# Other Important Developments in Agricultural Law and Taxation: The "Almost Top 10" of 2021

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### Overview: Part 1

I recently concluded a five-part series on what I viewed as the "Top Ten" agricultural law and agricultural tax developments of 2021. There were many "happenings" in ag law and tax in 2021 which meant that there were still some significant developments that didn't make the "Top Ten." In today's post I start discussing some of those. This will also be a multi-part series, and the developments are in no particular order.

The "Almost Top 10" of 2021, the first article in a series – it's the topic of today's post.

### Bankruptcy Trustee Cannot Retain Fee

***In re Doll, No. 21-cv-00731-RBJ, 2021 U.S. Dist. LEXIS 232612 (D. Colo. Dec. 6, 2021)***

The debtor filed Chapter 13 in late 2017, and failed to get the bankruptcy court to confirm his plan. The debtor made $29,900 in plan payments to the standing trustee. From that amount, the debtor's counsel received $19,800 and $7503.30 was paid to the state for property taxes. The trustee paid the balance of $2,596.70 to himself in partial satisfaction of the statutory 10 percent fee. The debtor sought the return of the amount the trustee paid himself based on 11 U.S.C. §1326 and its difference to the comparative Chapter 12 provision of 11 U.S.C. §1326(a)(1). The debtor pointed out that a trustee is allowed to retain fees when a debtor's Chapter 12 plan is not confirmed, but not in a Chapter 13. The bankruptcy court allowed the standing trustee to be compensated and the debtor appealed.

The district court agreed with the debtor, noting that 11 U.S.C. §1326(a)(2) provides, "if a plan is not confirmed, the trustee shall return any such payments not previously paid out and not yet due and owing to creditors." The district court reasoned that if the payments must be returned, the fees collected from such payments must be returned. That language, the district court noted, was in contrast to the Chapter 12 language providing that "if a plan is not confirmed, the trustee shall return any such payments to the debtor, after deducting…the percentage fee fixed for such standing trustee." The court reversed the reversed the bankruptcy court and remanded the case with instructions for the bankruptcy court to order the trustee to return the fee.

**Note:** While the district court expressed concern that a standing trustee may not be compensated for his efforts in situations such as this, the district court found the issue to be one for the Congress to address.

### LLC Gifts Recharacterized

***Smaldino v. Comr., T.C. Memo. 2021-127***

Estate planning is a complicated process, and it gets more complicated as assets increase in number and value. If a family business is involved, the complexity is increased further. In this case, the Tax Court pointed out how important it is to carefully do estate planning correctly. At its core, the case involved a gift

by a husband to his wife and then to an irrevocable trust. Because the plan wasn't implemented and/or administered properly, the IRS recast the transaction and the court agreed, with severe tax consequences.

**Facts of the case.** The couple had a real estate portfolio of nearly $80 million including numerous rental properties that they owned and operated. They agreed that the real estate should pass to the husband's children and grandchildren from his prior marriage. To accomplish that goal, he put 10 of the real estate properties into a family limited liability company (LLC) that he formed in 2003 (and for which he was designated as the manager) but which remained inactive until late 2012 when he had a health scare that finally motivated him to get his affairs in order. The LLC, in turn, was placed into a revocable trust of which he was the trustee. In 2013, he transferred approximately eight percent of class B member interests in the LLC to an irrevocable trust (dynasty trust) that he had created a few months earlier for the benefit of his children and grandchildren. He named his son as trustee.

At about the same time as the transfer to the dynasty trust, the petitioner transferred approximately 41 percent of the LLC membership interests to his wife (in an amount that roughly matched her then available federal estate and gift tax exemption), who then in turn transferred the same interests to the dynasty trust the next day. As a result, the dynasty trust owned 49 percent of the LLC. Simultaneously, the petitioner amended the LLC operating agreement to provide for guaranteed payments to himself and identified the dynasty trust as the LLC's sole member. On his 2013 gift tax return, the petitioner reported only his direct transfer of LLC interests to the dynasty trust and not those of his wife. A valuation report dated four months after the transfers to the dynasty trust stated that the 49 percent interest in the LLC had a value of $6,281,000. The federal estate and gift tax exemption was $5,250,000 in 2013. The IRS asserted that the petitioner had underreported the 2013 taxable gifts by not reporting the wife's gift to the dynasty trust, and asserted a gift tax deficiency of $1,154,000.

