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The Trap in Liquidating an S Corporation That Was Formerly a C Corporation

-by Neil E. Harl*

The dramatic shift in rules governing corporate liquidations in the Tax Reform Act of 1986,[1] has led to the development of strategies to ease the draconian provisions that have governed corporate liquidations for the past two decades including shifting to S corporation status.[2]

While such a shift in status may lead to a single tax (at the shareholder level) rather than the double tax characteristic of a C corporation, the liquidation of an S corporation after the transition from C corporation status may lead to tax consequences from the accumulated earnings and profits from the time the corporation was regularly taxed.[3] That trap is especially likely to impact situations where a shift from C corporation status to S corporation status occurs and the strategy is pursued of waiting until the major shareholders die before the S corporation is liquidated.

Income tax treatment of C corporations on liquidation

In general, gain or loss is recognized to a liquidating C corporation on the distribution of property in complete liquidation as if the property were sold at its fair market value.[4] The gain is taxed to the liquidating C corporation as ordinary income (even gain on capital assets and Section 1231 trade or business assets which is ordinarily entitled to capital gain treatment).[5] For many farm and ranch C corporations, the income tax liability at this first level of tax on liquidation is substantial, often totaling 30 to 35 percent of the gain involved.

On a complete liquidation, each shareholder recognizes gain or loss to the extent of the difference between the value of cash and property received and the income tax basis of the stock given up regardless of the form in which the distribution is received.[6] Each shareholder's gain or loss is the difference between the amount of the distribution and the income tax basis of the stock.[7] If the stock had been held for more than one-year, the gain would be long-term capital gain.[8]

The income tax basis of the property received in the liquidation is the fair market value at the date of the distribution.[9]

Thus, the liquidation of a C corporation involves two levels of tax – (1) income tax (at ordinary income tax rates) at the corporate level on the gain or loss from a deemed sale of the assets and (2) capital gains treatment at the shareholder level on any gain or loss involved on the exchange of stock for the distribution in liquidation.

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Income tax treatment of S corporations on liquidation

On the liquidation of S corporations, no gain or loss is normally recognized at the corporate level[10] unless the built-in gains tax applies.[11] The built-in gains tax applies to sales or exchanges of appreciated assets which are disposed of within 10-years after the corporation became an S corporation.[12] The tax imposed is the maximum corporate rate tax in which the disposition occurs applied to the lesser of – (1) the net recognized built-in gain (the net of built-in gains and built-in losses) or (2) the amount of taxable income if the corporation were not an S corporation.[13]

Income tax is recognized at the shareholder level as with C corporations.[14] For an S corporation without earnings and profits, distributions are first treated as a non-taxable return of basis on the stock with the remainder taxed as gain from the sale or exchange of property.[15]

If an S corporation has earnings and profits, distributions are treated as follows –

- A non-taxable return of capital to the extent of the "accumulated adjustments account;"[16]
- Dividends, to the extent of the S corporation's accumulated earnings and profits;[17]
- Non-taxable return of capital, to the extent of the shareholder's remaining stock basis; and
- Gain from the sale or exchange of property for the remainder of the distribution.[18]

The trap

Some corporations have shifted from C corporation status to S corporation status and waited for the major shareholders to die with a new income tax basis equal to the fair market value as of the date of death[19] or the alternate valuation date.[20] That assumed that no or very little income tax would be due if more than 10-years had elapsed since the corporation shifted from C to S corporation status[21] and if the deaths of the shareholders would eliminate the gain at the shareholder level. However, the presence of earnings and profits in an S corporation that formerly operated as a C corporation *results in a taxable distribution as a dividend even though the stock basis would otherwise have eliminated all gain*. That limits the benefits of a not uncommon strategy.

FOOTNOTES

[1] Tax Reform Act of 1986, Pub. L. No. 99-514, § 631(a), 100 Stat. 2817 (1986).

[2] I.R.C. § 1361(a)(1), (b). See generally 7 Harl, *Agricultural Law* § 56.02[1][a] (2008); Harl, *Agricultural Law Manual* § 7.02[3][c][ii] (2008); 2 Harl, *Farm Income Tax Manual* § 7.04[1][a][ii], [g] (2007 ed.).

[3] I.R.C. § 1368(c).

[4] I.R.C. § 336(a), as amended by Tax Reform Act of 1986, § 631(a), 100 Stat. 2817 (1986). See Al Zuni of Arizona, Inc. v. Comm'r, T.C. Memo. 1999-74 (gain recognized at corporate level as though inventory sold).

