Current Issues in Ag Law and Taxation

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Overview

Today's article addresses several current and recurring issues in the fields of law and taxation that are of importance to farmers and ranchers.

Right to Repair

Agribusinesses can exert power over farmers through limits on technology use and access, as well as by other agreements that producers sign to utilize services and products. A big issue is whether the ownership of the technology associated with farm equipment and machinery limits a farmer's right to repair.

When a farmer buys new machinery, the manufacturer may view the transaction more as a technology lease than as a machine sale. At issue is the ownership of the software and technology in the farm machinery. The dramatic increase in computerization of equipment means that all types of data are sent to the cloud by a transmitter. As a result, the manufacturer will claim that only an authorized dealer can make repairs.

This is the crux of the "right to repair" argument. John Deere has said it will provide timely electronic access to farmers and independent repair shops of the manuals, software and tools necessary to operate, maintain, repair or upgrade equipment. But access won't be free, and the agreement is off if a party to the deal introduces right to repair legislation in a state legislature. Other manufacturers have struck similar deals.

At least 11 states have introduced legislation on the issue recently. Colorado's right to repair law, *"The Consumer Right to Repair Agriculture Equipment Act," (HB 23-1011*) goes into effect at the start of 2024.

Good Husbandry Provisions in Ag Leases

According to the USDA, about 40 percent of all farmland is leased. A requirement of good husbandry is a part of all ag leases, either through language in the lease or implicitly where a court will require the tenant to farm in accordance with generally accepted farming practices. *See, e.g., Bostic v. Stanley, 608 S.W.3d 907 (Ark. Ct. App. 2020).* It's tied to the common law duty of "waste" – the tenant can't mismanage the land resulting in substantial injury. Examples include removing topsoil, demolishing buildings or fences, cutting timber or destroying cover crops. It can also include improper tillage practices and failing to control weeds or insects. There's no specific legal definition, so the interpretation of good husbandry's meaning is left up to the courts unless the lease has a specific clause.

In one case, a breach of the duty of good husbandry was found where the tenant started harvesting wheat too late. A breach was also found in another case where the tenant removed manure at the end of the lease. But a breach won't likely be found if weather prevents completion of harvest and other farms in the area have been similarly affected.

If you're concerned about your tenant's farming practices, consider putting a clause in a written lease detailing the farming practices that you deem appropriate and those that you don't.

WOTUS Update

The legal challenges and disputes continue related to the regulatory definition of "waters of the United States" or WOTUS. The disputes concern the EPA and Corp of Engineers regulation published on September 8 purportedly conforming the regulatory definition of "waters of the United States" to the Supreme Court's ruling in a case last May. https://www.federalregister.gov/documents/2023/09/08/2023-18929/revised-definition-of-waters-of-the-united-states-conforming The disputes have implications for many farmers and ranchers. Twenty-six states have sued claiming that the EPA and the Corps of Engineers violated the law when it modified its existing rule to supposedly comply with the Court's ruling. The states claim that the agencies didn't provide enough analysis or explanation of the scope of federal jurisdiction in response to the Court's decision. They also claim the federal agencies are undermining state control over land management and failed to define terms such as "relatively permanent" and "continuous connection."

In addition, Texas and Idaho claim that the modified rule oversteps state sovereignty and asserts federal authority over non-navigable waters. Some industry and ag groups have joined this lawsuit.

As the Supreme Court ruled, only relatively permanent waters that are directly connected to larger navigable water bodies are "waters of the U.S." It's up to the federal agencies to write a rule that provides the parameters of that definition. Expect the legal battles to continue.

Considerations When Buying Farmland

Whether to buy farmland is perhaps the biggest decision you'll have to make with respect to your farming operation as well as your legacy. But there are lots of things to consider before signing on the dotted line. Of course, price is a primary consideration in most transactions, but there are factors that can influence the land's value that aren't necessarily reflected in the sale price.

The following is a list of some of those factors:

- Make sure to account for any improvements that will be needed to buildings, fences and drainage tile.
- Also check the watershed and potential drainage or irrigation issues.
- Is the land in a drainage district?
- Is there potential for an endangered species habitat designation?
- Is there an old dump site on the property?

- Are there any government contracts such as the CRP or easements on the property?
- Is the land leased to a tenant? If so, has the tenancy been terminated? Simply buying the land will not terminate an existing lease.
- Is there a subsurface tenant?