The Tax Court agreed with the IRS, concluding that the wife's gift to the dynasty trust should be treated as a direct gift by the petitioner for numerous reasons. The Tax Court noted that the wife was not a "permitted transferee" under the LLC operating agreement and, thus, could not have owned the LLC interest. The Tax Court also pointed out that the petitioner had amended the LLC operating agreement on the same day of his transfer of LLC member units to the dynasty trust to reflect himself as the sole member. The Tax Court also pointed out that the transfers of the wife's LLC member interest were undated – they only had "effective" dates, and that the assignments were likely signed after the valuation report was prepared four months later. This meant that the wife had no real ownership rights in the LLC. In addition, the Tax Court pointed out that the 2013 LLC income tax return did not allocate any income to the wife even though the petitioner claimed that she had an ownership interest for one day. The LLC's return and associated Schedules K-1 listed the petitioner as a 51 percent partner and the dynasty trust as a 49 percent partner for the entire year. The petitioner's wife was not listed as a partner for any part of the year.

**Take home planning pointers.** The case is a good one for learning what *not* to do when setting up a trust and transferring LLC interests as part of an estate plan. The wife's holding of the LLC interests for a day (at most) before the transfer to the LLC and then her transferring the exact same interests received as a gift to the dynasty trust is not a good approach. It shows a lack of respect for the transaction. The wife's testimony at trial that she had no intent to hold the interest contradicted the alleged substance of the transaction. It also shows that she didn't understand the planning that was being engaged in – that's the fault of the attorneys involved. Also, the husband's failure to report the gift to his wife on a gift tax return was further demonstration that he didn't respect that transfer. With the amount of wealth involved in the case, a team of professionals should have been engaged, and all formalities of the various transactions should have been closely followed. This includes providing written consent for the wife's admission as an LLC member; providing the dates that documents were actually signed; not transferring the precise amount to the trust as was initially gifted; and having more time pass between the date of the gift to the wife and her subsequent

transfer. There was also no amended and restated LLC operating agreement to reflect her ownership (however brief). Also, tax returns did not properly reflect what the taxpayers were doing.

From a broader perspective, it simply is a bad idea to not do estate planning until health emergencies arise. The same is true for other significant life events. By waiting until estate planning is absolutely necessary, estate planning can be rushed and not be done as thoroughly as it otherwise should be. Estate planning is a process that takes time. The rushed process in the case was probably a factor in the IRS succeeding in its assertion of the “step transaction” doctrine.

There’s also another point from the timing involved in the case that has relevance to estate planning in 2020-2021. While I can’t be positive from reading the court’s opinion, it appears that the estate planning was done in late 2012, at least from the standpoint of document drafting, and then completed in 2013. 2012/2013 was a time when there was concern by many that the federal estate tax exemption would drop from $5 million to $1 million. Thus, many clients were worried about being faced with a “use-it-or-lose-it” situation not unlike the situation in 2021 going into 2022. The point is that this uncertainty in the law surrounding estate planning creates an substantial increase in work for estate planners to accomplish in a short timeframe. That combination can lead to a lack of thoroughness in the estate planning drafting and/or review process. It is possible that this was part of the problem that led to the unfortunate tax result of the case.

**Note:** Following legal formalities is important, such as creating and signing essential documents. Also, consistency in tax reporting is critical. In addition, thorough estate planning should involve a “team approach.” The attorneys drafting the legal documents and providing legal counsel; tax practitioners that can review the tax consequences of the plan; financial and insurance professionals. The more “eyes” that see an estate plan, the less chance that steps will be overlooked and/or mistakes made.

A key question in the case involved the timing of the transfers to the wife and then to the dynasty trust. How long should she have held those transfers before retransferring them to avoid IRS successfully asserting the step-transaction doctrine? In one case, six days was enough for holding assets as part of an overall estate plan before they were retransferred. *See Holman v. Comr., 130 T.C. 170 (2008), aff’d., 601 F.3d 763 (8th Cir. 2010).* In any event, the transaction must have economic substance if the transaction is to be respected taxwise.