[5] I.R.C. § 1(h).

[6] I.R.C. § 331(a).

[7] Treas. Reg. § 1.331-1(b).

[8] I.R.C. § 1221(a).

[9] I.R.C. § 334(a).

[10] I.R.C. § 331(a). See Ltr. Rul. 9218019, Jan. 23, 1992.

[11] I.R.C. § 1374(a).

[12] I.R.C. § 1374(d)(3).

[13] I.R.C. § 1374(b)(1).

[14] I.R.C. § 331(a). See Buda v. Comm'r, T.C. Memo. 1999-132, *aff'd*, 230 F.3d 1357 (6th Cir. 2000) (distribution of leasehold to sole shareholder of S corporation). See also Ltr. Rul. 9752038, Sept. 25, 1997 (distribution of all assets followed by complete liquidation).

[15] I.R.C. § 1368(b). See Treas. Reg. § 1.1368-1(c) (distribution by S corporation without earnings and profits not included in shareholder's income to extent distribution does not exceed the adjusted basis of all of the shareholder's shares of stock).

[16] I.R.C. § 1368(e)(1).

[17] I.R.C. § 1368(c)(2).

[18] I.R.C. § 1368(c); Treas. Reg. § 1.1368-1(d).

[19] I.R.C. § 2031(a).

[20] I.R.C. § 2032(a).

[21] I.R.C. § 1374(d)(7).

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CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

ANIMALS

HORSES. The plaintiff (owner) boarded a Tennessee Walking horse at the defendant's stables under a written agreement which provided that the defendant (Riverbend) "and its employees, owners and agents shall not be liable to Owner or any of Owner's guests for any negligent conduct or malfeasance of any sort, including any personal injury or property damage (including the injury or death of a horse). Owner agrees to indemnify and hold harmless Riverbend from any such liability. In the event a claim is filed against Riverbend, Owner agrees to indemnify Riverbend for all loss and damages, including reasonable attorney fees, resulting from the filing of any such claim." The plaintiff's horse was killed when the horse spooked while attached to a "hot walker" used to walk automatically until a horse cooled down after exercise by a trainer at the plaintiff's stables. The plaintiff filed an action for negligence, gross negligence and reckless conduct. The trial court held that the exculpatory clause was not void as to public policy and relieved the defendant of liability for negligence and that the defendant was not liable for gross negligence or reckless conduct because the defendant's conduct was not wanton, willful or showed a disregard for the safety of others. The appellate court affirmed, holding that the defendant was not a provider of professional services essential to public welfare; therefore, the exculpatory clause was enforceable. The plaintiff had provided expert testimony that the hot walker was inherently dangerous in design in that the walker had lead bars lower than head level; whereas, the great majority of walkers had leads about head level. The court held that the claim of gross negligence was properly dismissed because there was no evidence that the defendant negligently used the walker. The court refused to allow a claim of gross negligence for the non-negligent use of an inherently dangerous device. **Thrasher v. Riverbend Stables, LLC, 2008 Tenn. App. LEXIS 309 (Tenn. Ct. App. 2008)**.

BANKRUPTCY

FEDERAL TAXATION

DISCHARGE. The debtor was an attorney and failed to file tax returns and pay taxes for 1994 through 1998. The IRS prepared substitute returns for those years. The debtor filed for Chapter 7 in 1999 and filed returns for 1994 through 1997 based on estimated income and expenses. The debtor claimed that the supporting documents were no longer available. The IRS filed a Notice of Deficiency in 2002 and the debtor filed a petition in the Tax Court challenging the deficiency. The bankruptcy case was concluded as a no asset case and the IRS did not file any claims in that case. The debtor claimed that the taxes were discharged in the bankruptcy case but the Bankruptcy Court ruled that the taxes were not discharged. The appellate court upheld the ruling, holding that the taxes were nondischargeable under Section 523(a)(1)(A) because the taxes were still assessable after the bankruptcy case because of the pending Tax Court case involving the amount of the deficiency involved. On further appeal, the appellate court affirmed on the point that the taxes were nondischargeable but allowed the taxpayer to continue a claim that the tax penalties were dischargeable. ***In re* Hosack, 2008-1 U.S. Tax Cas. (CCH) ¶ 50,319 (5th Cir. 2008), *aff'g in part and rem'g in part*, 2007-1 U.S. Tax Cas. (CCH) ¶ 50,474 (N.D. Tex. 2007)**.

