

Chapter 5: Agricultural Issues and Rural Investments

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Note. Corrections were made to this workbook through January of 2024. No subsequent modifications were made. For terms used in this chapter, see the **Acronyms and Abbreviations** section following the index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

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DEDUCTING RESIDUAL (EXCESS) SOIL FERTILITY

While the practice of deducting residual soil fertility costs has been utilized for some time, the recent increase in farmland values and fertilizer prices has encouraged some farmland buyers to allocate part of the total purchase price of the farmland to fertilizer that the seller applied before the purchase. The same practice may also occur when the owner dies with part of the fair market value (FMV) of the land at the date of death being allocated to fertilizer that was applied before death. Such an allocation (either upon purchase or upon death) will allow a deduction for the value of the fertilizer rather than the full acquisition value being solely attributed to the land's basis. The concept is known as deducting "residual soil fertility." If the taxpayer can show that fertilizer or nutrients applied to the land are a separate asset that can be distinguished from the soil, and can establish their FMV, part of the purchase price of the land can be allocated to the fertilizer or nutrients and recovered through depreciation deductions.

Caution. Calculations for this deduction should be performed by an agronomist. Tax preparers must consider the reasonableness of the information provided in preparing the return.

RULES FOR ALLOCATION

When a group of assets that constitute a trade or business is purchased, the buyer must use a residual method to allocate the purchase price among the assets.¹ The seller must follow the same allocation rules to report gain or loss.² Depreciation can be claimed on depreciable assets associated with the farmland starting with the first tax year in which possession of the land is taken or the assets are placed in service. Under IRC §1060, the amount claimed is tied to the portion of the total cost of the farmland that can be allocated to any depreciable asset, such as fencing, field drainage tile, grain storage facilities, farm buildings, and irrigation equipment, just to name a few of the more common depreciable items.

Note. The seller must use the same allocation rules as the buyer to report gain or loss on the sale of a group of assets that constitute a trade or business as defined by Treas. Reg. §1.1060-1(b)(2)(i).

¹. IRC §1060.

². Ibid.

Note. The IRS implements allocations under §1060 via Form 8594, *Asset Acquisition Statement Under Section 1060*. Form 8594 sets forth the allocations to seven classes of assets. Form 8594 is used by both the seller and buyer of a trade or business group of assets to report such a sale if goodwill or a going concern value applies or could apply to the assets being sold.

Most farmland sales are **not** subject to the allocation rules of §1060 unless the land is purchased with a group of assets constituting a trade or business. Thus, while the parties to the sale transaction do not need to file Form 8594 to report the purchase price allocation, the buyer must allocate the purchase price to determine the income tax basis in the land and each depreciable improvement on the land.³ Likewise, the seller must allocate the purchase price for purposes of gain allocation between the land and any improvements on the land based on the ratio of the FMV of each item purchased (land and improvements) to the total combined FMV of the assets.⁴

Note. Even if taxpayers do not need to file Form 8594, many states require buyers and sellers of real estate to report the transaction and identify the parties to the transaction. If the parties made the same allocations, they are less likely to be challenged.

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If the parties to the transaction have adverse interests and the transaction is a bona fide arm's length transaction, a court will generally honor the manner in which the parties allocate the purchase price among the assets purchased in a group.⁵ Likewise, if those conditions are met, the IRS will also honor the allocation.⁶ Other than for related party sales, most farmland sales involve parties with adverse interests. **The buyer wants to allocate as much of the purchase price to depreciable assets and the seller wants to allocate as little as possible to those assets to avoid ordinary gain recognition. Conversely, the buyer wants to allocate as little as possible to land because it is non-depreciable, but the seller wants to allocate as much as possible to land to trigger capital gain rather than ordinary gain recognition.**

Deduction

IRC §180 allows a taxpayer engaged in the trade or business of farming to annually elect (by deducting the expense on the return) to deduct the cost of fertilizer, lime, potash, or other materials which enrich, neutralize, or condition land used in farming that has been either purchased or acquired during the tax year.⁷ Under the definition, a “farmer” is one who cultivates, operates, or manages a farm for gain or profit, either as owner or tenant. For a landlord, if the rent is based on production, the landlord meets the definition of a “farmer” for this purpose. A landlord receiving a fixed amount of rent will not satisfy the definition unless the landlord participates to a material extent in the operation or management of the farm.

Note. The §180 election is effective for one year, and once it is made it may only be revoked with the IRS's consent.⁸

³. Treas. Reg. §1.167(a)-5.

⁴. Treas. Reg. §1.61-6(a).

⁵. See, e.g., *Black Industries, Inc. v. Comm'r*, TC Memo 1979-61 (Feb. 22, 1979).

⁶. See IRS Pub. 225, *Farmer's Tax Guide* (2022), p. 33 for a further discussion of allocating the basis of acquired assets.

⁷. For this purpose, the definition of a “farmer” is set forth in Treas. Reg. §1.180-1(b) which cross references Treas. Reg. §1.175-3.

⁸. Treas. Reg. §1.180-2.

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If fertilization costs are not expensed, they are required to be capitalized (similar to field drainage tile or fencing expense deductions being amortized over a presumed useful life). This means residual soil fertility is a **capital asset** in the hands of an operating farmer, crop-share landlord, or cash rent landlord when farmland is acquired, with the cost amortized over the useful life of the asset. That useful life is typically three to four years. The general 15-year amortization rules do not apply because this is an acquisition of tangible, not intangible, property. Instead, the IRS position is that fertilizer costs should be amortized based on the percentage of use or benefit each year. That likely means that straight-line depreciation does not apply. An agronomist or other soil scientist may be able to provide sufficient information so that the property annual expense allocation can be determined.⁹

Note. A tax practitioner should follow the agronomist's report, when available.¹⁰ Usually, about 60% is deducted in the first year, with 30% deducted in the second year and the last 10% deducted in the third year. Using straight-line depreciation would result in recognizing deductions in a slower manner. Given the potential difficulties of measuring costs utilized annually, straight-line depreciation may be an acceptable alternative.

For farmland inherited from a decedent, the date of the decedent's death is the measurement date for determining whether residual soil fertility exists.¹¹ If it does, the FMV of the fertility can be depreciated by the decedent's estate or the beneficiaries of the estate that receive the farmland.



Practitioner Planning Tip

There is no IRS guidance on **how** to amortize fertility. Logically, the amount for excess fertility would be reported on Form 4562, *Depreciation and Amortization*, because that is where capitalization and amortization are typically reported. An appropriate approach would be to deduct the excess fertilizer supply on Schedule F, *Profit or Loss From Farming*, or Form 4835, *Farm Rental Income and Expenses*, as part of the overall deduction for fertilizer. This requires the tax practitioner to separately track the deduction. IRC §180 is the only election but it applies only to the deduction for **purchased** fertilizer. The deduction is actually more similar to IRC §611 dealing with depletion, for which there is no form.

⁹ See, e.g., IRS Pub. 225, *Farmer's Tax Guide* (2022), Chapter 4.

¹⁰ Ibid.

¹¹ IRC §180(a).

IRS GUIDANCE

The IRS issued Technical Advice Memorandum (TAM) 9211007¹² providing guidance on the deductibility of residual fertilizer supply and emphasizing that the taxpayer claiming the deduction must have beneficial ownership of the fertilizer. Under the facts involved, a corporation was owned by shareholders A and B. The corporation bought buildings, irrigators, pumps, wells, grain bins, and “residual fertilizer supply” on land that the shareholders purchased in their individual names. The shareholders leased the land to the corporation through a 1-year lease that automatically renewed unless notice of termination was given. The corporation amortized the value allocated to the residual fertilizer supply over seven years. The IRS determined that the corporation could not claim any amortization deduction because it was not the beneficial owner of the fertilizer.¹³

Note. The TAM does not discuss claiming a deduction for the residual supply under §180 because the residual supply was amortized over seven years.

In addition to beneficial ownership of the residual fertilizer supply, the IRS also specified in the TAM that the taxpayer must do the following.

1. Establish the presence and the extent of the fertilizer
2. Show the level of soil fertility attributable to the fertilizer applied by the prior owner
3. Provide a basis upon which to measure the increase in fertility in the land
4. Provide evidence indicating the period over which the fertility attributable to the residual fertilizer will be exhausted

In 1995, the IRS published a Market Segment Specialization Program (MSSP) addressing residual soil fertility.¹⁴ In the MSSP, the IRS notes that a deduction for residual fertilizer supply will be denied unless the taxpayer can establish the following.

1. Beneficial ownership of the residual fertilizer supply
2. The presence and extent of the residual fertilizer
3. That the residual fertilizer supply is actually being exhausted

In addition, the MSSP instructs IRS examining agents to make sure that the values assigned to depreciable farm assets are reasonable.

Note. If a deduction for residual fertilizer supply is taken under §180, the taxpayer does not need to provide evidence of the period over which the fertility of the fertilizer will be exhausted. This requirement applies to amortization. IRC §180 does not require the taxpayer to establish that the fertilizer (or other soil conditioner) is being exhausted.

¹² TAM 9211007 (Dec. 3, 1991).

¹³ See also *Helvering v. F. & R. Lazarus & Co.*, 308 U.S. 252 (1939).

¹⁴ IRS MSSP, *Guideline on Grain Farmers* (Training 3149-133, Jul. 1995).

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Points on the Requirements

Some additional points about the requirements set forth in the TAM and the MSSP can be made.

- **Beneficial ownership.** Where the fertilizer and the land are purchased by the same taxpayer as the farm operator (e.g., farm tenant buys the farmland), a showing of beneficial ownership of the fertilizer will not be an issue.
- **Presence and extent of fertilizer.** A taxpayer claiming a deduction for residual fertilizer supply should hire an agronomist to conduct soil tests and document the presence and extent of soil nutrients. Documenting the soil sampling procedure is critical, and the sampling should occur before the taxpayer applies any additional fertilizer. If possible, soil samples should be taken at the time of purchase. For farmland that is inherited, the sampling should occur before any new fertilization is applied.

Note. If farmland has an actual **excess** soil fertility base, it will normally bring a price premium upon sale.¹⁵ That is the same rationale that applies when farmland with fences, field drainage tile, and grain storage facilities is purchased — a price premium applies to factor in the existence of those assets. As for residual fertilizer supply, the excess amount can be measured by **grid sampling**. A buyer can anticipate that grid sampling will likely cost \$15–\$30 per acre. Agronomists and agricultural soil testing labs follow certain guidelines and procedures to determine average (base) soil fertility for various soil types. Once grid soil samples are obtained, the fertility levels of those samples are compared to the base fertility guideline levels for particular soil types to establish the amount of “excess” fertility on a tract of acquired farm real estate.

- **Level of fertility attributable to prior owner.** Having the soil tested at the time of purchase will distinguish the fertilizer level in the soil at the time of purchase.
- **Basis to measure increase in fertility.** This is difficult to establish because of the variability of soil fertility in general. The key is to obtain data for the established base soil fertility for the type of soil on the purchased farmland from comparable tracts and comparable soil types. By establishing the base soil fertility, the actual sampling on the purchased property will reveal whether excess residual fertilizer is present. But a taxpayer should be prepared for the IRS to counter with its own soil analysis showing a different base fertility level.

Note. There is little IRS guidance on what an acceptable baseline is for measuring residual fertilizer supply or excess available nutrients.

- **Period of exhaustion.** This depends on the types of nutrients, soil, crop rotations, etc. A professional agronomic report will be needed to establish the exhaustion period.

AMOUNT OF DEDUCTION

The actual deduction might be less than the agronomist’s value of the excess amount. If the land’s value combined with the value of the excess fertility exceeds the purchase price of the land, an allocation must be done for each one based on their respective FMVs.¹⁶

Example 1. Bill buys farmland for \$8,000 per acre. An agronomist values the excess fertility at \$4,000 per acre. Comparable land in the area without excess fertility sells for \$7,000 per acre. When the \$4,000 per acre for excess fertility is added to the land value without excess fertility, the total is \$11,000. Thus, the land is 63.6% ($\$7,000 \text{ sale price without excess fertility} \div \$11,000 \text{ total cost}$) of the total value, and the excess fertility is 36.4% ($\$4,000 \text{ excess fertility} \div \$11,000 \text{ total cost}$). A reasonable deduction would be \$2,912 per acre ($36.4\% \times \$8,000 \text{ purchase price}$) as the deduction for excess fertilizer supply, not the \$4,000 per acre that the agronomist determined.

¹⁵ IRS MSSP, *Guideline on Grain Farmers* (Training 3149-133, p. 12-1, Jul. 1995).

¹⁶ Ibid.

DOCUMENTATION

While the IRS does not require it, perhaps the best way to document the deduction for excess soil fertility is to provide for the allocation of value to the amount of above average soil fertility in the purchase contract for the farmland. In addition, a written summary of how the computation was made and the time period over which it would deplete due to crop production should be obtained from the agronomist or other expert involved. This will be beneficial for establishing the proper amortization period for the excess soil fertility and will provide substantiation of the deduction upon any subsequent IRS (or state) audit.

Example 2. Farmer buys 80 acres of land at a January auction for \$16,000 per acre. Farmer hires an agronomist to analyze fertility values resulting in a fertility valuation of \$1,500 per acre. For this soil type, the baseline fertility value is deemed to be \$300 per acre. The excess fertility amount is \$1,200 per acre (\$1,500 – \$300) and is expected to be utilized equally over three years. For the year of purchase and each of the next two years, Farmer will have an excess fertility deduction of \$32,000 (80 acres × \$1,200 = \$96,000 total fertility ÷ 3 years).

The total fertility deduction is 7.5% of the purchase price (\$1,200 excess fertility ÷ \$16,000 purchase price).

RECAPTURE

If a deduction for excess fertilizer supply is claimed and the land is later sold, the amount of the selling price **attributable to the excess fertility** will be recaptured as ordinary income similar to all other depreciable property. It does not qualify for capital gain treatment. Any remaining gain will be taxed at capital gain rates. If the taxpayer continues to own the land until death, recapture is avoided.¹⁷

APPLICATION TO PASTURE/RANGELAND

The IRS has not specifically addressed the application of §180 to pasture or rangeland. The only IRS guidance on the excess soil fertility issue is the 1991 TAM and the MSSP referenced previously. But, §180 does indicate that “land used in farming” for purposes of the provision includes “land used...for the sustenance of livestock.” So, in theory, the same concepts that apply to cropland apply to land used for grazing. However, the makeup and value of the minerals differs. With pasture and rangeland, the value of potassium and phosphorous contained in the soil is much less than the value of the same minerals in soil used to raise row crops.¹⁸ The value per unit is not the same such that the owner of the grazing land would not apply fertilizer (especially at the current high prices) to enhance the land’s value — the economics disincentivize such activity.

Native Pasture

The nutrient balance on a native pasture is very tight and there is no “excess” nutrient in a native pasture system.¹⁹ These systems are rarely, if ever, fertilized with commercial fertilizer or external manure applications, with the exception being (perhaps) for a native field that is hayed. Nitrogen can increase production and allow increased stocking rates, but is not profitable to do so. Native hay meadows are sometimes fertilized with 30-40# nitrogen and 10# phosphorous. Fertilizing native grass usually increases any cool-season grasses in the stand (e.g., Kentucky bluegrass and annual bromes) and increases broadleaves. Prescribed burning in the late spring is then recommended to set those unwanted species back the next year.

¹⁷ IRC §1250(d)(2).

¹⁸ *Livestock Production: Nutritional Value of Range Forage*. Frost, Rachel & Mosley, Jeff. The Rangelands Partnership. [rangelandsgateway.org/topics/uses-range-pastureland/nutritional-value-range-forage] Accessed on Jul. 27, 2023.

¹⁹ *Management Strategies for Rangeland and Introduced Pastures*. Bidwell, T.G. & Woods, Bob. Mar. 2017. Oklahoma State University Extension. [extension.okstate.edu/fact-sheets/management-strategies-for-rangeland-and-introduced-pastures.html] Accessed on Jul. 27, 2023.

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Native rangeland is very efficient at using nitrogen and obtains it from lightning/rainfall and non-symbiotic fixation (e.g., *Clostridium* and *Azotobacter*). There may be some symbiotic nitrogen fixation by native legumes. The year after a drought, biomass on rangeland may increase because of unused nitrogen in the soil, if rainfall is normal or above. This increase in production not only relies on moisture, but on how the pasture was managed during the year of drought.

Application

While §180 applies to grazing land, pasture grass is not the same as cropland when it comes to nutrients.²⁰ While the **concept** applies equally, the **application** does not. Given that rangeland has a lower per acre FMV than cropland, and the excess soil fertility (even if it is present and can be measured) would be less than what is present on cropland, any associated §180 deduction would likely be insufficient to justify the cost.

Caution. Some states may not follow IRS guidance on deducting excess soil fertility. Practitioners should familiarize themselves with applicable state rules.

COST SEGREGATION — AN ALTERNATIVE

As an alternative to the approach laid out previously for obtaining a deduction for residual fertilizer supply, cost segregation can identify the “available nutrients” in the soil. With a cost segregation approach, the buyer allocates part of the land’s purchase price to the land’s components on the basis of FMV.²¹

Authority exists for allocating part of the land’s purchase price to the assets acquired with the land.

- **Timber.** Treas. Reg. §1.611-3(f) allows taxpayers to use scientific methodology to allocate part of the purchase price of land to standing timber acquired with the land. Procedurally, a forester would estimate the value of the trees on the land at the time of purchase by conducting a timber “cruise.”²² The purchase price would then be allocated to the basis of the land and the basis of the timber using the FMV for each asset respectively.
- **Water rights.** The sale of land with vested water rights allows for the allocation of the purchase price between the taxpayer’s basis in the land and the water rights.²³ The allocation is allowed on the theory that a premium was paid for the land to acquire the water rights. In *Gladden*, the court remanded the case to the Tax Court for a determination of the premium that was paid. The court held that if, on remand, the Tax Court found it “impracticable or impossible” to determine the premium, the taxpayers could use the full cost basis in the land to reduce their gain on the sale of the water rights.²⁴

Note. The basis of water rights for land overlying the Ogallala formation (located in the central High Plains region) is the difference in value of land with a supply of ground water and land without a supply of ground water.²⁵

- **Sod.** Sod is a natural deposit that is depletable under §611.²⁶ Likewise, soil and loam are natural deposits.²⁷ Thus, taxpayers can claim a cost depletion allowance attributable to the sale of topsoil as a partial offset to gain realized on the transaction.

²⁰ Ibid.

²¹ See *Hospital Corporation of America v. Comm’r*, 109 TC 21 (1997); AOD 1999-008 (Aug. 30, 1999).

²² See, e.g., *Planning a timber cruise and using it*. Jun. 2011. Oregon State University. [extension.oregonstate.edu/forests/health-managment/planning-timber-cruise-using-it] Accessed on Jul. 5, 2023.

²³ Treas. Reg. §1.61-6(a). See also *Gladden v. Comm’r*, 262 F.3d 851 (9th Cir. 2001).

²⁴ Ibid, citing *Inaja Land Co., Ltd. v. Comm’r*, 9 TC 727 (1947).

²⁵ Rev. Proc. 66-11, 1966-1 CB 624.

²⁶ See, e.g., *Meyers v. Comm’r*, 66 TC 235 (1976).

²⁷ Rev. Rul. 79-411, 1979-2 CB 246.

When a farm is purchased, the cost segregation approach allows the purchase price to be allocated among the land, buildings, fences, tile lines, timber, mineral rights, and other assets purchased with the land. Then the amount allocated to the land is further allocated to the soil and the nutrients in the soil, the cost of which could then be amortized over the anticipated period of exhaustion.²⁸ In the *Hospital Corporation of America* case, the court held that taxpayers can allocate part of the cost of a building to components of the building, and depreciate the components over their respective (shorter) recovery periods.

Example 3. Kelly Ghoulish paid \$1,225,000 (\$1.2 million purchase price and \$25,000 transaction costs) for 140 acres of farmland. The land was pattern tiled and contained an old machine shed. A soil test revealed that the land had high levels of soil nutrients due to the seller spreading excess hog manure. Kelly and the seller did not enter into an agreement concerning the allocation of the purchase/selling price to the nutrients or improvements, and neither of them filed Form 8594.

Shortly after the purchase, Kelly met with her tax preparer, Gina Bogg, who told Kelly that she could allocate part of the purchase price to the tile and soil nutrients if she could establish their value. Based on that advice, Kelly located the map of the tile lines (obtained from the county National Resources Conservation Service (NRCS) office) that showed the tiling was five years old. She took the map to a tiling contractor (who was on an NRCS-approved list) who provided a written estimate that the tiling had another 50 years of usefulness and would cost (presently) \$40,000 to replace.

Kelly estimated that the FMV of the tile was \$36,364, calculated as follows.

$$\begin{aligned}
 \text{Tile FMV} &= \left(\frac{\text{Replacement cost}}{\text{Full tile lifespan}} \right) \times \text{Remaining tile lifespan} \\
 &= \left(\frac{\$40,000}{50 \text{ years remaining usefulness} + 5 \text{ years of past use}} \right) \times 50 \text{ years} \\
 &= \left(\frac{\$40,000}{55} \right) \times 50 \\
 &= \$36,364
 \end{aligned}$$

Kelly did not allocate any value to the machine shed because it was in poor shape and either needed substantial repairs to be useful or to be demolished. The tile has a 15-year class life and is eligible property for IRC §179 expensing, bonus depreciation, or modified accelerated cost recovery system (MACRS) regular depreciation.

Kelly paid \$4,000 to an agronomist to analyze the soil. The agronomist took the results of soil samples and compared them with what the state land grant university recommended as optimal for the various soil types of the land that Kelly purchased. The agronomist valued the available nutrients in excess of the suggested optimal amount by multiplying that excess by what it would cost Kelly to buy and apply that amount of excess. The agronomist then determined the period of time it would take Kelly to use up the excess amount based on the crops she would plant in a normal crop rotation for the area if she did not add any additional nutrients to the soil. Kelly took the agronomist's report and estimated the FMV of the various soil nutrients on a per acre basis to be \$450, or \$63,000 for the 140 acres. Lastly, Kelly hired an appraiser to provide her with an estimate of the FMV of comparable farmland without pattern tiling and without excess nutrients. The appraisal came in at \$1.1 million.

²⁸ *Hospital Corporation of America v. Comm'r*, 109 TC 21 (1997).

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Kelly gave this information to Gina. Gina allocated the \$1,225,000 purchase price as follows.

Land (including transaction costs)	\$1,125,636
Field tile	36,364
Excess fertility	63,000
Total purchase price	\$1,225,000

The excess fertility was further defined by each soil nutrient based on the FMV of each. The allocated purchase price to each particular soil nutrient identified by the agronomist was depreciated based on the exhaustion period the agronomist specified.

Kelly's potential tax savings to help pay for the farmland investment from this allocation process amount to \$270 per acre, calculated as follows.

FMV of nutrients ($\$450 \times 140$ acres)	\$63,000
FMV of tile	36,364
Depreciable costs	\$99,364
Tax rate ^a	38%
Potential tax savings	\$37,758
	$\div 140$
Potential savings per acre	\$ 270

^a 22% federal rate $\times$ 80% qualified business income deduction (QBID) + 15.3% self-employment tax rate + 5.1% state tax.

BUY-SELL AGREEMENTS

A buy-sell agreement is a frequently used mechanism by a closely held farming or ranching business (as well as many non-farm businesses) to integrate the needs and capabilities of the business with the succession planning and transition objectives of the owners. A well-drafted buy-sell agreement can be a very useful document to assist in transitioning a family business from one generation to the next. It can also be a useful device for balancing out inheritances among heirs by ensuring the heirs interested in running the family business end up with control of the business and other heirs end up with non-control interests.

Common events that trigger buy-sell agreements are death, divorce, or bankruptcy. A buy-sell agreement can effectively provide a market for the ownership interests, limit transferability of those interests outside the immediate family, and establish a procedure for buying a deceased owner's interests which, in turn, can aid in establishing certainty as to the value of the shares for federal estate tax purposes. Likewise, when utilized properly, a buy-sell agreement may also provide estate tax valuation discounts.

Note. A buy-sell agreement is typically a separate document, although some (or all) of its provisions may be incorporated in its bylaws, the partnership agreement, the limited liability company (LLC) operating agreement and, on occasion, in an employment agreement with owner-employees. For many small businesses, a well-drafted buy-sell agreement is perhaps just as important as a will or trust. It can be the key to passing on the business to the next generation successfully.

VALUATION

While very few farming and ranching operations (and small businesses in general) are subject to the federal estate tax because of the current level of the exemption, some are.²⁹ For those that are, in addition to providing a market for closely held shares at a determinable price, the buy-sell agreement can serve as a mechanism for establishing the value of the interest for estate tax purposes — or otherwise establish the value of the decedent's interest at death.

General Rule³⁰

In general, the value of a closely held business (or other property) is determined without regard to any option, agreement, or other right to acquire or use the property at a price less than the FMV of the property, or any restriction on the right to sell or use the property.

Exception. A buy-sell agreement can establish the value of a deceased owner's interest if six basic requirements are satisfied. Three of the requirements are statutory³¹ and three have been judicially created. The statutory requirements specify that the buy-sell agreement must:

1. Be a bona fide business arrangement;³²
2. Not be a device to transfer property to members of the decedent's family for less than full and adequate consideration in money or money's worth;³³ and
3. Contain terms that are comparable to other arrangements entered into by persons in an arm's length transaction.³⁴

A buy-sell agreement must satisfy each of the three statutory requirements if family members own 50% or more of the property subject to the restriction. An agreement is deemed to satisfy all three of the statutory requirements if more than 50% percent of the value of the property subject to the restriction is owned directly or indirectly by individuals who are **not** members of the transferor's family. The interests owned by the nonfamily members must be subject to the same restrictions as the property owned by the transferor.³⁵

Judicial opinions have created three additional requirements that a buy-sell agreement must satisfy to be effective to establish the value of a decedent's interest.³⁶ The agreement must also meet the following requirements.

- Contain a purchase price that is fixed and determinable under the agreement
- Be legally binding during life and after death
- Be entered into for a bona fide business reason and not be a substitute for a testamentary disposition for full and adequate consideration

To establish the purchase price with certainty, an appropriate valuation method must be established. An independent party valuation will not only satisfy the requirements of IRC §2703 but also provide an estimate of the potential funding obligation and the liquidity expectations of the seller/estate.³⁷

²⁹ IRC §2010.

³⁰ IRC §2703(a).

³¹ IRC §2703(b).

³² IRC §2703(b)(1).

³³ IRC §2703(b)(2).

³⁴ IRC §2703(b)(3).

³⁵ Treas. Reg. §25.2703-1(b)(3).