### Conclusion

In the next article, I will look further at other developments of 2021 that weren’t quite significant enough on a national scale to make the 2021 Top Ten list.

**Overview: Part 2**

I recently concluded a five-part series on what I viewed as the "Top Ten" agricultural law and agricultural tax developments of 2021. There were many "happenings" in ag law and tax in 2021 which meant that there were still some significant developments that didn't make the "Top Ten." In yesterday's article, I began discussing some of those. Today's article continues with another important court decision in 2021 that just wasn't quite big enough to make the "Top Ten" list.

The "Almost Top 10" of 2021, the second article in a series – it's the topic of today's post.

**Estate Planning Mistake Costs Family Multi-Million Dollar Charitable Deduction**

***Estate of Warne v. Comr., T.C. Memo. 2021-17***

*Warne* is yet another case that points out how skilled and knowledgeable estate planners must be to ensure that tax rules are clearly understood and properly accounted for in carrying out client goals. In *Warne* , improper planning reduced a charitable deduction for an estate by $2.5 million. The case involved the transfer to charity of majority interests in limited liability companies (LLCs) owning real estate, and the resulting reduction in the otherwise available charitable deduction for those interests.

**What's the issue?** At its core, *Warne* involved the issue of the application of a control premium for ownership interests in entities. An estate tax valuation issue that has been battled in the courts and addressed by the IRS for over 60 years is whether a block of stock in an entity that carries with it control of the entity's operating and dividend policy, corporate salaries and particularly the ability to compel the entity's liquidation should be valued at a premium above the underlying asset value if offered to the public. *See, e.g., Rev. Rul. 59-60, 1959-1 C.B. 242; Rev. Rul. 67-54, 1967-1 C.B. 269; Turner v. Comr., T.C. Memo. 1964-161.*

**Background.** Assuming that a control premium applies to value a block of stock, should it be applied to stock that is split due to language contained in a decedent's will, trust or other estate planning documents? The issue has arisen in the context of the marital deduction. In *Estate of Chenoweth, 88 T.C. 1577 (1987),* the decedent owned 100 percent of the stock of a corporation. He left 51 percent of the stock to his surviving wife. The Tax Court held that a control premium should be added to the amount passing to the wife – the marital deduction legacy. But it was not to be spread across 100 percent of the stock. The Tax Court determined that the value of the shares that passed to her should be valued with a control premium of 38 percent over the per share value of the same shares that were included in the decedent's gross estate. The block of stock funding the marital deduction was valued as a separate block without regard to the context from which it was separated. As a result, the Tax Court applied a control premium to the block of stock that funder the marital deduction, and also applied a minority interest discount to the stock that funded the non-marital bequest.

**Note:** The principle of *Chenoweth* is this - where a transfer to a surviving spouse is unrestricted but is less that the decedent's entire interest in property, the value of the interest passing to the surviving spouse is to be valued as a separate interest in property and not as an undivided portion of the decedent's entire interest. Valuation, for purposes of the marital deduction, does *not* have to be the same as for purposes of the gross estate.

The IRS has applied the principle of *Chenoweth* in *Priv. Ltr. Rul. 9050004 (Aug. 31, 1990)* and *Tech, Adv. Memo. 9403005 (Oct. 14, 1993).*These IRS determinations involved the valuation of partial interests distributed to a surviving spouse or to a marital trust. In the 1995 private letter ruling, a qualified terminable interest property (QTIP) interest under a marital deduction formula will was funded with 49 percent of the stock in a closely-held corporation, with 51 percent passing to another trust. The IRS concluded that the stock funding the QTIP should be subject to a minority interest discount when determining the value of the

marital deduction. The 1994 private letter ruling involved the valuation of a minority interest of closely-held stock that passed to the decedent's surviving spouse. The IRS determined that, when valuing the decedent's gross estate, the decedent's stock was to be valued as a single interest, but when valuing the marital deduction, the value of the minority interest passing to the surviving spouse should reflect a minority interest discount.

Clearly, the same result obtained in *Chenoweth* and the private letter rulings could apply in the context of a charitable bequest. Indeed, this is what happened in *Warne* where it appears the estate planners drafted the client right into a costly trap.

