse died before the decedent. The decedent's spouse's will provided for passing of the estate to an intervivos trust set up by the decedent's predeceased spouse. Under the trust agreement, the trust was then split into two marital trusts and a family trust. One marital trust received a reverse QTIP election and both marital trusts were QTIP. At the death of the decedent, the children became vested owners of the estate with one child disclaiming a portion of the trust. The IRS ruled that, because the disclaimer was filed more than nine months after the predeceased spouse's death, the disclaimer was ineffective for estate tax purposes and gave rise to gift tax. **Ltr. Rul. 9707026, Nov. 19, 1996**.

The decedent owned a life insurance policy on the decedent's life and the surviving spouse was the beneficiary of that policy. The surviving spouse was the executor of the estate and was co-trustee of a marital trust for the surviving spouse. In order to allow full funding of the testamentary bequests, the surviving spouse disclaimed all interest in the life insurance policy. The IRS ruled that the disclaimer was effective and that the surviving spouse's powers as trustee and executor were sufficiently restrained under state law that the spouse did not have a general power of appointment over the disclaimed property; therefore, the disclaimer was effective because the surviving spouse had no power to direct passing of the property. **Ltr. Rul. 9707008, Nov. 12, 1996**.

GROSS ESTATE. The decedent had conveyed real property to an Illinois Land Trust. The trust agreement provided that the trustee, a bank, could not convey or otherwise deal with the property without the written consent of the decedent. The trust agreement also provided that the beneficiaries of the trust had only the power of direction to deal with the title to the property, to manage and control the property, and to collect any rent or mortgage payments received for the property. The decedent had conveyed beneficial interests in the trust to heirs within three years before the decedent died. The Tax Court had held that the land trust created two retained powers in the decedent. One power was as grantor to direct the sale or conveyance of the property and the other power was as a beneficial interest holder to collect income and to control the property. The Tax Court had held that the conveyances of the beneficial interests to the heirs removed the decedent's ability to control conveyance of the property as to those interests because the decedent had a fiduciary duty to protect those interests. The appellate court agreed with the Tax Court's characterization of the interests and powers retained by the decedent but disagreed that the decedent relinquished the decedent's power to convey the property as to the beneficial interests conveyed. The appellate court held that the decedent's power as grantor to control the sale or conveyance of the property continued after the conveyance of the beneficial interests and that the decedent was under no fiduciary duty, under Illinois law, to protect the beneficiaries' interest in the trust. In other words, the decedent retained the power to revoke the beneficial interests by conveying the property free of the trust; therefore, the value of the beneficial interests was included in the decedent's gross estate. **Est. of Bowgren v. Comm'r, 97-1 U.S. Tax Cas. (CCH) 60,257 (7th Cir. 1996)**.

INTEREST. The decedent's estate consisted primarily of farm real property. The estate requested and received a one year extension to pay estate tax because the estate had difficulty selling estate property to raise funds for payment of the estate tax. The estate requested a second extension which was pending at the time of this case. The IRS had filed a notice of deficiency and the estate challenged the amount of the deficiency in this case. The estate requested the Tax Court to delay a ruling in the case so that the interest accruing on the deficiency would be deductible. I.R.C. § 6512(a) denies deductions of interest after a court decision becomes final. The court withheld issuance of a final order until either the extension expired or was denied (including appeals of the denial) or the estate tax was paid in full. **Est. of Wetherington v. Comm'r, 108 T.C. No. 4 (1997)**.

MARITAL DEDUCTION-*ALM* § 5.04[3].* At the time Treas. Reg. § 20.2056(b)-7(d)(3) was promulgated, the position contained in the regulation was the subject of litigation in a number of cases and had been rejected by two circuit courts in *Estate of Clayton v. Comm'r, 976 F.2d 1486 (5th Cir. 1992), rev'g 97 T.C. 327 (1991), and Estate of Robertson v. Comm'r, 15 F.3d 779 (8th Cir. 1994), rev'g 98 T.C. 678 (1992)*. Since that time, *Estate of Spencer v. Comm'r, 43 F.3d 226 (6th Cir. 1995), rev'g T.C. Memo. 1992-579*, also rejecting the IRS position, has been decided. Additionally, in *Estate of Clack v. Comm'r, 106 T.C. 131 (1996)*, the Tax Court reversed the position it had taken previously in *Estate of Clayton, Estate of Robertson, and Estate of Spencer*. The IRS has issued a temporary regulation which amends the regulations in accordance with the circuit courts' decisions in *Estate of Clayton*, *Estate of Robertson*, and *Estate of Spencer*, and the Tax Court's decision in *Estate of Clack*. The amendment adds Temp. Treas. Reg. § 20.2056(b)-7T(d)(3)(ii), which states that an income interest (or life estate) that is contingent upon the executor's election under section 2056(b)(7)(B)(v) will not be precluded, on that basis, from qualification as a ``qualifying income interest for life'' within the meaning of I.R.C. § 2056(b)(7)(B)(ii). In accordance with the addition of Temp. Treas. Reg. § 20.2056(b)-7T(d)(3)(ii), Temp. Treas. Reg. § 20.2056(b)-7T(h) Example 6(ii) and Temp. Treas. Reg. § 20.2044-1T Example 8 were also added. **62 Fed. Reg. 7156 (Feb. 18, 1997)**.

