REAL ESTATE, TRUST AND PROBATE LAW JOURNAL

Recent Developments in Oil and Gas and Real Estate Taxation

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1. Real Estate Tax Matters.

1.01. In the case of the *Estate of Steve K. Backemeyer, Deceased v. Commissioner*, 147 T.C. No. 17 (Dec. 8, 2016), the Internal Revenue Service was attempting to disallow certain deductions claimed by deceased taxpayer's spouse for expenditures incurred for certain farm matters. Taxpayer was a sole proprietor farmer and in 2010 purchased certain farm inputs which were to be used in cultivating crops for the following year. Taxpayer had purchased fertilizer, seed, chemicals and fuel to use in planting crops for 2011. However, Mr. Backemeyer died before he was able to use any of these materials. All of the assets were listed on the inventory prepared for his estate with such inputs being valued at their purchase price.

All of Mr. Backemeyer's estate passed to the Backemeyer Family Trust of which Mrs. Backemeyer was a trustee. Mrs. Backemeyer continued her own farming operations primarily attempting to grow corn and soy beans on the farm real estate. During 2011, Mrs. Backemeyer took an in-kind distribution of the farm inputs from the Backemeyer Family Trust and used all of the inputs to grow corn and soy beans.

In the notice of deficiency the Service indicated that it was improper for Mrs. Backemeyer to deduct the expenditures for farm inputs in 2011 which her deceased husband had already deducted in the return filed for 2010. This amounts to a double deduction and therefore contravenes basic principles of tax law. Alternatively, the Service requested that the deduction for the farm inputs for 2010 be recaptured for his 2010 return. During the pendency of the litigation the Service recanted on its disallowance of Mrs. Backemeyer's utilization of the deductions for the farm inputs but indicated that Mr. Backemeyer's return should be adjusted because the tax benefit rule required he recapture the farm input deduction he claimed for 2010.

Generally, Section 162 provides a deduction for the ordinary and necessary expenses paid or incurred during the taxable year in carrying out a trade or business. The regulations under Section 162 specify that a farmer who operates a farm for profit is entitled to deduct from gross income all amounts actually expended in the carrying on of the business of farming. The costs of seed and young plants which are purchased for further development and cultivation prior to sale in later years may be deducted as an expense in the year of purchase provided that the farmer follows a consistent practice of deducting such costs. The Service did not dispute that the deduction of the expenses by Mr. Backemeyer in 2010 was appropriate, nor does it dispute that the deduction by Mrs. Backemeyer for the use of those farm inputs in 2011 was inappropriate. However, it does argue that the tax benefit rules should preclude the use of the deductions in two separate years. The Court summarized that the tax befit rule requires an amount being included in gross income in the current year if and to the extent that: (1) the amount was deducted in the year prior to the current year; (2) the deduction resulted in a tax benefit; (3) an event occurs in

the current year that is fundamentally inconsistent with the premises on which the deduction was originally based; and (4) had a non-recognition provision of the Internal Revenue Code does not prevent the inclusion in gross income. An example of the implication of this rule would be if a taxpayer deducts the cost of an asset and converts the expensed asset to some other non-business or personal use that action is inconsistent with the earlier deduction and thus the tax benefit rule would require inclusion of income of the amount of the unwarranted deduction.

The Court in following Supreme Court language has ruled that the same receipt cannot be made the basis of both income and estate tax. In this case, the farm inputs were subject to tax as part of Mr. Backemeyer's estate. Disallowing the deduction of these farm inputs in 2010 would have increased his income and his increased income would be included in his estate for the same year. Thus, identical money would be the basis of two assessments. This result is consistent even if Mr. Backemeyer's estate did not actually owe any amount payable because of the unified credit or the marital deduction. The fact that the basis of the deducted farm inputs had been reduced to zero when they were deducted on the 2010 return and stepped up because of Section 1014 has no moment as if Congress sought to foreclose a step-up it would have done so legislatively.