**Facts of *Warne*.** *In Warne,* a married couple started investing in real estate in the 1970s, continuing to acquire properties during their remaining lifetimes. Their estate plan involved them transferring ownership of the properties to five separate LLCs. The LLCs also held various leased fee interests associated with the properties. In 1981, they created a Family Trust with the wife named as trustee. The Family Trust became the majority interest holder of the five LLCs. The husband died in 1999 and the wife in 2014 with the Family Trust included in her estate. In late 2012, the wife gifted fractional interests in the LLCs to her sons and granddaughters.

Upon the wife's death, the Family Trust owned majority interests in each of the five LLCs. Remainder interests were transferred to the wife's children and grandchildren as well as a sub-trust of the family trust. She also left 75 percent of her interest in an LLC that the Family Trust owned 100 percent of to the family charitable foundation. The remaining 25 percent was left to a church. Her estate valued the LLCs by applying discounts for lack of control and lack of marketability. The estate also claimed a charitable deduction for the full 100 percent value of the LLC interests donated to charity which matched the value of that LLC that was included in the decedent's gross estate.

The IRS challenged the amount of the discounts and also reduced the charitable deduction because of the split donation of the LLC interests between the foundation and the church. On the valuation of the LLC interests, the Tax Court noted that the LLC operating agreements gave much control to the holder of the majority interest, including the power to unilaterally dissolve the LLC and appoint and remove managers. The Tax Court was inclined to allow no discounts, but the parties had stipulated that some discount for lack of control applied. Hence, the Tax Court determined that a lack of control discount of four percent should apply. The Tax Court also allowed a five percent discount for lack of marketability.

On the charitable donations, the Tax Court noted that the proper valuation focused on what the charities *received.* Because each charity received only a fractional interest in the LLC, the Tax Court reasoned that a discount should apply. The Tax Court accepted the parties' stipulated discount of 27.385 percent for the 25 percent LLC interest donated to the church and a four percent discount for the 75 percent LLC interest donated to the charitable foundation. The effect of the discounts reduced the total charitable contribution by more than $2.5 million.

**Implications.** What was overlooked in *Warne* was the decades of caselaw and IRS rulings mentioned above indicating that a minority interest discount could likely apply to the transfer of what ultimately was passage of the entire estate to charity. The key to understanding the discount issue in the case is not what was transferred to the charity. It is in understanding what the charity received. The interests were split, with each charity receiving a minority interest, but with 100 percent of the decedent's estate passing to charity. The court didn't explain why the interests were split between the family foundation and the church, but the result of structing the estate plan that way didn't work. That was very flawed estate planning. I doubt the client wanted it that way – there wouldn't have been litigation if that were the case.

To maximize a charitable contribution deduction, full ownership in entities must be transferred to a single charitable beneficiary. The gifted interests should not be split. In *Warne*, the trust could have given a full

100 percent ownership interest in an entity to the foundation, and then some other interest or interests could have been given to the church.

When the matter involves the marital deduction, the estate plan should attempt to have both spouses in a minority position so that shares of stock applied to the marital deduction would be at the same value as the value of the stock in the decedent's gross estate. When doing estate planning for a farmer/rancher (or other person) that holds majority control of a closely-held business (such as a farm or ranch), the goal is to shelter the full unified credit amount (currently $12.06 million) in a credit shelter trust while still obtaining the desired funding of the marital bequest (which carries out the marital deduction) from the other stock. To avoid underfunding the marital bequest, consideration should be given to issuing or recapitalizing enough non-voting stock to allow the marital bequest to be funded with voting stock, or have the marital bequest always receive a controlling interest.

**Conclusion**

Estate planning is very complicated when a closely-held family business is involved, such as a farm or a ranch. It will become even more complex if the Congress lowers the federal estate tax exemption, or simply does nothing. Simply by doing nothing, the exemption is set to fall to $5 million (in inflation-adjusted dollars) at the start of 2026. Thankfully, the estate tax and trust provisions proposed last summer did not become law. Will pieces of those proposals come back in 2022? Time will tell.

If the goal is to keep the family farm or ranch in the family as a viable economic operation in the hands of subsequent generations, don't short-change estate planning.

I will continue the journey through other significant 2021 developments in ag law and tax next time.