³⁶ See e.g., *Estate of True v. Comm'r*, 390 F.3d 1210 (10th Cir. 2004); *St. Louis County Bank v. U.S.*, 674 F.2d 1207 (8th Cir. 1982).

³⁷ See Rev. Rul. 59-60, 1959-1 CB 237, as amplified by Rev. Rul. 83-120, 1983-2 CB 170.

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Business Purpose. The courts have indicated that preserving a business with family control for purposes of continuity and management can serve as a bona fide business arrangement.³⁸ This includes planning for the future liquidity needs of the decedent's estate.³⁹ But an entity that consists only of marketable securities is not a bona fide business arrangement.⁴⁰ The long-established position of the IRS is that:

*It is always necessary to consider the relationship of the parties, the relative number of shares held by the decedent, and other material facts to determine whether the agreement represents a bona fide business arrangement or a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth.*⁴¹

Note. The business reasons for executing the buy-sell agreement should be documented.

Nondevice. The buy-sell agreement must not simply be a device to reduce estate tax value. This requires more than expressing a desire to maintain family control of the business.⁴²

Comparable Terms. This requirement is satisfied if the agreement is one that unrelated parties in the same line of business could have reached in an arm's length transaction.⁴³ This fair bargain standard is typically based on expert opinion testimony.

TYPES OF AGREEMENTS

There are three basic types of buy-sell agreement:

1. Redemption
2. Cross-purchase
3. Hybrid

Redemption Agreement

A redemption agreement is also known as an "entity purchase" agreement. It is a contract between the owners of the business and the business whereby each owner agrees to sell their interest to the business upon the occurrence of certain events. For redemption agreements, if the requirements of IRC §§302(b) and 303 are not satisfied, the redemption is taxed as a dividend distribution (ordinary income without recovery of basis) to the extent of the stockholder's allocable portion of current and accumulated earnings and profits, without regard to the stockholder's basis in their shares. This can be a significant problem for post-mortem redemptions. The estate of a deceased shareholder would normally receive a basis in the shares equal to their value on the date of death or the alternate valuation date. Thus, dividend treatment can result in the recognition of the entire purchase price as ordinary income to a redeemed estate, whereas sale or exchange treatment results in recognition of no taxable gain whatsoever.

³⁸ See *St. Louis County Bank v. U.S.*, 674 F.2d 1207 (8th Cir. 1982); *Estate of Lauder v. Comm'r*, TC Memo 1992-736; *Estate of Gloeckner v. Comm'r*, 152 F.3d 208 (2nd Cir. 1998).

³⁹ *Estate of Amlie v. Comm'r*, TC Memo 2006-76 (Apr. 17, 2006).

⁴⁰ *Holman v. Comm'r*, 601 F.3d 763 (8th Cir. 2010).

⁴¹ Rev. Rul 59-60, 1959-1 CB 137. See also *Estate of True v. Comm'r*, TC Memo 2001-167, *aff'd.*, 390 F.3d 1210 (2004); *Estate of Blount v. Comm'r*, TC Memo 2004-116 (Oct. 31, 2005).

⁴² See, e.g., *Estate of True v. Comm'r*, 390 F.3d 1210 (10th Cir. 2004); *Estate of Lauder v. Comm'r*, TC Memo 1992-736 (1992).

⁴³ Treas. Reg. §25.2703-1(b)(4).

Cross-Purchase Agreement

This type of agreement is a contract between or among the owners (the business is not necessarily a party to the agreement) whereby each owner agrees to sell their shares to the other owners on the occurrence of specified events. With a cross-purchase agreement, unless the shareholder is a dealer in stock, any gain on the sale is a capital gain regardless of the character of the corporation's underlying assets.⁴⁴ For an estate that sells the stock shortly after the shareholder's death, no gain is recognized if the agreement sets the sale price at the date of death value.⁴⁵ The purchasing shareholders increase their basis in their total holdings of corporate stock by the price paid for the shares purchased under the agreement, even if the shares are paid for with tax-free life insurance proceeds.

Hybrid Agreement

Sometimes businesses use a hybrid agreement. This type of agreement is a contract between the business and the owners whereby the owners agree to offer their shares first to the corporation and then to the other owners on the occurrence of certain events. Under a "wait and see" type of buy-sell agreement, the identity of the purchaser is not disclosed until the actual time of purchase as triggered in the agreement. The corporation will have the first opportunity to purchase shares, followed by the remaining shareholders. Finally, the corporation may be obligated to buy any remaining shares.

If an S corporation election is in place, the corporate income is taxed to the shareholders and can be withdrawn from the corporation to fund a cross-purchase agreement without triggering additional tax. If the triggering event is something other than death, a cross-purchase agreement is required to achieve an increased cost basis to the purchasing shareholder(s). A hybrid agreement requires the corporation to redeem only as much stock as will qualify for a sale or exchange treatment under §303, and then requires the other shareholders to buy the balance of the available stock. This permits the corporation to finance part of the purchase price to the extent required to pay estate taxes and expenses, and assures the sale or exchange treatment on the entire transaction.⁴⁶

A buy-sell agreement that imposes employment-related restrictions may create ordinary compensation income (without recovery of basis).⁴⁷ However, an agreement containing transfer restrictions that are sufficient to render the stock substantially non-vested (substantial risk of forfeiture) may prevent the current recognition of ordinary income.

FUNDING APPROACHES

To be operational, the parties to the agreement must have funds available to buy the stock at the time the agreement is triggered. It is possible to use the business's accumulated earnings to fund a redemption. Such a strategy may not be treated as a "reasonable need of the business," with the result that the business (if it is a C corporation) could be subject to the **accumulated earnings tax**.⁴⁸ However, corporate accumulations used to pay off a note given to a stockholder for a redemption is a reasonable need of the business as a debt retirement cost.⁴⁹

Life Insurance

Typically, life insurance is purchased for each business owner to cover the total purchase price (or at least the down payment of coverage). However, the premiums on such policies are not deductible⁵⁰ and can create a substantial ongoing expense.

⁴⁴ IRC §1221.

⁴⁵ IRC §§1014 and 2032.

⁴⁶ IRC §303(b)(3).

⁴⁷ IRC §83.

⁴⁸ IRC §531.

⁴⁹ See *Smoot Sand & Gravel Corp. v. Comm'r*, 274 F.2d 495 (4th Cir. 1960), cert. denied, 362 U.S. 976 (1960).

⁵⁰ See IRC §264.

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Corporate-Owned Policy. One approach is for the corporation to buy a life insurance policy on the life of each stockholder, with the corporation as the policy owner, premium payor, and beneficiary of these policies. The corporation would then use the life insurance to finance the purchase if, at the end of the first option period, the corporation buys the deceased stockholder's interest. Alternatively, the corporation could lend the insurance proceeds to the stockholders if, at the end of the corporate option period, it is decided that the surviving stockholders should be the buyers (or to the extent stock remained to be purchased after the corporation's option expires). Investment payments would be deductible to the stockholders and considered income to the corporation.

Shareholder-Owned Policy. An alternative approach is for each shareholder to buy, pay for, own, and be the beneficiary of a life insurance policy for each of the other shareholders. The surviving shareholders would then receive the proceeds when one shareholder dies, and, if a cross-purchase is indicated and appropriate, use the proceeds as the necessary funds to carry out the buy-sell agreement. The surviving shareholders could also lend the proceeds to the corporation if a redemption agreement is utilized to enable the corporation to buy additional shares. Alternatively, the surviving shareholders could make capital contributions, which would have the effect of increasing each shareholder's stock basis.

Observation. Generally, the cash value of a permanent life insurance policy may be withdrawn by a loan or surrender of the policy, but the value may be a very small percentage of the death benefit, making it inadequate to finance the buy-out. Disability insurance may be used to finance a purchase occasioned by an owner's disability, but it can be quite expensive. Furthermore, it cannot be applied toward the purchase of an interest of an owner who is retiring, or be used to prevent the sale of an interest in the business to a buyer outside the family unit.

Other Approaches. A combination of the above approaches could also be used for funding the wait-and-see buy-sell agreement. For example, the corporation could own cash value life insurance, and the owners could own term insurance. Also, the parties could have a split-dollar arrangement whereby the corporation pays for the cash value portion of the premiums and the shareholders own the policy and pay for the term portion of the premiums, with the proceeds split between them.

Potential Problem. One potential problem of a corporation being the beneficiary of a life insurance policy designed to fund the buy-out of the shares of a deceased shareholder is that the IRS could argue the policy proceeds are included in the corporate value. In *Estate of Blount v. Comm'r*,⁵¹ the issue was whether the insurance proceeds were contractually tied to the redemption of corporate shares treated as corporate property for valuation purposes. The decedent owned 83% of the stock in a corporation at death. There was a life insurance policy owned by the company that provided some \$3.1 million to pay off the mandated buyout of the shares under a buy-sell agreement, providing for a fixed value of the decedent's shares. The buy-sell agreement value was held not to be controlling for estate tax purposes, mainly because the deceased owned 83% of the stock and could have changed the agreement at any time. Furthermore, the court determined that the buy-sell agreement was not similar to those involved in arm's length transactions.

The 11th Circuit reversed on the basis that the redemption obligation of the buy-sell agreement was a liability offsetting the value of the death benefits used to fund the redemption.⁵² Thus, even if the death benefits were included in the corporate value, there was a corresponding offsetting liability that would be accounted for by a "reasonably competent businessperson interested in acquiring the company."⁵³

Note. In the *Cartwright* decision preceding the Tax Court's decision in *Blount*, the Ninth Circuit court deducted the insurance proceeds from the value of the organization when they were offset by an obligation to pay those proceeds to the estate in a stock buyout.⁵⁴

⁵¹ *Estate of Blount v. Comm'r*, TC Memo 2004-116 (May 12, 2004).

⁵² *Estate of Blount v. Comm'r*, 428 F.3d 1338 (11th Cir., 2005).

⁵³ *Ibid.*

⁵⁴ *Cartwright v. Comm'r*, 183 F.3d 1034 (9th Cir., 1999).

The issue in *Blount* and *Cartwright* resurfaced in *Connelly v. U.S.*⁵⁵ In *Connelly*, two brothers were the only shareholders of a closely held family roofing and siding materials business. They entered into a stock purchase agreement that required the company to buy back shares of the first brother to die. The company then purchased about \$3.5 million in life insurance coverage to ensure it had enough cash to redeem the stock. The brother holding the majority of the company's shares (77.18%) died on October 1, 2013. The company received \$3.5 million in insurance proceeds. The surviving brother chose not to buy his shares, so the company used a portion of the proceeds to buy the deceased brother's shares from his estate for \$3 million pursuant to a sale and purchase agreement. Under the agreement, the estate received \$3 million, and the decedent's son received a 3-year option to buy company stock from the surviving brother. If the surviving brother sold the company within 10 years, the brother and decedent's son would split evenly any gain from the sale.

The estate valued the decedent's stock at \$3 million and included that amount in the taxable estate. Upon audit, the IRS asserted that the FMV of the decedent's corporate stock should have factored in the \$3 million in life insurance proceeds used to redeem the shares. This would have resulted in a higher value of the decedent's stock than was reported. The IRS assessed over \$1 million in additional estate tax. The estate paid the deficiency and filed a refund claim in federal district court.

The district court noted that a stock-purchase agreement is respected when determining the FMV of stock for estate tax purposes upon satisfying the requirements of §2703(b) (as noted previously) and the additional judicially created requirements (also noted previously). The IRS expert claimed that the insurance proceeds should be included in the company's value as a nonoperating asset. Allowing the redemption obligation to offset the insurance proceeds undervalued the company's equity and the decedent's equity interest in the company, and would create a windfall for a potential buyer that a willing seller would not accept. The IRS expert concluded that the FMV of the company was \$6.86 million rather than \$3.86 million. The IRS also claimed that the stock purchase agreement failed to control the value of the company. The estate claimed that the company sold the decedent's shares at FMV and that the shares had been properly valued. Thus, according to the estate, the \$3 million in life insurance proceeds were properly excluded from the decedent's estate based on the appellate opinion in *Blount*. The estate claimed that the stock purchase agreement provided a sufficient basis for the court to accept the estate's valuation as the proper estate-tax value of the decedent's shares. On that point, the IRS claimed that the stock purchase agreement was not a bona fide business arrangement and, as such, did not control the value of the decedent's stock. The IRS's position was that the stated estate planning objectives of the stock purchase of continued family ownership of the company were insufficient to make it a bona fide business arrangement, particularly because the brothers did not follow it by disregarding the agreement's pricing mechanisms.

The district court did not rule on the bona fide business arrangement issue because it determined that the estate had failed to show that the stock purchase agreement was not a device to transfer wealth to the decedent's family members for less than full-and-adequate consideration. The process that the surviving brother and the estate used in selecting the redemption price bolstered the court's conclusion that the stock purchase agreement was a testamentary device. They also did not obtain an outside appraisal or professional advice on setting the redemption price, thereby disregarding the appraisal requirement set forth in the agreement. The district court also noted that the agreement did not provide for a minority interest discount for the surviving brother's shares or a lack of control premium for the decedent's shares, with the result that the decedent's shares were undervalued. According to the district court, this also demonstrated that the stock purchase agreement was a testamentary device to transfer wealth to the decedent's family members for less than full-and-adequate consideration and was not comparable to similar agreements negotiated at arm's length.

⁵⁵ *Connelly v. U.S.*, No. 4:19-cv-01410-SRC, 2021 U.S. Dist. LEXIS 179745 (E.D. Mo. Sep. 21, 2021).

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On the issue of whether the life insurance proceeds should be included in the corporate value, the court rejected the appellate court's approach in *Blount*, finding it to be analytically flawed. The court concluded that the appellate court in *Blount* misread Treas. Reg. §20.2031-2(f)(2), and that the regulation specifically requires consideration to be given to nonoperating assets, including life insurance proceeds, "to the extent such nonoperating assets have not been taken into account in the determination of net worth." The district court concluded that the text of the regulation does not indicate that the presence of an offsetting liability means that the life insurance proceeds have already been "taken into account in the determination of a company's net worth." The court also concluded that, "by its plain terms, the regulation means that the proceeds should be considered in the same manner as any other nonoperating asset in the calculation of the FMV of a company's stock... and... a redemption obligation is not the same as an ordinary corporate liability."

There is a difference, the court noted, between a redemption obligation that simply buys shares of stock, and one that also compensates for a shareholder's past work. One that only buys stock is not an ordinary corporate liability — it does not change the value of the corporation as a whole before the shares are redeemed. It involves a change in the ownership structure with a shareholder essentially "cashing out." The court noted that the parties had stipulated that the decedent's shares were worth \$3.1 million, aside from the life insurance proceeds. The insurance proceeds were not offset by the company's redemption obligation and, accordingly, the company's FMV and the decedent's shares included all of the insurance proceeds. The IRS position was upheld.

On appeal, the U.S. Court of Appeals for the 8th Circuit affirmed.⁵⁶ The appellate court held that the stock purchase agreement requiring the redemption of a deceased shareholder's shares did not affect the value of the shares for estate tax purposes under §2703 because it did not provide for a fixed price or a formula for arriving at one. Instead, the agreement merely laid out two mechanisms by which the brothers might agree on a price - mutual agreement or appraisal. As for the appraisal approach, there was nothing in the agreement that fixed or prescribed a formula or measure for determining the price that the appraisers would reach. Thus, neither mechanism constituted a fixed or determinable price for valuation purposes. The appellate court determined that the \$3 million that the corporation actually paid for the deceased brother's shares constituted an amount determined after death that was derived by an agreement between the brothers and not by any formula in the buy-sell agreement.

As for the value of the corporation (and, hence, the deceased brother's interest in the corporation), the appellate court determined that the life insurance proceeds were an asset that increased the shareholders' equity, and that an obligation to redeem shares is **not** a liability in the ordinary business sense. Thus, the proper valuation of the corporation in accordance with IRC §§2042 and 2031 must include the life insurance proceeds without treating the obligation to redeem shares as an offsetting liability. The court reasoned, that for a willing buyer at the time of the brother's death to own the stock outright, a willing buyer would account for control of the life insurance proceeds. The buyer would therefore pay up to \$6.86 million for the corporation, "taking into account" the life insurance proceeds and then either extinguishing the agreement or redeeming the shares. Conversely, the appellate court determined that a hypothetical willing seller of the corporation would not find acceptable a price of \$3.86 million with the knowledge that the company would be receiving \$3 million in life insurance proceeds.

To illustrate its rationale, the appellate court explained that if it valued the corporation without accounting for the life insurance proceeds intended for redemption, then upon the brother's death, each share was worth \$7,720 before redemption. After redemption, the deceased brother's interest is extinguished, with the surviving brother having full control of the corporation's \$3.86 million value. The appellate court noted that this would essentially quadruple the value of the surviving brother's shares, but that treating the life insurance as an offsetting liability would leave the stock value undisturbed (which was the estate's position). The economic reality of the situation, the appellate court concluded, was that the life insurance proceeds were an asset that increased shareholders' equity. The buy-sell agreement thus had nothing to do with being a corporate liability.

Note. There is now a split on this issue between the 8th Circuit on one side, and the 9th and 11th Circuits on the other.

⁵⁶ *Connelly v. U.S.*, No. 21-3683, 2023 U.S. App. LEXIS 13629 (8th Cir. 2023).

IMPROPER USAGE OF CHARITABLE REMAINDER ANNUITY TRUSTS

A **charitable remainder trust** is an irrevocable trust to which cash or other property is transferred.⁵⁷ The trust takes a carryover income tax basis in the transferred asset(s). The trust then sells the transferred assets (the sale is not taxable because the seller is a charity) and uses the income from the sale to pay the donor or other designated person(s). The payments continue for a specific term of up to 20 years or the life of one or more beneficiaries (typically the transferor). At the end of the term, the remainder of the trust passes to at least one designated charity. The remainder donated to the charity must be at least 10% of the initial net FMV of all the property placed in the trust.

There are two types of charitable remainder trusts. The type of trust is tied to how payment from the trust is made. A **charitable remainder unitrust (CRUT) pays a percentage** of the trust value annually to noncharitable beneficiaries.⁵⁸ The payments must be at least 5% and not exceed 50% of the FMV of the trust's assets, valued annually. A **charitable remainder annuity trust (CRAT) pays a specific dollar** amount each year.⁵⁹ The amount is at least 5% and no more than 50% of the value of the trust's property, valued as of the date the trust was established.

Payments from a charitable remainder trust are taxed to the non-charitable beneficiaries.⁶⁰ The non-charitable beneficiaries report the income on Schedule K-1 (Form 1041), *Beneficiary's Share of Income, Deductions, Credits, etc.*, as distributions of the trust's income and gains.

The distributions are reported in a particular order.⁶¹

- Tier 1.** Payments are considered ordinary income first to the extent the trust had ordinary income for the year and undistributed ordinary income from prior years. This means that if the trust had enough ordinary income to cover all the payments, the payments would be are taxed as ordinary income.

Observation. It is not advisable to transfer ordinary income property to the trust — especially not ordinary income property with low or no income tax basis.

- Tier 2.** Once the trust's ordinary income is exhausted, payments are taxed as capital gains based on the sale or disposition of the trust's capital assets. The payments are taxed as capital gains to the extent of the trust's capital gain for the current year and any undistributed capital gain income from prior years.
- Tier 3.** After all the trust's ordinary income and capital gain have been distributed, any additional payments are then characterized as other income to the extent of the trust's current year and accumulated other income.
- Tier 4.** Finally, after the first three tiers of distributions have been made, any further payments are considered to be from the principal of the trust and are not taxable.

The contribution to a charitable remainder trust will qualify for a partial charitable deduction. The deduction is limited to the present value of the charitable organization's remainder interest, calculated as the value of the donated property minus the **present value** of the annuity that the trust pays to the non-charitable beneficiary (or beneficiaries).⁶² The deduction is also subject to adjusted gross income (AGI) and other limits set forth in IRC §170(e).

A charitable remainder trust must file Form 5227, *Split-Interest Trust Information Return*, every year. A beneficiary must report any income received from the trust as reported on Schedule K-1 of Form 1041.

⁵⁷ IRC §664.

⁵⁸ IRC §664(d)(2).

⁵⁹ IRC §664(d)(1).

⁶⁰ Treas. Reg. §1.664-1(d)(ii)(a).

⁶¹ Ibid.

⁶² Treas. Reg. §1.664-2(c).

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IRS CONCERNS

The IRS closely monitors the use of charitable trusts. The following are some of the issues that draw the IRS's attention.

- Inflating the basis of assets transferred to the trust and failure to account for the transfer of any assets to the trust
- Mischaracterizing distributions of ordinary or capital gain income as distributions of corpus
- Not closely following the ordering rules
- Self-dealing, making an upfront cash payment to a charitable beneficiary in lieu of the remainder interest, or a transfer of the trust's remainder interest to a non-qualified organization
- Paying personal expenses with trust funds, or borrowing funds from the trust
- Using loans or forward sales of assets or other financial schemes to hide capital gains or income in the trust

Furrer Case

In *Furrer*,⁶³ the Tax Court began its opinion by noting that the Furrers formed a CRAT, “after seeing an advertisement in a farm magazine.” The Furrers raised corn and soybeans on their Indiana farm. In July 2015, they formed the first of two CRATs, naming their son as trustee. The Furrers were the life beneficiaries, and they designated three qualified charities as remaindermen. They transferred 100,000 bushels of corn and 10,000 bushels of soybeans from their farm to the first CRAT, which then sold the grain for \$469,003. The CRAT distributed \$47,000 to the charities and used the balance to purchase a single premium immediate annuity (SPIA), which made annual payments to the Furrers of \$84,369 in 2015, 2016, and 2017. The SPIA issued a Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, to the trustee listing the annuity payments as “gross distributions” and showed a small amount of interest as the “taxable amount.” The Furrers claimed a \$47,000 charitable deduction.

The Furrers created a second CRAT in 2016, naming themselves as the life beneficiaries and seven qualified charities as the remainder beneficiaries. They also funded that trust with grain that they raised. The CRAT sold the grain for \$691,827 and distributed \$69,294 to the charities. The annuity from this trust was payable over 2016 and 2017 in the amount of \$124,921 each year. The SPIA also issued a Form 1099-R to the trustee listing the annuity payments as “gross distributions” and showing a small amount of interest as the “taxable amount.” They claimed a charitable deduction of \$69,294.

On their 2015 and 2016 returns, the Furrers did not claim charitable deductions for their transfers to the CRATs, but reported only the interest income from the SPIA, which was reported to them by the life insurance company providing the annuity. They treated the balance of the annuity distributions that they received as a nontaxable return of corpus under IRC §664(b)(4). They also reported their transfers of crops to the CRATs on Forms 709, *United States Gift (and Generation-Skipping Transfer) Tax Return*, for 2015 and 2016, which reflected the FMV of the crops with a cost basis of zero. The CRATs reported the sales of crops as sales of business property on Form 4797, *Sales of Business Property*, treating the crops as having substantial basis (derived from the purported purchase of the grain at FMV) that generated a small loss for 2015 and a small gain for 2016. Their son (as trustee) prepared the CRATs' returns.

On audit, the Furrers claimed they should be entitled to charitable deductions for the in-kind transfers of the crops that were ultimately destined for the charitable remaindermen, which were not claimed on their return. They made this claim even though they had no income tax basis in the grain that was transferred to the CRATs. The IRS Revenue Agent allowed the charitable deductions, but the IRS still issued a notice of deficiency for each year because of the omitted income from the annuity, and increased the Furrer's Schedule F income by \$83,440 in 2015, and \$206,967 in 2016 and 2017. This resulted in tax deficiencies of \$55,040 for 2015, \$56,904 for 2016, and \$95,907 for 2017. The IRS also added an accuracy-related penalty for each year.

⁶³ *Furrer v. Comm'r*, TC Memo 2022-100 (Sep. 28, 2022).

Note. A transfer of crops to a CRAT can be a good tax strategy if a charitable deduction is not desired or needed. The transfer is not a sale and avoids inclusion on Schedule F, where it also avoids self-employment (SE) tax.

At no time did the Furrers secure an appraisal (qualified or otherwise) of the crops they transferred to the CRATs. They also did not attach to their 2015 or 2016 return a completed Form 8283, *Noncash Charitable Contributions*, substantiating the gifts, and they did not maintain the written records that the regulations required. But, even had they done so, they would not have been entitled to any charitable deduction because of the lack of an income tax basis in the grain transferred to the trusts.

Note. For gifts of property (other than publicly traded securities) valued in excess of \$5,000, the taxpayer generally must obtain a qualified appraisal of the property and attach a fully completed appraisal summary on Form 8283 to the return on which the deduction is claimed.⁶⁴ A “qualified appraisal” must be prepared by a “qualified appraiser” no later than the due date of the return, including extensions.⁶⁵ The taxpayer must also maintain records substantiating the deduction.⁶⁶

After the Furrers filed the Tax Court petition, the IRS conceded the accuracy-related penalties due to lack of the immediate supervisor’s approval. But, the IRS attorneys also requested leave to amend its answer to disallow the charitable deductions that the revenue agent allowed. The Tax Court held that the IRS carried its burden of proof on the charitable deduction disallowance issue — the Furrers did not substantiate the in-kind donations and they had no income tax basis in the crops. Thus, any charitable deduction was limited to zero, regardless of whether they would have satisfied the substantiation requirements.

The IRS also maintained that the annuity distributions were fully taxable as ordinary income on the basis that the grain was inventory that the Furrers held for sale to customers in the ordinary course of their farming business. The Tax Court agreed and noted that the Furrers violated the ordering rules for income tax treatment of distributions from the CRATs. The trusts’ sale of the grain involved a sale of ordinary income property (raised grain). As a result, the annuity was purchased with the proceeds of ordinary income property, and any distributions from the trust to the Furrers retained that same ordinary income character. While the Furrers tried to apply the income exclusion rules of IRC §72 to the annuity distributions, the Tax Court noted that §664 provides a special rule for annuity distributions from CRATS that was not in their favor. In addition, even if §72 applied, the Tax Court noted that the Furrers would not have been able to use the exclusion rule because they had no “investment in the contract” – the funds used to purchase the contract had never been taxable. Among the biting comments by the Tax Court in the opinion was: “This argument does not pass the straight-face test.”

Note. Many aspects of the set-up of the CRATs were wrong, and by not accepting the adjustment made by the IRS revenue agent and filing a Tax Court petition, the Furrers ended up **losing** the charitable deductions that the revenue agent had (mistakenly) allowed. Granted, the Furrers got the accuracy-related penalty to go away, but that was achieved at the price of losing substantial charitable deductions. Whether the IRS should have conceded on the penalty issue is an open question. The Tax Court’s approach to IRS supervisory approval as a prerequisite to applying penalties has been disregarded by two Circuit Courts of Appeal. According to the 11th and 9th Circuits, supervisor approval at any time before assessment is enough to satisfy the statute.⁶⁷

⁶⁴. IRC §170(f)(11)(C).