The debtors filed their final Chapter 7 bankruptcy case on May 23, 2003 and owed taxes from timely filed returns for 1996 and 1998. The debtors claimed that the 1996 and 1998 taxes were discharged in the final Chapter 7 case under Section 523(a) because the returns were filed more than three years before the bankruptcy filing. The debtors had filed two previous bankruptcy cases, one just after the filing of the 1996 return and one after the filing of the return for 1998. The IRS argued that the previous filings tolled the three year period, leaving less than three years of untolled time between the filing of the returns and the filing of the final Chapter 7 petition. The court held that only the duration of the second bankruptcy case tolled the limitation period because only the 1996 return preceded that filing. No tolling period applied to the 1998 taxes because no case, except the final Chapter 7 case, was filed after that return. **Imarah v. Comm'r, T.C. Memo. 2008-137**.

FEDERAL AGRICULTURAL PROGRAMS

DISASTER PAYMENTS. The plaintiff had participated in a city's sewage sludge disposal program under which the sludge was sprayed on the plaintiff's crop and pasture land as fertilizer. After the crops showed signs of damage and the plaintiff's cattle became sick, the plaintiff had the soil tested. The tests showed that the soil was contaminated with a variety of toxic chemicals and heavy metals from the sludge. The evidence showed that the city had filed to properly test and monitor the contents of the sludge. The contamination resulted in the land being unsuitable for growing crops for human consumption or for feeding to livestock. The plaintiff filed a disaster subsidy claim for prevented-planting acres under the 2002 Farm Bill, listing environmental contamination as the cause of the prevented planting. The USDA eventually denied the plaintiff's claims, relying on statements from EPA officials that the plaintiff's land was not contaminated. The court extensively reviewed the evidence presented and found that the records clearly established that the city had failed to properly monitor the composition of the sludge and that the plaintiff's soil was heavily contaminated with toxic chemicals which made the land unsuitable for food production. Therefore, the court held that

the USDA improperly denied the plaintiff's claim for prevented planting acres subsidy. The court refused to remand the case back to the USDA for further action, holding that the record was sufficiently clear that the plaintiff, as a matter of law, was entitled to the subsidy payments. **McElmurray v. United States, 2008 U.S. Dist. LEXIS 13829 (S. D. Ga. 2008)**.

LIVESTOCK MANDATORY REPORTING. The AMS has adopted as final regulations reauthorizing and amending the Livestock Mandatory Reporting program as required by the Livestock Mandatory Reporting Act of 1999, as extended by legislation in 2006. **73 Fed. Reg. 28605 (May 16, 2008)**.

MILK. The AMS has adopted as final regulations amending the Fluid Milk Promotion Order by removing the late-payment charges applied to processors who mistakenly underreport the amount of assessments owed to the National Fluid Milk Processor Promotion Board, provided that the processor has not made more than two reporting errors in the prior 12 months and the processor pays its past due assessments not later than the last day of the month following notification by the Board that additional assessments are due. **73 Fed. Reg. 29389 (May 21, 2008)**.

WETLANDS. The plaintiff had requested that the Natural Resources Conservation Service (NCRS) make a determination as to a 0.7 acre portion of the plaintiff's farm. The NCRS determined that the parcel was wetlands and the plaintiff appealed the determination, arguing that the parcel was part of an area which had been excavated and otherwise disturbed by the construction of drainage ditches and the channelization of a nearby river. Although the U.S. Corps of Engineers had previously determined that the land was disturbed wetlands, the NCRS determination was upheld in an administrative appeal. The plaintiff argued that the parcel was wetlands which had been converted prior to December 23, 1985, and was no longer wetlands under 7 C.F.R. § 12.2(a). The court found that the NCRS determination was not improper because the previous findings of the Corps of Engineers and others did not make findings that the specific land involved had been converted prior to December 23, 1985. Instead, the reports covered a larger tract in general; whereas, the NCRS determination was limited to the specific 0.7 acres involved here. In addition, the NCRS determination was supported by findings of two secondary indicators of wetland hydrology on the 0.7 acres which were sufficient to qualify the property as wetlands. **Groenendyk v. Johanns, 2008 U.S. Dist. LEXIS 11153 (S.D. Iowa 2008)**.

