2023 in Review – Ag Law and Tax Developments (Part 2)

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Overview

Today's article is the second in a series discussing the top developments in agricultural law and taxation during 2023. As I work my way through the series, I will end up with the top ten developments from last year. But I am not there yet. There still some significant developments to discuss that didn't make the top ten list.

Significant developments in ag law and tax during 2023, but not quite the top ten – it's the topic of today's post.

Scope of the Dealer Trust

In re McClain Feed Yard, Inc., et al., Nos., 23-20084; 23-20885; 23-20886 (Bankr. N.D. Tex. 2023)

The Packers and Stockyards Act of 1921 (PSA) (*7 U.S.C. §§ 181 et seq.*), applies to transactions in livestock or poultry in interstate commerce involving a covered a packer, dealer, market agency, swine contractor, or live poultry dealer. The PSA creates statutory trusts and requires bonds of market participants which may provide funds to reduce losses incurred by unpaid cash sellers of livestock or poultry. A similar provision applies for perishable commodities created by the Perishable Agricultural Commodity Act. *7 U.S.C. § 499e(c).*

Historically, there have been numerous attempts to amend the PSA to create a "Dealer Trust" that would establish a statutory trust similar to the Packer Trust created by the PSA at 7 U.S.C. § 196. These efforts succeeded with legislation signed into law on December 27, 2020, that adds new Section 318 to the PSA. *Codified at 7 U.S.C. § 217b.*

The Dealer Trust's purpose is to protect unpaid cash sellers of livestock from the bankruptcy of feeders, brokers and small processors. The new law puts unpaid cash sellers of livestock ahead of prior perfected security interest holders. It's a provision like the trust that exists for unpaid cash sellers of grain to a covered grain buyer. The first case testing the scope of the Dealer Trust Act is winding its way through the courts.

A case involving the new Dealer Trust Act hit the courts in 2023. Over 100 livestock producers have $122 million in unpaid claims against three defunct cattle operations, and a lender says one of the feedyards sold about 78,000 cattle and didn't pay on the loans. The problems stem from a $175 million Ponzi and check-kiting scheme that the debtors were engaged in.

One issue is what the trust contains for the unpaid livestock sellers. Is it all assets of the debtors? It could be – for feedyards and cattle operations, practically all the income is from cattle sales. So far, USDA has approved for payment only $2.69 million of claims for cash sellers of livestock, claiming that the balance is owed to non-cash sellers not covered by the law.

The law is new, so it's not clear yet what is a trust asset for the benefit of the cash livestock sellers, and what assets, if any, are in the debtors' bankruptcy estates. We should learn the answer to those questions in 2024.

Equity Theft

Tyler v. Hennepin County, 598 U.S. 631 (2023)

Equity that a homeowner has in their home/farm is the difference between the value of the home or farm and the remaining mortgage balance. It's a primary source of wealth for many owners. Indeed, the largest asset value for a farm or ranch family is in the equity wrapped up in the land. In the non-farm sector, primary residences account for 26 percent of the average household's assets. Certainly, the government has the constitutional power to tax property and seize property to pay delinquent taxes on that property. But is it constitutional for the government to retain the proceeds of the sale of forfeited property after the tax debt has been paid? That was a question presented to the U.S. Supreme Court in 2023.

In this case, Hennepin County. Minnesota followed the statutory forfeiture procedure, and the homeowner didn't redeem her condominium within the allotted timeframe. The state ultimately sold the property and bagged the proceeds – including the homeowner's equity in the property.

She sued, claiming that the county violated the Constitution's Takings Clause (federal and state) by failing to remit the equity she had in her home. She also claimed that the county's actions amounted to an unconstitutional excessive fine, violated her due process and constituted an unjust enrichment under state law. The trial court dismissed the case and the Eighth Circuit affirmed finding that she lacked any recognizable property interest in the surplus equity in her home. On further review, the U.S. Supreme Court unanimously reversed. The Court held that an unconstitutional taking had occurred.

All states have similar forfeiture procedures, but only about a dozen allow the state to keep any equity that the owner has built up over time. Now, those states will have to revise their statutory forfeiture procedures.

Customer Loyalty Rewards

Hyatt Hotels Corporation & Subsidiaries v. Comr., T.C. Memo. 2023-122

Many companies, including agribusiness retailers, utilize customer loyalty programs as a means of attracting and keeping customers. Under the typical program, each time a customer or "member" buys a product or service, the customer earns “reward points.” The reward points accumulate and are computed as a percentage of the customer’s purchases. When accumulated points reach a designated threshold, they can then be used to buy an item from the retailer or can be used as a discount on a subsequent purchase (e.g., cents per gallon of off a fuel purchase). Some programs make be structured such that a reward card is given to the customer after purchases have reached the threshold amount. The reward card typically has no cash value and expires within a year of being issued. A “loyalty rewards” program is a cost to the retailer and a benefit to the customer, triggering tax issues for both.

In *Hyatt*, the petitioner established a “Gold Passport” rewards program in 1987 that provided its customers with reward points redeemable for free future stays at its hotels (the petitioner own about 25 percent of its branded hotels with the balance owned by third parties who license the petitioner’s IP and/or management services). Under the program, the petitioner required hotel owners to make payments into an operating fund (Fund) when a customer earned “points.” The petitioner was the custodian of the Fund and compensated a hotel owner out of the Fund when a guest redeemed reward points for free stays. The petitioner determined the rate of compensation. The petitioner invested portions of the Fund's unused balance in marketable securities which generated gains and interest. In 2011, the petitioner changed the compensation formula to increase the amount it could hold for investment. The petitioner also used the Fund to pay administrative and advertising expenses that it determined were related to the rewards program.

The points could not be redeemed for cash and were not transferrable. In addition, any particular member hotel could not get the payments to the Fund back except by providing free stays to members. The Fund allocated from 46-61 percent to reward point redemptions. Fund statements described the funds as belonging to the hotel owners that paid into the Fund. The petitioner’s Form 10-K filed with the SEC treated the Fund as a “variable interest entity” eligible for consolidated reporting. When the petitioner provided management services to member hotels, payments into the Fund were reported as “expenses.”

The petitioner did not report the Fund’s revenue into gross income with respect to the hotels it did not own and did not claim any deductions for expenses paid on the basis that petitioner was a mere trustee, agent or conduit for hotel owners rather than a true owner of the Fund. But, the petitioner did claim deductions for its share of program expenses associated with the 25 percent of hotels that it owned. The petitioner reported Fund assets and liabilities on a consolidated basis on Schedule L. The petitioner’s Form 1120 did not state that it was using the trading stamp method or include any statement concerning Treas. Reg. §1.451-4. The petitioner’s position was that third-party owners should make their own decision about tax treatment of the money they paid to the Fund.

The IRS audited and took the position that the petitioner was using an improper accounting method which triggered an I.R.C. §481 adjustment requiring the including in the petitioner’s income the cumulative amounts from 1987 (Fund revenue less expenditures). The IRS asserted an adjustment of $222.5 million and additional adjustments in 2010 and 2011. The petitioner disagreed and filed a Tax Court petition.

The Tax Court determined that the amounts the petitioner received related to the customer reward program (i.e., Fund revenue) were revenue includible in gross income because of the petitioner's significant control over the Fund. That control indicated that the petitioner had retained a beneficial interest in the Fund, and the exception under the "trust fund" doctrine established in *Seven-Up Co. v. Comr., 14 T.C. 965 (1950), acq., 1950-2 C.B. 4, did* not apply.

Hyatt lays down a good "marker" for tax advisers with clients that offer loyalty reward programs to customers. Retail businesses that offer such programs will want to ensure that their program is structured in a manner that can fit within the trust fund doctrine's exception for excluding program funds from gross income.

Basis of Assets Contained in an Intentionally Defective Grantor Trust (IDGT)

Rev. Rul. 2023-2, 2023-16 I.R.B. 658

An IDGT is an irrevocable trust that is designed to avoid any retained interests or powers in the grantor that would result in the inclusion of the trust's assets in the grantor's gross estate upon the grantor's death. Normally, an irrevocable trust is a tax entity distinct from the grantor and has its own income and deductions (net of distributions paid to beneficiaries) reported on its own income tax return. But there is language included in an IDGT that causes the income to be taxed to the grantor. So, a separate return need not be prepared for the trust, but you still get the trust assets excluded from the grantor's estate at death. It also allows the grantor to move more asset value to the beneficiaries because the grantor is paying the tax.

Note: The term "intentionally defective grantor trust" refers to the language in the trust that cause the trust to be defective for income tax purposes (the trust grantor is treated as the owner of the trust for income tax purposes) but still be effective for estate tax purposes (the trust assets are not included in the grantor's gross estate).

This structure allows the IDGT's income and appreciation to accumulate inside the trust free of gift tax and free of generation-skipping transfer tax, and the trust property is not in the decedent's estate at death. This will be an even bigger deal is the federal estate tax exemption is reduced in the future from its present level of $13.61 million. Another benefit of an IDGT is that it allows the value of assets in the trust to be "frozen."

A question has been whether the assets in an IDGT receive a stepped-up basis (to fair market value) when the IDGT grantor dies. Over the years, the IRS has flip-flopped on the issue but in 2023 the IRS issued a Revenue Ruling taking the formal position that the trust assets do *not* get a stepped-up basis at death under I.R.C. §1014 because the trust assets, upon the grantor's death, were not acquired or passed from a decedent as defined in I.R.C. §1014(b). So, the basis of the trust assets in the hands of the beneficiaries will be the same as the basis in the hands of the grantor.

Not getting a stepped-up basis at death for the assets in an IDGT is an important consideration for those with large estates looking for a mechanism to keep assets in the family over multiple generations at least tax cost. An irrevocable trust may still be appropriate for various reasons such as asset protection and overall estate tax planning. But, the IRS ruling does point out that it's important to understand all of the potential consequences of various estate planning options.