⁶⁵. IRC §170(f)(11)(E); Treas. Reg. §1.170A-13(c)(3).

⁶⁶. Treas. Reg. §1.170A-13(b)(2)(ii)(D).

⁶⁷. See, e.g., *Kroner v. Comm’r*, 48 F.4th 1272 (11th Cir. 2022) and *Laidlaw’s Harley Davidson Sales, Inc. v. Comm’r*, 29 F.4th 1066 (9th Cir. 2022).

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Gerhardt, et al. Case

The *Gerhardt, et al.*⁶⁸ case involved facts substantially similar to that of *Furrer*. Indeed, the case involved the same promoters of the CRAT and SPIA that were involved in *Furrer*. The case involved family members in different states that contributed appreciated property, including farmland and hog buildings, to CRATs. The CRATs then sold the properties and bought 5-year SPIAs with most of the proceeds. Like the *Furrers*, the *Gerhardts* did not report the annuity payments as income except for small amounts of interest. One branch of the family exchanged their Iowa farm property including farmland, hog buildings, and equipment (plus cash) with another family member in a transaction intended to qualify as a like-kind exchange under IRC §1031.

The Tax Court held that the annuity payments were distributions taxable as ordinary income under §664, and that IRC §1245 precluded the deferral of gain realized on the disposition of the Iowa farm property. The Tax Court also noted that IRC §1015 governs transfers in trust (other than in trust by gift) and that under **either** §1015(a) or (b), the basis in the property transferred to the CRAT is what it otherwise would be in the donor's hands. Thus, like the result in *Furrer*, the Tax Court rejected the *Gerhardts*' view that the basis of assets donated to the CRAT was its FMV.

Note. The Tax Court noted that it had considered facts and arguments nearly identical in *Furrer* and had reached the same conclusion. The court also invited the *Gerhardts* to distinguish themselves from *Furrer*, but their briefs did not even mention *Furrer*, even though their legal counsel was the same person that represented the *Furrers*. The Tax Court also noted that the *Gerhardts* failed to cite even a single case in support of their position.

The Tax Court also held that §1245 property was involved in the §1031 exchange, and that §1245 precluded deferral of the gain realized. The Tax Court noted that the gain from the disposition of §1245 property is recognized as ordinary income as limited under §§1245(a) and (b). The Tax Court also noted that if both §1245 property and non-§1245 property are disposed of in the same transaction, then gain is allocated between the §1245 property and the non-§1245 property in proportion to their respective FMVs.⁶⁹ The Tax Court rejected the *Gerhardt*'s argument that §1031 trumps §1245 as to the timing of gain recognition.

Note. IRC §1245 property includes “property which is or has been property of a character subject to the allowance for depreciation provided in section 167” that is either personal property or a single-purpose agricultural or horticultural structure.⁷⁰

Observation. In early 2022, the U.S. Department of Justice filed a complaint seeking to bar the professionals involved in selling the CRATs and SPIAs involved in the *Furrer* and *Gerhardt* cases from continuing to do so. The government allegations detail the defendants' involvement with at least 70 CRATs in a scheme estimated to result in \$40 million of unreported income and \$8 million in lost tax revenue. In May 2023, a court permanently barred five defendants from promoting this CRAT tax scheme and ordered multiple parties to disgorge \$1.5 million in alleged ill-gotten gains.⁷¹

⁶⁸ *Gerhardt, et al. v. Comm'r*, 160 T.C. (2023).

⁶⁹ Treas. Reg. §1.1245-1(a)(5).

⁷⁰ IRC §§1245(a)(3)(A) and (D).

⁷¹ *Court Permanently Bars Five Defendants From Promoting Charitable Remainder Annuity Trust Tax Scheme*. May 31, 2023. U.S. Department of Justice. [www.justice.gov/opa/pr/court-permanently-bars-five-defendants-promoting-charitable-remainder-annuity-trust-tax] Accessed on Jul. 4, 2023.

FORM 1041 FOR FARM ESTATES AND TRUSTS

There are two kinds of taxes owed by an estate — the federal estate tax on the **transfer of assets** from the decedent to beneficiaries and heirs reported on Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return* and on the **income generated by assets** of the decedent's estate reported on Form 1041, *U.S. Income Tax Return for Estates and Trusts*.

Note. Form 706 can be thought of as the final “balance sheet” of the decedent, and Form 1041 can be thought of as the first “income statement” of the estate. This topic is also covered in detail in the Settling a Taxpayer's Estate section of the 2023 *University of Illinois Federal Tax Workbook*, Chapter 9: Individual Taxpayer Issues.

Observation. Most estates do not have a federal estate tax obligation because the estate does not exceed the level of the exemption equivalent of the unified credit at death (\$12,920,000 for deaths in 2023). However, Form 706 may be filed for portability purposes if there is a surviving spouse. Even if no Form 706 is filed (either for tax or portability purposes), there may be a state-level tax associated with death which will necessitate the completion of a final inventory of the decedent's assets. States that presently have either a state estate tax or state inheritance tax are as follows: CT; HI; IL; IA (through 2024); KY; ME; MD; MA; MN; NE; NJ; NY; OR; PA; RI; VT; and WA. The District of Columbia also has an estate tax.

When someone dies, their assets become property of their estate. Any income those assets generate is also part of the estate and may trigger the requirement to file an estate income tax return. Examples of assets that would generate income to the decedent's estate include savings accounts, certificates of deposit (CDs), stocks, bonds, mutual funds, farmland, business, and rental property.

Estates and non-grantor trusts must file income tax returns just as individuals do, but with some important differences. Income is taxed at either the entity or beneficiary level depending on whether it is allocated to principal or allocated to distributable income, and whether it is distributed to the beneficiaries.

For decedents that held an interest in a partnership at death, IRC §706(a) provides a general rule:

*Except in the case of a termination of a partnership and except as provided in paragraph (2) of this subsection, the taxable year of a partnership shall not close as the result of the death of a partner, the entry of a new partner, the liquidation of a partner's interest in the partnership, or the sale or exchange of a partner's interest in the partnership.*⁷²

The tax year of a partnership closes with respect to a partner whose entire interest in the partnership terminates (whether by reason of death or otherwise).⁷³ Although death may cause a dissolution of a partnership under state law principles in some states,⁷⁴ for federal tax purposes, termination occurs only when specified conditions occur. These conditions include when “no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.”⁷⁵

Note. Many farm partnerships are 2-member partnerships. In such situations, Rev. Rul. 99-6 is critical.⁷⁶ The ruling provides the applicable tax treatment when a partnership (or LLC) goes from being taxed as a partnership to becoming a disregarded entity. This occurs, for example, when a surviving partner buys out a deceased partner (or a living partner who wants to retire) and continues the partnership business.

⁷² IRC §706(c)(1).

⁷³ IRC §706(c)(2).

⁷⁴ See, e.g., Uniform Partnership Act §31.

⁷⁵ IRC §708(b)(1).

⁷⁶ Rev. Rul. 99-6, 1999-6 IRB 6.

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Ultimately, the decedent's interest in partnership income determined for the portion of the partnership tax year before death is included on the final Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.*, for the decedent and reported on the decedent's final return.⁷⁷ The post-death share of income associated with the partnership interest is reported by the transferee.⁷⁸ This results in more than one Schedule K-1 issued for the partnership interest in that year.

FORM 1041

The decedent and the decedent's estate are separate taxable entities. An **estate** is required to file Form 1041 if it has gross income of \$600 or more for the tax year (the personal exemption amount for an estate), or a beneficiary who is a non-resident alien.⁷⁹ Form 1041 is also required for a domestic trust that has any taxable income for the tax year, gross income of \$600 or more for the tax year, or a beneficiary who is a non-resident alien.

Form 1041 is used by the fiduciary of a domestic decedent's estate, trust, or bankruptcy estate to report the following.⁸⁰

- Income, deductions, gains, losses, etc. of the estate or trust
- Income that is either accumulated or held for future distribution or distributed currently to the beneficiaries
- Income tax liability of the estate or trust
- Employment tax on wages paid to household employees

The Form 1041 exemption amounts are as follows.

- Estate: \$600
- Simple trust: \$300
- All other trusts: \$100

Note. Form 1041 cannot be properly prepared without first reading the governing document(s) for provisions regarding taxation.

Computation of Gross Income

A decedent's estate figures its gross income in much the same manner as an individual. Most deductions and credits allowed to individuals are also allowed to estates and trusts. However, a trust or decedent's estate is also allowed an income distribution deduction for distributions to beneficiaries. There are generally two types of beneficiaries — income beneficiaries and remainder beneficiaries. Income distributions are reported to beneficiaries and the IRS on Schedules K-1 (Form 1041).

⁷⁷ See, e.g., Treas. Reg. §1.706-4.

⁷⁸ Ibid.

⁷⁹ IRC §1041; Instructions for Form 1041.

⁸⁰ Instructions for Form 1041.

Beneficiaries and State Tax

A determination must be made to identify which state(s) has **nexus (jurisdiction)** to tax the estate or trust. Although a will or trust may express which state's laws govern administration of the estate or trust, nexus for purposes of state taxation is usually based on the location of any real property held in the estate or trust, the principal place of the administration of the estate or trust, and transactions and other income flows involving the estate, trust, and beneficiaries. In essence, if the beneficiaries have a **present right to income or other distributions**, there may be nexus for tax purposes on the share of their interest even though the administration is in another state.⁸¹

Note. Form 56, *Notice Concerning Fiduciary Relationships*, should be filed with the IRS to ensure notices with respect to the decedent will be sent to the appropriate fiduciary. If necessary, Form 2848, *Power of Attorney and Declaration of Representative*, should also be filed under the signature of the fiduciary designated on Form 56. Care should be taken to ensure that powers of attorney for more than one person, such as an attorney and a CPA, do not supersede prior powers.

5

Filing Deadline

For **calendar-year estates and trusts**, Form 1041 and Schedule(s) K-1 must be filed on or before April 15 of the following year.⁸² For **fiscal-year estates and trusts**, Form 1041 must be filed by the 15th day of the 4th month following the close of the tax year. An automatic 5½ -month extension can be applied for if more time is needed to file the estate income tax return (Form 1041) via Form 7004, *Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns*.

Estimated Tax

In general, an estate or trust must pay quarterly estimated income tax in the same manner as individuals.⁸³ Form 1041-ES, *Estimated Income Tax for Estates and Trusts*, is used to compute and pay estimated tax. However, trusts and estates are exempt from the estimated tax requirement during the first two taxable years following the grantor's death.

Note. Shortly after death, the executor or administrator should obtain an employer identification number (EIN) for the estate. The EIN is in the format 12-345678X and can be applied for online or by fax or mail.

POSSIBLE INCOME-GENERATING ITEMS FOR AN ESTATE

Income of estates and non-grantor trusts is taxed at either the entity or the beneficiary level, depending on the answer to the following two questions.

- Is each income, loss, or deduction item part of the trust's or estate's distributable income, or is it part of a change in the principal?
- Is the income, loss, or deduction item distributed to the beneficiaries, or does the entity retain it?

Form 1041 identifies the types of income that must be included and calculated on an estate's income tax return. The instructions to Form 1041 provide detailed advice on filling out and completing Form 1041 with examples of income-generating assets. Selected types of such assets are described next.

Note. IRS Pub. 559, *Survivors, Executors, and Administrators*, provides guidance for survivors, executors, and administrators of estates, and provides discussion about income that needs to be included on Form 1041.

⁸¹. See *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*, 139 S. Ct. 2213 (2019).

⁸². Instructions for Form 1041.

⁸³. *Ibid.*

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Interest Income⁸⁴

Any type of property owned by the estate that generates interest will generally be considered an income-generating asset. Examples of assets that generate interest income include the following.

- Accounts with banks and credit unions (including CDs and money market accounts)
- Notes, loans, and mortgages
- U.S. Treasury bills, notes, and bonds
- U.S. savings bonds
- Interest earned from other assets that show up on the decedent's Form 1099-INT, *Interest Income*
- Other assets described in IRS examples

Dividends

Dividends are distributions from corporations and mutual funds paid to the decedent or estate when they own stock.⁸⁵ Ordinary dividends, typically stock, are taxable as income (i.e., not capital gains). In general, any dividend received from common or preferred stock is an ordinary dividend.

If the decedent or estate receives a Form 1099-DIV, *Dividends and Distributions*, ordinary dividends are shown in box 1a.⁸⁶ A Form 1099-DIV is issued by every payor (i.e., corporation) that provides dividends of at least \$10 in a given year.

Business Income

Business income is any income the decedent or their estate receives from their business.⁸⁷ If there is any connection between the income received and the business, it is business income. A connection exists if the income payment would not have been made if the decedent did not have the business. Business income is usually received in the form of cash, checks, and credit card charges.

Examples of business income include the following.⁸⁸

- Bartering for property or services (e.g., a lawyer who provides legal services for a fee, an artist who sells a painting)
- Real estate rents (e.g., the owner of a hotel)
- Personal property rents (e.g., the rental of vehicles, tuxedos, televisions)

Observation. If the decedent was a farmer or the decedent's estate operates a farm, the income generated from the farm must usually be reported on the estate's income tax return. The asset that generates the income is clear — it is the farm. In general, farm income usually comes from the sale of farm products (e.g., livestock and crops).

⁸⁴. Ibid.

⁸⁵. Ibid.

⁸⁶. Form 1099-DIV, *Dividends and Distributions*.

⁸⁷. Instructions for Form 1041.

⁸⁸. Ibid.

Capital Gain (or Loss)

Capital gain (or loss) is the difference in the value of an asset from when it was bought to when it was sold.⁸⁹ The net gain or loss from sales and exchanges of capital assets made by the trust or estate is reported on Schedule D (Form 1041), *Capital Gains and Losses*, and attached to Form 1041. Any net **gain** is reported on Form 1041 line 4, which flows from part III, line 19, column (3) of Schedule D. Any net **loss** is reported on line 4, which flows from part IV, line 20 of Schedule D.

Note. Schedule D, *Capital Gains and Losses* (Form 1040), *U.S. Individual Income Tax Return*, **cannot** be substituted for Schedule D, *Capital Gains and Losses* (Form 1041), *U.S. Income Tax Return for Estates and Trusts*.

Capital gains are assessed on any asset the estate or decedent owned and used for personal or investment purposes.⁹⁰ If the decedent or estate has capital gains, they will usually be taxed at a lower rate than ordinary income.

Examples of possible capital assets include the following.⁹¹

- Stocks and bonds
- Timber
- Household furnishings
- Car used for pleasure or commuting
- Coin and stamp collections
- Gems and jewelry
- Gold, silver, and other metals

Note. If an estate has a home that was recently sold, the difference in value between when it was acquired and when it was sold might be considered a capital gain reported on Schedule D (Form 1041).

Ordinary Gain

Ordinary gain is income earned from the sale of an asset that is not a capital asset.⁹² The sale of non-capital assets will result in ordinary gains or losses. Common examples of non-capital assets that can generate income include stock held mainly for sale to customers, accounts receivable acquired in the ordinary course of business, certain copyrights, harvested crops of a farmer, and supplies normally used or consumed during the normal course of business.

⁸⁹. IRC §1221.

⁹⁰. Instructions for Form 1041.

⁹¹. Ibid.

⁹². IRC §1221.

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Suggested Steps to Completing Form 1041

To complete Form 1041, it is imperative to identify each estate asset that is generating income, define the income correctly, and obtain the proper tax forms to fill out. From a procedural standpoint, the following is a suggested approach.

1. Start with interest income and work through the various income types to compute the amount of income the estate has generated in the past year.
2. Aside from using Form 1041 to see what other forms are needed, do not complete Form 1041 until later. A Schedule C, *Profit or Loss From Business* or Schedule F, for instance, may be necessary.
3. If the estate has business income reported on Schedule C (Form 1040), calculate the business's gross receipts and total expenses. Then, subtract total expenses from the gross receipts to calculate net profit to be entered on Form 1041.
4. Transfer the appropriate numbers from the schedules to the appropriate lines on Form 1041.
5. To calculate the estate's total income, add the numbers on lines 1 through 8 and enter the result on line 9 of Form 1041.

WHERE TO REPORT INCOME

Taxable income received by a cash-basis taxpayer prior to death is reported on Form 1040.⁹³ Depending on the titling of the assets in the decedent's estate, any income received after death may be reported by one of the following.

- A trust on Form 1041
- An estate on Form 1041
- The beneficiaries on their income tax returns
- The decedent's final Form 1040 if an election is made to report accrued interest on U.S. savings bonds under the IRC §454(a) election

The following table summarizes the reporting locations for the various types of post-death income.

Type of Holding	Income After Death Reported by...
Accounts with designated beneficiaries (including payable-on-death and transfer-on-death)	Beneficiaries directly
Assets owned by trusts	Trusts on Form 1041
Assets passing through probate estates	Estates on Form 1041
Assets owned jointly with the right of survivorship	Survivors directly
Assets owned under tenancy by the entirety	Surviving spouse
Assets owned by the deceased as tenants in common with another person	Estates on Form 1041
Assets owned by trusts and held as tenants in common with another person or entity	Trusts on Form 1041
Assets titled to the deceased alone with no beneficiaries or joint tenancy	Estates on Form 1041

⁹³ Instructions for Form 1040.

METHOD OF ACCOUNTING AND TAX YEAR

Taxable income for an estate is computed using the method of accounting regularly used in keeping the estate's books and records.⁹⁴ The method used must clearly reflect income. The accounting method may only be changed with IRS consent via Form 3115, *Application for Change in Accounting Method*, and filing Form 1128, *Application to Adopt, Change or Retain a Tax Year*.

The moment of death determines the end of the decedent's tax year.⁹⁵ The fiduciary selects the estate's tax period upon filing the first income tax return. The estate's first tax year may be any period of 12 months or less that ends on the last day of the month. If the last day of any month other than December is selected, a fiscal tax year is adopted.

Note. A distinguishing factor applicable to an estate is that it can elect a fiscal year other than a calendar year. Making the election might give the estate or beneficiaries a tax-deferral opportunity and provide the executor with additional time to organize the estate's affairs. This can be advantageous when the decedent dies late in the calendar year.

DEDUCTIONS

A decedent's estate is allowed the following deductions (not miscellaneous itemized deductions) in arriving at AGI.⁹⁶

- Costs paid or incurred in connection with the administration of the estate or trust that would not have been incurred if the property were not held in such estate or trust
- Deductions allowable under IRC §642(b) (concerning the personal exemption of an estate or non-grantor trust)
- Distribution deduction under IRC §651 (the deduction for simple trusts required to distribute current income)
- Distribution deduction under IRC §661 (the deduction for complex trusts)

A cost is subject to the 2% floor on itemized deductions if all the following apply.⁹⁷

- It is included in the definition of miscellaneous itemized deductions under IRC §67(b);
- It is incurred by an estate or non-grantor trust; and
- It commonly or customarily would be incurred by a hypothetical individual holding the same property.

These requirements can provide uncertainty as to how to handle some common expenses of a trust or an estate. Common areas of concern include the following.

- Ownership costs
- Tax preparation fees
- Investment advisory fees
- Appraisal fees
- Certain fiduciary expenses

⁹⁴ IRS Pub. 559, *Survivors, Executors, and Administrators*.

⁹⁵ Ibid.

⁹⁶ Ibid.

⁹⁷ Treas. Reg. §1.67-4(a)(2).

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Charitable Deduction

An estate is allowed an unlimited charitable deduction for amounts paid or treated as paid during the year for charitable purposes.⁹⁸ To be deductible, the bequest must be pursuant to the terms of the governing instrument that gives specific authority for the fiduciary to make the contribution, be from gross income, and be for a qualifying charitable purpose.

Note. The payment from gross income includes all forms of gross income (capital gain, income in respect of a decedent (IRD), etc.).

Miscellaneous Itemized Deductions

The Tax Cuts and Jobs Act (TCJA) eliminates miscellaneous itemized deductions that would have otherwise been subject to the 2% floor for tax years beginning after 2017 and before 2026.⁹⁹ However, above-the-line trust and estate administration expenses, such as fiduciary fees, are not miscellaneous itemized deductions. These amounts are reported as excess deductions on Form 1041, Schedule K-1, box 11, code A.¹⁰⁰

IRC §67(e) carves out an exception for estates and non-grantor trusts. Under the exception, certain deductions are allowable at arriving at AGI and are not subject to the 2% floor if the amount of the claimed deduction is paid or incurred in connection with the administration of the estate or trust and would not have been incurred if the property were not held in the trust or estate (e.g., a fiduciary fee, tax preparation fee for estates and non-grantor trusts). For grantor trusts, items of income and expense pass through to the grantor, and the trust is disregarded as a separate taxable entity. Thus, administration expenses for a grantor trust are attributed to the grantor/owner and are disallowed.

Note. Only the portion of a bundled fiduciary fee allocable to trust administration is considered an allowable deduction in arriving at AGI.

Non-Miscellaneous Itemized Deductions

For the final return of a trust, if there are excess deductions (i.e., total deductions, excluding the charitable deduction and the exemption, exceeding gross income) on termination that are non-miscellaneous itemized deductions, a beneficiary's share of the excess deductions should be entered in box 11, using Code B, on Schedule K-1 (Form 1041).¹⁰¹ The fiduciary should provide a descriptive statement and amount for each of the allowable non-miscellaneous deductions. The beneficiary may deduct the excess deduction on Schedule A, *Itemized Deductions*, of Form 1040. If the beneficiary does not have sufficient income in that year to absorb the entire deduction, the balance may not be carried over to a succeeding year. The amount of excess deductions in the final year is determined as follows.

- Each deduction directly attributable to a class of income is allocated in accordance with Treas. Reg. §1.652(b)-3(a).¹⁰²
- To the extent of any remaining income after application of the allocation rules under Treas. Reg. §1.652(b)-3(a), deductions are allocated in accordance with the provisions in Treas. Reg. §1.652(b)-3(b);¹⁰³ and
- Deductions remaining after the application of the first two steps comprise the excess deductions on termination of the estate and are allocated to the beneficiaries under Treas. Reg. §1.642(h)-4.¹⁰⁴

⁹⁸ IRS Pub. 559, *Survivors, Executors, and Administrators*.

⁹⁹ *Tax Cuts and Jobs Act*, PL 115-97, Title I, §11045(a), creating IRC §67(g).

¹⁰⁰ Instructions for Schedule K-1 (Form 1041).

¹⁰¹ Treas. Regs. §§1.642(h)-2(a)(1), (a)(2), and (b)(1).

¹⁰² Treas. Reg. §1.642(h)-2(b)(2)(i).

¹⁰³ Treas. Reg. §1.642(h)-2(b)(2)(ii).

¹⁰⁴ Treas. Reg. §1.642(h)-2(b)(2)(iii).

Distributable Net Income

An estate or trust's distributable net income (DNI) is computed using a formula: gross income less deductible expenses, less personal exemption.¹⁰⁵ The trust or estate distributes (or is required to distribute) the income to a beneficiary and generally deducts that amount. The beneficiary includes that amount in its gross income. A **distributions deduction** prevents the double taxation of the income of the trust or estate. The deduction is the lesser of DNI or the sum of the income required to be distributed and other amounts "properly paid or credited or required to be distributed" to the beneficiaries.¹⁰⁶

Note. There is no distribution deduction for "amounts paid, permanently set aside, or to be used for charitable, etc., purposes" even if the charitable contribution deduction itself is not allowed.¹⁰⁷

DNI allows the fiduciary to determine how much income is subject to tax and how much is taxed to the beneficiaries.¹⁰⁸ DNI helps to characterize the income distributed to beneficiaries for the distribution deduction, as well as measuring the amount of the income that is distributed to the beneficiaries, creating an amount of deductible income for the estate or trust.

The DNI of a trust or estate is equal to the taxable net income of the trust or estate after subtracting the income distribution deduction itself, the personal exemption, and most capital gains and losses (but special rules apply).¹⁰⁹ In other words, DNI is calculated based on accounting income less any tax-exempt income net of allocable expenses.

Note. The accounting method and period of the estate determine when the deduction may be claimed.¹¹⁰ The beneficiary's tax year is not relevant.

The reason the distribution deduction is not included in the calculation of DNI is because the distribution to beneficiaries is a function of DNI.¹¹¹ Additionally, the personal exemption is not used because it is not a component of DNI. Instead, it offsets income and is not allocated to beneficiaries through DNI. Finally, capital gains and losses are generally allocated to the principal and thus not typically included in the DNI calculation.

Generally, capital gains are excluded from DNI and, thus, are taxed to the estate or trust. If the governing instrument allocates capital gains to income, they are included in DNI and are taxed to the beneficiary. Capital gains are excluded from DNI to the extent that such gains are allocated to corpus and are not: paid, credited, or required to be distributed to any beneficiary during the tax year, or paid, permanently set aside, or to be used for charitable purposes.¹¹²

The distribution deduction is unique to trusts and estates and is not available to individuals.¹¹³ A trust or estate is not allowed a deduction for the distribution of principal to beneficiaries. A deduction against a trust's or estate's taxable income is only allowed for the distribution of trust or estate income to beneficiaries.

¹⁰⁵. IRC §643(a).

¹⁰⁶. IRC §661(a).

¹⁰⁷. *Mott v. U.S.*, 462 F.2d 512 (Ct. Cl. 1972).

¹⁰⁸. IRS Pub. 559, *Survivors, Executors, and Administrators*.

¹⁰⁹. *Ibid.*

¹¹⁰. *Ibid.*

¹¹¹. *Ibid.*

¹¹². IRC §643(a)(3).

¹¹³. IRS Pub. 559, *Survivors, Executors, and Administrators*.

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The amount of the income distribution deduction is subject to a DNI limitation.¹¹⁴ The amount of the DNI limitation is equal to the DNI of the trust or estate less certain tax-exempt interest of the trust or estate.

Generally, an income distribution deduction is allowed if a trust or estate is required to distribute income to beneficiaries.¹¹⁵ To determine this deduction, it is necessary to calculate the DNI, as well as the fiduciary accounting income (FAI) and the distributions that are required to be made to the beneficiaries. Typically, this distribution is equal to the lesser of the total amount of income distribution (required to be) made to the beneficiaries or the DNI of the trust or estate.

Deduction In Respect of a Decedent

Expenses otherwise deductible do not cease to be deductible because of a person's death.¹¹⁶ Thus, a deduction in respect of a decedent (DRD) must be identified when preparing a Form 1041. Deductions relating to interest, taxes, depletion, and expenses relating to business property or property used for the production of income may be items of DRD, as well as the foreign tax credit.