**Overview: Part 3**

As readers of this blog will note, I recently concluded a five-part series on what I viewed as the "Top Ten" agricultural law and agricultural tax developments of 2021. There were many "happenings" in ag law and tax in 2021 which meant that there were still some significant developments that didn't make the "Top Ten." So far, those development that didn't make the "Top Ten, but are still very significant as to their impact on the ag sector and those that represent farmers and ranchers involve, whether a bankruptcy trustee can retain the trustee's fee in certain situations; improper set-up of an LLC that caused significant gifts to be recharacterized for tax purposes; and a case involving a huge estate planning mistake that cost the family a $2.5 million charitable deduction.

In today's article I continue with another important development in agricultural law during 2021 that just wasn't quite big enough to make the "Top Ten" list, but is still very significant – a change in the way "habitat" is defined for species listed as "endangered" under federal law.

A change is the way the feds define "habitat" for endangered species – it's the topic of today's post.

**Background.** The Endangered Species Act (ESA) establishes a regulatory framework for the protection and recovery of endangered and threatened species of plants, fish and wildlife. 16 U.S.C. § 1531 *et seq* (2002). The U.S. Fish and Wildlife Service (USFWS), within the Department of the Interior, is the lead administrative agency for most threatened or endangered species.

The ESA has the potential to restrict substantially agricultural activities because many of the protections provided for threatened and endangered species under the Act extend to individual members of the species when they are on private land. For example, in *People for the Ethical Treatment of Property Owners v. United States Fish and Wildlife Service, 852 F.3d 990 (10th Cir. 2017),* a USFWS rule concerning the "taking" of a Utah prairie dog on private property was upheld on basis that the Congress has the power to regulate purely local activities that are part of an economic class of activities that have a substantial economic effect on interstate commerce. Ts is because the court determined that the Commerce Clause authorized the regulation of noncommercial purely intrastate activity that is an essential part of a broader regulatory scheme. As such, the "take" regulation at issue was constitutional. The court noted that approximately 68 percent of ESA-protected species have habitats that do not cross state borders and, as such, the ESA could be severely undercut if the ESA only allowed protection to those species whose habitats were in multiple states.

The ESA prohibits individuals from "taking" a listed species. To take a species is to harass, harm, pursue, hunt, shoot, wound, kill, trap, capture, or collect or attempt to engage in any such conduct with a listed species. When a species is listed as endangered or threatened, the Secretary of the Interior must consider whether to designate "critical habitat" for the species. Once a habitat designation is made, land use activities on private land designated as habitat can be severely restricted. Critical habitat must first be habitat. It must be an area that is essential for conservation of the species. *See, e.g., Weyerhauser Co. v. United States Fish and Wildlife Service, 139 S.Ct. 361 (2018).* But, it need not include the entire geographical range which the species could potentially occupy. That was federal government's position until the U.S. Supreme Court in *Weyerhauser* determined otherwise. That decision was a major victory for farmers and ranchers and other private property owners because about half of the species listed as endangered or threatened have approximately 80 percent of their habitat on privately owned land.

**Note:** In late August of 2021 an appeal was filed in a case from New Mexico by ranchers on their assertion that USFWS acted in an arbitrary and capricious manner when it ignored the costs and benefits of designating critical habitat for the New Mexico Meadow Jumping Mouse. In 2016, the U.S. Fish and Wildlife Service issued a final rule designating critical habitat for the rodent across 14,000 acres and 170 miles of streams in Arizona, Colorado, and New Mexico. The USWFS asserted that the regulatory costs to the

ranchers would not exceed $100 million, with $15 million of that cost imposed on grazing activities of the ranchers by regulating grazing activities. The disaffected ranchers claim that the cost is grossly underestimated and that their water rights would not be adequately protected under law by the actions of the USFWS. The trial court determined that the USFWS' incremental effects approach to considering economic impacts was consistent with the ESA, and excluding compensation for impacts on water rights was proper as the claim was speculative. *Northern New Mexico Stockman's Association v. United States Fish and Wildlife Service, 494 F. Supp. 3d 850 (D. N.M. 2020).* The U.S. Circuit Court of Appeals for the Tenth Circuit heard oral arguments in the case on appeal on January 21, 2022.

**2019 regulations.** In 2019, the USFWS published final rules entitled, "Endangered and Threatened Wildlife and Plants; Revision of the Regulations for Listing Species and Designating Critical Habitat." *83 Fed. Reg. 35,193 (Aug. 12, 2019).* The final rules clarified the procedures and criteria that are used to add or remove species from the endangered and threatened species lists and how their critical habitat is designated. The new rules also eliminate the rule that, by default, extended many prohibitions on endangered species to those species that only had threatened status. In addition, the final rules further defined the procedures for interagency cooperation.

Importantly, the 2019 final rules modified the ESA listing process, and allowed for economic impacts of the potential listing, delisting or reclassifying of a species to be accounted for. The findings of anticipated economic impact must be publicly disclosed. In addition, the Secretary was required to evaluate areas occupied by the species, with unoccupied areas only being considered "essential" where a critical habitat designation that is limited only to the geographical areas that a species occupies would be inadequate to ensure conservation of the species. In addition, for an unoccupied area to be designated as critical habitat, the Secretary had to determine that there is a reasonable certainty that the area will contribute to the conservation of the species and that the area contains one or more physical or biological features essential to the conservation of the species. Also, a "threatened" listing for a species was to be evaluated in accordance with whether the species is likely to become endangered in the "foreseeable future" (as long as a threat is probable).

**2021 developments.** Additional final rules were published in December of 2020 that became effective in mid-January of 2021. These rules modified the definition of "habitat" to make habitat designations less burdensome on private property owners, and clarifying when the USFWS may exclude certain areas from designation as critical habitat by confining the definition to simply the ecosystem that a species presently occupied rather than the historical range of the species. The final rules became effective January 19, 2021. *85 FR 8237 (eff. Jan. 19, 2021).*

The very next day, the new White House Administration indicated that it would be reviewing the ESA rules pursuant to Executive Order 13990 *(86 Fed. Reg. 7037, Jan. 20, 2021).* On October 27, 2021, the USFWS published proposed rules that would rescind the Trump Administration's critical habitat rule. *50 C.F.R. Part 17, RIN 1018-BD84 (Oct. 27, 2021).* Prompted by the Administration, the USFWS then said it did not agree that areas must be excluded from designation when the costs exceed the benefits if it will not result in the extinction of a species. The USFWS now claims that it should retain discretion to make those decisions on excluded areas.

### Conclusion

The issues involved with respect to the ESA and "habitat" designation are important to those agriculture and other private landowners that could be financially impacted by the new regulation. A new, expanded, definition of "critical habitat" would pose greater land use restrictions on private property, much of it farm and ranch land. That will likely lead to more court battles over the property regulation and whether a compensable taking has occurred.

**Overview: Part 4**

Today's article is the fourth in a series discussing what I view of significant developments in 2021 that weren't quite big enough to make my "Top Ten" list. This time I discuss for tax four tax developments that occurred in 2021 that weren't quite big enough to make the "Top Ten."

More significant developments of 2021 in ag law and tax – it's the topic of today's post.

**Estate Tax Closing Letter Doesn't Preclude Later Exam of Form 706**

***C.C.A. 202142010 (Apr. 1, 2021)***

IRS Letter 627, an estate tax return closing letter, is issued to an estate and specifies the amount of the net estate tax, the state death tax credit or deduction, and any generation transfer tax for which an estate is liable. The position of the IRS, however, is that the letter is not a formal closing agreement. Thus, the issuance of the letter does not bar the IRS from reopening or reexamining the estate tax return to determine estate tax liability if: (1) there is evidence of fraud, malfeasance, collusion, concealment or misrepresentation of a material fact; (2) there is a clearly defined, substantial error based on an established IRS position; or (3) another circumstance indicating that a failure to reopen the case would be a serious administrative omission. Thus, when the IRS issues Letter 627 after accepting the return as filed, the issuance does not constitute an examination and IRS may later examine Form 706 associated with the estate that received the letter.

***IRS Supervisor Review - "Immediate Supervisor" is Person Who Actually Supervised Exam***

***Sand Investment Co., LLC v. Comr., 157 T.C. No. 11 (2021)***

Under the Internal Revenue Code (Code), an IRS examining agent must obtain written supervisory approval to the agent's determination to assess a penalty on any asserted tax deficiency. Under I.R.C. §6751(b)(1), the approval must be from the agent's "immediate supervisor" before the penalty determination if "officially communicated" to the taxpayer. In a partnership audit case under the 1982 Tax Equity and Fiscal Responsibility Act (TEFRA), supervisory approval generally must be obtained before the Final Partnership Administrative Adjustment (FPAA) is issued to the partnership. *See, e.g., Palmolive Building Investors, LLC v. Comr., 152 T.C. 75 (2019).* If an examiner obtains written supervisory approval before the FPAA was issues, the partnership must establish that the approval was untimely. *See, e.g., Frost v. Comr., 154 T.C. 23 (2020).*

In this case, the IRS opened a TEFRA examination of the petitioner's 2015 return. The IRS auditor's review was supervised by a team manager. While the audit was ongoing, the agent was promoted and transferred to a different team, but continued handling the audit still under the supervision of the former team manager. Ultimately, the agent asserted an accuracy-related penalty against the petitioner and the former team manager signed the approval form. The next day, the auditor sent the petitioner several documents indicating that a penalty might be imposed. Two days later the new team manager also signed the auditor's penalty approval form. The petitioner challenged the imposition of penalties because the new team manager hadn't approved the penalty assessment before the auditor sent the penalty determination to the petitioner. The Tax Court held that the supervisor who actually oversaw the agent's audit of the petitioner was the "immediate supervisor" for purposes of the written supervisory approval requirement of I.R.C. §6751(b)(1). There was no evidence that the new team manager had any authority to supervise the agent's audit of the petitioner.

**Meal Portion of Per Diem Allowance Eligible to be Treated As Attributed to a Restaurant.**

***IRS Notice 2021-63, 2021-49 IRB 835***

Under I.R.C. §274(n)(1) and Treas. Reg. §1.274-12, a deduction of any expense for food or beverages generally is limited to 50 percent of the amount otherwise deductible (i.e., as an ordinary and necessary business expense that is not lavish or extravagant under the circumstances). However, the Consolidated Appropriations Act, 2021, provides that that the full cost of such an expense is deductible if incurred after Dec. 31, 2020, and before Jan. 1, 2023, for food or beverages "provided by a restaurant." Meals obtained from a grocery or convenience store do not qualify. The IRS, with this notice, specified that a taxpayer may treat the meal portion of a per diem rate or allowance paid or incurred after Dec. 31, 2020, and before Jan. 1, 2023, for meals purchased while traveling away from home as being attributable to food or beverages provided by a restaurant.

**Note:** The Notice is effective for expenses incurred by an employer, self-employed individual or employees described in I.R.C. §62(a)(2)(B) through (E) after December 31, 2020, and before January 1, 2023.

**Credit Card Reward Dollars May Be Taxable**

***Anikeev, et ux. v. Comr., T.C. Memo. 2021-23***

The petitioners, husband and wife, spent over $6 million on their "Blue Cash" American Express credit cards ("Blue Card") from 2013 to 2014. They used their Blue Cards to accumulate as many reward points as possible, which they did by using the cards to buy Visa gift cards, money orders or prepaid debit card reloads that they later used to pay the credit card bill. The credit card earned then five percent cash back on certain purchases after spending in $6,500 in a single calendar year. Before purchases were sufficient for them to reach the five percent level, the card earned one percent cash back on certain purchases. Rewards were issued in the form of "rewards dollars" that could be redeemed for gift cards and statement credits.

In 2013, the petitioners charged over $1.2 million for the purchase of Visa gift cards, reloadable debit cards and money orders. In 2014 they charged over $5.2 million primarily for the purchase of Visa gift cards. They then used the Visa gift cards to buy money orders which they used to pay the American Express bills.

They redeemed $36,200 in rewards dollars from the card as statement credits in 2013 and $277,275 in 2014. The petitioners did not report these amounts as income for either year. The IRS audited and took the position that the earnings should have been reported as "other income." The petitioners claimed that when a payment is made by a seller to a customer, it's generally seen as a "price adjustment to the basis of the property" – the "rebate rule." *Rev. Rul. 79-96, 1976-1 C.B. 23.* Under this rule, a purchase incentive is not treated as income. Instead, the incentive is treated as a reduction of the purchase price (and associated reduction of basis) of what is purchased with the rewards or points. