

REAL ESTATE TRUST AND PROBATE LAW JOURNAL  
RECENT DEVELOPMENTS IN OIL AND GAS AND REAL ESTATE TAXATION

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**I. Real Estate Tax Matters**

1.01 In *Wendell Falls Development, LLC v. Commissioner*, T.C. Memo. 2018-45, the Taxpayers were attempting to deduct the value of a conservation easement imposed on property which was then sold to a city. In this case the partnership was developing approximately 1,280 acres of land which was to be converted into approximately 4,000 residential lots, commercial spaces, an elementary school and a park. Part of the 1,280 acres contained a 125 acre tract adjacent to a private lake. The development plan indicated that all of the residential lots would have access to this park through a series of greenway trails.

The developers placed a conservation easement on the 125 acres of land in favor of the Smokey Mountain National Land Trust and then conveyed this property to Wake County. The partnership valued the 125 acres at \$4,818,000 and Wake County paid \$3,020,000 for the property and thus the Taxpayer determined that the charitable conservation easement had a value of \$1,798,000.

The Court noted that section 170(a) allows a deduction for a charitable contribution. No deduction for a charitable contribution is allowed if a taxpayer expects a substantial benefit from the contribution. By placing the conservation easement on the 125 acres, the Taxpayer insured that Wake County (once it acquired the land) could only utilize the 125 acres for a county park. Thus, in accordance with the development plan, the partnership as a prospective seller of residential lots and clusters could indicate that the purchaser would benefit from the increased value of the lots by having the park as an amenity.

The Court held that the value of a conservation easement is equal to the value of the land prior to the grant of the easement minus the value of the land after the easement. In this case the best use of the 125 acres was as park land in the middle of a master planned community and thus the conservation easement did not diminish the value of the 125 acres because it did not prevent it from being put to its best use. Therefore, the value of the charitable contribution was zero. The Court then noted as to whether an under reporting penalty of 20% or 40% should be assessed in connection with this transaction. The 40% penalty is assessed for a gross valuation misstatement and the 20% penalty is assessed for negligence, a substantial understatement of income tax or a substantial valuation misstatement. The Service withdrew the assessment of the 40% penalty. The Court held that the 20% penalty is not applicable when there was reasonable cause for reporting a deduction and the deduction was reported in good faith. In this case, the Taxpayer presented evidence from two state certified real estate appraisers and the real estate appraiser appointed by the Internal Revenue Service did not contradict their values. Therefore, the Court held that there was no reason for the imposition of the 20% penalty.

1.02 *Phillips v. Commissioner*, USCA, 11 Sur, 2018-1 USTC ¶50,253.

In this case the Taxpayers, husband and wife, owned an S Corporation (“Olsen and Associates”) that was in the real estate development business. Taxpayers had several subsidiary corporations or LLC’s, each one formed for a specific project. The entities obtained substantial debt from banks and other financial institutions and this debt was guaranteed by the Taxpayers. Olson and Associates had the bank loans on the various properties. During the mid-2000s the S Corporations were hit hard by the economic downturn and many of its projects failed and the financing institution brought state court actions for the repayment against the relevant special entities and the loan guarantors including the Taxpayers. Many of the properties were sold at an amount less than the outstanding loans and thus the Taxpayers were liable for the guaranteed amount. Mrs. Phillips deducted her portion of these losses and indicated that her basis in the S Corporation would increase by the amount of judgments rendered against her for the S Corporations’ losses.

A shareholder’s deduction of an S Corporation loss is limited to the sum of the adjusted basis of the shareholder’s stock in the S Corporation and the shareholder’s adjusted basis of any indebtedness that the S Corporation has to the shareholder. Taxpayers argued that the judgment rendered caused the shareholder’s basis to increase by the amount of the judgment applicable to the shareholder. However, the Internal Revenue Service argued that when a shareholder steps into a creditor’s shoes by making an actual payment toward the corporation’s debt is the time that the basis increases. The critical factor is whether at the loan’s origination, the third party lender views the corporation or the shareholder as the primary obligor on the debt. In this case it was determined that the corporation, at the time of the indebtedness, was the primary obligor on the debt and thus the Phillips’ liability for the judgments rendered against the corporation does not give rise to the indebtedness from the corporation to them until and unless they pay part or all of the obligation. In this case that did not occur so the shareholder’s basis in the S Corporation was not increased and the losses claimed by the taxpayer were disallowed.

1.03 *Wicks vs. United States*, U.D. District Court, Northern District Oklahoma 2018-1 USTC ¶ 5142.

In this case, the plaintiff was contesting the assessment of additional taxes by virtue of the Internal Revenue Service’s classifying his cattle ranching business as an activity not engaged in for profit. The procedural aspects of the case were somewhat convoluted as there was an assessment made, tax paid, a suit by the taxpayer for a refund and a request for a summary judgment on the part of the Internal Revenue Service. Putting aside the procedural abnormalities, taxpayer since 2006 had adjusted gross income of an average of \$992,000 per year and since 1997 when he began cattle ranching he showed ranching deductions of \$807,380. With respect to his cattle ranching business, plaintiff built and maintained a cattle ranch in Oklahoma of which he was the sole owner and operator. In building and maintaining his cattle ranch he did not have a written business plan or financial projections, did not use QuickBooks or any other accounting software, did not create a separate bank account, has not executed any written contracts, has not formed a business entity, has not marketed or promoted his cattle operation, insured his cattle against catastrophic loss or consulted a financial advisor concerning his cattle operation. His only experience prior to starting his ranch was feeding and working cattle as a child.

In 1997, taxpayer purchased 80 acres of land with a dilapidated barn and unusable fences and he repaired the barn and secured the fences. In 1998, he purchased two Longhorn heifers and in 2001 he built a new barn. In 2002 he bought an additional 180 acres of land, adjacent to the original 80 acres and improved the new land by replacing the fence, enlarging the pond to hold more water, installed rural water so cattle could be watered during drought conditions, built a working cattle facility and consulted with a local rancher regarding profitable methods of cattle ranching. In 2006, he purchased additional cows in order to enter into a crossbreeding operation which he knew would take a minimum of four years. Taxpayer did maintain spreadsheets listing expenses he incurred for his cattle ranching activity. He performed essentially all of the labor required to build and maintain his ranch spending three to four days a week at the ranch. Taxpayer purchased the tracts of land for a total of \$175,000 and in 2014 his ranch was appraised at \$725,000.

The Service identified the nine factors contained in Treasury regulations §1.183 and noted that the activity must be engaged with an actual and honest profit objective and the analysis of the nine factors was not merely a numerical computation as no one factor is determinative as all facts and circumstances must be taken into account. The Court held that the Plaintiff did operate his cattle ranch in a manner consistent with other local ranchers and that he did demonstrate a willingness to accept new business operating methods. The fact that he employed no sophisticated business practices and the fact that his records were so rudimentary did not indicate a profit objective.

Plaintiff did spend an extensive amount of time working on the ranch performing hard labor and this indicates that especially, where an activity does not have a substantial personal or recreational aspect, a profit motive would be indicated. With respect to the possibility that the assets would appreciate in value is often not relevant because of the fact that the ranching activity and the appreciation in value of the land are separate activities and thus one does not augment the other unless they constituted a single activity.

In determining whether this is a single activity the Court must look to the degree of organizational and economic interrelationship of the land and the activity. In this case, Plaintiff may have bought the land (initial purchase) without being committed to developing a cattle ranch but in connection with the second purchase it was obvious that he was intent on developing a cattle ranch and thus the land and cattle would be treated as a single activity.

Taxpayer had never made a profit with respect to the cattle ranching but the Court indicated that farming is not the most profitable business which one can be engaged. The Court concluded that raising cattle generally lacks significant recreational aspects. The Service argued that this factor is relevant because Plaintiff maintained a personal residence on the ranch and has admitted to enjoying the outdoors. The Court noted that no evidence suggested that Plaintiff engage in cattle raising for personal or recreational purposes. Therefore, the Court concluded that even though the burden to prove the requisite profit objective is on the Taxpayer, viewing the evidence in a light most favorable to plaintiffs the Court found a reasonable jury would conclude that the Plaintiff was engaged in cattle ranching for a profit.