Note. There is no definition of DRD, and thus it is not always clear when a deduction within one of these deduction categories is an item of DRD.¹¹⁷

For an item to be DRD, the decedent, or a prior decedent, must have been liable for such expenses.¹¹⁸ Examples of deductions attributable to a decedent include unreimbursed employee expenses, hobby losses, and expenses attributable to the decedent's business.

RATE BRACKETS

The rate brackets applicable to trusts and estates (2023) are set forth in the following table.¹¹⁹ The rate structure for the taxation of accumulated income of estates and trusts is substantially compressed to reduce the benefits of retaining income inside an estate or a trust.

Trusts and Estates			
If Taxable Income Is			
Over	But Not Over	The Tax Is	Of the Amount Over
\$ 0	\$2,900	10%	\$ 0
2,900	10,550	290.00 + 24%	2,900
10,550	14,450	2,126.00 + 35%	10,550
14,450		3,491.00 + 37%	14,450

¹¹⁴. IRC §651.

¹¹⁵. IRC §661(c).

¹¹⁶. Instructions for Form 1041.

¹¹⁷. IRC §691(b).

¹¹⁸. Ibid.

¹¹⁹. IRC §1(e).

DEATH OF REVOCABLE TRUST GRANTOR

The purpose of many revocable grantor trusts is to handle the disposition of the taxpayer's assets upon the grantor's death without subjecting the decedent's assets to probate. Assets held by a trust are not required to be probated; this can save court costs and keep the assets' disposition private. When the grantor dies, the trust becomes irrevocable and requires a separate income tax return (Form 1041) to report trust income earned after death. The assets held by the trust are gathered, maintained, and/or distributed according to the trust's terms by the successor trustee.

Obtaining a Taxpayer Identification Number

After the grantor dies, the trust must obtain a taxpayer identification number (TIN). This is the case even if the trust obtained a separate TIN during the grantor's life.¹²⁰

Example 4. P.J. established the P.J. Revocable Family Trust on January 2, 2015. Under the trust's terms, P.J. retained control over all assets and rights of the trust. P.J. obtained a TIN and opened a bank account at 1st Hometown Bank in the trust's name. Upon P.J.'s death on July 1, 2023, the trust was required to obtain a new TIN.

Caution. Care must be exercised in the trust's transition year when reporting the amount of income, gains, losses, deductions, and credits allocable to the grantor and the trust in the pre-death and post-death periods. For instance, if the trust provided the grantor's social security number (SSN), a TIN will need to be provided to third-party payors because the grantor's SSN dies with the grantor. Upon receipt of a TIN, banks and brokers, for example, may require the trust to establish new accounts. This could present timing and logistical challenges for the trustee.

Income Follows Title

One of the most difficult aspects of preparing the trust return after the grantor's death is identifying the assets and related income that belong to the trust. Intentionally or not, many individuals do not title all their assets in the trust's name. The practitioner must understand the flow of the assets from the deceased person to the ultimate beneficiaries to properly report the taxable events.

Note. For a farmer or rancher, many assets do not have a title. These assets include crops, livestock, machinery, equipment, all-terrain vehicles, and vehicles used solely on the farm. Transferring these assets to a trust before death can make the estate administration easier.

It is not uncommon for some of the decedent's assets to fail being retitled into the name of the trustee of the trust before death. This could result in a probate of those assets requiring the probate estate to file a separate income tax return (Form 1041) to report the income earned by the estate post-death.¹²¹ To "catch" the assets not titled to the trust, many individuals also include a **pour-over** or **spill-over** provision in their wills stating that any assets not already in the trust will be transferred to the trust after their deaths.

Example 5. Use the same facts as **Example 4**. P.J. owned a home but failed to have the house titled in the name of her trust. P.J.'s will includes the following pour-over provision.

I give the rest and residue of my property to the successor trustee of The P.J. Revocable Family Trust dated January 2, 2015.

P.J.'s executor hired an attorney to probate her will. Because of the pour-over will provision, the house was transferred to the trust through probate administration.

¹²⁰. Treas. Reg. §301.6109-1(a)(3)(i)(A).

¹²¹. An estate may use a fiscal year ending at the end of a month not to exceed a 1-year period after death.

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Even though a taxpayer has a pour-over will, not all assets are subject to estate administration. Assets that do not pass upon death through the estate or trust include the following.

- Assets held jointly with rights of survivorship — these assets and the related income pass directly to the other owner(s).
- Accounts with designated beneficiaries — these assets are distributed directly to the designated beneficiaries.

Example 6. Use the same facts as **Example 5**. P.J. had three other accounts at the bank where the trust savings account was maintained.

1. P.J.'s primary checking account was in her name alone with no other owners or beneficiaries specified. This account did not receive any interest income. This account became part of her estate because there were no other owners and no designated beneficiaries. Under the terms of her will, the balance of the checking account was distributed to the trust.
2. Her interest-bearing checking account was held jointly with rights of survivorship with her niece, K.M. This account did not become part of the estate or the trust. The balance of this account went directly to K.M.
3. P.J. had a money market account with her husband listed as the beneficiary. This account did not become part of either the estate or the trust. The account's balance passed directly to her husband.

Note. The savings account under the trust's original EIN belonged to the trust and stayed with the trust.

IRC §645 Election

Most revocable living trusts meet the definition of a **qualified revocable trust** under §645 because of the grantor's retained right to revoke the trust.¹²² This is particularly important if the decedent's estate also has assets not in a revocable trust at death that must be probated. IRC §645 allows the trust and the estate to be combined on one tax return by means of an election via filing Form 8855, *Election to Treat a Qualified Revocable Trust as Part of an Estate*, made by the trustee and the executor to treat the trust as part of the estate.¹²³

Note. The §645 election is valid for two years after the decedent's date of death, where the electing trust is taxed as part of the applicable estate. The duration of the election starts on the day of the decedent's death and ends on the day both the trust and estate distributed all their assets or the day before the applicable date, whichever is **earlier**. The applicable date depends on whether a Form 706 is required to be filed. For estates where Form 706 **is not required** to be filed, the applicable date is two years after the decedent's date of death. For estates where Form 706 **is required** to be filed, the applicable date is two years after the decedent's date of death, or six months after the date of the final determination of estate tax liability, whichever is **later**.¹²⁴

¹²² IRC §645(b)(1). The election is made no later than the time for filing the return for the first tax year of the estate, including extensions. Once made, the election is irrevocable.

¹²³ IRC §645(a). Even if there is no separate probate estate, the election can be used to file the trust return (or several separate qualified revocable trusts as though the trust were an estate).

¹²⁴ Treas. Reg. §1.645-1(f).

There are various income tax advantages associated with making a §645 election that would not otherwise be available with a separate trust filing. These advantages include the following.

- The use of a fiscal year end for the trust¹²⁵
- A larger exemption amount (\$600 rather than \$300 for a simple trust compared to \$100 for all other trusts)
- The ability to deduct medical expenses paid by the trust on the decedent's final income tax return
- A potentially longer timeframe for owning S corporation stock (period of administration rather than a 2-year period)
- The ability to claim a charitable deduction for amounts permanently set aside for charitable purposes but not yet paid¹²⁶
- The ability to deduct losses for in-kind pecuniary bequests otherwise nondeductible under the related-party rules for trusts
- A 2-year waiver of the material participation requirement under the passive loss rules¹²⁷

Note. During the election period, income and deductions are reported on a combined basis (in terms of reporting income and expenses on Form 1041), but the DNI deduction must be computed separately for the estate and trust.¹²⁸ Thus, it is possible that distributions from the estate and trust will result in different allocations to beneficiaries as well as different income tax liabilities for the estate and trust.

When the election terminates, the electing trust component is deemed to have been distributed to a new trust. The new trust will be required to report on a calendar year, which may cause beneficiaries to receive two Schedule K-1s in the same tax year where the co-electing estate files on a fiscal year basis.

REPORTING INCOME EARNED FROM THE DECEDENT'S ASSETS

Nominee Forms¹²⁹

The Forms 1099 issued to a deceased person often report income that was paid after death. The deceased person in this case is treated as a **nominee**. The IRS requires that a nominee file the appropriate Forms 1099 to report the income attributable to the actual recipients.

Copy A of the applicable Form 1099 must be filed with a Form 1096, *Annual Summary and Transmittal of U.S. Information Returns*, to the appropriate IRS service center by the last day of February following the calendar year for which the income is reported (the due date is March 31 if the nominee form is filed electronically).

The income recipient(s) must be given Copy B of the Form 1099 by the last day of January following the calendar year for which the income is reported. On the Form 1099, the nominee should be listed as the "payer." The actual recipients are listed as the "recipient" on each Form 1099 issued by the nominee.

¹²⁵. This might allow income to be deferred to a future tax year. It may also allow sufficient time to file only one tax return and finalize estate matters more efficiently.

¹²⁶. IRC §642(c).

¹²⁷. IRC §469(i)(4). Participation is treated as active.

¹²⁸. Treas. Reg. §1.645-1(e)(2)(iii).

¹²⁹. Instructions for Form 1040.

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Decedent's Final 1040

On the decedent's final Form 1040, all income reported under the decedent's SSN should be shown on the return.¹³⁰ Adjustments for amounts actually received by other people should be subtracted on the appropriate form.

FAI¹³¹

There are several ways that FAI can be determined under state law and, therefore, for federal income tax purposes. Generally, FAI (often called trust or estate accounting income or simply net income) is the amount of money the fiduciary calculates to be on-hand and available to currently distribute to the income beneficiaries of a trust or an estate. FAI is calculated by the fiduciary based on the terms of the governing instrument and the local laws of the estate's situs.

INCOME TAX BASIS

The decedent's estate includes all property owned by the decedent at death to the extent of the decedent's ownership interest. In general, the income tax basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent is the FMV of the property as of the date of the decedent's death.¹³²

Note. The IRC §1014 basis step-up rule for appreciated property acquired from a decedent can sometimes also be leveraged with the gain exclusion under IRC §121. Farm business owners sometimes retire to a place in town, acquiring a residence separate from the farm or ranch that the surviving spouse or family may be willing to sell. As a result, this provision can provide liquidity without tax consequences.¹³³

Income in Respect of a Decedent

IRC §1014(c) carves out property that constitutes the right to receive IRD from the scope of the basis adjustment rules of §1014.

Note. IRC §691(a) describes the IRD concept and its scope. Conceptually, IRD is aimed at equalizing the treatment of cash and accrual-basis taxpayers with regard to items of income that is earned and thus accrues (economically) before a realization event has occurred to cause that income item to be taken into account for tax purposes. Common examples of IRD include compensation earned but not yet paid, accounts receivable from a cash-basis taxpayer, U.S. savings bond interest, and unearned gains on installment contracts.

Basis adjustments are also specifically required for IRD in the case of S corporation stock inherited from a decedent.¹³⁴ Similar adjustments are likewise required in partnerships, but rules within subchapter K permit different outcomes at death as compared with an S corporation. Rather than the rigid per-share, per-day allocation method of Subchapter S, Subchapter K allows partnerships to vary allocations by agreement.¹³⁵ Allocations pursuant to those agreements must satisfy the requirement of substantial economic effect.¹³⁶ Those agreements may also be overridden by other provisions of the Code.¹³⁷

^{130.} Ibid.

^{131.} Ibid.

^{132.} IRC §1014(a). Exceptions to the fair market rule exist for property subject to a special use valuation election under IRC §§2032 or §2032A; property representing IRD as defined under IRC §691; certain domestic international sales corporation (DISC) stock as defined in IRC §992(a); and appreciated property that the decedent acquired within a year of death as defined by §1014(e).

^{133.} If an installment contract is used to finance the sale of the principal residence, *Debough v. Shulman*, 799 F.3d 1210 (8th Cir. 2015), holds that under IRC §1038(e), a taxpayer loses the benefit of the IRC §121 exclusion if the residence is repossessed and not resold within one year thereafter.

^{134.} See IRC §1367(b)(4) (requiring basis of inherited stock to be reduced by the value attributed to IRD).

^{135.} IRC §704(a).

^{136.} See IRC §704(b).

^{137.} See, e.g., IRC §704(c).

Pre-Paid Farm Expenses. Many farmers pre-pay and deduct farm production inputs (feed, seed, fertilizer) in the tax year of purchase rather than the year in which the inputs are used in the farming business. That can raise questions of the tax treatment if the farmer dies after pre-paying for the inputs in one tax year but before using them in crop/livestock production in the following tax year. This issue was addressed in *Estate of Backemeyer v. Comm'r*,¹³⁸ involving a farm couple in Nebraska. In *Backemeyer*, the husband incurred expenses for the purchase of seed, chemicals, fertilizer, and fuel during 2010, which he planned to use for the 2011 crop production cycle. Unfortunately, he died on March 13, 2011, before he was able to use these inputs. His estate reported these items as “inventory” with an FMV equal to the purchase price. The couple deducted the inputs as expenses on their joint 2010 income tax return.

The husband’s estate plan directed that the inputs were to be transferred to his family trust, in which his wife was the trustee. After his death, his surviving widow became actively involved in farming, using those inputs to grow crops in 2011. She sold a portion of those crops in 2011 and a portion in 2012, reporting the full value of the crops sold as gross income. She then prepared two Schedules F for their joint return for 2011. One of them claimed income from crop sales during her husband’s life. The other reported the income from her own farming operations, which claimed the input costs as deductions that were also claimed as deductions on the husband’s Schedule F in 2010.

The IRS audited and asserted a deficiency associated with the deduction of the prepaid expenses in the 2011 tax year, arguing that there was no evidence that expenses were incurred in excess of cash expenses the wife paid in connection with 2011 crop production. The wife challenged the IRS by filing a Tax Court petition. At the Tax Court, the IRS changed its position, arguing that the deduction was appropriate in 2011, but the **tax benefit rule** required the value of the 2010 deductions to be recaptured.

The Tax Court disagreed with the IRS position and upheld the 2010 deductions, ruling that the tax benefit rule did not require those amounts to be taken into income when they were not used in production for the husband on account of his death. The surviving wife also acquired these inputs at FMV (which was deemed to be their purchase price) at the time of death under §1014. The inputs were includable assets on the husband’s Form 706 and were deemed to be taxed there.

Note. If not for the basis step-up rule of §1014, the surviving wife would have acquired the inputs at zero basis. Normally, double deductions are not allowed, but §1014 is a policy choice that Congress made allowing for nonrecognition on account of death. However, the Tax Court in *Backemeyer* also noted that the depreciation recapture rules under IRC §§1245 and 1250 do **not** extend to transfers at death.

¹³⁸. *Estate of Backemeyer v. Comm'r*, 147 TC 17 (Dec. 8, 2016).

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Crops and Livestock. Farm crops (whether harvested or still growing) and livestock (whether raised or purchased) by a cash method farmer¹³⁹ are also treated as inventory and subject to basis adjustment under §1014, rather than IRD. In Rev. Rul. 58-436,¹⁴⁰ the IRS ruled that livestock and farm crops, whether raised or received from tenants for rent, by a cash method farmer was not IRD, but inventory or property subject to the rules of §1014.¹⁴¹ The ruling follows *Estate of Burnett v. Comm'r*,¹⁴² which distinguished these items from rights to receive income that would otherwise fall in the category of IRD. Also, the ruling treats the value of feed on hand at the date of death, which would be consumed by cattle before their sale, as includable in the estate and then treated as a deductible administration expense for estate tax purposes.¹⁴³

Note. Treas. Reg. §1.61-4 addresses gross income of farmers and allows crop shares to be included as gross income in the year they are reduced to money. Owning such property is not, therefore, ownership of a right to income. Stepped-up basis rules do not apply to property owned by a crop share landlord.

Contract Grain and Livestock Deliveries. If a farmer delivers grain to satisfy a contract which is not paid until after their death, the contract right is a right to receive income that is within the scope of IRD.¹⁴⁴ According to the court, if the decedent lived to receive these amounts due to them under the cooperative contracts, they would have been reportable and taxable in the decedent's hands as income. The court distinguished *Burnett* on the grounds that the taxpayer had no realization event at death because there was no contract. The IRS later agreed in a private letter ruling that *Linde* should not be extended to the farmer who died owning crops, thereby resulting in the crops being treated as IRD.¹⁴⁵

In *Estate of Peterson v. Comm'r*,¹⁴⁶ the decedent contracted to sell calves raised on Nebraska ranches to a feeder in Sioux City, Iowa. The terms required him to wean and weigh the calves, then tender those calves to a delivery point. The total number was an estimate, with the buyer having an opportunity to reject those that did not meet his standards. The parties agreed to defer the date for delivery as some of the calves were not ready to wean. The decedent bore the risk of loss and was required to feed the calves until the buyer accepted the calves. Several hundred calves were culled from the herd because the decedent thought that the buyer would not like them.

¹³⁹ The term "farmer" as used here means an individual that bears the risk of production or risk of price change associated with the production of an agricultural commodity. The term does not include a non-material participation crop share landlord that is not bearing the risk of production or risk of price change.

¹⁴⁰ Rev. Rul. 58-436, 1958-2 CB 366. The ruling also extends to livestock and crops when the executor elects the alternative valuation date under IRC §2032. Any change in value between the date of death and the date of disposition is ignored for this purpose, meaning that the executor who sells the property before the alternative valuation date does not realize income. Instead, the full value of the property is included in the decedent's estate.

¹⁴¹ Compare against *Willging v. U.S.*, 474 F.2d 12 (9th Cir. 1973), where the court held that an accrual basis farmer using the farm price method in a community property state was not eligible to apply §1014 to step up the basis of crop inventories produced during the year in which he died. Taxpayer Husband died on November 15, at which time his farm inventories had increased from \$1,195 at the beginning of the year to \$37,953 at the time of his death.

¹⁴² *Estate of Burnett v. Comm'r*, 2 TC 897 (1943).

¹⁴³ *Estate of Backemeyer v. Comm'r*, 147 TC 17 (2016) supports claiming deductions for income tax purposes associated with these items, even though the Tax Court's ruling does not specifically address the issue.

¹⁴⁴ See, e.g., *Comm'r v. Linde*, 213 F.2d 1 (9th Cir. 1954) (contract rights associated with grapes delivered to cooperatives that were comingled with grapes from other producers for further processing into wine, brandy, and other products, of which the taxpayer would receive a share after expenses, were IRD in the hands of the taxpayer's surviving spouse).

¹⁴⁵ See PLR 5612115440A (Dec. 11, 1956).

¹⁴⁶ *Estate of Peterson v. Comm'r*, 74 TC 630 (1980), 667 F.2d 675 (8th Cir. 1981).

The decedent died before delivering the calves. His estate fed and cared for them, ultimately delivering the calves, and receiving the balance of payment. At issue was whether the entire proceeds received were IRD or whether only the proceeds representing the incremental value of the calves compared with their value as of the date of death. The key factor for the court was whether the decedent had a contractual right to payment at the date of his death. The court noted that the issue was not whether the decedent “closed” the sale or transferred title and possession of an asset before death, but whether his successor acquired a right to receive proceeds from an asset’s disposition on the one hand or acquired the asset itself on the other. The court focused on the following four elements.

1. A contract regarding the disposition of the underlying assets
2. Performance of the substantive, non-ministerial acts required as preconditions for sale, such that the right to the proceeds derives from death and not efforts on behalf of the estate
3. No economically material contingencies that might have disrupted the sale
4. The decedent would have actually or constructively received the sales proceeds had he lived

The court determined that three of these four elements were satisfied (items 1, 3, and 4), but the fact that only about $\frac{2}{3}$ of the calves were old enough to wean meant that the performance of the contract required additional work to complete the delivery. The right to receive the proceeds thus stemmed from further efforts to satisfy the contract. These were not perfunctory or ministerial acts, but essential and substantial ones. Thus, the proceeds from the sale of the calves were not IRD because a significant number of the calves were not in a deliverable state on the date of the decedent’s death, and the activities the estate performed were substantial and essential acts that the decedent had not performed before death.

Farm Landlord as Decedent. The outcome is different for a cash-basis landlord operating under a non-material participation share lease.¹⁴⁷ Treas. Reg. §1.61-4 generally provides that crop shares are included in gross income in the year when they are sold. In Rev. Rul. 64-289,¹⁴⁸ the IRS took the position that crop shares or livestock held by the decedent at the time of death, along with crop shares the taxpayer had a right to receive at the time of death for economic activities occurring before death, are IRD taken into account in the year the crops or livestock are sold. In the ruling, the IRS used a pro-rata method that treats the portion of rent as IRD based on the number of days in the rental period up through the day of death and the portion of rent treated as income for the estate running from the day after death to the end of the rental period.

Example 7. Larry Landlord entered into a crop share lease with Thomas Tennent effective January 1, 2023, for the 2023 calendar year. Larry died on August 28, 2023. Thus, 240 days of the rental period occurred during his life. Larry’s share of his corn crop was delivered to his estate on December 6, 2023. The estate sold half the corn in 2023, and the balance in 2024. According to the IRS, 65.75% ($240 \div 365$) of the proceeds of each sale are treated as IRD, while 34.25% ($125 \div 365$) are treated as income for the estate.

Note. Larry as a **crop share landlord** did not receive any stepped-up basis for the growing crop value on August 28, 2023. If Larry had been an **operating farmer** and Schedule F filer, a stepped-up basis would have applied.

¹⁴⁷. See Rev. Rul. 64-289, 1964-2 CB 173.

¹⁴⁸. Ibid.

Intentionally Defective Grantor Trust

An estate planning technique that is largely restricted in usage to higher wealth individuals is that of an intentionally defective grantor trust (IDGT).¹⁴⁹ With an IDGT, the grantor sells assets to a grantor trust, and the trust pays for the assets by issuing a note to the grantor. There is no gain because the seller (grantor) is treated as still owning the assets. Because the note bears a fixed rate of interest that freezes the value of the assets in the grantor's estate, over time an enormous amount of property can be leveraged out of the estate. Under IRC §7872, if credit is extended to a family member or to a trust for the benefit of a family member, the note should bear the applicable federal rate (AFR).

A significant question involves whether the trust assets receive an FMV basis at the time of the grantor's death. Rev. Rul. 85-13¹⁵⁰ states that a grantor trust is ignored for income tax purposes but not for estate tax purposes. As a result, the assets transferred to the trust are not included in the transferor's estate. In a typical IDGT transaction, the basis of the assets in the grantor's hands is lower than what the basis in the assets will be at death. The trust takes the grantor's (low) basis. The amount for which the grantor sells the assets to the IDGT does not matter in this regard. It is a gift, not a sale.

The answer to the question of what the basis of the trust's assets are upon the grantor's death has not been entirely clear. The question is whether a stepped-up basis is achieved without the assets being included in the grantor's estate. Up until the time the grantor dies, the grantor is treated as owning the assets.¹⁵¹ At death, the assets are treated for income tax purposes as being transferred to the trust — acquired from a decedent (basis step-up).¹⁵² In Chief Counsel Advice (CCA) 200923024,¹⁵³ the IRS took the position that there is no gain recognition when assets leave a grantor trust at death — there is no deemed sale at death. But the IRS followed that up with CCA 200937028¹⁵⁴ saying that a step-up in basis is not achieved for assets in a grantor trust when the grantor dies. Later, in 2012, the IRS issued a private letter ruling¹⁵⁵ saying that there is a stepped-up basis on assets in a grantor trust when the grantor dies. Ultimately, in 2015, the IRS said it would not issue any more rulings while it “studied the matter.”¹⁵⁶

In early 2023, the IRS concluded its study of the issue and with the issuance of Rev. Rul. 2023-2,¹⁵⁷ took the position that there is no step up in basis because the property was not a bequest, devise, or inheritance from the decedent and did not fall within one of the six other types of property listed in §1014(b) that qualify for a basis adjustment at death.

IMPACT OF DEATH ON TAX ATTRIBUTES

Some Code provisions expressly deal with the matter of a surviving spouse's entitlement to tax attributes connected with a joint return, but others leave room for ambiguity.¹⁵⁸ Outside of marriage, tax attributes are generally not transferable.¹⁵⁹ Within marriage, joint filing “generally does not permit either spouse to inherit or otherwise retain after the marriage ends a tax benefit that was originally conferred upon the other spouse.”¹⁶⁰

Note. Although the surviving spouse is entitled to file a joint return in the year the spouse dies, the income reported on the joint return only includes the deceased spouse's income (and deductions) preceding death and the surviving spouse's income (and deductions) for the entire taxable year.¹⁶¹

¹⁴⁹ *Helping a client benefit from an intentionally defective grantor trust*. Bryniarski, Barbara. Nov. 2021. AICPA. [www.thetaxadviser.com/newsletters/2021/nov/helping-client-benefit-intentionally-defective-grantor-trust.html] Accessed on Aug. 15, 2023.

¹⁵⁰ Rev. Rul. 85-13, 1985-1 CB 184.

¹⁵¹ IRC §671.

¹⁵² IRC §§671 and 1014.

¹⁵³ CCA 200923024 (Jun. 5, 2009).

¹⁵⁴ CCA 200937028 (Sep. 11, 2009).

¹⁵⁵ Ltr. Rul. 201245006 (Nov. 9, 2012).

¹⁵⁶ Rev. Proc. 2015-37, 2015-26 IRB 1196.

¹⁵⁷ Rev. Rul. 2023-2, 2023-16 IRB 658.

¹⁵⁸ See, e.g., *Vichich v. Comm'r*, 146 TC 12 (2016), where the Tax Court explained that despite the ability to file a joint tax return, some tax attributes are personal and subject to defeasance at death.

¹⁵⁹ *Ibid*.

¹⁶⁰ *Ibid*.

¹⁶¹ IRC §6013(a)(3); Treas. Reg. §1.6013-1(d)(1).

Net Operating Losses

Net operating losses (NOLs) attributed to one spouse may be used to offset the income of the other spouse to the full extent of their combined income.¹⁶² An NOL attributed to one spouse before marriage may not be used to offset income attributed to another spouse after marriage.¹⁶³ Likewise, a surviving spouse who incurred an NOL after her husband's death was not permitted to carry them back to the joint returns during their marriage in which all income belonged to her husband.¹⁶⁴

When both spouses are engaged in farming and share the risk of the farming operation as equal "partners," the surviving spouse may carry forward half of the NOL reflected on a joint return to offset the surviving spouse's own income after the first spouse dies.¹⁶⁵

In the year of death, operating losses and any NOL from business operations can be deductible only on the decedent's final return filed on their behalf. Unused amounts are not deductible by the decedent's estate.¹⁶⁶ The same is true of capital losses, including unused carryforwards.¹⁶⁷

Capital Loss Carryovers

Capital loss carryovers expire at death to the extent they are not utilized on the final return.¹⁶⁸ When a deceased spouse has a capital loss during the final year or a capital loss carryforward, the surviving spouse may be able to utilize that tax attribute by filing a joint return and attempting to create gains to offset the loss by selling their separate property, but only during the year of the deceased spouse's death.

Example 8. Victor has a capital loss carryforward of \$100,000 during 2023. Under IRC §1211(b), the couple could only use \$3,000 of that loss to offset ordinary income in the final return, leaving \$97,000 to expire. However, if Victor and his wife held property in joint tenancy in which the surviving wife now has a basis of, for instance, \$300,000 and the property has a FMV of \$400,000, upon the surviving wife's sale of the property, she may be able to utilize the carryforward to avoid tax on the gain, but only on a joint return filed for the year of Victor's death.

Passive Activity Losses

If a taxpayer with an interest in a passive activity experiences losses, those losses may be suspended (deferred) under IRC §469(a) and carried forward to future tax years to reduce passive activity income in those years. Rental activities (other than engaged in by a qualified real estate professional) are presumptively covered.¹⁶⁹ A limited exception is also available for up to \$25,000 of deductions attributable to rental activities in which an individual actively participated, subject to a phase-out beginning at \$100,000 of AGI.¹⁷⁰

¹⁶² Ibid., citing Treas. Regs. §§1.172-7(c) and 1.175-3(d).

¹⁶³ Ibid., citing *Calvin v. U.S.*, 354 F.2d 202 (10th Cir. 1965).

¹⁶⁴ Ibid., citing *Zeeman v. U.S.*, 395 F.2d 861 (2nd Cir. 1968).

¹⁶⁵ See *Rose v. Comm'r*, TC Memo 1973-207 (Sep. 19, 1973) and Rev. Rul. 74-175, 1974-1 CB 52. While *Rose* and the Revenue Ruling do not involve a farming set of facts, they do provide guidance on the treatment of an NOL when both spouses are informally operating the farming business as equal "partners." The case and ruling should not be read to likewise apply to USDA farm program payments, self-employment tax, or other Code provisions.

¹⁶⁶ See Rev. Rul. 74-175, 1974-1 CB 52.

¹⁶⁷ Ibid.

¹⁶⁸ Ibid.

¹⁶⁹ See IRC §469(c)(2).

¹⁷⁰ See IRC §469(i).

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If a taxpayer disposes of an entire interest in a passive activity in a fully taxable transaction that does not involve a related party, suspended losses are treated as a loss which is not from a passive activity to the extent those losses exceed other passive gains.¹⁷¹

A disposition by death is subject to a special rule that coordinates with the adjusted basis rules in §1014. Any suspended loss in the year of disposition is reduced by the step-up in basis that occurs in the hands of the transferee.¹⁷² This reduction in the suspended loss is disallowed and may not be deducted by anyone.¹⁷³ If any suspended loss remains after this reduction, then the loss may be taken as a deduction on the decedent's final return and may be used to offset nonpassive income.¹⁷⁴

Note. A qualified business loss (QBL) also expires upon the taxpayer's death and is not deductible by the decedent's estate.¹⁷⁵

Charitable Deduction

Charitable contributions are subject to limitations based on gross income, with excess contributions carried forward for up to five future tax years.¹⁷⁶ Excess charitable contributions are personal to the taxpayer who made the contributions.¹⁷⁷

For a deceased spouse, the regulations provide in part:

In case of the death of one spouse, any unused portion of an excess charitable contribution which is allocable in accordance with subdivision (i) of this subparagraph to such spouse shall not be treated as paid in the taxable year in which such death occurs or in any subsequent taxable year except on a separate return made for the deceased spouse by a fiduciary for the taxable year which ends with the date of death or on a joint return for the taxable year in which such death occurs.¹⁷⁸



Practitioner Planning Tip

Filing a joint return to expand the contribution base, using as much of the carryforward as possible, is advisable not only in the final year, but in all years affected by an excess contribution carryover.

Observation. Married couples filing joint returns and making contributions to charity should also carefully consider how their contributions are documented. The regulations presuppose that contributions are tracked specifically for each spouse, along with income earned by each spouse, for purposes of computing a separate limitation for each spouse.¹⁷⁹

¹⁷¹. See IRC §§469(g)(1)(A) and (B).

¹⁷². See IRC §469(g)(2)(A).

¹⁷³. See IRC §469(g)(2)(B).

¹⁷⁴. See FSA 200106018 (Feb. 9, 2001).

¹⁷⁵. IRS Pub. 559, *Deduction of Losses*, referencing IRS Pub. 536, *Net Operating Losses (NOLs) for Individuals, Estates, and Trusts*.

¹⁷⁶. See IRC §170(d)(1).

¹⁷⁷. *Vichich v. Comm'r*, 146 TC 12 (2016).

¹⁷⁸. Treas. Reg. §1.170A-10(d)(4)(iii) (containing an example that the deceased spouse's allocable share of the unused contribution carryforward is extinguished).

¹⁷⁹. Different considerations are involved for taxpayers in community property states; Treas. Regs. §1.170A-8(a) and (d)(2)(ii).

Soil and Water Conservation Expenses

IRC §175 provides for a deduction attributable to soil and water conservation expenditures. There is a limitation on deductibility that requires otherwise deductible expenditures to be limited to 25% of the gross income derived from farming during the taxable year, with the excess carried forward to succeeding taxable years.¹⁸⁰ However, the provision says nothing about the consequences of death before all the expenditures have been deducted. Presumably, the excess is a tax attribute that dies with the taxpayer if it cannot be used in the taxpayer's final return.¹⁸¹

In contrast, if an assessment from a soil or water conservation or drainage district is assessed on farmland, a portion of that assessment is potentially deferred over a 9-year period.¹⁸² The deferred amount can be treated as paid or incurred during the taxable year when the taxpayer dies.¹⁸³

E-FILEING AND ELECTRONIC SIGNATURES

Form 1041 was added to the Modernized e-File (MeF) platform on January 2014. MeF can accept the current and prior two tax years.¹⁸⁴ Thus, in processing year 2023, MeF will accept Form 1041 tax years 2020, 2021, and 2022. In addition to prior tax years, MeF offers the ability to file amended 1041 returns and attach any supporting documents as a PDF.

Note. Documents can no longer be mailed to the IRS if Form 1041 is filed electronically.¹⁸⁵

Qualified fiduciaries or transmitters may be able to file Form 1041 and related schedules electronically. For an electronically filed Form 1041, it may be signed by using a personal identification number (PIN).¹⁸⁶ Form 1041 may also be e-filed using Form 8453-FE, *U.S. Estate or Trust Declaration for an IRS e-file Return*. If Form 1041 is e-filed and there is a balance due, the fiduciary may authorize an electronic funds withdrawal with the return. If there are joint fiduciaries, only one is required to sign the return.

TAX ISSUES ASSOCIATED WITH EASEMENT PAYMENTS

Rural landowners often receive payment from utility companies, oil pipeline companies, wind energy companies, solar energy companies, and others for rights-of-way or easements over their property. The rights acquired might include the right to install pipeline, aerogenerators and associated access roads, electric lines, and similar access rights. Payments may also be received for the placement of a negative easement on the property such that the landowner is restricted from utilizing their property in a manner that might decrease an adjacent landowner's property value.

The receipt of easement payments raises several tax issues. The payments may trigger income realization and recognition, or could be offset partially or completely by the recipient's income tax basis in the land that the easement impacts.¹⁸⁷ A sale of only part of the land could be involved, or a separate payment for crop damage could be made.

¹⁸⁰ IRC §175(b).

¹⁸¹ Note that the FMV basis of the farmland under §1014 principles would presumably incorporate the value of any such conservation expenditures, negating the impact of IRC §1252, which otherwise requires a recovery of tax benefits under §175 if the connected farmland is disposed of within 10 years of the date of acquisition. This approach would be similar to that recognized in depreciation recapture provisions, such as §§1245 and 1250, where death trumps recapture rules.

¹⁸² IRC §175(f).

¹⁸³ IRC §175(f)(3).

¹⁸⁴ *E-file for Estates and Trusts*. May 30, 2023. IRS. [www.irs.gov/e-file-providers/estates-and-trusts] Accessed on Aug. 15, 2023.

¹⁸⁵ *Ibid*.

¹⁸⁶ See Form 8879-F, *IRS e-file Signature Authorization for Form 1041*.

¹⁸⁷ For a general and brief discussion of the issue, see IRS Pub. 225, *Farmer's Tax Guide*, p. 18 (2022).

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NATURE OF THE TRANSACTION

The grant of a right-of-way often involves a **perpetual easement** that “runs with the land” and is recorded with the title to the land. This binds the current and subsequent property owners subject to the grant. If a perpetual easement is conveyed and the grantor **does not** retain beneficial rights, the transaction involves a **sale** of the underlying tract.¹⁸⁸ However, in many situations, the landowner retains beneficial rights to use the easement property. For example, a landowner may grant an easement to a pipeline company to bury a pipe but retains the right to plant crops on the surface of the easement property if the use does not interfere with the easement. In a situation involving retained rights, the transaction involves the sale of an easement rather than a sale of the underlying tract.

Caution. Sometimes the parties to a transaction may believe that a sale of an easement is involved, and the transaction may be described in that manner. However, the transaction, in reality, may be structured as a lease. If the transaction is a lease, sale treatment is not possible, and ordinary income results without an ability to offset the income by the affected property’s basis. If not a sale, the favored provisions of IRC §§1031 (like-kind exchange) and 1033 (involuntary conversion rules) are not available.

EASEMENT PAYMENTS

Permanent Easements

The grant of a limited easement is treated as the sale of a **portion** of the rights in the land impacted by the easement, with the proceeds first applied to reduce the affected land’s basis.¹⁸⁹

Note. Generally, if the grant of an easement deprives the taxpayer of practically all the beneficial interest in the land except for the retention of mere legal title, the transaction is considered a sale of the land that the easement covers. In such cases, gain or loss is computed in the same manner as a sale of the land itself under IRC §§1221 or 1231.¹⁹⁰

When an easement is granted over a **specific portion** of the landowner’s property, only the land’s basis that is allocable to that portion is reduced by the amount received for the grant of the easement.¹⁹¹ Any excess amount received is treated as a capital gain.¹⁹²

Treas. Reg. §1.61-6(a) follows this principle.

When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts, and the gain realized or loss sustained on the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to such part. The sale of each part is treated as a separate transaction and gain or loss shall be computed separately on each part. Thus, gain or loss shall be determined at the time of sale of each part and not deferred until the entire property has been disposed of.¹⁹³

¹⁸⁸. Rev. Rul. 72-255, 1972-1 CB 221; *Fasken v. Comm’r*, 71 TC 650 (1979); *Wickersham v. Comm’r*, TC Memo 2011-78 (Jul. 28, 2011).

¹⁸⁹. See Rev. Rul. 54-575, 1954-2 CB 145; Rev. Rul. 59-121, 1959-1 CB 212.

¹⁹⁰. *Ibid.*

¹⁹¹. See, e.g., Rev. Rul. 59-121, 1959-1 CB 212.

¹⁹². *Ibid.*

¹⁹³. See also Rev. Rul. 72-255, 1972-1 CB 221.

The regulation presents two tax issues associated with allocating the landowner's income tax basis in the property.

1. The allocation of basis between the portion of the property that is subject to the easement and the balance of the property that is not subject to the easement¹⁹⁴
2. The allocation of basis between the rights created by the easement and the balance of the rights in the property

Note. Under the regulation, allocation of basis does **not** require proration based on acreage of the entire tract. Instead, basis allocation is “equitably apportioned.” For example, if the land subject to the easement is adjacent to a road, it is possible to allocate a greater portion of the basis per acre to the property subject to the easement.¹⁹⁵ Allocation is most often based on FMV but can also be based on assessed value at the time of the acquisition.¹⁹⁶

Based on the regulation, a taxpayer cannot compare the entire basis in the property from which an easement is acquired with the sale price of the easement unless the entire property is truly impacted by the easement. For example, in *Iske v. Comm'r*,¹⁹⁷ the taxpayer sold easements during condemnation proceedings initiated by a utility to acquire right-of-way easements across land the taxpayer owned. The taxpayer did not include the condemnation award in gross income on the tax return for that year because, as the taxpayer argued, he did not receive a taxable gain on the sale of the easements. However, the court disagreed with the taxpayer's position. The court reasoned that Treas. Reg. §1.61-6(a) required the taxpayer to apportion his basis in the property between the land sold and the land retained. The taxpayer could not use his entire basis in the two parcels involved to offset the amount he received for the easements. **The court found it crucial that the taxpayer did not provide any evidence that a portion of his basis could not be allocated to the property that the easement affected.**

Example 9. Garrulous Energy Company paid \$4,000 for an easement along the eastern boundary of Marcia Megawatt's farm. The easement is for the construction of an access road to the location on Marcia's farm where an aerogenerator will be erected. The easement covers approximately five acres of Marcia's 160-acre farm.

Marcia has an income tax basis of \$750 per acre in her farmland. For purposes of reporting gain from the \$4,000 easement payment, Marcia can offset the \$4,000 payment by the \$3,750 income tax basis that is allocable to the five acres that the easement impacts (\$750 per acre basis $\times$ 5 acres). Thus, Marcia must only report \$250 of gain (\$4,000 – \$3,750) from the sale of the easement.¹⁹⁸

Note. Easement contracts usually describe the exact area of the property affected by the easement. From the legal description, the square footage of that area can be determined. Basis can then be computed per acre. One acre equals 43,560 square feet.

If the easement impacts the taxpayer's entire property (which is uncommon), the amount received for the easement can be offset by the taxpayer's basis in the entire property for purposes of computing taxable gain.

Observation. A taxpayer who takes the position that the grant of an easement impacts their entire property bears the burden of proving that position. The IRS will likely challenge it. The ultimate outcome is heavily fact dependent.

¹⁹⁴. If the easement affects only a specific portion of the tract, only the basis allocable to the affected portion is reduced by the price received from the easement. Rev. Rul. 68-291, 1968-1 CB 351.

¹⁹⁵. See, e.g., *Vaira v. Comm'r*, 52 TC 986 (1969); Treas. Reg. §1.61-6(a).

¹⁹⁶. *Medlin v. Comm'r*, TC Memo 2003-224 (Jul. 29, 2003).

¹⁹⁷. *Iske v. Comm'r*, TC Memo 1980-61 (Mar. 5, 1980).

¹⁹⁸. The gain is IRC §1231 gain. For further guidance on the calculation technique utilized in the example, see Rev. Rul. 68-291, 1968-1 CB 351.

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Example 10. Vern sells multiple easements to a wind energy company for access to a major aerogenerator project on his ranch. The easements cover 550 acres (out of 640 total acres that Vern owns) and bisect Vern's property. The wind energy company constructed fences on each side of every easement and installed gates in the fences so that Vern could move his livestock through the easements. Because of these particular facts, Vern might successfully argue for an offset of basis in his entire 640 acres. Vern must establish that the easements affect his use of the entire 640 acres rather than just the 550 acres covered by the easements.¹⁹⁹

Caution. If it is not possible to allocate the basis of the entire property between the interest that is sold and the interest that is retained, then the easement proceeds can be used to reduce the basis in the entire property affected.²⁰⁰ However, the IRS is likely to challenge an allocation of basis across the entire property. A favorable IRS letter ruling or court decision in which the court finds it impracticable or impossible to determine the specific portion of the property impacted by the easement may be necessary.²⁰¹

Income tax basis must also be allocated between the rights that the taxpayer retains and the easement rights that are sold. For purposes of this basis allocation, the general rule is that the allocation of basis in the property must be allocated between the interest sold and the interest retained in the proportions that their respective FMVs bear to the FMV of the entire property.²⁰²

It may be possible to determine the actual portion of a client's property that is impacted by an easement project by examining the terms of the particular easement. Many easement agreements prohibit the landowner from building anything on the property that would interfere with the maintenance or operation of the easement holder's property. That could give the landowner a reasonable argument that the easement affects **all** the landowner's property. If there is sufficient basis in the land to absorb the easement payment, the landowner will not have any gain to report.

Example 11. Tom owns an 80-acre tract of farmland that he bought in 1983 for \$40,000. It is entirely pastureland and no improvements were made to it. Tom was approached by a wind energy company to construct three aerogenerators on his property. The company is willing to pay Tom \$25,000 for an easement. The easement terms prevent Tom from building anything on the property that would obstruct the company's access to the aerogenerators or that would block the wind. Tom should be able to reduce the basis in his entire tract by the amount of the easement payment. This reduces his basis to \$15,000 (\$40,000 – \$25,000) and no gain to report.

Note. If the wind energy company were to pay Tom for the right to construct additional aerogenerators on his property in a future year, Tom would again reduce his remaining basis in his tract by the amount of the additional payment. To the extent the payment exceeds Tom's basis in his property, Tom would have a taxable gain reportable on part 1 of Form 4797 (where it is netted with other §1231 gains and losses).

¹⁹⁹. This example is based on the facts in *Bledsoe v. U.S.*, 67-2 TC 9581 (1967). See also *Conway v. U.S.*, 73-1 TC 9318 (1973).

²⁰⁰. Rev. Rul. 77-414, 1977-2 CB 299.

²⁰¹. See, e.g., *Gilbert v. U.S.*, 808 F.2d 1374 (10th Cir. 1987). Also see *Fasken v. Comm'r*, 71 TC 650 (1979). Taxpayer was granted four easements for utility lines. The court required the consideration received for the easements applied against the portion of the adjusted basis for the ranch allocable to the acreage affected by each particular easement instead of applying the consideration against the ranch's entire basis. The taxpayer was unable to show that usefulness of the ranch was affected by easements or that it was not possible to allocate basis to the area actually affected by each easement.

²⁰². Rev. Rul. 77-413, 1977-2 CB 298 (the amount realized from the sale of real property did not include the value of a 20-year possessory interest retained in part of the property). See also, Ltr. Rul. 8025116 (Mar. 28, 1980).

Caution. Tom’s logic in **Example 11** may be challenged by the IRS. Many commercial aerogenerators are placed on 300–350 foot towers. If this is the case, the tips of the blades might reach as high as 525 feet. In that scenario, it might be illogical for Tom to argue that his future construction of a machine shed, for example, could possibly block the wind to the three aerogenerators.

If Tom wants to erect a structure on his farm, he should ask the wind energy company if the structure violates the standard “no interference” clause. In most scenarios, permission is granted to erect the structure.

The following case law supports the argument that an easement can affect **all** of a taxpayer’s property and, hence, allows the taxpayer’s entire basis in the property to be applied against the easement payment.

- *Bledsoe v. U.S.*²⁰³ — The landowner sold nine perpetual easements to the U.S. Army Corps of Engineers to allow road access to a dam. The easements covered only 47.3 acres, but the court allowed the landowner to reduce the basis of the entire 454.54 acres because the easements restricted his use of the property. The easements varied in width from 100 to 400 feet and bisected his ranch. The easement holder then constructed a fence along the road on both sides and built gates in the fences so that the taxpayer could move his cattle across the easements. **Contrary** to the general rule, the court held that the easements were not sales, and that the taxpayer was entitled to apply the easement proceeds against the property’s basis.
- *Conway v. U.S.*²⁰⁴ — The landowner sold a right-of-way across his farm to a coal company, retaining ingress and egress rights and a reversion of the right-of-way upon abandonment. The court allowed the landowner to offset the payment received for the grant by the landowner’s basis in the entire property.
- *Inaja Land Co., Ltd. v. Comm’r*²⁰⁵ — The City of Los Angeles paid the landowner \$50,000 for a perpetual easement that allowed the city to flood the land when it diverted water into a river that flowed through the land. The easement did not cover the entire tract, but because it affected the use of the entire tract, the court allowed the payment for the easement to reduce the basis of the entire tract. The court specifically noted that apportionment was impossible.

Severance Damage Payments

An easement can bisect a landowner’s property in such a manner that the property not subject to the easement can no longer be put to its highest and best use. This is more likely with commercial property and agricultural land that has the potential to be developed. Severance damages may be paid to compensate the landowner for the resulting lower value of the unaffected property. For example, in *Foster, et al. v. Comm’r*,²⁰⁶ the amount received from a utility company for a right-of-way easement for high voltage lines was applied against the taxpayer’s basis in the entire property as severance damages. The court determined that an additional amount paid for a “sway” easement also reduced the basis in the entire property. The court found that both easements were integrally related and impacted the entire property.

²⁰³. *Bledsoe v. U.S.*, 67-2 TC 9581 (1967).

²⁰⁴. *Conway v. U.S.*, 73-1 TC 9318 (1973).

²⁰⁵. *Inaja Land Co., Ltd. v. Comm’r*, 9 TC 727 (1947).

²⁰⁶. *Foster, et al. v. Comm’r*, 80 TC 34 (1983), *aff’d and vacated*, 756 F.2d 1430 (9th Cir. 1985).

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If severance damages exceed the landowner's basis in the property not subject to the easement, gain is recognized.²⁰⁷

Note. Under §1033, the landowner may be able to defer gain resulting from the payment of severance damages by using the severance damages to restore the property affected by the easement or by investing the damages in a timely manner in other qualified property.²⁰⁸ The landowner is not required to apply the severance damages to the portion of the property subject to the easement. Additionally, if the easement affects the remainder of the property such that the pre-easement use of the property is not possible, the sale of the remainder of the property and use of the sale proceeds (plus the severance damages) to acquire other qualified property can be structured as a deferral transaction under §1033.²⁰⁹

Temporary Easement Payments

Some easements may involve an additional temporary easement to allow the holder to have space for access, equipment, and material storage while conducting construction activities on the easement property. A separate designation for a **temporary easement** for these purposes generates **rental income** for allocated amounts. As one alternative, it may be advisable to include the temporary space in the perpetual easement, which is then reduced after an established period. Under this approach, the payment attributable to the temporary easement can be applied to reduce the basis in the tract subject to the permanent easement.²¹⁰ A second alternative, classifying any payments for a temporary easement as damage payments, may be possible, depending on the facts.

Damage Payments

Upfront payments to a landowner for actual, current damage to the property caused by easement construction activities may be offset by basis in the affected property.²¹¹ Payments for property damage caused by environmental contamination and/or soil compaction are examples of this type of payment. A payment for damage to growing crops, however, is treated as a sale of the crop, which is reported by an operating farmer on line 2 of Schedule F. If the landowner is a crop share landlord, the payments are reported on line 1 of Form 4835.

Any payment for **future** property damage is generally treated as rent.

Note. Most easements contain release language covering loss of rents, damage to the surface, damage to fences, water impoundments, vegetation, and crops. The release language generally applies to future damages. In the IRS's view, any associated payment constitutes rent that cannot be offset by basis. Clearly, careful drafting of the easement that distinguishes between upfront damage payments and covenants to compensate for future damages is essential. It is unclear whether courts would assume that construction activities necessarily result in damages. In any event, maintaining relevant documentation is key.

²⁰⁷. Rev. Rul. 68-37, 1968-1 CB 359.

²⁰⁸. Rev. Rul. 83-49, 1983-1 CB 191.

²⁰⁹. Rev. Rul. 59-361, 1959-2 CB 183.

²¹⁰. Rev. Rul. 73-161, 1973-1 CB 366.

²¹¹. See, e.g., FSA 200228005 (Mar. 29, 2002). Settlement proceeds received for land contamination and impact on water rights are treated as a nontaxable return of capital to the extent of basis.

Lease Payments

A right of use that is not an easement generates ordinary income to the landowner and is, potentially, net investment income subject to the 3.8% net investment income tax.²¹² Thus, transactions that are a lease or a license generate rental income with no basis offset. For example, when a landowner grants surface rights for oil and gas exploration, the transaction is most likely a lease. Easements for pipelines, roads, surface sites, and similar interests that are for a definite term of years are leases.²¹³ Likewise, if the easement is for “as long as oil and gas is produced in paying quantities,” it is a lease.²¹⁴

Note. When a landowner retains reversionary rights, sale treatment may not result unless the retained rights are contingent. However, a transaction involving a contingent reversion in case the easement is not used or abandoned constitutes a sale of an easement.²¹⁵ Likewise, if reversion is triggered, for example, on the failure to maintain insurance coverage, the filing of bankruptcy, assignments for the benefit of creditors, or an unauthorized assignment or like events, the easement status is maintained.

A lease is characterized by periodic payments. A lease is indicated when failure to make a payment triggers default procedures and potential forfeiture.

Lease payments are not subject to SE tax in the hands of the recipient, regardless of the landowner’s participation in the activity.²¹⁶ Accordingly, the annual lease payment income is reported on Schedule E, *Supplemental Income and Loss*, with the landowner likely having few or no deductible rental expenses.



Practitioner Planning Tip

Tax preparers should review Forms 1099 received by the landowner and properly report and document upon which forms the income is reported.

Note. Lease transactions are most likely to be found with respect to oil and gas exploration and development, and solar energy production agreements. The lease payment structure for solar energy development is similar to that of an oil and gas transaction, except that solar royalty payments are not as common as solar rental payments. This is because there are many variables involved when attempting to calculate revenues and expenses associated with solar farm production, making annual rental payments more efficient.

²¹². IRC §1411.

²¹³. *Gilbertz v. U.S.*, 808 F.2d 1374 (10th Cir. 1987).

²¹⁴. *Vest v. Comm’r*, 481 F.2d 238 (5th Cir. 1973); *Estate of Reinke v. Comm’r*, TC Memo 1993-197 (May 4, 1993); *Wineberg v. Comm’r*, TC Memo 1961-336 (Dec. 14, 1961), *aff’d*, 326 F.2d 157 (9th Cir. 1963).

²¹⁵. *Ibid.*

²¹⁶. IRC §1402(a)(1).

Negative Easement Payments

A landowner may make a payment to an adjacent or nearby landowner to acquire a **negative easement** over the other landowner's tract. A negative easement is a restriction placed on the tract to prevent the owner from specified uses of the tract that might diminish the value of the payor's land. For instance, a landowner may fear that their property would lose market value if a pipeline, high-power transmission line, or aerogenerator were placed on adjacent property. Thus, the landowner might seek a negative easement over the adjacent property to prevent that landowner from granting an easement to a utility company for that type of activity on the adjacent property.

In a field service advice (FSA) memorandum,²¹⁷ the IRS decided that a negative easement payment is rental income in the hands of the recipient. It is not income derived from the taxpayer's trade or business. The facts of the ruling involved a C corporation that owned property adjacent to a plant owned by another corporation. The adjacent corporation wanted to protect itself from potential liability as a result of activities on the C corporation's property. Accordingly, it paid the C corporation for a negative easement over a strip of land closest to its border to act as a buffer. The agreement between the parties for the recorded negative easement called for annual payments for a term of years. The C corporation wanted to characterize the payments as business income to avoid triggering an additional 20% tax under the personal holding company (PHC) rules of IRC §§541-547.

Note. A C corporation is a PHC under IRC §542(a)(1) if more than 50% of the corporate stock is held, either directly or indirectly, by five or fewer individuals, **and** the corporation derives at least 60% of its adjusted ordinary gross income (AOGI) from passive investment sources. Rental income is included in AOGI unless adjusted rental income:

- Is at least 50% of AOGI, and
- Dividends for the tax year equal or exceed the amount (if any) by which the corporation's nonrent PHC income for that year exceeds 10% of its ordinary gross income.

In other words, if the mixture of rental income and other passive income sources exceed the 10% threshold and the rental income exceeds the 50% threshold, the PHC tax could be triggered.

The IRS noted that there was no direct authority as to how to treat negative easement payments for PHC purposes. However, the IRS did find cases involving conservation reserve program (CRP) payments to landowners and the SE tax treatment of those payments to be relevant. In *Morehouse v. Comm'r*,²¹⁸ the 8th Circuit reversed the Tax Court and held that CRP payments were rental payments (for SE tax purposes) because they were compensation to the landowner for the government's possession and use of the landowner's property. The court determined that the CRP payments were synonymous with easement payments and were not subject to SE tax in the hands of a nonfarmer.

In the FSA, the IRS defined rent as "amounts received for the use of, or right to use, property of the corporation." The IRS cited *Morehouse* for the proposition that CRP payments are "rents" that are paid to the landowner for the government's **use** of the property. In the FSA, the IRS determined that the negative easement payments were made to prevent the C corporation from using its property in a way that would diminish the value of the other corporation's property. This, the IRS found, was a "use" of the C corporation's property.²¹⁹ The IRS believed that *Morehouse* supported its FSA position because Mr. Morehouse was a nonfarmer and the government was using his property for the government's own purposes.

Note. Although the FSA was not the result that the taxpayer desired (because of the complications with the PHC), the FSA does hold that negative easement payments are "rents" that are not subject to SE tax. However, the rents would be treated similarly to other passive sources of income and could be subjected to the 3.8% net investment income tax under IRC §1411. In addition, the IRS's position taken in the FSA could be applied to situations involving the government's use of a taxpayer's property to enhance wildlife and conservation.

²¹⁷ FSA 20152102F (Feb. 25, 2015).

²¹⁸ *Morehouse v. Comm'r*, 769 F.3d 616 (8th Cir. 2014), *rev'g* 140 TC 350 (2013).

²¹⁹ The IRS stated, "We believe this is using/employing the property for the accomplishment of a business purpose, i.e., to avoid/limit liability."

Reporting the Transaction

The party that acquires the easement must report the transaction using Form 1099-S, *Proceeds From Real Estate Transactions*.²²⁰ Rental payments and damage payments are reported on Form 1099-MISC, *Miscellaneous Income*.²²¹

EMINENT DOMAIN

Proposed easement acquisitions can be contentious for many landowners. Often, landowners may not willingly grant a pipeline company or a wind energy company the right to use the landowners' property. In those situations, eminent domain procedures under state law may be invoked. These procedures involve a property's condemnation. The power of eminent domain is the right of the state government (called the "taking power" for the federal government) to acquire private property for public use, subject to the constitutional requirement that "just compensation" be paid. Although eminent domain is a power of the government, developers of pipelines and certain other types of energy companies are often delegated the authority to condemn private property. The condemnation award (the constitutionally required "just compensation") paid is treated as a sale for tax purposes.²²²

Note. The condemnation award is tied to the "taken" property's FMV. As is the case with negotiated easements, the landowner may also recover amounts for a temporary easement, severance damages, crop damage payments, and for the relocation of fixtures and personal property. Interest on these amounts may also be recovered. These additional amounts must be authorized by state law. Payments to relocate fixtures and personal property are typically set at the lesser of the property's FMV or the actual cost to relocate the property. If any amount paid is allocated to §§1245 or 1250 property, recapture could be triggered.

The IRS's view is that a condemnation award represents the sales price of the property taken, and the Tax Court generally agrees.²²³ However, if the condemnation award clearly exceeds the FMV of the property taken, a court may entertain arguments about the various components of the award.²²⁴ Thus, it is important for a landowner to preserve any evidence that might support allocating the award to various types of damages.

Observation. If a personal residence is part of the condemnation, the taxable amount of the award is decreased by the gain excluded under §121(d)(5)(B).

Deferral of Gain

Although a condemnation award is treated as a sale for tax purposes, §1033 (involuntary conversion rules) allows a recipient to elect to defer gain realized from a condemnation (and sales made under threat of condemnation) by reinvesting the proceeds in qualifying property.

Note. A sale made under threat of condemnation can occur, for example, when a landowner sells easements over their property to a company that is threatening to condemn the easement unless the landowner grants it.²²⁵

²²⁰ Instructions for Form 1099-S.

²²¹ Instructions for Form 1099-MISC.

²²² See, e.g., *Hawaiian Gas Products, Ltd., v. Comm'r*, 126 F.2d 4 (9th Cir. 1942).

²²³ Rev. Rul. 59-173, 1959-1 CB 201; *Asjes v. Comm'r*, 74 TC 1005 (1980).

²²⁴ See, e.g., *Conran v. U.S.*, 322 F.Supp. 1055 (E.D. Mo. 1971).

²²⁵ In these situations, one issue is whether the company actually has the power of condemnation. See, e.g., *Texas Rice Land Partners, Ltd. v. Denbury Green Pipeline-Texas, LLC*, 363 S.W.3d 192 (Tex. 2012). An operator of a carbon dioxide pipeline secured easements under the threat of condemnation when the operator was not a common carrier having such power at the time of the acquisitions. See also Rev. Rul. 74-8, 1974-1 CB 200. A sale made under the threat of condemnation was an involuntary conversion when the utility at issue did not actually possess the power of eminent domain, even though the utility could acquire it.

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The election to defer gain under §1033 is made by simply not reporting the condemnation gain realized on the return for the tax year the award is received.²²⁶ However, in the year in which the gain is realized, the regulations require the taxpayer to disclose the details concerning the replacement property.²²⁷

Example 12. Ole McDonald received a \$200,000 condemnation award on a tract of farmland from Earth, Wind, & Fire Inc. on December 1, 2022. A Form 1099-S is issued to Mr. McDonald. He plans to purchase qualifying replacement property within three years. The transaction is reported on Form 4797 as follows.

Form 4797 Department of the Treasury Internal Revenue Service	Sales of Business Property (Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2)) Attach to your tax return. Go to www.irs.gov/Form4797 for instructions and the latest information.	OMB No. 1545-0184 2022 Attachment Sequence No. 27					
Name(s) shown on return Ole McDonald		Identifying number ***-**-6789					
1a Enter the gross proceeds from sales or exchanges reported to you for 2022 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20. See instructions		1a 200,000					
b Enter the total amount of gain that you are including on lines 2, 10, and 24 due to the partial dispositions of MACRS assets.		1b					
c Enter the total amount of loss that you are including on lines 2 and 10 due to the partial dispositions of MACRS assets		1c					
Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year (see instructions)							
2	(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
	Land Condemnation	07/01/99	12/01/22	200,000		200,000	0

Mr. McDonald attaches the following election to his return:

An election is made under IRC § 1033 to defer gain on condemnation award received. The taxpayer intends to replace the property within the replacement period.

Note. The purpose of showing the receipt of the funds on Form 4797 is to reduce the likelihood of receiving a CP-2000 (underreported income) notice and to begin the documentation of the need for acquiring replacement property within the prescribed time. The basis reported is equal to the gross sales price to accomplish the deferral of income.

²²⁶. A partnership makes the election at the partnership level. *Demirjian v. Comm’r*, 457 F.2d 1 (1972).

²²⁷. Treas. Reg. §1.1033(a)-2(c)(2). If the replacement property has not been acquired at the time the return is due and, thus, the details concerning the replacement property are not available to disclose, the election to defer the gain is deemed to have been made if no gain is reported.

For real property acquired by condemnation or threat of condemnation, the gain realized can be deferred if the proceeds are reinvested in like-kind property²²⁸ **within three years after the close of the first tax year in which the taxpayer realizes any part of the gain** (i.e., in the first year in which the proceeds exceed the taxpayer's basis in the affected property) on the involuntary conversion.²²⁹ More specifically, the replacement period begins on the earlier of the date of disposition or the date that condemnation is threatened, and ends three years after the close of the first tax year in which any part of the gain is realized.²³⁰

Note. Detailed information concerning the condemnation should be disclosed with the return for any year in which gain from the transaction is realized. Likewise, information concerning the replacement property should be disclosed for the tax year (or years) in which the replacement property is acquired. Form 4797 is used to report an involuntary conversion of property used in the taxpayer's trade or business (or capital assets held for business or profit). Form 8949, *Sales and Other Dispositions of Capital Assets*, is used to report gain from capital assets not held for business or profit.

If the landowner uses severance damages to restore property that is retained or to reinvest in the replacement property, the severance damages may also qualify for deferral under §1033. Likewise, if the condemnation makes the use of the remainder of the landowner's land impractical such that the landowner sells the remaining property, the sale proceeds may also qualify for deferral under §1033.

If the amount realized from the condemnation is less than the cost of the replacement property, the taxpayer's basis in the replacement property is the cost of the replacement property less any unrecognized gain. If the amount realized from the condemnation exceeds the cost of the replacement property, the landowner has gain recognition to the extent of the excess of the amount of the gain realized over cost, and the basis in the replacement property is the cost less any unrecognized gain.²³¹

The IRS ruled that basis is allocated between land and improvements,²³² even if the condemnation award was only for land. IRC §1223 establishes the holding period for the replacement property, and the IRS ruled that the holding period of the condemned property is attributed proportionally to the property acquired.²³³

Note. Deferral under §1033 may not result in the deferral of recapture income under §§1245 or 1250. This is particularly the case if multiple classes of property are condemned because the regulations require the amount realized from the condemnation to be allocated between the various classes. In situations when the sale proceeds would be treated as a capital gain, and the replacement property would reduce ordinary income, reporting both the sale and expense may be preferable to income deferral.

²²⁸. Like-kind property is property that is similar or related in service or use. IRC §1033(a). But, the "like-kind" rules for real property set forth in IRC §1031 apply. IRC §1033(g); Treas. Reg. §1.1031(a)-1(b). This is a more relaxed standard than applies for personal property trades.

²²⁹. The replacement period is three years if the condemned property is held for productive use in the taxpayer's trade or business or for investment. When a §1033 election is made, the IRS has three years from the date it receives notification of replacement or failure to replace in which to assess a deficiency.

²³⁰. Constructive receipt rules apply. Also, it is important to ensure that the transaction for the replacement property is finalized within the replacement period. See, e.g., *Fort Hamilton Manor v. Comm'r*, 445 F.2d 879 (2d Cir. 1971). Upon request, the IRS may extend the replacement period for good cause.

²³¹. IRC §1033(b)(2).

²³². Rev. Rul. 79-402, 1979-2 CB 297.

²³³. Rev. Rul. 81-285, 1981-1 CB 173.

Expenses

Expenses that the landowner incurs during the condemnation process are treated as capital expenditures. Thus, they are added to the landowner's basis in the property subject to the easement. This has the effect of reducing the gain (or increasing the loss) upon condemnation. Expenses that are made to substantiate and recover severance damages are capitalized as part of the basis of the property that is not condemned.

ESTATE TAX IMPLICATIONS

Long-term leases (known as a "leased-fee interest")²³⁴ can also impact the federal estate value of the land subject to the lease. Property is valued for estate tax purposes at its FMV as of the date of the decedent's death. FMV is determined under a willing-buyer, willing-seller test.²³⁵ The Tax Court has held that leased-fee interests must be taken into account for their impact on the value of the real estate for estate tax purposes.²³⁶ In *Estate of Mitchell v. Comm'r*,²³⁷ the decedent's estate included various residential rental properties with one of the properties having an unexpired lease at the time of the decedent's death. Under the terms of the lease, the tenant could renew the lease for about 20 years after the date of the decedent's death. The Tax Court valued the property subject to the lease by adding the value of the landlord's reversionary interest in the property to the adjusted value of the lease payments that were owed to the decedent. The result was an enhancement to the property's value for estate tax purposes.

Observation. A long-term agreement signed shortly before death likely has little impact on the subject property's estate tax value, because the agreement (particularly for mineral and wind energy development) has an initial development/prospecting phase that runs for several years before the primary phase of the easement. Thus, if the decedent dies during the prospecting phase, uncertainty remains as to whether production will ever occur on the premises. Consequently, there should be no valuation enhancement. However, if death occurs after the development phase and activity commenced on the leased premises, the IRS could argue for a valuation enhancement.

A related estate tax concern involves special-use valuation.²³⁸ One court held that grant of an easement was a disposition of a property interest under federal law resulting in recapture tax being triggered under IRC §2032A(c)(1).²³⁹

SOLAR ENERGY PRODUCTION

As noted previously, the transactions that farm, ranch, and rural landowners enter into with solar energy companies are most likely to be lease agreements. The tax principles applicable to lease agreements with wind energy companies, oil and gas companies, and others are likewise applicable to solar energy leases. However, there are some unique aspects of solar energy leases, such as the following.

- Easement and allocation of basis issues are likely not present. A lease will be for a certain amount of acres and the solar arrays will take up that amount of the land.
- Under many state laws, solar farms are exempt from personal property tax and instead pay an annual nameplate capacity tax on a per megawatt of electricity generation basis.
- State law often continues to classify and value the land under the solar arrays as if the arrays did not exist.²⁴⁰ Thus, land that is classified as agricultural before arrays are placed on the land under a solar energy lease will continue to be classified as agricultural land.

²³⁴. In *Marks v. Comm'r*, TC Memo 1985-179 (Apr. 10, 1985), the court said that a leased-fee interest exists when the "owner of commercial or income-producing property has the right to receive the actual contract rent that the property is generating over the remaining terms of the outstanding leases on the property..."

²³⁵. Rev. Rul. 59-60, 1959-1 CB 237; Treas. Reg. §20.2031-1(b).

²³⁶. *Estate of Mitchell v. Comm'r*, TC Memo 2011-94 (Apr. 28, 2011).

²³⁷. Ibid.

²³⁸. IRC §2032A.

²³⁹. *Estate of Gibbs v. U.S.*, 161 F.3d 242 (3d Cir. 1998). At issue was the grant of an agriculture preservation easement that ensured the land subject to the easement would not be developed.

²⁴⁰. See, e.g., Neb. Rev. Stat. §77-6203(4).

Another approach involving solar energy production involves a landowner's investment in solar equipment and the related rights and responsibilities. In these situations, questions can arise concerning the taxpayer's income tax basis in the solar equipment, bonus depreciation, the at-risk rules of IRC §465, and the passive activity rules of §469. In 2018, the Tax Court dealt with these issues.

Golan Case²⁴¹

In 2010, the Golans (a married couple) bought an investment in solar equipment and its related rights and obligations from a solar contractor formed as an LLC. The LLC installed solar panels and related solar equipment on three of the Golans's properties. The parties engaged in a **power purchase agreement (PPA)**, providing that the Golans would buy the electricity generated at a discount and the LLC would retain ownership of the equipment and the right to tax benefits for a short period of time. During that time, the LLC retained the burdens and benefits of ownership.

In 2011, the LLC sold the equipment to the Golans, and the equipment was installed on the roofs of three of their properties. The purchase was subject to the PPA. The Golans paid \$300,000 consisting of a down payment of \$90,000, a credit for certain rebates of \$57,750, and a \$125,000 promissory note (maturity date of 2041) with no fixed payment amount and interest at 2% (which the Golans personally guaranteed). The note required all monthly revenue generated by the panels to be paid to the LLC. The Golans granted the LLC an option to buy the solar equipment for the outstanding balance of the promissory note after the 5-year tax credit recapture period. The panels were not connected to the grid until after the Golans bought them.

After an audit, the IRS asserted that the Golans could not claim the IRC §46 rehabilitation credit and could not claim IRC §179 depreciation. The IRS did not make any claim that the Golans could not claim the energy credit of IRC §48 or bonus depreciation under IRC §168(k). The IRS did, however, reduce the Golan's basis in the solar equipment from \$300,000 to \$152,500 on the grounds that they had not paid anything toward the down payment during 2011. The IRS asserted that the Golans were not at risk under §465 because the LLC had a continuing interest in the projects and could not claim basis in \$57,750 of utility rebates that were assigned to the LLC. The IRS also claimed that the Golans were engaged in a passive activity under §469.

Basis. The court noted that the \$90,000 down payment was not paid in 2011; therefore, under Treas. Reg. §1.1012-1(a), the Golans could not add it to their basis for that year. As for the \$57,750 of utility rebates, the court noted that the Golans neither received them nor reported them as income. Instead, the Golans had assigned the rebates to the LLC. Accordingly, the rebates could not be added to the Golans's basis in the solar equipment. But, the promissory note was a recourse obligation issued in exchange for the solar equipment. Thus, the principal amount of the note counted as basis.

Caution. The court (and IRS) appeared to be unconcerned that the promissory note was serving as a means of providing cash flow for the investment. Because the Golans did not make any payment on the note in 2011 and the cash flow limitation in the note, the IRS could have claimed that the LLC was the owner of the solar equipment in 2011 at the time the panels were placed in service.

Bonus Depreciation. The court held that the Golans could claim bonus depreciation because they were the original users of the panels. The IRS claimed that the panels were placed in service under the contract before the Golans owned them. But, the court noted that the panels were not connected to the grid until after the Golans had purchased them. As such, the panels were not ready and available for use until the time of the grid connection.

Note. The IRS did not argue that the Golans were not entitled to the energy credit of §48, which also requires that the "original use of such property commences with the taxpayer."²⁴²

^{241.} *Golan v. Comm'r*, TC Memo 2018-76 (Jun. 5, 2018).

^{242.} IRC §48(a)(3)(B)(ii). An exception to this rule exists for sale-leasebacks within 3-months of the placed-in-service date per IRC §50(d)(4).

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At-Risk. The court determined that the Golans were at-risk with respect to the promissory note for the purpose of depreciation. The court held that the LLC did not have a prohibited continuing interest in the panels because the LLC was not entitled to any assets of the projects upon a liquidation. Instead, the LLC only had a gross receipts interest (monthly revenue) rather than a prohibited net profits interest. The fact that a loan in a transaction is made by a promoter of the transaction does not necessarily mean that the promoter has a prohibited continuing interest in the transaction.²⁴³

Passive Activity. The court held that the Golans were not subject to the passive loss rules of §469. The court, based on what it determined was the Golans's credible testimony, held that they spent more than 100 hours on the projects at the three properties during the year in question and no one else spent more time than they did.²⁴⁴

Penalties. The court determined that the Golans relied in good faith on the advice of a tax preparer who had sufficient expertise to justify their reliance and to whom they provided all necessary accurate information. The court also acknowledged that the Golans met with the tax professional four times to discuss the solar venture. The court found that the couple made a good-faith effort to establish their proper tax liability and reasonably relied on the advice of their return preparer; therefore, they were not liable for the accuracy-related penalties.

TAX TREATMENT OF R&E AND R&D EXPENSES

Before a recent change in the law (explained next), a taxpayer could elect to currently deduct the amount of certain reasonable research and experimentation (R&E) expenses paid or incurred in connection with a trade or business.²⁴⁵ The research and development (R&D) credit, computed based upon qualified research expenditures, is a general business tax credit which reduces tax liability (rather than reducing taxable income), if allowed.²⁴⁶

Expenses associated with innovative activities that develop a new business product are deductible R&E expenditures, even though the innovations provide future benefits.²⁴⁷ That can also apply to activities that develop a new chemical that can be applied to seed or crops that enhances productivity. In short, due to the R&E expenditures, the farmer does not need to determine if the expense provides only a current benefit or a benefit that may last into the future. However, the TCJA limited the tax benefit for tax years beginning after 2021.²⁴⁸

Note. Agriculture-related businesses deduct R&E expenditures every year as their customer-farmers experiment with different chemicals and fertilizers. The benefit of the credit depends upon weather, soil types, and hardness of the plants. Expenses associated with product development activities can count, and they may also generate an R&D credit under IRC §41.

²⁴³. See, e.g., *Krause v. Comm'r*, 92 TC 1003 (1989).

²⁴⁴. See Treas. Reg. §1.469-5T(a). A good case for the detailed evidence that is required to document 100 hours of work in a taxable year is *Leland v. Comm'r*, TC Memo 2015-240 (Dec. 14, 2015).

²⁴⁵. IRC §174.

²⁴⁶. IRC §41.

²⁴⁷. IRC §174.

²⁴⁸. *Tax Cuts and Jobs Act*, PL 115-97, §13206 part 3 subpart A.

DEDUCTIONS FOR R&E EXPENSES

As mentioned previously, through 2021, taxpayers could elect to currently deduct the amount of certain reasonable R&E expenditures in the year paid or incurred in connection with a trade or business.²⁴⁹ Instead of making the election, a taxpayer could forgo a current deduction, capitalize the expenses, and recover them ratably over the useful life of the research for up to five years. Alternatively, an election could be made to recover them over a period of 10 years. By doing so, the taxpayer would avoid alternative minimum tax (AMT) preferences and adjustments.

Note. Software development costs could be deducted immediately, amortized over five years from the date of completion, or amortized over three years from the date the software was placed in service.²⁵⁰

Generally, no current deduction is allowable for expenditures for the acquisition or improvement of land, or of depreciable or depletable property used in connection with any research or experimentation.²⁵¹ In addition, no current deduction is allowed for research expenses incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral, including oil and gas.²⁵²

Qualified research is related to developing a product that can be used in the taxpayer's trade or business.²⁵³ It is an activity or project that a taxpayer undertakes to create a new or improved component of the taxpayer's business using a systemic experimentation process that relies on principles of physical or biological sciences, engineering, or computer science designed to evaluate one or more alternatives to achieve a result that was uncertain when the research activity began.²⁵⁴

R&E Expenses under the TCJA

The TCJA specifies that for amounts paid or incurred in tax years beginning **after** Dec. 31, 2021, "specified R&E expenses" incurred in the United States **must be capitalized** and amortized ratably over a 5-year period beginning with the midpoint of the tax year in which the specified R&E expenses were paid or incurred.²⁵⁵

Note. The provision is one of the permanent provisions of the TCJA that does **not** sunset and return to its pre-2018 version.

The R&E expenses cannot be currently deducted. Amortization continues even if the underlying property is disposed of, retired, or abandoned during that period, with the amortization period beginning at the midpoint of the tax year in which the expenditures are incurred or paid. This effectively limits the first-year deduction to 10% of the IRC §174 expenditures in years one through five, with the remaining 50% deducted in year six.

Example 13. For tax year 2021, Widget Corp., had taxable income of \$2 million. Widget's total R&E expenses (domestic) were \$400,000. The full \$400,000 was deductible in 2021, resulting in a taxable income of \$1.6 million. At a 21% corporate rate, the federal income tax due is \$336,000.

Assume that Widget Corp. had the same tax situation for 2022. The deduction is 50% of one-fifth of \$400,000, which is \$40,000. Taxable income is \$1.96 million and the resulting federal income tax due would be \$411,600 (\$1.96 million × 21% federal rate). This is an increase of \$75,600 (\$411,600 – \$336,000) or 22.5% (\$75,600 ÷ \$336,000).

Note. Software development costs are to be treated as §174 expenses.

²⁴⁹ IRC §174.

²⁵⁰ Rev. Proc. 2000-50, 2000-52 IRB 601.

²⁵¹ IRC §174(c)(1).

²⁵² IRC §174(c)(2).

²⁵³ Treas. Reg. §1.174-2(a).

²⁵⁴ Ibid.

²⁵⁵ *Tax Cuts and Jobs Act*, PL 115-97, §13206, amending IRC §174.

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The TCJA amendment also specifies that adherence to the new capitalization rules represents a change in the taxpayer's accounting method under IRC §481 that was initiated by the taxpayer and made with IRS's consent. The IRS has added the §174 change to the list of automatic accounting method changes to be made on Form 3115.²⁵⁶ Instead of filing Form 3115, a taxpayer can file a statement with their return for the first year of adoption only.²⁵⁷ The statement must include the following information for each applicant.

- Name and EIN
- Year of change
- Designated change number (DCN 265)
- Description of the type of R&E expenditures
- Amount of R&E expenditures paid or incurred
- Declaration that the applicant is changing its method of accounting to amortize R&E expenditures over the applicable 5-year or 15-year period and the change is being made on a cut-off basis

If the expenses are incurred in tax years beginning after December 31, 2025, the provision is applied on a **cut-off basis**. That means there is no adjustment under §481(a) for expenses paid or incurred in tax years that begin before 2026.

Note. For taxpayers engaged in the trade or business of farming, if §174 is not applicable, the expenses incurred are likely to be ordinary and necessary expenses incurred in the ordinary course of the trade or business of farming and, therefore, deductible in the year paid under IRC §162.

R&D TAX CREDIT

The Economic Recovery Tax Act of 1981²⁵⁸ introduced the credit for increasing research activities. The credit is better known as the research and development credit, or simply the R&D credit. It is a general business credit for R&D costs that a taxpayer either incurs directly or that a third party performs for the taxpayer. A qualified taxpayer is one with under \$50 million in average annual gross receipts.²⁵⁹ The credit offsets both regular tax and AMT.²⁶⁰ The purpose of the credit as enacted is still the same today — to incentivize research and experimentation by providing a tax credit for activities that develop a new component of a taxpayer's business or improve an existing component's performance, functionality, reliability, or quality.²⁶¹

Note. For more information on the R&D credit, see the 2023 *University of Illinois Federal Tax Workbook*, Chapter 11: New Developments.

²⁵⁶. Rev. Proc. 2023-11, 2023-3 IRB 417.

²⁵⁷. Ibid.

²⁵⁸. *Economic Recovery Tax Act of 1981*, PL 97-34.

²⁵⁹. IRC §38(c)(5)(A)(iii).

²⁶⁰. IRC §38(c)(1).

²⁶¹. IRC §41(d)(3)(A).

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For certain defined smaller businesses, the credit can offset the employer portion of social security taxes up to \$500,000 (with some limitations).²⁶² Smaller businesses for purposes of the R&D credit are those with less than \$5 million in gross receipts for the applicable taxable year and no gross receipts for any of the five preceding taxable years.²⁶³

Observation. Claiming the R&D credit can partially offset the higher tax liability (post-2021) from the TCJA change to §174. For the year in which the R&D credit is claimed, the wages, supplies, and 65% of contract research expenses need not be amortized based on the §174 rules when calculating the R&D credit.