FEDERAL ESTATE AND GIFT TAXATION

GENERATION-SKIPPING TRANSFERS. The decedent had created an inter vivos revocable trust which became irrevocable on the decedent's death. The trust provided that, upon the decedent's death, the trust was to be divided into a marital trust, a family trust funded with the smallest amount of property necessary to reduce the estate tax to zero using the marital deduction, and a second marital trust. The surviving spouse was the beneficiary of the marital trusts and the decedent's three children were the remainder beneficiaries of the family trust. On the death of the surviving spouse, the marital trusts' property passed to the family trust. The children disclaimed their remainder interests in the family trust to the extent the removal would not result in any GST tax after application of any exemption by the decedent's estate and surviving spouse. After the death of the surviving spouse, the trustee split the first marital trust into a GST-exempt trust and a GST-non-exempt trust. The IRS ruled that the split was a qualified severance of the first marital trust under I.R.C. § 2642(a)(3) and the exempt trust had an inclusion ratio of zero and the non-exempt trust had an inclusion ratio of one. **Ltr. Rul. 200820003, Jan. 17, 2008; Ltr. Rul. 200820004, Jan. 17, 2008; Ltr. Rul. 200820005, Jan. 17, 2008; Ltr. Rul. 200820006, Jan. 17, 2008**.

FEDERAL INCOME TAXATION

ALTERNATIVE MINIMUM TAX. The taxpayer exercised employer-granted incentive stock options (ISOs) in 1997, 1998 and 2000 and included in alternative minimum tax income the spread between the exercise price of the stock options and the date-of-exercise fair market value of the stock. In 2001 the taxpayer sold some of the stock acquired by ISO in 1997, 1998 and 2000 but received less than the date-of-exercise fair market value for the stock sold. The taxpayer carried back the net loss on amended returns for 1999 and 2000. The IRS assessed a deficiency and the issue was whether the limitation period of I.R.C. § 6501(h) applied. The court found that the record established that the taxpayer claimed a net operating loss, and not a capital loss, for AMT purposes in the 2001 return and that the net operating loss for AMT purposes was carried back in the 1999 return and the 2000 return. The court held that the period of limitations in I.R.C. § 6501(h), applied with respect to the deficiency for each of the taxpayer's taxable years 1999 and 2000 that is attributable to the carryback to each of those years of the net operating loss for AMT purposes that they claimed in the 2001 amended return. **Nemitz v. Comm'r, 130 T.C. No. 9 (2008)**.

CAPITAL ASSETS. The IRS has announced the withdrawal of proposed regulations which had clarified the circumstances in which accounts or notes receivable were "acquired . . . for services rendered" under I.R.C. § 1221(a)(4). **Ann. 2008-41, 2008-1 C.B. 943**.

CORPORATIONS

PERSONAL SERVICE CORPORATION. The taxpayer was a professional engineering corporation owned by two shareholders. One shareholder was a licensed engineer, owned 60 percent of the corporation and performed engineering services for the corporation. The other shareholder owned 40 percent of the corporation, had an engineering degree but worked primarily in the corporation's planning department, although the shareholder performed some engineering services. The court held that the ownership test of I.R.C. § 448(d)(2) was met because over 95 percent of the stock was owned by employees who performed at least some of the qualifying field services, engineering, of the corporation. The court also held

that the function test of I.R.C. § 448(d)(2) was met because the planning department activities performed constituted engineering under state law; therefore, more than 95 percent of all employee time was spent on engineering activities. The court noted that the corporation failed to provide detailed time sheets to demonstrate that the employees spent more than 5 percent of their time on non-engineering activities. Therefore; the court held that the corporation was taxable as a personal service corporation under I.R.C. § 11(b)(2). **Grutman-Mazler Engineering, Inc. v. Comm'r, T.C. Memo. 2008-140**.

WAIVER OF DIVIDENDS. The taxpayers were related individual shareholders of a corporation who held stock eligible for dividend distributions. The corporation decided to increase its quarterly dividend as part of a plan to increase the value of its publicly traded stock. Because the increased funds for the additional dividend would impair other business plans of the corporation the taxpayers agreed to waive their right to a dividend to the extent it exceeded the normal amount. The taxpayers claimed that persons related to the taxpayers, as defined in *Rev. Proc. 67-14, 1967-1 C.B. 591,* would not receive in the aggregate, either directly or beneficially, more than 20 percent of the amount of any regular quarterly cash dividend in excess of the amount of the per share dividend declared and paid to non-waiving shareholders and that no taxpayer was related, within the meaning of section 3.02 of *Rev. Proc. 67-14*, to any non-waiving shareholder. The IRS ruled that a bona fide business reason existed for the waivers and that the taxpayers would not recognize income from the waivers. The IRS also ruled that the ruling would no longer be applicable if any change in the stock ownership during the waiver period enabled non-waiving relatives to receive more than 20 percent of the total dividends distributed to the non-waiving shareholders, unless the change occurs because of death. In addition, this ruling will not be effective for a period longer than three years from the date of the ruling. **Ltr. Rul. 200820019, Feb. 11, 2008**.