Checking available public records and asking questions of the current owner and neighbors is a good thing to do. Also, physically inspect the property, and get the seller to sign a thorough disclosure document.

Perhaps most importantly, don't let your emotions drive the decision.

Exclusion of Meals and Lodging from Income

The value of meals and lodging furnished on the business premises for the employer's convenience and as a condition of employment is not taxable income to the employee and is deductible by the employer if the meals and lodging is provided in-kind. It also isn't wages for FICA and FUTA purposes.

This is a C corporation benefit. A C corporation provides the broadest fringe benefits of any entity structure. One of those is the ability to provide tax-free meals and lodging to employees. The meals and lodging must be furnished on the business premises, be provided for the employer's convenience and as a condition of employment. Remoteness of the farm or ranch is a factor, but not a determining one. *See, e.g., Caratan v. Comr., 442 F.2d 606 (9th Cir. 1971).* Whether you have a good business reason to have employees on the premises at all times is. A key to success on that issue is documenting the need and requirement in employment agreements or corporate resolutions.

If done right, it can be a nice tax-free fringe benefit for employees and a deduction for the corporation.

Hobby Losses

For a business expense to be deductible, it generally must be "ordinary and necessary" and incurred in a business that is conducted with a profit intent. If not, the activity is deemed to be a hobby and associated losses are "hobby losses." The impact of the tax law on hobby losses is currently harsh.

Over the years, many cases involving ag activities have been the focus of the IRS. If the activity is deemed to be a hobby, any losses are miscellaneous itemized deductions which are currently disallowed. *See, e.g., Gregory v. Comr., 69 F.4th 762 (11th Cir. 2023), aff'g., T.C. Memo. 2021-115.* But all the income from the activity must be reported into gross income.

The IRS and the courts analyze nine factors for determining whether there is a profit intent. Those factors are the manner in which the activity is conducted; the taxpayer's expertise or that of adviser(s); the time and effort put in; whether there's an expectation that the assets will appreciate in value; the taxpayer's success in carrying on similar activities; the taxpayer's history of income or loss; whether there's ever been a profit; and two socioeconomic factors.

None of the factors is conclusive by itself. It's how they stack up in a given situation. What is for sure, though, is that the tax rule is harsh if your activity is deemed to be a hobby.

An S Corporation is a Separate Entity from Yourself

A key principle of tax law is that you can't deduct expenses that you pay on behalf of someone else. That rule extends to corporations and their shareholders. The rule was applied in a recent Tax Court case, *Vorreyer, et al. v. Comr., T.C. Memo. 2022-97,* involving a farming business operating as an S corporation.

You can't deduct an expense of your corporation as your own - even if the corporation is a pass-through entity such as an S corporation. While there's a limited exception, it didn't apply in the recent case where the taxpayers operated a farm individually and through several related entities including an S corporation. They paid the corporation's property taxes and utility expenses and deducted the amounts on their personal returns.

But the Tax Court said that the business expenses of the S corporation could not be disregarded at the corporate level. The S corporation's income must 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.

The result was that the deductions on the shareholders' personal returns were disallowed. Although S corporate income or loss would eventually flow through to them, a corporation is a separate taxable entity.

The lesson is clear – make sure to respect an entity structure. You can't claim a personal deduction for a corporate expense.

FBAR Penalties

In recent years some American farmers have started farming operations in foreign countries, particularly in South America. Doing so could trigger a provision in the Bank Secrecy Act and if the provision is violated, the penalties can be harsh. Under the rule, persons with a bank account in a foreign country containing $10,000 or more must report the account to the IRS by the annual tax filing deadline.

In a recent case involving a dual citizen of the U.S. and Romania, the IRS asserted penalties of almost $3 million. He didn't know about the requirement and didn't report his foreign accounts for several years. He disputed the penalty amount, claiming that it should be reduced to $50,000 based on his failure to file one form annually for five years that disclosed all of his foreign accounts. The Government claimed the penalty was on a per account basis. He won the argument at the trial court but lost on appeal. At the Supreme Court he won – the penalty is on a per-form basis. *Bittner v. United States, 598 U.S. 85 (2023).*

For farmers with farming operations outside the U.S. it's likely that a foreign bank account exists. If so, it's imperative that Form FinCen 114 is filed annually that reports those accounts to the IRS.

Conclusion

I'll ramble on more next time. And…I'm starting to compile my list of the biggest ag law and tax developments of 2023. What do you think were the most important ones?

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