Note. While R&D expenses qualify as R&E expenses under §174, not all R&E expenses qualify for the R&D credit. Costs for facilities and depreciation, among others, must still be amortized.

While the R&D credit is available to a wide array of businesses, including farming businesses, primary questions surround the provision's scope of application.

5

Definitions

As noted previously, the R&D credit applies to activities (including research and software development) that develop a new business component or improve an existing component's performance, functionality, reliability, or quality.²⁶⁴ A **business component** is "any product, process, computer software, technique, formula, or invention which is to be held for sale, lease, or license," or which is used by the taxpayer in the taxpayer's trade or business. The credit equals a percentage of the taxpayer's current year **qualified research expenses (QREs)** that exceed a base amount. Expenses that are incurred with respect to a qualified activity are used to compute the R&D credit and are QREs. A QRE can result from in-house activity as well as expenses incurred via contracts. For in-house activity, a QRE includes wages on Form W-2, *Wage and Tax Statement*, paid to employees that are either directly involved in an activity (including research) that develops, supervises, or supports a new business, as well as the cost of supplies and payments for qualified services (e.g., consultants and engineers).²⁶⁵

Under certain federal farm programs, especially those programs designed to provide environmental benefits, the U.S. Department of Agriculture (USDA) shares part of the expense associated with complying with the program.²⁶⁶ While the expense associated with establishing a conservation/environmental structure/program on the farm might otherwise qualify as a QRE, the portion that the government subsidizes (via IRC §126) would not be a QRE because the taxpayer did not incur the cost. In addition, as explained next, qualified expenses would be limited to a test plot rather than those incurred for an entire field (e.g., research expenses associated with an entire field compared to another field that used different sprays, etc.). For farm taxpayers, this is a key point of understanding. The taxpayer must determine to what extent expenses are merely operating expenses (not QREs) or valid expenses toward the R&D credit.

²⁶². *The Inflation Reduction Act of 2022*, PL 117-169, increased the credit amount from \$250,000 to \$500,000 for qualified small businesses for tax years beginning after December 31, 2022. See IRC §41(h)(4)(B)(i)(II).

²⁶³. IRC §41(h)(3)(A).

²⁶⁴. Treas. Reg. §1.41-4(a).

²⁶⁵. IRC §41(b); see also *Suder v. Comm'r*, TC Memo 2014-201 (Oct. 1, 2014).

²⁶⁶. See, e.g., IRC §126.

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An expense is a QRE if it satisfies the following 4-part test.

1. **Qualified purpose test.** The research activity must be intended to discover information that is applied to develop or improve the functionality, quality, etc., of a business component. A business component is any product, process, computer software, technique, formula, or invention which is to be held for lease, sale, license, or use in the taxpayer's trade or business.²⁶⁷
2. **Technological nature test.** The process of experimentation used to discover information must fundamentally rely on principles of the physical or biological sciences, engineering, or computer science.²⁶⁸
3. **Experimentation test.** Substantially all (80% or more) of the activities must employ a process of experimentation.²⁶⁹ A process of experimentation is a process that is designed to evaluate one or more alternatives (through, for example, modeling, simulation, or a systematic trial and error methodology) to achieve a desired result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer's research activities.²⁷⁰
4. **Uncertainty test.** The process of experimentation/research must be designed to eliminate uncertainty (regarding the company's capability, methodology, or appropriateness of design of a business component).²⁷¹

Note. Each of the four tests applies separately to each business component a taxpayer uses as the factual basis for the research credit claim.²⁷² In addition, the application of the four tests under §41(d)(1) to business components and requirements related to the four tests does not change if a taxpayer uses a statistical sample under Rev. Proc. 2011-42²⁷³ to substantiate a research credit claim. This does not change when the IRS uses a statistical sample to audit a research credit claim.

Note. Treas. Reg. §1.41-4A(d) provides a general exclusion for funded research. It states that research funded by any grant, contract, or otherwise by another person, including any governmental entity, does not constitute qualified research for purposes of the research credit. In addition, all agreements entered into between the taxpayer performing the research and other persons must be considered in determining the extent to which the research is funded — not only research contracts.

²⁶⁷. IRC §41(d)(1)(B)(ii); Treas. Reg. §1.41-4(a)(2)(i).

²⁶⁸. IRC §41(d)(1)(B)(i); Treas. Reg. §1.41-4(a)(4).

²⁶⁹. IRC §41(d)(1)(C).

²⁷⁰. Treas. Reg. §1.41-4(a)(2)(iii).

²⁷¹. IRC §41(d)(1)(A); Treas. Reg. §1.41-4(a)(2).

²⁷². FAA 20212501F (May 10, 2021).

²⁷³. Rev. Proc. 2011-42, 2011-37 IRB 318.

Illustrative Cases

- In *Max v. Comm'r*,²⁷⁴ a fashion designer's multistep process of designing garments failed three tests of the 4-part test and, therefore, did not constitute qualified research. The Tax Court determined that the petitioner failed the "uncertainty" test because its activities were not "investigative" in nature as it already had the requisite information to solve problems as they arose. The petitioner's employees had already faced the uncertainties in prior years — how to align prints, alter standard patterns for the plus-size line, fit garments, and cut fabrics along the proper grain. Thus, these issues were not uncertainties as contemplated by §174. The Tax Court also found that the petitioner failed the technological nature test because the taxpayer's fit testing was not engineering, draping fabric was not materials science, and shrinkage tests were not chemistry. The petitioner failed the experimentation test because the petitioner's "method of simple trial and error" was not akin to the scientific method or a systematic trial and error methodology. In addition, the Tax Court held that the petitioner did not prove that substantially all the garments underwent a process of experimentation.
- In *Little Sandy Coal Co. v. Comm'r*,²⁷⁵ the Tax Court held that the petitioner failed to show that "substantially all" the activities in developing vessels satisfied the experimentation test. The petitioner claimed that because the vast majority of the vessel, including every major system on the vessel, was re-engineered and redesigned, the "substantially all" requirement was met. Alternatively, the petitioner claimed that 87% of employee development time involved elements of the vessel that differed from the previous model. The Tax Court disagreed, concluding that the "substantially all" requirement applies in reference to activities and not the physical elements of the business component being developed or improved. The Tax Court also pointed out that direct support does not constitute qualified research and is not included in the numerator in determining whether substantially all the taxpayer's activities constitute elements of a process of experimentation.
- In *Harper v. Comm'r*,²⁷⁶ the Tax Court held that the IRS failed to show a military structures builder was not entitled to \$825,300 in tax credits for R&E expenses. The petitioner specialized in military design-build projects, including over 30 military housing projects. The IRS claimed that the designs were not tangible "products" under §41. The Tax Court rejected the IRS position on the basis that the designs could still potentially constitute "processes, techniques, or inventions" which would qualify under §41. This is a significant taxpayer win.

Example 14. In 2023, Acme Co. incurs the following employee hours and wage expense in developing a new product.

- **Qualified research.** 600 engineering hours (\$72,000 of wage expense) in developing and testing the new product
- **Direct supervision.** 60 manager hours (\$9,000 of wage expense) directly supervising the engineering team developing and testing the new product
- **Direct support.** 120 production hours (\$9,600 of wage expense) for machining prototypes of the new product used in qualified research

The total number of employee hours incurred is 780 at a cumulative wage expense of \$90,600.

Acme Co.'s development activities do not satisfy the "substantially all" requirement of the process of experimentation test at the product level because the qualified research constitutes only 77% ($600 \div 780$) of employee hours and only 79.5% ($\$72,000 \div \$90,600$) of the wage expense relate to the performance of qualified research. Thus, Acme Co. can either not claim the R&D credit, apply the "shrinking back" rule to find discreet elements of the new product that satisfy the "substantially all" requirement, or review the manager or production hours to see whether some of those hours constitute qualified research.

²⁷⁴. *Max v. Comm'r*, TC Memo 2021-37 (Mar. 29, 2021).

²⁷⁵. *Little Sandy Coal Co. v. Comm'r*, TC Memo 2021-15 (Feb. 11, 2021).

²⁷⁶. *Harper v. Comm'r*, TC Memo 2023-57 (May 10, 2023).

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Mechanics of the R&D Tax Credit

Once the qualified activities and QREs are determined, the R&D tax credit is 6% of eligible expenses for each of the first three years that qualified research activities are conducted.²⁷⁷ After that, the alternative simplified method sets the R&D credit at 14% of the excess of QREs for the tax year over 50% of the average QREs for the three preceding tax years multiplied by 79% (factoring in a reduction via IRC §280C).²⁷⁸ The reduction factor is 1 minus the highest corporate tax rate and increased from 65% to 79% upon enactment of the TCJA.

Example 15. Bucky is trying to determine his R&D credit for 2023. Because this is his 4th year of incurring research activity expenses, Bucky applies the alternative simplified credit computation. Assume that Bucky incurs QREs of \$50,000 in 2020, \$62,500 in 2021, and \$75,000 in 2022. The average over those three years is \$62,500. For 2023, Bucky incurs \$75,000 of QREs. From that amount, Bucky subtracts 50% of the average QREs for the prior three years, or \$31,250 ($\$62,500 \times 50\%$) resulting in \$43,750 eligible costs (\$75,000 QRE – \$31,250). That amount is then multiplied by 14%, resulting in a preliminary credit of \$6,125. Bucky elects the reduced credit under §280C to avoid reducing his deductible expenses by the amount of the R&D credit. The \$6,125 amount is then multiplied by 79% (the §280C credit reduction), which yields an R&D credit of \$4,839. The instructions for Form 6765, *Credit for Increasing Research Activities*, are instrumental in properly computing the credit and accurately completing Form 6765. Bucky claims the credit in Section B as shown on the following Form 6765.

Under Common Control		17	
Section B—Alternative Simplified Credit. Skip this section if you are completing Section A.			
18	Certain amounts paid or incurred to energy consortia (see the line 1 instructions)	18	0
19	Basic research payments to qualified organizations (see the line 2 instructions)	19	0
20	Qualified organization base period amount (see the line 3 instructions)	20	0
21	Subtract line 20 from line 19. If zero or less, enter -0-	21	0
22	Add lines 18 and 21	22	0
23	Multiply line 22 by 20% (0.20)	23	0
24	Wages for qualified services (do not include wages used in figuring the work opportunity credit)	24	75,000
25	Cost of supplies	25	
26	Rental or lease costs of computers (see the line 7 instructions)	26	
27	Enter the applicable percentage of contract research expenses. See the line 8 instructions	27	
28	Total qualified research expenses. Add lines 24 through 27	28	75,000
29	Enter your total qualified research expenses for the prior 3 tax years. If you had no qualified research expenses in any one of those years, skip lines 30 and 31	29	187,500
30	Divide line 29 by 6.0	30	31,250
31	Subtract line 30 from line 28. If zero or less, enter -0-	31	43,750
32	Multiply line 31 by 14% (0.14). If you skipped lines 30 and 31, multiply line 28 by 6% (0.06)	32	6,125
33	Add lines 23 and 32	33	6,125
34	Are you electing the reduced credit under section 280C? ☒ Yes ☐ No If "Yes," multiply line 33 by 79% (0.79). If "No," enter the amount from line 33 and see the line 17 instructions for the statement that must be attached. Members of controlled groups or businesses under common control, see instructions for the statement that must be attached	34	4,839

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13700H Form 6765 (Rev. 12-2020)

Note. If a taxpayer does not incur at least the level of QREs that Bucky did in the preceding example, it may not be worth the extra recordkeeping and tax preparation cost of claiming the credit.

²⁷⁷. IRC §41(c)(5)(B)(ii).

²⁷⁸. IRC §§41(c)(5) and (h).

Privately held businesses having \$50 million or less in average gross receipts for the three preceding tax years can use the R&D credit to offset the AMT.²⁷⁹ Additionally, start-up companies, or those with less than \$5 million in gross receipts for the current tax year and no gross receipts for the five preceding years, may use R&D credits against their payroll tax liability.²⁸⁰

Recordkeeping

A taxpayer claiming the R&D credit must retain records in a sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit.²⁸¹

Research Credit Refund Claims

A refund will be disallowed unless the taxpayer files a valid claim for refund before the expiration of the limitations period under IRC §6511.²⁸² A valid claim for refund must set forth in detail each ground upon which the refund is claimed and facts sufficient to establish the exact basis of the refund claim.²⁸³

The IRS requires a taxpayer to include minimum facts in a refund claim for it to be valid under the specificity requirement for research credit refund claims filed on or after January 10, 2022.²⁸⁴ At a minimum, a research credit refund claim must:²⁸⁵

1. Identify all the business components to which the research credit refund claim relates for the tax year;
2. For each business component, identify all research activities performed, all individuals who performed each research activity, and all the information each individual sought to discover; and
3. Provide the total qualified employee wage expenses, total qualified supply expenses, and total qualified contract research expenses for the claim year, which may be done on Form 6765.

The IRS requires taxpayers provide the facts in a written statement rather than the production of supporting documents, such as a research credit study, unless the taxpayer specifies the exact pages in the documents a specific fact. The taxpayer must verify the accuracy of the facts provided by signed declaration under the penalty of perjury. In most cases, the signature on the amended return will satisfy this requirement. Instead of specific names of each individual who performed each research activity, taxpayers may identify the individuals by listing their titles or positions. Information may be aggregated but must identify the specific number of individuals and each individual's title or position.²⁸⁶

Note. For additional information about the required documentation and the particulars of a refund claim, see **uofi.tax/23x5x1** [www.irs.gov/businesses/corporations/research-credit-claims-section-41-on-amended-returns-frequently-asked-questions].

²⁷⁹. IRC §38(c)(5)(A)(iii).

²⁸⁰. IRC §§41(h)(3)(A)(i) and (4)(B)(i).

²⁸¹. Treas. Reg. §1.41-4(d).

²⁸². Treas. Reg. §301.6402-2(a)(1).

²⁸³. Treas. Reg. §301.6402-2(b)(1).

²⁸⁴. FAA 20214101F (Sep. 17, 2021).

²⁸⁵. Ibid.

²⁸⁶. Ibid.

Transition Period²⁸⁷

A transition period exists through January 10, 2024, during which taxpayers have 45 days to perfect an R&D credit refund claim before the IRS's final determination on the claim. If during the transition period an R&D credit refund claim is determined to be deficient, the taxpayer will be mailed a letter providing 45 days to perfect the claim. If the IRS does not receive the information or the missing information is insufficient, the entire claim for refund will be rejected.

Application to Agriculture

As noted previously, the R&D credit applies to costs incurred associated with research to develop new products or improve existing ones. It is important that the research involves technological information or some sort of application that is intended to develop new or improved business products or processes. It is also important that the research activities have a process of experimentation that relates to a new or improved function, performance, reliability, efficiency, or quality.

The kind of research activities on a farm that generates qualified expenses for the R&D credit are those that are new to the farm and involve testing of something before it can be used on a larger scale. For farmers, the credit could potentially have a wide application – farmers often are tinkering or investigating ways to improve productivity or efficiency of crop or livestock production. Common examples might include:

- Testing new fungicides and seed treatment in an attempt to control insect disease;
- Testing precision planting equipment in an effort to find ways to increase efficiency and/or yield;
- Experimenting with organic fertilizer or a cover crop to determine the impact on soil fertility and/or soil erosion;
- Trying new cultivation techniques such as strip tillage;
- Experimenting with irrigation and drainage and determining the impact on soil productivity and/or erosion;
- Coming up with new weed/pest management techniques;
- Experimenting with crop genetics;
- Testing various planting dates, plant population, and row spacing to determine the impact on plant growth and development;
- Testing combines and other harvesting equipment to minimize crop waste and/or decrease harvest time;
- Working on customized animal feed formulations;
- Developing customized software; and
- Researching and designing new grain bins.

Observation. The R&D credit can have a broad application to many activities that occur on a farm or ranch. But, the IRS is unlikely to allow the R&D credit to be applied to the whole farm. The credit is for R&D — in other words, something that would occur in a laboratory. The entire farm is not a laboratory, but a test plot is. It is likely that the IRS will argue that the qualified research activities (which give rise to QREs) would have to occur in a test plot or similar research focused area, with expenses (including qualified wages, and the cost of chemicals, fertilizer, seed, etc.) allocated to the specific area of the test plot. That will result in a small number for most farmers, especially in the Midwest. Higher value crops, such as potatoes, onions, and fruits, might have bigger numbers, but the point remains that the QREs (and, hence, the R&D credit) must be associated with a test plot or similar research focused area and not the entire farm.

²⁸⁷. *Research Credit Claims (Section 41) on Amended Returns Frequently Asked Questions*. Oct. 4, 2022. IRS. [www.irs.gov/businesses/corporations/research-credit-claims-section-41-on-amended-returns-frequently-asked-questions] Accessed on Jul. 6, 2023.

Caution. The IRS has been focused on abuses with the R&D credit for the past few years. In situations where the IRS has suspected abuses, it has threatened to turn CPA firms over to the IRS Office of Professional Responsibility.²⁸⁸ On May 20, 2022, the IRS Criminal Investigation Division raided the Houston headquarters of R&D tax consulting firm, Alliantgroup. Related to that raid, the IRS subpoenaed various CPA firms that referred clients to Alliantgroup and sought client tax returns as part of the investigation. The government's demand references R&D tax credits, cost segregation, and IRC §179D (commercial buildings energy efficiency deduction) and any related information from as far back as January 1, 2011.

AGRICULTURE-RELATED RULINGS AND CASES

EXCISE TAX

Excise Tax Expense Rather Than Gross Excise Tax Liability Used in Computing Cost of Goods Sold for Fuel Blender *Growmark, Inc. v. Comm'r*, 160 TC 11 (May 16, 2023)

Growmark, Inc., an agricultural supply cooperative that also blends fuel (including ethanol and biodiesel), serves the supply needs of its member-patrons that are primarily independent farmers. Growmark incurred an IRC §4801 fuel excise tax liability when it removed a taxable fuel that it owned as a position holder (holding inventory in a fuel distribution facility) from a rack at a distribution facility. Growmark also incurred the §4801 tax regarding gallons of ethanol and biodiesel that Growmark removed and sold as part of an alcohol fuel mixture or biodiesel mixture. During the tax years at issue, the excise tax reflected Growmark's fuel mixtures for sale to third parties for use as a fuel. The ethanol that Growmark produced and then blended with taxable fuel was eligible for either the alcohol fuel mixture excise tax credit²⁸⁹ or the alcohol mixture income tax credit.²⁹⁰ However, Growmark only claimed the alcohol fuel and biodiesel mixture excise tax credits under IRC §6426 for all the alcohol fuel and biodiesel mixtures it produced and sold during 2009 and 2010.

Growmark filed Form 720, *Quarterly Excise Tax Credit Tax Return*, for each of the quarters beginning or ending within its tax years 2009-2010 and claimed the credit. As a fuel blender, Growmark could reduce its taxable income from fuel mixture sales by subtracting its cost of goods sold (COGS), including certain federal excise taxes. For each year in issue, Growmark filed Form 1120-C, *U.S. Income Tax Return for Cooperative Associations*, on which it included in its COGS its actual excise tax expense (excise tax liability less the amount of tax credits allowed under §6426). That caused Growmark's COGS to be lower and its taxable income higher than it would have been had its excise tax liability not been reduced by the tax credits it received. Growmark later claimed that it could claim its gross excise tax liability unreduced by the tax credits it received as part of its COGS. The IRS disagreed. Thus, the issue was whether Growmark had to reduce deductions based on fuel tax liability or include the refundable fuel tax credits in income.

²⁸⁸. *Galleria High Rise Offices Target of IRS Criminal Investigators Friday [UPDATED]*. Downing, Margaret. May 20, 2022. Houston Press. [www.houstonpress.com/news/irs-raids-galleria-offices-13421664] Accessed on Aug. 18, 2023.

²⁸⁹. IRC §§6426(a)(1) and (b).

²⁹⁰. IRC §40(a)(1).

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The IRS had previously taken the position that when there is no actual excise tax liability, a purely refundable fuel tax credit does not reduce any deduction for fuel or create any addition to income.²⁹¹ When there is actual fuel tax liability, the IRS's position is that the credits must first offset this liability and reduce the deduction for tax expense (or COGS) or be included in income.²⁹² The IRS has also won several court cases on the issue.²⁹³ The Tax Court agreed with the IRS, noting that the legislative history and the statutory construction support the conclusion that the tax credits must first be used to offset tax liability — actual excise expense rather than gross excise tax liability — must be used to calculate COGS.

Note. The facts of the case did not allow the Tax Court to address the situation where the entity generating the fuel tax credit is separate from the activity generating the excise tax liability. Potentially, it could be possible to achieve the result the petitioner sought by structuring the taxpayer's business differently.

HOBBY LOSS

IRS Focuses on Wrong Issues — Loses Hobby Loss Argument and Misses Reallocation Argument *Carson v. Comm'r*, No. 23086-21S (U.S. Tax Ct. Mar. 22, 2023)

The Oklahoma ranch at issue was originally owned by Leslyn Jo Carson's grandmother and then inherited by Leslyn Jo's mother. In 2009, as part of a family succession plan, Leslyn Jo's mother transferred the ranch to a revocable trust. Under the trust's terms, if Leslyn Jo's mother died and was predeceased by Leslyn Jo's stepfather, the ranch would pass equally to Leslyn Jo and her brother. If Leslyn Jo's stepfather was alive at the time of Leslyn Jo's mother's death, the ranch would remain in trust for his life and then be distributed equally to Leslyn Jo and her brother upon their stepfather's death. Leslyn Jo and her mother executed two separate agreements in 2013 and 2016, whereby Leslyn Jo agreed to contribute financially to the ranch and that Leslyn Jo and her mother would jointly agree about the amount, if any, of cash distributions from ranch earnings that would be made to Leslyn Jo.

From 2014 to 2019, Leslyn Jo paid the ranch expenses, but her mother reported on her return the income from cattle sales. Leslyn Jo did not receive any cash distributions from ranching activities and did not report ranch income. Leslyn Jo's children participated in rodeos, and the income from the rodeo activities was reported on Leslyn Jo's Schedule F under "livestock activities." For 2017, the Carson's Schedule F reported gross income of \$2,741 and deductions of \$128,990 from the ranching activity. For 2018, the Carson's Schedule F reported gross income of \$8,063, including \$1,867 of compensation for labor services performed by the children for local ranches and \$6,196 for the children's rodeo competition winnings. Expense deductions claimed on Schedule F were \$133,929. From 2014-2019, the Carsons reported cumulative losses of \$502,742 on Schedule F which far exceeded the cumulative Schedule F gross income and largely offset the Carson's ordinary income (primarily wage income). The IRS audited the couple and determined that the Schedule F activity was rodeo and not ranching, ignoring the fact that the Schedule F expenses were predominantly from the ranching activity. As a result, the IRS determined that the rodeo activity was not engaged in with the requisite profit motive and disallowed all Schedule F deductions for 2017 and 2018.

²⁹¹. CCA 201342010 (Aug. 29, 2013).

²⁹². See IRS Notice 2015-65, 2015-35 IRB 235; CCA 201406001 (Jan. 13, 2014).

²⁹³. See *Sunoco, Inc. v. U.S.*, 908 F.3d 710 (Fed. Cir. 2018), *cert. denied*, 140 S. Ct. 46 (2019); *Delek US Holdings, Inc. v. U.S.*, 32 F.4th 495 (6th Cir. 2022); *Exxon Mobil Corporation v. U.S.*, 43 F.4th 424 (5th Cir. 2022).

The Tax Court determined that the IRS had focused improperly on the rodeo activity rather than the ranching activity. The Tax Court further noted that the Carsons credibly testified that the Schedule F activities primarily related to the ranch and not to rodeos. As such, the losses related to the ranching activity and not the rodeo activity, and the IRS failed to challenge the profit motive of the ranching activity. The Tax Court refused to allow the IRS to refocus its challenge to the Schedule F deductions on the ranching activity, holding that the IRS had waived its right to do so. **Thus, the activity reported on Schedule F for 2017 and 2018 was deemed to be engaged in for profit.**

Observation. It could be expected that the IRS would question the arrangement between Leslyn Jo and her mother. It was not anticipated that the IRS would focus solely on the Schedule F income that resulted solely from the rodeo activity of the Carson children. The arrangement between Leslyn Jo and her mother was more akin to that of a partnership, and the fact that the ranch was in a revocable trust meant that the mother could revoke the trust at any time. This possibly led to an IRS argument that there really was not a trade or business activity being conducted. Indeed, the expenses Leslyn Jo paid were really the trust's expenses. It was the trust that was conducting the trade or business activity. Clearly, the arrangement was designed to prevent Leslyn Jo from recognizing any income. But, the IRS made the mistaken assertion that the primary purpose of the business was to fund the rodeo activities of the children, and failed to acquire and analyze relevant information about the nature of the ranching activity.

In *Carson*, because the IRS did not focus on a partnership arrangement between Leslyn Jo and her mother, it also did not press a reallocation argument. The IRS has broad powers to reallocate income, deductions, credits, or allowances as necessary to reflect economic reality or prevent tax evasion.²⁹⁴

In a 2010 case, the U.S. Tax Court again used the assignment of income doctrine in another farm case involving a “midstream” incorporation. In *Slota v. Comm’r*,²⁹⁵ a farm couple operated a sole proprietorship farming operation. Income from the operation consisted of proceeds from the sale of crops and the receipt of federal farm program payments. The crop income and the farm program income was deposited into the couple’s personal farm account. In September of 2005, the couple formed a corporation and named themselves as the sole shareholders and directors. They did not execute a deed, sales contract, or any written agreement that transferred or leased the couple’s farmland to the corporation. They did transfer to the corporation \$10,000 from their personal bank account to establish the corporate account. After incorporation, in October 2005, Mr. Slota deposited the 2005 government payments (except one) into their personal account. That one government payment was deposited into the corporate account. Later in October, Mr. Slota transferred the balance of the USDA payments and the crop sale proceeds to the corporate account. For 2005, the Slotas reported \$195,938 from crop sales and \$61,416 in farm program payments on Schedule F. They claimed an expense deduction for \$44,165 of USDA payments and \$20,532 of crop sale proceeds that they had put in the corporate account. They reported \$481 of SE tax liability. For the fiscal year ending September 30, 2006, the corporation reported \$370,647 of income, but completely offset it by expenses.

The IRS disagreed with the Slotas’s reporting, attributing to the couple all the funds that were deposited into or transferred to the corporate account in 2005 (except the one government payment). The IRS increased the Slotas’ tax liability to \$28,445 under the assignment of income doctrine. While the Slotas argued that they transferred their crops to the corporation, the IRS did not agree. The IRS noted that the Slotas had already reduced the crops to income before transferring the crop income (proceeds) to the corporation. Consequently, the couple earned the income before transferring it to the corporation. Likewise, because the USDA payments were issued in the couple’s names, those payments were not corporate income.

²⁹⁴. IRC §482; see, e.g., *Rooney v. U.S.*, 305 F.2d 681 (9th Cir. 1962). The IRS was upheld in reallocating production expenses incurred by the individual taxpayer to a newly formed corporation. The case involved a July 31 transfer of a growing hop crop (which had been sold under contract the prior January 22) to a new corporation with the crop harvested in late August and early September.

²⁹⁵. *Slota v. Comm’r*; TC Summ. Op. 2010-152 (Oct. 12, 2010).

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The court agreed with the IRS, applying the assignment of income doctrine. The court specifically noted that the Slotas had no documents indicating that they had actually transferred the land or the crops to the corporation. All they transferred was the proceeds of the crops and the government payments that had been paid to them personally.

LODGING AND MEALS

Value of Employer-Provided Housing Not Excludable from Income

Smith v. Comm'r, TC Memo 2023-6 (Jan. 12, 2023)

The value of meals and lodging furnished on the business premises for the employer's convenience and as a condition of employment are not taxable income to the employee (and the employee's spouse and dependents) and are deductible by the employer if they are provided in-kind.²⁹⁶ Likewise, the value of meals and lodging furnished on the business premises for the convenience of the employer are not wages for Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) purposes.

Note. As an employer-provided fringe benefit, the meals and lodging arrangement is available only to an individual who is an employee of a C corporation. Owners of other entities cannot take advantage of this fringe benefit. For instance, sole proprietors and partners in a partnership do not have the necessary employee status to qualify for the fringe benefit. Also, IRC §1372 bars S corporation employees who own, directly or indirectly, more than 2% of the outstanding stock from receiving tax-free fringe benefits, including the IRC §119 meals and lodging fringe benefit. In addition, with respect to S corporations, the IRC §318 attribution rules apply in determining who is considered an S corporation shareholder.²⁹⁷

Cory Smith was an Air Force veteran and engineer who accepted an offer of employment with a defense contractor to work as an engineer in Australia. He was given options for housing: a furnished house for which he would have to report the fair rental value on his return, or a payment to compensate him for the cost of owning or renting housing. He accepted company-provided housing approximately 11 miles from his work location. After eight years of living in the company-provided housing, the company ceased providing housing and he had to find housing on his own.

For 2016 and 2017, Cory reported the value of the housing provided to him on his return, but then filed amended returns claiming an offsetting deduction for "employee benefit programs." On his 2018 return, he reported the value of the housing but also claimed a deduction for "employee benefit programs." The IRS disallowed the deductions.

The Tax Court noted that certain conditions must be satisfied to exclude the value of employer-provided lodging from income under §119. For example, the lodging must be furnished for the convenience of the employer, furnished on the business premises, and the employee must be required to accept the lodging as a condition of employment. The Tax Court determined that the lodging was not furnished on the business premises. Cory's occasional business activities at the home were not sufficient to establish the housing was integral to his business activities and the housing was not necessary for the performance of his duties.

Note. The phrase "on the business premises" has been the subject of extensive judicial interpretation. But the principles have been applied relatively uniformly. A key case on the matter is *Benninghoff v. Comm'r*,²⁹⁸ where the court noted that the "touchstone" of the business premises test is the lodging's relationship to the business activity of the employer. In other words, the lodging must bear an integral relationship to the business activity of the employer.

²⁹⁶. IRC §119. This tax treatment is available only for meals and lodging furnished to *employees*, not *tenants*. See *Weeldreyer v. Comm'r*, TC Memo 2003-324 (Nov. 25, 2003); *Schmidt v. Comm'r*, TC Memo 2003-325 (Nov. 25, 2003); *Tschetter v. Comm'r*, TC Memo 2003-326 (Nov. 25, 2003); *Waterfall Farms, Inc. v. Comm'r*, TC Memo 2003-327 (Nov. 25, 2003).

²⁹⁷. The IRS will not issue rulings on whether the value of meals or lodging is excludable from gross income by an employee who is a controlling shareholder of the corporate employer. Rev. Proc. 2013-3, 2013-1 IRB 113.

²⁹⁸. *Benninghoff v. Comm'r*, 71 TC 216 (1978).

Meals that are provided to employees during working hours without the furnishing of lodging must be furnished for substantial non-compensatory business reasons of the employer. Examples include emergency call situations, employer business activity that permits a short meal break, and insufficient eating facilities in the vicinity of the employer's premises.²⁹⁹

A significant question is whether the value of groceries furnished to an employee that the employee then prepares into meals is eligible for the exclusion. The IRS claims that it is not.³⁰⁰ However, the courts have ruled that either the employer or the employee may prepare the groceries into meals if the arrangement otherwise meets the requirements of §119.³⁰¹ The issue is not settled. Some courts have held that groceries are included under the definition of meals, but other courts and the IRS have ruled that the value of groceries is not meals and is includable in an employee's gross income.

For the value of lodging to be excluded, the employee must be required to accept the lodging on the premises as a condition of employment (such as for security reasons, livestock observation, or periodic chores). The lodging must be provided in-kind. Cash allowances for lodging (and meals) are includable in gross income to the extent the allowance constitutes compensation.³⁰²

The litigated cases on this issue date back to the 1930s. The first pair of cases involved individuals working for the Dole Corporation in Hawaii. These individuals were plantation managers in pineapple fields, and they argued that they were required to remain on the premises and, as such, the value of meals and lodging provided to them by the corporation should not be included in their income. They prevailed in court.

In a 1948 case, the rental value of a corporate-owned farmhouse occupied by the sole shareholder of the farm corporation was included in the shareholder's taxable income. In a 1966 Wyoming case, *Wilhelm v. U.S.*,³⁰³ the taxpayers owned a ranch in a remote location several miles from the nearest town. The taxpayers transferred the ranch, ranch house, and all the equipment to the corporation and attempted to live in the house tax-free. The corporation also bought the food and treated it as a deductible expense. The IRS challenged the practice. The Federal District Court for the District of Wyoming ruled against the IRS and noted that the ranch was a grass ranch that put up very little hay and required constant attention by persons experienced in grass ranch requirements to keep cattle alive. The court also noted that during snowstorms, the cattle needed to be fed daily, needed to be moved, waterholes had to be kept open, and the cattle had to be protected against the hazards of being trapped or falling into ravines. The court felt that the employees had no other choice but to accept the facilities furnished by the corporate employer, and that the food and lodging were furnished to the employees not only for the convenience of the employer, but were indispensable to have the employees on the job at all times.

²⁹⁹. Treas. Reg. §1.119-1(a)(2).

³⁰⁰. Rev. Rul. 77-80, 1977-1 CB 36.

³⁰¹. *Jacobs v. Comm'r*, 493 F.2d 1294 (3d Cir. 1974) (the definition of groceries included non-food items such as napkins, toilet tissue, and soap, because these items were an integral part of furnishing meals and lodging); *Harrison v. Comm'r*, TC Memo 1981-211 (Apr. 28, 1981) (corporate employees (farm wives) bought the groceries and converted them into meals which were then furnished to the corporate employees and their families on the farm premises; farm wives were paid a small annual salary with their duties defined as including the preparation of meals for corporate employees).

³⁰². See, e.g., Ltr. Rul. 9801023 (Sep. 30, 1997).

³⁰³. *Wilhelm v. U.S.* 257 F. Supp 16 (D. Wyo. 1966).

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The *Wilhelm* case was a very important decision, but it also raised the question of how a court would view the situation if the corporation were located in a less remote area. In 1971, the U.S. Court of Appeals for the 9th Circuit addressed this issue in the context of a grape and crop farming operation in *Caratan v. Comm'r*.³⁰⁴ In *Caratan*, the corporation was located within a 10-minute drive from a residential area of a nearby town. Company policy required supervisory and management personnel to reside on the farm. Company-owned lodging was supplied free of charge for this purpose. The court, in ruling against the IRS, held that the issue was not the remoteness of the corporation, but whether there was a good business reason to require the employees to remain on the premises. The court indicated that the nature of the farming enterprise would determine the reasonableness of requiring employees to reside on the premises rather than the location of the corporation from the nearest town. Whether corporate business required around the clock work such as the case with a grain drying operation, a farrow-to-finish operation, a dairy, or a cattle ranch with characteristics similar to the ranch involved in the *Wilhelm* case was the real issue.

Historically, cash grain operations have had the greatest difficulty in successfully excluding the cost of lodging and meals provided by the corporation to employees. The IRS has difficulty in accepting the fact that grain farmers simply cannot lock up their machinery after the fall harvest, return the next spring and expect it to still be there. The IRS does not put much weight on security, and thinks there is no reason why a grain farmer cannot live in town if all that occurs is the planting, cultivating, and harvesting of a crop. On the other hand, livestock ventures or those that are irrigating or drying grain typically have had better success against an IRS challenge. For example, taxpayers were successful in one case involving only a grain operation with the emphasis on grain drying as a reason to be on the premises on a continuing basis.³⁰⁵

Note. For farming and ranching corporations attempting to exclude the cost of meals and lodging from employees' income, there should be a resolution by the board of directors clearly setting forth the requirement that employees are required to live on the premises.³⁰⁶ Sometimes this resolution is questioned because the same people who make the decision as members of the board of directors are the same people who are also employees living in the corporation's house and eating the corporation's food. Thus, while it is not necessarily an arm's length determination, such a resolution should be adopted.

A 1994 decision from the same court (but a different judge) that decided *Wilhelm* in 1966 declared that the reasoning in *Wilhelm* "is no longer persuasive." In *Dilts v. U.S.*,³⁰⁷ the court disallowed the deductibility of the value of the shareholder's food and lodging from their taxable income. The case involved an unusual set of facts where the taxpayers, to get around the limits applicable to S corporations, argued that the operation was really a partnership and cited a 1968 case treating partners as employees (one of the few cases to do so). The court in *Dilts* rejected that argument. Although not part of the holding, the court then proceeded to criticize the tax code provision allowing meals and lodging to be excluded from shareholders' incomes. The court cited public policy concerns and congressional intent to treat similarly situated people as similar for tax purposes to achieve "horizontal equity." The court reasoned that it would be inequitable to allow corporate shareholders to receive benefits in the form of exclusions that are unavailable to sole proprietors.

Observation. The *Dilts* case is out of step with the IRS, Tax Court, and the Circuit Courts of Appeal that have decided cases in this area.

^{304.} *Caratan v. Comm'r*, 442 F.2d 606 (9th Cir. 1971).

^{305.} *Johnson v. Comm'r*, TC Memo 1985-175 (Apr. 8, 1985); compare with *J. Grant Farms, Inc. v. Comm'r*, TC Memo 1985-174 (Apr. 8, 1985) (swine raising and grain drying operation).

^{306.} Corporate resolutions that authorized the construction of a residence on the farm business premises for the controlling shareholder that focused on the need to entertain business visitors at the corporate location to justify the construction of the residence, rather than the need for ongoing poultry breeding activities, weakened the corporation's argument that the controlling shareholder was required to live in the corporate residence as a condition of employment, resulting in a loss of the exclusion. *Peterson v. Comm'r*, TC Memo 1966-196 (Sep. 2, 1966) (controlling shareholder had also resided in a nearby community for about the prior 10 years while managing the farming business).

^{307.} *Dilts v. U.S.*, 845 F. Supp. 1505 (D. Wyo. 1994).

CONSERVATION EASEMENTS

Penalties Imposed on Donated Conservation Easement Transaction

Plateau Holdings, LLC, Waterfall Development Manager, LLC, Tax Matters Partner v. Comm'r, TC Memo 2021-133 (Nov. 30, 2021).

Plateau donated a conservation easement to a qualified charity and claimed a \$25.5 million charitable donation deduction. The IRS challenged the valuation of the easement and its validity in an earlier decision. The Tax Court agreed, disallowed the deduction, and imposed a 40% penalty for gross overvaluation of the easements. The deduction was disallowed because the easements were not protected in perpetuity. This was due to a provision in the deeds granting the easements to the charity that reduced the charity's proportionate share of the sale proceeds by an impermissible carve-out for donor improvements upon a judicial extinguishment of the easements. In the present case, the IRS sought an additional 20% penalty for negligence due to Plateau's substantial understatement of tax under IRC §§6662(a) and (b)(1)-(2). The 20% penalty would apply to the portion of the underpayment resulting from the Tax Court's decision in the prior case that Plateau was not entitled to a charitable deduction. The Tax Court did not allow the 20% accuracy-related penalty because Plateau had reasonable cause and acted in good faith with respect to the claimed charitable deduction corresponding to the correct valuation of the easements.

5

Safe Harbor Language Provided for Conservation Easement Deeds

IRS Notice 2023-30, 2023-17 IRB 766

Under the SECURE 2.0 Act, §605(d)(1), which was enacted as part of the Consolidated Appropriations Act of 2023,³⁰⁸ the IRS was required to provide safe harbor language for extinguishment and boundary line adjustment clauses in conservation easement deeds by April 28, 2023. The IRS issued this notice on April 24, 2023, providing the safe harbor language and triggering a 90-day period for a donor to amend an easement deed to substitute the safe harbor language for the corresponding language in the original deed. Thus, under §605(d)(2) of the SECURE 2.0 Act, donors are allowed, but not required, to amend their deeds to include this language. Donors wanting to make the change must do so by July 24, 2023. Any amendment will be treated as effective as of the date of the recording of the original easement deed. The IRS points out in the notice that an amendment cannot be made for any easement deed relating to any contribution that was part of a reportable transaction or was a transaction that was not treated as a qualified conservation contribution by reason of §170(h)(7). This includes a transaction for which a charitable deduction contribution had been disallowed by the IRS and the donor was contesting the disallowance in federal court before the amended deed was recorded, or a transaction for which a claimed charitable deduction for the contribution resulted in an underpayment and a penalty under IRC §§6662 or 6663 had been finally determined.

³⁰⁸. Consolidated Appropriations Act of 2023, PL 117-328.

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Easement Donation Case Heads to Trial

Morgan Run Partners, LLC v. Comm’r, TC Memo 2022-61 (Jun. 14, 2022)

Morgan Run Partners sought a readjustment of partnership items after the IRS disallowed Morgan’s \$26 million deduction for the donation of a syndicated conservation easement and assessed penalties. The IRS claimed that the deed granting the easement on 232 acres of farmland near Birmingham, Alabama, failed to protect the easement in perpetuity as §170(h)(5)(A) requires. The IRS moved for summary judgment.

The Tax Court analyzed the language of the deed granting the easement and first noted that it did not specify when the FMV of the donee’s property right in the farmland was to be calculated. Also, the Tax Court noted that the deed language did not address the possibility that the easement might be extinguished in a future judicial proceeding. The deed stated that the parties intended there would not be future events that would result in the extinguishment of the easement and that nothing would cause the easement donation to fail as a qualified contribution under §170(h). The deed also stated the easement could be terminated by the exercise of eminent domain, but it did not clearly specify how any proceeds were to be allocated. The Tax Court noted that Treas. Reg. §170A-14(g)(6)(i) establishes a formula for determining the allocation of proceeds between the donor and donee upon the extinguishment of the easement. However, the Tax Court reasoned the deed’s general language that §170(h) would not be violated gave Morgan a reasonable argument that it had not violated the requirement that the easement be protected in perpetuity or the “extinguishment” regulation.

Accordingly, summary judgment for the IRS on the “protected in perpetuity” requirement was denied. However, the Tax Court granted summary judgment to the IRS on the penalty issue finding Morgan’s claim that the Revenue Agent may have communicated information regarding an assessment to Morgan failed to introduce a fact issue.

Retained Ownership of Movable Surface Negates Conservation Easement Deduction

CCA 202236010 (Sep. 9, 2022)

The Chief Counsel’s office of the IRS has taken the position that a conservation easement donation is invalid under the requirements of §170(h) if:

- The donor of the easement retains a qualified mineral interest,
- The ownership of the surface estate and mineral interest has never been separated, and
- Under the terms of the deed, the donor can use a surface-mining method to extract the subsurface minerals with the donee’s approval.

The IRS said the result would be the same even if the donee would have to approve the surface-mining method because the donated easement would not be donated exclusively for conservation purposes in accordance with §170(h)(5). The IRS pointed out that Treas. Reg. §1.170A-14(g)(4) states that a donated easement does not protect conservation purposes in perpetuity if any method of mining that is inconsistent with the particular conservation purposes of the contribution is permitted at any time.

But the IRS pointed out that a deduction is allowed if the mining method at issue has a limited, localized impact on the real estate and does not destroy significant conservation interests in a manner that cannot be remedied. Surface mining, however, is specifically prohibited where the ownership of the surface estate and the mineral interest has never been separated. On the specific facts involved, the IRS determined that the donated easement would not be treated as being made exclusively for conservation purposes, because the donee could approve surface mining of the donor’s subsurface minerals.

FARMING DEDUCTIONS

IRS Questions Farming Practices, But Tax Court Allows Most Deductions

Hoakison v. Comm’r, TC Memo 2022-117 (Dec. 5, 2022)

Steven and Judy Hoakison, a married couple, farmed in southwest Iowa. Judy worked off-farm at a veterinary clinic, and Steven was a full-time delivery driver for United Parcel Service (UPS). He purchased his first farm in 1975, four years after graduating high school, and started a cow-calf operation. The Hoakisons lived frugally and always avoided incurring debt, when possible, by purchasing used equipment with cash and Steven doing his own repairs and maintenance. The Hoakisons were able to weather the farm crises of the early-mid 1980s by farming in this manner. Ultimately, the couple owned five tracts totaling 482 acres. The tracts were noncontiguous and ranged anywhere from six to 14 miles apart. On the tracts, the Hoakisons conducted a row-crop and cow-calf operation. Steven worked on the farms early in the mornings before his UPS shift and after his shift ended until late into the night. Over the years, the couple acquired approximately 40 tractors with 17 in use during the years in issue (2013-2015). The tractors had specific features or used a variety of mounted implements to perform the various tasks needed to operate the noncontiguous farms. Certain tractors were dedicated to a particular tract and attached to implements to save time and effort in taking the implements off and reattaching them. The Hoakisons also had several used pickup trucks and a machine shed that they used to store farm equipment.

The Hoakisons’s tax returns for 2013-2015 showed farm losses each year, primarily due to depreciation and other farm expenses. The IRS disallowed significant amounts of depreciation and other farm expense deductions, largely on its claim that the Hoakisons were not engaged in a farming business, but rather were engaged in a “nostalgic” activity with an excessive and unnecessary amount of old tractors. The IRS imposed a substantial understatement penalty of over \$25,000 for the years combined. The IRS took the position that the couple’s pickups and other vehicles were subject to the listed property strict substantiation requirements of IRC §274(d).

The Tax Court disagreed about the trucks that had been modified for use on the farm and were only driven a de minimis amount for personal purposes, but agreed regarding one pickup the Hoakisons used to travel from farm to farm and to the UPS office. As to the disallowed depreciation on certain tractors, the IRS asserted that the tractors were not used in the Hoakisons’s farming business because, according to the IRS, Steven was a collector of antique tractors and the acquisition and maintenance of 40 tractors, most of them more than 40 years old, served no business purpose and involved an element of “nostalgia.” The Tax Court disagreed, noting that Steven had sufficiently detailed his farming practices – avoidance of debt and personally repairing and maintaining the tractors and other farm equipment to avoid hiring mechanic work – and that this was an approach that worked well for them. The Tax Court also noted that the IRS failed to account for the Hoakisons’s noncontiguous tracts, which meant that it was necessary to have various tractors and implements located at each farm to save time moving tractors from farm to farm and assembling and disassembling various attachments. As such, the Tax Court concluded that the items of farm machinery and tractors were used in the couple’s farming business and, thus, it was immaterial whether the purchase of the various farm tractors and implements constituted ordinary and necessary expenses. The Tax Court also determined that the machine shed was a depreciable farm building.

As to various other farming expenses, the Tax Court allowed the Hoakisons’s claimed deductions for utilities, insurance, gasoline, fuel, oil, and repair/maintenance expenses. The Tax Court upheld the accuracy-related penalty with respect to the underpayment of tax related to depreciation claimed on assets that had been previously depreciated, but otherwise denied the penalty.

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ENTITY ISSUE

Corporation Separate Entity from Shareholders

Vorreyer, et al. v. Comm'r, TC Memo 2022-97 (Sep. 21, 2022)

John and Chris Dowson operated a farm individually and through several related entities, including an S corporation and a partnership. The Dowsons were shareholders of an S corporation, and they paid property taxes and utility expenses on behalf of the S corporation in proportion to their respective ownership interests. They then deducted the amounts on their personal returns. The IRS denied the deductions and the Tax Court agreed.

The Tax Court noted that a taxpayer cannot deduct expenses paid on behalf of another taxpayer.³⁰⁹ That rule extends to corporations and their shareholders.³¹⁰ A shareholder cannot deduct, as a personal expense, an expense that furthers the corporation's business.³¹¹ While there is a limited exception allowing a deduction by a shareholder on behalf of a corporate taxpayer for an expenditure the corporation is financially unable to pay to "protect or promote" the business,³¹² the exception did not apply in this case. The Tax Court pointed out that although S corporation income or loss eventually flows through to the shareholders, a corporation "remains a separate taxable entity [from its shareholders] regardless of whether it is a subchapter S corporation or a subchapter C corporation."³¹³ Thus, the business expenses of the S corporation could not be disregarded at the corporate level for purposes of §162. The income of the S corporation had to be matched at the corporate level against the S corporation's expenses that were incurred to produce that income before the net income or loss amount can flow through to the shareholders.³¹⁴ The partnership bought two semi-trucks with a cost of \$70,126 and included the expense as part of its claimed repairs and maintenance expense deduction on Schedule F of its Form 1065, *U.S. Return of Partnership Income*, which the IRS disallowed. The Tax Court upheld the IRS determination, noting that the partnership had not made a §179 election on its return for the truck purchases.

³⁰⁹. See *Deputy v. du Pont*, 308 U.S. 488 (1940).

³¹⁰. See *Westerman v. Comm'r*, 55 TC 478 (1970).

³¹¹. See *Kahn v. Comm'r*, 26 TC 273 (1956).

³¹². See, e.g., *Lohrke v. Comm'r*, 48 TC 679 (1967).

³¹³. *Russell v. Comm'r*, TC Memo 1989-207 (May 1, 1989).

³¹⁴. IRC §1366(a)(2).

REAL ESTATE

Loss on Sale of Real Estate was Capital Loss

Musselwhite v Comm'r, TC Memo 2022-57 (Jun. 8, 2022)

William Musselwhite had been involved in real estate ventures since the mid-1980's. In 2005, William and his business partner formed an LLC. In 2006, the LLC bought four unimproved lots for \$1 million and re-platted them into nine lots. The terms of the sale agreement included certain guarantees-of-resale-within-one-year and allocation of ownership of the nine lots between the parties, with the seller allocated five lots. The sales agreement also included buy-back provisions and other conditions related to development and sale of the lots. The seller was to complete improvements on some of the lots. William financed the purchase of the lots via a loan from a bank. In 2007, the real estate market collapsed, and due to no improvements and lack of sales, the LLC sued the seller. To settle the suit, the seller transferred his partially improved lots to William. The LLC made no further improvement to those lots. The bank's later appraisals indicated that the lots were not known to be for sale. The LLC divided up the lots and the existing debt and distributed four of the lots to William. Within four months, William sold the lots at a loss of \$1,022,726 and reported a Schedule C deduction of \$1,022,726 as COGS. The IRS disagreed, characterizing the loss as a capital loss because the lots were, in the IRS's view, capital assets.

The Tax Court agreed with the IRS that the lots were capital assets and did not meet the definition of stock in trade under §1221(a)(1) that would either be held in inventory or held primarily for sale to customers in the ordinary course of business. The Tax Court noted that the distinction between a capital asset and one held for sale to customers in the ordinary course of business is a fact question. Those factors in the 4th Circuit (the Circuit to which the case would be appealable) include the following.

1. The purpose for which the property was acquired
2. The purpose for which the property was held
3. Improvements, and their extent, that the taxpayer made to the property
4. The frequency, number, and continuity of sales
5. The extent and substantiality of the transaction
6. The nature and extent of the taxpayer's business
7. The extent of advertising or lack thereof
8. The listing of the property for sale directly through a broker

The Tax Court noted while no single factor is determinative, the factors overwhelmingly favor the IRS. The Tax Court also noted that the reason a taxpayer holds real estate can change by the taxpayer developing investment property to prepare it for sale, and that IRC §735(a)(2) provides that gain or loss on the sale or exchange by a distributive partner of inventory items distributed by a partnership is ordinary income/loss if the items are sold or exchanged within five years from the date of distribution.

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SHAREHOLDER COMPENSATION

Deduction for Full Amount of C Corporate Shareholder Compensation Not Deductible

Clary Hood, Inc. v. Comm'r, TC Memo 2022-15 (Mar. 2, 2022), *aff'd in part, vac'd in part and remanded*, No. 2022-1573, 2023 U.S. App. LEXIS 13385 (4th Cir. May 31, 2023)

The Hoods, a married couple, were the sole shareholders of Clary Hood, Inc., a corporation engaged in the construction business that excavated, graded, and prepared land for development. The petitioner's growth was irregular from 2000 on. Clary Hood took a relatively modest salary between 2000 and 2012, but took a big increase in the years 2013 to 2016, ostensibly to compensate for earlier years. The company had an outside consulting firm perform an analysis to determine what Clary's compensation should be. While the IRS conceded that Clary had been underpaid, the IRS challenged the amount in 2015 and 2016 as excessive.

The Tax Court examined the usual factors considered in such a case, including the following.

- The employee's qualifications
- The nature, extent, and scope of the employee's work
- The size and complexities of the business
- A comparison of salaries paid with gross income and net income
- The prevailing general economic conditions
- A comparison of salaries with distributions to stockholders
- The prevailing rates of compensation for comparable positions in comparable concerns
- The salary policy of the taxpayer as to all employees

The Tax Court denied a deduction for the full amount of the compensation. In addition, the IRS assessed an accuracy-related penalty for both years. Clary was able to show that he relied in good faith on the advice of the accounting firm and the Tax Court did not sustain the penalty. However, for the second year, Clary could not substantiate its reliance on the outside adviser.

On appeal, the appellate court affirmed the Tax Court's denial of deductions stemming from \$10 million in total bonuses paid to Clary, concluding that they were more like non-deductible dividends based on the multi-factor approach required by the Treasury Regulations. **However, the appellate court vacated the \$282,000 penalty for 2016 because Clary had relied on a professional's advice in paying out the bonus for that year that was based on a "consistent methodology."**