1.01. In *US v. Mary Carol Johnson*, 2016-2 U.S.T.C. ¶ 60,698, the District Court in Utah was attempting to hold the trustee of a decedent's trust liable for estate taxes due. In this case, decedent owned an interest in a hotel (stock) which she transferred to a revocable trust of which she was trustee. The decedent had the power to alter, amend, modify or terminate the trust. Pursuant to Section 2033 due to her retained rights, the value of the hotel stock was included in decedent's estate. Because the closely held stock constituted the majority of the decedent's adjusted gross estate the successor trustees elected to defer payment of the remaining estate tax and make installment payments on the deferred amount. Because of restrictions contained in the Nevada gaming license held by the hotel, the trustees were require to distribute the trust assets to the heirs. This was done and the distribution agreement indicated that the assets distributed to him or her would be subject to a lien upon such assets to pay the estate tax due on such assets.

About a week prior to the first due date of the estate tax installment, the Internal Revenue Service sent a letter to the executor of the estate indicating a method of eliminating her personal liability for the unpaid estate tax by granting a special lien for estate tax. The executor provided the IRS with an executed agreement to the special lien which was signed by all of the beneficiaries of the estate and restricted the sale of the hotel stock while the lien on the stock was in effect. In January of 2002, the hotel filed for bankruptcy. As a result of the bankruptcy proceedings the beneficiaries were instructed to stop making any more distributions to pay the estate tax. By May of 2002, the Bankruptcy Court approved the sale of all hotel assets free and clear of liens, claims or encumbrances to a third party. As shareholders, the heirs received no value for the hotel ownership interest in the bankruptcy. After an extremely procedural battle the Court found that the personal representatives of the estate satisfied the first two requirements of making a special lien election and consequently after making such election the personal representatives were discharged from personal liability as a matter of law and the government's claim for fiduciary liability was moot.

1.03. In *Wasco Real Properties I, LLC v. Commissioner*, T.C. Memo 2016-224, the Internal Revenue Service was examining the ability to deduct interest and ad valorem taxes. In this case, three separate faming partnerships had acquired certain land which was being developed into almond tree orchards. The loans they received were largely from third parties and the proceeds from the loans were used to plant and grow almond trees for use in its business. The partnerships deducted the interest the paid on the loans to third parties and also deducted the property taxes paid on the land. The Internal Revenue Service disallowed these deductions under Internal Revenue Code Section 263A indicating that the taxes and interest must be capitalized rather than deducted. The taxpayers argued that Section 263A does not apply to either the property taxes or the interest because the taxes and the interest relate not to the production of almond trees but to the land. The Court noted that the Federal income tax law distinguishes between a payment that is currently deductible and one that must be capitalized. Capital expenses are not exhaustively enumerated in the Code but deductions on the other hand are exemption to the norm of capitalization and require a specific statutory provision. The Service indicated that Section 263A was designed to prevent the distortion of income that would otherwise occur from presently deducting an expense that does not correlate to the production of current income. The Court also noted that the confusion over whether an expense is currently deductible or must be capitalized was initially included in the Revenue Act of 1864 and thus has one of the longest lineages of any provision of the Internal Revenue Code. The Court then noted that Section 263A(1) was supplemented by former Section 189 (which was repealed by the Tax Reform Act of 1986). Section 263A(1) required taxpayers to capitalize real property, construction period, interest and taxes. This provision was normally applicable to developers of real property but by analogy can certainly be applicable to taxpayers' situation. After a long argument taxpayers' were denied the current deduction of interest and taxes on the property utilized to plant the almond orchard and indicated these expenses must be depreciated over the life of the relevant asset or where no specific asset or useful life can be ascertained will be deductible upon the dissolution of the enterprise.

1.04. In *Hargis v. Commissioner*, T.C. Memo 2016-232, the Court was reviewing losses claimed by a shareholder of an S Corporation and whether taxpayer could deduct those losses to the extent the shareholder had basis in the S Corporation. In this case, taxpayer owned several S Corporations. The S Corporations were in the business of purchasing rundown nursing homes, renovating them and then renting them to new tenants. Taxpayer's S Corporation managed the day-to-day business of running the nursing homes. During the time the taxpayer purchased a rundown nursing home and began renovations substantial losses would be incurred. Even after the nursing home was renovated losses would continue until the reputation of the business had been rehabilitated. In order to obtain funds for the renovation process taxpayer either borrowed from one of his other nursing home entities or borrowed from banks or other financial institutions. In these loans the proceeds were advanced directly by the lending entity to the borrowing company. Taxpayer was either the co-borrower or the guarantor of each of the loans received by the entities.

Generally, a taxpayer can deduct losses from S Corporation operations only to the extent of the basis the shareholder possesses in the S Corporation. Basis can be derived by contributions to the S Corporation, previously taxed income held by the S Corporation, or loans to the S Corporation. The Service stated that taxpayer was not entitled to increase his basis in

the operating companies because of his participation as co-borrower or guarantor of loans. The Service indicated that basis can only be derived from loans if a taxpayer directly borrows money from a third party and then advances that borrowed money to their S Corporation and in this way the taxpayer will have made an actual economic outlay. In this case, the petitioner never was subject to the burden of paying back the amounts borrowed on the loans as there were no defaults on the loans and he was never called upon to make payments personally even though as a co-borrower he was directly liable for repayment of the loans. The Court emphasized that the taxpayer never pledged any of his personal property as collateral for the amounts borrowed by his company. This assertion is almost embarrassing when made by the Tax Court because the taxpayer personally signed then loans and thus his entire estate (less any exempt property) was obligated for the repayment of the loan. The Court is seeming to say that he would be more personally liable if he had pledged an automobile or something else as security for the loan.

The taxpayer argued that the substance over the form of the transaction is that the taxpayer was personally obligated to repay the loans and thus should be able to derive basis from those loans. The Court stated that when a taxpayer chooses the form of a transaction the taxpayer is bound by that form and may not argue that the substance triggers differing tax consequences. The Court also made the amazing statement that in any case of a loan that would not have been made to a corporation but for a shareholder's personal credit worthiness and guaranty of repayment does not in itself indicate that the bank looked at the shareholder for repayment. It is difficult to understand where a bank will not make a loan to a corporation without the shareholder's guaranty how that bank was not looking for the shareholder for the ultimate repayment of the obligation. Notwithstanding the obvious the Court held that the shareholder's role as co-maker or guaranty of the operating companies' notes did not entitle him to claim basis in the indebtedness of the operating companies and thus he was not entitled to deduct losses incurred by the S Corporation.

2. Oil and Gas Tax Matters.

In *Stewart v. Commissioner*, we see the continuing emphasis on procedural requirements imposed by the Internal Revenue Service creating a barrier to an appropriate ruling. In this case, a Partnership managed a portfolio of oil and gas properties. These oil and gas properties were sold and the Partnership received a 20% interest worth approximately $20 million. Initially the Partnership filed a tax return reporting the $20 million as ordinary income and each partner received a Schedule K-1 form to report his share of the Partnership income. Two years later the Partnership determined that its income from the sale of the properties was not ordinary income but capital gains. Accordingly, the Partnership amended its Form 1065 and reissued amended Schedules K-1 forms to its partners. Four of the five partners amended their individual returns and ultimately received refunds. The fifth partner filed his amended return but the government denied his refund request. In investigating the refund the government determined that the partnership's interest was compensation for services and therefore the fifth partner's earnings should be taxed as ordinary income, not capital gains. This investigation also brought to light to the government's attention the refunds it had issued to the other four partners. In examining the case the Court determined that in order for partnerships to properly amend an income tax return they must file an administrative adjustment request under Internal Revenue Code Section 6227. The Court indicated that Internal Revenue Service regulations require that a partnership or

partner seeking to make an adjustment of a partnership item, such as the reclassification of income file the form prescribed by the Internal Revenue Service for that purpose in accordance with the form's instructions. The Court determined that the amended return was insufficient to change the characterization of the $20 million from ordinary income to capital gains without the filing of a Form 8082. Therefore, the refund to the other four partners was invalid and must be repaid. The issue was not whether the sale generated capital gain income but whether the correct form was filed. This procedure of requiring superfluous forms to be filed in order to obtain simple tax equity seems to be increasing within the Service and the alarming fact is that the requirement for these additional forms are generally prescribed in instructions to the form and these instructions can have more weight than the statute itself.