SPECIAL USE VALUATION-*ALM* § 5.03[2].* Certiorari to the U.S Supreme Court has been applied for in the following case. The decedent died on December 15, 1995 owning farm property. The decedent's estate attempted to make a special use valuation election on the estate's timely filed estate tax return. However, the executor failed to fill in the "yes" box after the question on the form asking if a special use valuation was elected and the return failed to include the recapture agreement of the qualified heirs. The IRS notified the estate that the election was incomplete and the estate supplied the recapture agreement within 90 days after the IRS notification. The IRS denied the election because the initial return did not substantially comply with the election requirements. The court held that the recapture agreement was an essential element of the election and the estate return did not substantially comply with the election; therefore, the estate was not entitled, under I.R.C. § 2032A(d)(3) to perfect the election. The estate also argued that Section 1421 of the Tax Reform Act of 1986 allowed the perfection of the election because the original estate tax return provided "substantially all the information" for the election. The court held that the recapture agreement was an essential part of the "information" required by Section 1421 and the failure to provide the agreement prevented the estate from perfecting the election after notice by the IRS. **Estate of Lucas v. United States, 96-2 U.S. Tax Cas. (CCH) ¶ 60,247 (11th Cir. 1996)**.

VALUATION. The taxpayer established a 5-year annuity trust which provided an annuity to the taxpayer. If the taxpayer died before the end of the trust term, the remaining annuities were to be paid to the surviving spouse, unless the taxpayer revoked that interest. If the taxpayer revoked the spouse's interest, the spouse predeceased the taxpayer, or the spouse died before the end of the term, the remaining annuity payments were to be paid to the taxpayer's estate. The remainder interests were held by the taxpayer's descendants. The issues here were the valuation of (1) the interest held by the surviving spouse assuming the taxpayer died before the end of the term and did not revoke the spouse's interest and (2) the value of the taxpayer's estate to receive annuity payments if the taxpayer died before the end of the term and revoked the spouse's interest. The IRS ruled that interest number (1) was not a qualified interest because it was contingent and interest number (2) was not a qualified interest because the term was not fixed. Thus, the value of the taxpayer's annuity interest was not decreased by the value of interests (1) and (2). **Ltr. Rul. 9707001, Oct. 25, 1996**.

FEDERAL INCOME TAXATION

C CORPORATIONS.

ACCOUNTING METHOD. The taxpayer corporation had claimed research and development expenditures over several years but after an IRS audit, the expenditures were disallowed and required to be capitalized. The IRS ruled that the disallowance was an IRS-imposed accounting method change which did not require the taxpayer to obtain IRS consent. **Ltr. Rul. 9707003, Oct. 31, 1996**.

REORGANIZATIONS. A farm corporation was owned by the members of two families. When the members of one family decided to curtail their involvement in farming, the corporation was reorganized as two corporations by transferring some of the assets to the second corporation and exchanging stock in the new corporation for the stock of the members of one family in the old corporation. The IRS ruled that the reorganization was eligible for tax-free treatment as a "Type D" reorganization. **Ltr. Rul. 9705024, Nov. 5, 1996**.

CASUALTY LOSSES. S. 239 has been introduced to include floods or other weather-related conditions as casualties causing the sale of livestock under I.R.C. § 451 which currently allows the deferral of income from sales of livestock only because of drought. The same amendment would be made to I.R.C. § 1033 for purposes of the involuntary conversion and replacement of property sold because of casualties.

During a remodeling of the taxpayer's home, the home was damaged by high winds and rain. The taxpayers presented estimates of the value of the damage but the estimates did not include sufficient detail of the items damaged or their value. In addition, although the taxpayers presented invoices for repair work, the invoices were insufficient to determine whether the work performed was limited to repair of the wind and rain damage. The court held that the casualty loss claimed by the taxpayers was not allowed for failure to substantiate the amount of the loss. **Oliver v. Comm'r, T.C. Memo. 1997-84**.

***Agricultural Law Manual* (ALM). For information about ordering the *Manual*, see the last page of this issue.**

CHARITABLE DEDUCTION. The taxpayer owned 380 acres of rural property. In 1984, the taxpayer sold 48 acres to a development company which developed the land into residential lots. The state then offered to purchase the remaining acres and the taxpayer had the property appraised at $12 million but sold the land to the state for $6 million and claimed a $6 million charitable deduction from the sale. The taxpayer's value was reduced by the court to $10 million based on the value of the property as residential development property and $2 million of the charitable deduction was disallowed. **Glick v. Comm'r, T.C. Memo. 1997-65**.

HOBBY LOSSES. The taxpayer was employed full time as a director of mental health clinics. The taxpayer owned a rural property and purchased three horses to be trained as jumpers. The court held that the taxpayer could not deduct expenses in excess of income from the horse breeding and training activity because (1) the taxpayer did not seek expert advice on how to make the activity profitable, (2) the taxpayer did not keep separate records for the activity, (3) the taxpayer did not provide sufficient efforts in the activity to prepare the horses for profit generating activities, (4) the activity had only losses for each year of operation, (5) the taxpayer had substantial income from employment, and (6) the taxpayer failed to demonstrate any reasonable expectation of appreciation in the value of the horses. The taxpayer also purchased a bull and four cows with calf. The cows produced calves each year and the taxpayer raised the calves until they reached market weight before selling the calves. The court also held that the calf operation was not entered into with the intent to make a profit but did not explain the various factors for that decision. **Drummond v. Comm'r, T.C. Memo. 1997-71**.

INCOME AVERAGING. Senators Shelby, Grassley, Cochran, Roberts, Abraham and Hutchinson have introduced a bill, Senate 251, which allows taxpayers with income from a farming business to elect to use two year income averaging for the income from that business. Farming income includes gain from the sale of property (except land) regularly used in the farming business for a substantial period before the sale.

SAFE HARBOR INTEREST RATES
March 1997

	Annual	Semi-annual	Quarterly	Monthly
		Short-term		
AFR	5.83	5.75	5.71	5.68
110% AFR	6.43	6.33	6.28	6.25
120% AFR	7.02	6.90	6.84	6.80
		Mid-term		
AFR	6.42	6.32	6.27	6.24
110% AFR	7.07	6.95	6.89	6.85
120% AFR	7.72	7.58	7.51	7.46
		Long-term		
AFR	6.86	6.75	6.69	6.66
110% AFR	7.57	7.43	7.36	7.32
120% AFR	8.26	8.10	8.02	7.97

RETURNS. The IRS has issued a revised revenue procedure concerning obtaining copies of filed tax returns. The fee for a copy of a return has been increased to $23.00, submitted in advance with Form 4506, Request for Copy of Transcript of Tax From. Return transcripts and account transcripts are available for no charge from the IRS. **Rev. Proc. 97-11, I.R.B. 1997-_, __**.

S CORPORATIONS-*ALM* § 7.02[3][c].*

BANKS. The IRS has issued guidance for banks, under I.R.C. § 581, to change their method of accounting for bad debts from the reserve method, I.R.C. §585, to the specific charge-off method, I.R.C. § 166, so that the bank may make the S corporation election. **Rev. Proc. 97-18, I.R.B. 1997-_, __**.

PRODUCTS LIABILITY

HERBICIDE. The plaintiff was a part-time farmer who grew silage corn for feed. Most of the corn was grown for feed for the plaintiff's own livestock, but the plaintiff occasionally sold some of the crop to neighbors. The plaintiff contracted with the defendant to have the defendant, an herbicide manufacturer and distributor, to spray the corn fields for weed prevention. The defendant purchased a herbicide from another manufacturer and applied it to the plaintiff's fields. The herbicide was ineffective against crabgrass and the plaintiff experienced a loss of yield for two crop years. The plaintiff sued in negligence, strict liability and negligent misrepresentation and sought damages for the loss of the value of the reduced yield of the corn. The court held that the plaintiff was an ordinary consumer in that the plaintiff was a part-time farmer and sold very little of the corn to third parties. The court also held that the plaintiff's loss was an economic loss in that the herbicide was damaged by the alleged negligent acts and not the corn. The court reviewed Vermont law to hold that economic losses were allowed in actions for negligence and strict liability. The court also allowed the claim for negligent misrepresentation because the plaintiff presented evidence that employees of the herbicide manufacturer supplied information about the effectiveness of the herbicide against crabgrass. **Mainline Tractor & Equipment Co. v. Nutrite Corp., 937 F. Supp. 1095 (D. Vt. 1996)**.

STATE TAXATION

VALUATION. The taxpayers owned and operated a dairy farm on 148 acres within a city limits. The property had extensive frontage on a road and on a lake. The city valued the property for property tax purposes as residential development property and the taxpayers appealed that valuation. The taxpayers argued that the valuation of the property in residential parcels was incorrect because the entire property was used as a dairy farm. The court held that the valuation statute required valuation of property at its highest and best actual or potential use; therefore the valuation based on residential development was allowed under the statute. The court also ruled that the difficulties of obtaining development rights were not sufficient to invalidate the valuation. **Scott Const. v. City of Newport, 683 A.2d 382 (Vt. 1996)**.

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