DISASTER LOSSES. On May 5, 2008, the president determined that certain areas in Oklahoma are eligible for assistance from the government under the Disaster Relief and Emergency Assistance Act (42 U.S.C. § 5121) as a result of severe storms, tornadoes and flooding, which began on March 17, 2008. **FEMA-1752-DR**. Taxpayers who sustained losses attributable to these disasters may deduct the losses on their 2007 returns.

EXPENSE METHOD DEPRECIATION. The taxpayer started a consulting business in 2002 and used two vehicles in traveling to various sites for research. The taxpayer claimed expense method depreciation for both vehicles but did not keep written records of the travel time, distance and purpose of each use of the vehicles. The taxpayer provided only oral testimony as to the nature and location of the research sites, which clearly demonstrated that one vehicle was used more than 50 percent for business purposes. However, the same testimony was held not sufficient to demonstrate the extent of business and personal use of the other vehicle; therefore, the court held that the expense method depreciation claimed for the second vehicle was to be recaptured for lack of substantiation of the business use of the vehicle. **Birdsill v. Comm'r, T.C. Summary Op. 2008-55**.

HEALTH SAVINGS ACCOUNTS. For tax years beginning after December 31, 2006, the maximum annual HSA is the indexed statutory amount, without reference to the deductible of the high deductible health plan. For calendar year 2009, the limitation on deductions under I.R.C. § 223(b)(2)(A) for an individual with self-only coverage under a high deductible health plan is $3,000 ($5,900 for family coverage). For calendar year 2009, the limitation on deductions under I.R.C. § 223(b)(2)(B) for an individual with family coverage under a high deductible health plan is $5,950 ($11,600 for family coverage). **Rev. Proc. 2008-29, I.R.B. 2008-22**.

IRA. The taxpayer was age 53 when the taxpayer retired. When the taxpayer was 55, the taxpayer received a distribution of $23,500 from a qualified retirement plan, of which $16,177 was used for medical expenses. The taxpayer included the entire distribution in taxable income but paid no 10 percent tax for early withdrawal. The taxpayer argued that the I.R.C. § 72(t)(1)(A)(v) exception applied because the distribution was made when the taxpayer was 55. The court held that the exception did not apply because it applied only where the taxpayer *retired* after reaching age 55. Because the taxpayer retired at age 53, the exception could not be used; however, the court and IRS allowed the medical exception to apply and only $7290 of the distribution was subject to the 10 percent additional tax. **Williams v. Comm'r, T.C. Summary Op. 2008-53**.

LIKE-KIND EXCHANGES. The taxpayer was a limited liability company taxed as a partnership and an affiliate of a real estate investment trust (REIT). The REIT owns the majority of a limited partnership which owns most of the taxpayer. The taxpayer entered into a like-kind property exchange through a qualified intermediary for property owned by the limited partnership. The limited partnership also entered into a like-kind property exchange with an unrelated party but that exchange involved some cash because the acquired property was subject to less liabilities. The IRS ruled that the taxpayer's exchange was eligible for I.R.C. § 1031 like-kind exchange treatment so long as the taxpayer did not transfer the property within two years of its acquisition. **Ltr. Rul. 200820017, Feb. 7, 2008; Ltr. Rul. 200820025, Feb. 7, 2008**.

LIMITED LIABILITY COMPANIES. The taxpayers were consecutive owners of a single-member limited liability company. The LLC did not make the "check-the-box" election to be treated as a corporation for tax purposes. The LLC failed to pay employment taxes and filed for bankruptcy. The IRS assessed the taxpayers for the unpaid employment taxes incurred during each's ownership of the LLC. The taxpayers argued that the "check-the-box" regulations, Treas. Reg. § 301.7701-3 conflicted with the employment tax regulations in that the employment tax regulations treated the LLC as the employer liable for the taxes and the "check-the-box" regulations allowed the taxpayers as owners to be liable for the taxes. The court held that no conflict arose in that the "check-the-box" regulations did not affect the definition of employer but only determined the proper party for

liability for taxes incurred by the LLC which had not made an election to be treated as a corporation for tax purposes. **L & L Holding Co., LLC v. United States, 2008-1 U.S. Tax Cas. (CCH) ¶ 50,324 (W.D. La. 2008)**.

PARTNERSHIPS

BASIS ADJUSTMENT. A partner in a limited partnership died but the partnership inadvertently failed to file an I.R.C. § 754 election to adjust the basis of partnership property on the partnership return for the year of the partner's death. The IRS granted a 60-day extension of time to file an amended return with the election. **Ltr. Rul. 200820001, Feb. 1, 2008**.

DISTRIBUTIVE SHARE. The IRS has adopted as final regulations which provide rules for testing the substantiality of an allocation under I.R.C. § 704(b) where the partners are look-through entities or members of a consolidated group, provide additional guidance on the effect of other provisions, such as I.R.C. § 482, upon the tax treatment of a partner with respect to the partner's distributive share under I.R.C. § 704(b), and revise the existing rules for determining the partners' interests in a partnership. **73 Fed. Reg. 28699 (May 19, 2008)**.

The IRS has issued proposed regulations under I.R.C. § 704(c) which provide that the anti-abuse rule takes into account the tax liabilities of both the partners in a partnership and certain direct and indirect owners of such partners. The proposed regulations further provide that an I.R.C. § 704(c) allocation method cannot be used to achieve tax results inconsistent with the intent of subchapter K. **73 Fed. Reg. 28765 (May 19, 2008)**.

QUALIFIED ENVIRONMENTAL REMEDIATION EXPENDITURES ELECTION. The taxpayer was a limited liability company treated as a partnership for federal income tax purposes. The taxpayer used an accounting firm to prepare its income tax returns and the firm properly make the I.R.C. § 198 election to deduct currently the QER expenditures on the first tax year of the expenses. However, due to a change in accounting firms, the election was not made in the second tax year. The IRS granted the taxpayer an extension of time to file an amended return with the election. **Ltr. Rul. 200820027, Feb. 5, 2008**.

SALE OF PARTNERSHIP INTEREST. The taxpayer was a trust which borrowed stock from a brokerage account in order to make a short sale of the stock. The proceeds of the sale were transferred to a limited partnership in exchange for a limited partnership interest. The partnership assumed the obligation to replace the borrowed shares. The trust's limited partnership was further transferred to another limited partnership for another limited partnership interest. The second partnership sold its interest in the first partnership to an individual for substantially less than the proceeds of the sale but subject to the obligation to replace the borrowed stock. The trust treated the transaction as a capital loss, excluding the value of the obligation to replace the stock from the amount received for the sale of the partnership interest. The court held that the obligation to replace the borrowed stock was not so contingent to remove its value as an obligation; therefore, the sale did not result in a loss passed through to the trust from the partnerships. **Kornman & Associates, Inc. v. United States, 2008-1 U.S. Tax Cas. (CCH) ¶ 50,333 (5th Cir. 2008), *aff'g*, 2006-2 U.S. Tax Cas. (CCH) ¶ 50,554 (N.D. Tex. 2006)**.

REFUNDS. The taxpayer was a corporation which filed its 1999 and 2000 corporate income tax returns in April 2004, claiming a refund on both returns. The taxpayer claimed to have made estimated tax payments in 1999 and 2000 which it claimed were not tax payments but deposits. The IRS rejected the refund claims, under I.R.C. § 6511(b)(2)(A) because the claims were made more than three years after payment of the taxes giving rise to the refund claims. The court held that the refund claims were filed too late because the estimated tax payments were not made within three years of the refund claim. The decision is designated as not for publication. **Alternative Entertainment Enterprises, Inc. v. United States, 2008-1 U.S. Tax Cas. (CCH) ¶ 50,330 (6th Cir. 2008), *aff'g*, 2007-1 U.S. Tax Cas. (CCH) ¶ 50,183 (E.D. Mich. 2007)**.

SAFE HARBOR INTEREST RATES
June 2008

	Annual	Semi-annual	Quarterly	Monthly
		Short-term		
AFR	2.08	2.07	2.06	2.06
110 percent AFR	2.29	2.28	2.27	2.27
120 percent AFR	2.50	2.48	2.47	2.47
		Mid-term		
AFR	3.20	3.17	3.16	3.15
110 percent AFR	3.52	3.49	3.47	3.46
120 percent AFR	3.84	3.80	3.78	3.77
		Long-term		
AFR	4.46	4.41	4.39	4.37
110 percent AFR	4.91	4.85	4.82	4.80
120 percent AFR	5.36	5.29	5.26	5.23

Rev. Rul. 2008-28, I.R.B. 2008-22.

SALE OF RESIDENCE. The taxpayer was single with two daughters when the taxpayer purchased a residence. One daughter was traumatized by a sexual assault on a school bus. Although the taxpayer sought therapy for the daughter, the daughter's school performance deteriorated. The taxpayer sold the residence within two years in order to move the daughter away from the school where the assault occurred The IRS ruled that the sale of the taxpayer's house was the result of unforeseen circumstances and allowed the exclusion of gain on the sale of the taxpayer's house based on the maximum dollar limitation multiplied by a fraction equal to the number of days lived in the house divided by 730. **Ltr. Rul. 200820016, Feb. 7, 2008**.

S CORPORATIONS

SIMPLIFIED EMPLOYEE PENSION. The taxpayers were married and both were employees of an S corporation owned by the husband. The corporation established a simplified employee pension account and the husband, as president of the corporation, signed the SEP agreement which stated that the corporation agreed to make annual contributions to an IRA for all employees. The taxpayers were the only employees but the corporation made a contribution only to the husband's IRA. The wife made separate contributions to her IRA. The taxpayers claimed a deduction from gross income of the amount paid by the

corporation. The IRS and court ruled that the deduction was not allowed because the corporation did not make contributions to the IRAs of all employees. The court rejected the argument that the contribution to the husband's account could be attributed as also contributed to the wife, noting that there was no statutory or regulatory authority for such attribution. **Brown v. Comm'r, T.C. Summary Op. 2008-56**.

TRAVEL EXPENSES. The taxpayer originally lived with parents in Idaho while the taxpayer received an education to become an electrical power lineman. The taxpayer left some personal property at the parents' home when the taxpayer moved to California to enter a three and a half year journeyman lineman training program in which the taxpayer learned skills while employed by various contractors. In one tax year during this time, the taxpayer claimed travel expenses to and from Idaho when the taxpayer made visits to the parents. The court held that the taxpayer's connection with Idaho was too insubstantial to qualify as the taxpayer's tax home for purposes of claiming travel expenses. The court noted that the taxpayer had little hope of finding a job in Idaho and paid no housing expenses to the parents. **Yanke v. Comm'r, T.C. Memo. 2008-131**.

The taxpayer was employed as a policeman and claimed deductions for travel to and from work, including trips to state and federal courts to appear as a police witness. The taxpayer claimed as deductions expenses for gas and parking. The court held that the deductions for travel expenses to and from work were non-deductible personal expenses. The court also held that the expenses incurred while traveling to the courts were non-deductible because the taxpayer did not provide written records of the time, amount and purpose of the expenses. **Snead v. Comm'r, T.C. Summary Op. 2008-57**.

LANDLORD AND TENANT

BREACH OF LEASE. The plaintiffs rented farm land to the defendants under a written lease. After the defendants took possession, the plaintiffs learned that the defendants had subleased a portion of the land and that the sub-tenant was growing sugar beets on the land. The plaintiffs argued that the growing of sugar beets was a violation of the lease terms and sought termination of the lease and damages. The defendants counterclaimed for lost profits from an anticipatory breach which resulted in the loss of profits from planting soybeans on the reminder of the land. The trial court ruled that no breach occurred because the lease contained no prohibition against planting sugar beets. The plaintiffs argued that custom and usage in the area prevented tenants from subleasing farm land or planting sugar beets. The defendants were awarded a portion of the claimed lost profits because of failure to prove the amounts claimed. The appellate court affirmed on the issue of breach, holding that the lease was unambiguous and evidence of custom and usage as implied terms was not allowed to interpret the lease terms. The court noted that the plaintiffs never mentioned any prohibition against growing sugar beets in the lease negotiations or in any advertisements about the leased land. The appellate court also affirmed the damage award as supported by substantial evidence, given the lack of adequate evidence to support the defendants' full claim of lost profits. **Langer v. Bartholomay, 2008 N.D. LEXIS 40 (N.D. 2008)**.

PRODUCTS LIABILITY

HERBICIDE. The plaintiff was a sweet potato farmer who had used the herbicide Dual, manufactured by the defendant, for many years on the sweet potato crop. The defendant stopped manufacturing Dual and offered a new herbicide, Outlook, as appropriate for use on sweet potatoes. The plaintiff's sweet potato crops suffered significant losses from damage caused by the new herbicide and the plaintiff brought an action redhibition (strict liability), breach of contract, negligence, negligent misrepresentation and violation of the Louisiana Products Liability Act. The negligence, negligent misrepresentation and state law claims were dismissed as pre-empted by FIFRA. The defendant moved for summary judgment on the remaining claims, arguing that the label adequately warned the plaintiff that the herbicide could damage sweet potatoes and should be used only where the risk of crop loss from weeds exceeded the risk of loss from herbicide damage. The court held that there remained sufficient questions of material fact as to whether the defendant knew that substantial and unreasonable crop losses would result from the use of the herbicide, making the herbicide unfit for its intended use. The court noted that it was unreasonable for the defendant to expect the plaintiff to test the herbicide where the plaintiff had been using a similar product manufactured by the defendant without such losses. **Dawson Farms, LLC v. BASF Corp., 2008 U.S. Dist. LEXIS 38733 (W.D. La. 2008)**.

PROPERTY

PRESCRIPTIVE EASEMENT. The plaintiff owned land neighboring the defendant's land. The previous owners of the properties had agreed that the owner of the plaintiff's land could use a farm lane for access to the property. After the plaintiff and defendant acquired their properties a dispute arose as to the acceptable use of the lane and the defendant eventually fenced off the lane. The plaintiff sought a prescriptive easement over the lane. The court held that the original use of the lane was by permission; therefore, no prescriptive easement could arise from the plaintiff's use of the lane. Because the initial use was permissive, the defendant was entitled to rescind permission at any time. **Engle v. Carlson, 2008 Neb. App. LEXIS 94 (Neb. Ct. App. 2008)**.

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IN THE NEWS

2008 FARM BILL. The U.S. Senate and House of Representatives have passed the Food, Conservation and Energy Act of 2008, H.R. 2419, overriding a presidential veto, although Title III of the bill was inadvertently omitted from the process and will need re-enactment after the Memorial Day recess. The *Agricultural Law Digest* will publish a summary of the law by Dr. Neil E. Harl in the next issue.

"PHISHING" SCAMS. The web site of the U.S. Tax Court, www.ustaxcourt.gov, has the following notice "The United States Tax Court has received many telephone calls regarding an e-mail which purports to originate from the Court being sent by a member of the Tax Court's practitioner bar. This message is an example of 'Spear Phishing,' which is an e-mail spoofing attempt that targets a specific organization. The Tax Court is not disseminating any e-mail notice to anyone who currently has a case before this Court. If you receive an e-mail with a subject line that includes the text, 'Notice of Deficiency #' followed by a series of numbers or 'US Tax Petition,' along with a malformed docket number following the format #000-000, and a sender address of noreply@ustaxcourt.org, complaints@ustaxcourt.org, or notice@ustaxcourt.org, please ignore/delete the e-mail and do not click any link within the e-mail message." Although this notice is good advice, one would hope that the Justice Department would also institute a program, provided by many e-commerce sites, to allow these e-mails to be reported so that the perpetrators can be apprehended through tags on the e-mails.

FARM INCOME TAX, ESTATE AND BUSINESS PLANNING SEMINARS
by Neil E. Harl

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Spend a week in Hawai'i in January 2009 and attend a world-class seminar on Farm Income Tax, Estate and Business Planning by Dr. Neil E. Harl. The seminar is scheduled for January 6-10, 2009 at the spectacular ocean-front Outrigger Keauhou Beach Resort on Keauhou Bay, 12 miles south of the Kona International Airport on the Big Island, Hawai'i.

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The Agricultural Law Press has made arrangements for substantial discounts on partial ocean view hotel rooms at the Outrigger Keauhou Beach Resort, the site of the seminar. The seminar registration fee is $645 for current subscribers to the *Agricultural Law Digest,* the *Agricultural Law Manual* or the *Principles of Agricultural Law*. The registration fee for nonsubscribers is $695. For more information call Robert Achenbach at 541-466-5544 or e-mail at robert@agrilawpress.com.

AALA ANNUAL AGRICULTURAL LAW SYMPOSIUM

The American Agricultural Law Association is holding its 29th annual Agricultural law Symposium on October 13 & 14, 2008 at the Marriott Hotel in downtown Minneapolis, MN.

Topics will include annual updates on bankruptcy, income and estate tax, federal farm programs, food safety and environmental law. Special panel presentations are being planned for topics of special interest to Minnesota and Midwest practitioners, as well as panel discussions on national agricultural law topics.

More information can be found on the AALA web site http://www.aglaw-assn.org or by contacting Robert Achenbach, AALA Executive Director at RobertA@aglaw-assn.org or by phone at 541-466-5444.