Tax Potpourri – Hobby Losses; Employer-Provided Housing; Tax Computation for Fuel Blenders; and Conservation Easement Deeds

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Overview

Recently, the U.S. Tax Court has issued opinions involving several areas that also can involve farmers and ranchers. With today's post I highlight some of those recent cases and provide some context for how the issues might apply to agricultural producers and/or agribusinesses.

Recent Tax Court cases (and a Rev. Rul.) of interest – it's the topic of today's post.

IRS Focuses on Wrong Issues – Loses Hobby Loss Argument

Carson v. Comr., No. 23086-21S (U.S. Tax Ct. Mar. 22, 2023)

The Oklahoma ranch at issue was originally owned by the petitioner's grandmother and then inherited by petitioner's mother. In 2009, as part of a family succession plan, the petitioner's mother transferred the ranch to a revocable trust. Under the trust's terms, if the mother died and was predeceased by the petitioner's stepfather, the ranch would pass equally to the petitioner and her brother. If the petitioner's stepfather were alive at the time of the mother's death, the ranch would remain in trust for his life and then distribute equally to the petitioner and her brother upon the stepfather's death. The petitioner and her mother executed two separate agreements in 2013 and 2016 whereby the petitioner agreed to contribute financially to the ranch and that the petitioner and her mother would jointly agree about the amount, if any, of cash distributions from ranch earnings would be made to the petitioner. From 2014 to 2019, the petitioner paid the ranch expenses, but the mother reported on her return the income from cattle sales. The petitioner did not receive any cash distributions from ranching activities and as a result did not report ranch income. The petitioner's children participated in rodeos, and the income from the rodeo activities were reported on the petitioner's Schedule F under "livestock activities." For 2017, the petitioner's Schedule F reported gross income of $2,741 and deductions of $128,990 from the ranching activity. For 2018, the petitioner'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 petitioner reported cumulative losses of $502,742 on Schedule F which far exceeded the cumulative Schedule F gross income and largely offset the ordinary income of the petitioner and her husband (primarily wage income). IRS audited 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. The Tax Court determined that the IRS had focused improperly on the rodeo activity rather than the ranching activity, noting that the petitioner had 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.

Note: It's puzzling why the IRS didn't question the arrangement between the petitioner and her mother. It's equally puzzling why the IRS focused solely on the Schedule F income resulting from the children's rodeo activity. The arrangement between the petitioner 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. That fact could have easily led IRS to claim that there really wasn't a trade or business activity being conducted between the petitioner and her mother. Indeed, the expenses the petitioner paid were really the trust's expenses meaning that it was the trust that was conducting the trade or business activity. It's also puzzling why the IRS did not focus on the fact that the arrangement was designed to prevent the petitioner from recognizing any income. But the IRS mistakenly claimed that the primary purpose of the business was to fund the rodeo activities of the children. There was no attempt to find and examine relevant information concerning the ranching activity.

Value of Employer-Provided Housing Not Excludible from Income

Smith v. Comr., T.C. Memo. 2023-6

The petitioner 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 - 1) a furnished house for which he would have to report the fair rental value on his return; or 2) a payment to compensate him for the cost or 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, the petitioner reported the value of the housing provided to him on his return, but then filed amended returns that claimed 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 I.R.C. §119 – 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. The petitioner's occasional business activities at the home were not sufficient to establish that the housing was integral to the employer's business activities and the housing was not necessary for the performance of his duties.

Note: There are numerous cases involving farms and ranches on the issue of employer-provided meals and lodging with the focus being on the definition of the "business premises" and "for the convenience of the employer."

Excise Tax Expense Rather Than Gross Excise Tax Liability Used in Computing COGS for Fuel Blender

Growmark, Inc. v. Comr., 160 T.C. No. 11 (2023)

The petitioner, 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. The petitioner incurred an I.R.C. §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. The I.R.C. §4801 tax was also incurred with respect to the gallons of ethanol and biodiesel when it removed and sold the ethanol or biodiesel as part of an alcohol fuel mixture or biodiesel mixture. During the tax years at issue, the excise tax reflected the petitioner's fuel mixtures for sale to third parties for use as a fuel. The ethanol that the petitioner produced and then blended with taxable fuel was eligible for either the alcohol fuel mixture excise tax credit of I.R.C. §6426(a)(1) and (b) or the alcohol mixture income tax credit under I.R.C. §40(a)(1). However, the petitioner only claimed the alcohol fuel and biodiesel mixture excise tax credits under I.R.C. §6426 for all of the alcohol fuel and biodiesel mixtures it produced and sold during 2009 and 2010. The petitioner 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 on the Forms. As noted above, as a fuel blender the petitioner 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, the petitioner filed Form 1120-C (cooperative tax return) on which it included in its cost-of-goods-sold (COGS) its actual excise tax expense (excise tax liability less the amount of tax credits allowed under I.R.C. §6426). That caused the petitioner'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. The petitioner 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 the petitioner had to reduce deductions based on fuel tax liability or include the refundable fuel tax credits in income. 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. C.C.A. 201342010 (Aug. 29, 2013). When there is actual fuel tax liability, the IRS position is that the credits must first offset this liability and reduce the deduction for tax expense (or COGS) or be included in income. See Notice 2015-65, 2015-35, IRB 235; C.C.A. 201406001 (Jan. 13, 2014). The IRS has also won several court cases on the issue. *See Sunoco, Inc. v. United States, 908 F.3d 710 (Fed. Cir. 2018), cert. den., 140 S. Ct. 46 (2019); Delek US Holdings, Inc. v. United States, 32 F.4th 495 (6th Cir. 2022); Exxon Mobil Corporation v. United States, 43 F. 4th 424 (5th Cir. 2022).* The Tax Court agreed with the IRS, noting that the legislative history and the statutory construction supporting 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.

Safe Harbor Language Provided for Conservation Easement Deeds

Notice 2023-30, 2023-17 IRB 766

Under Section 605(d)(1) of the SECURE 2.0 Act, which was enacted as part of the Consolidated Appropriations Act, 2023, P.L. 117-328, the IRS was required to provide safe harbor language for extinguishment and boundary line adjustment clauses in conservation easement deeds by April 28, 2023. 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 Section 605(d)(2) of the Secure Act 2.0, 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. 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 I.R.C. §170(h(7); 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 I.R.C. §6662 or §6663 had been finally determined.

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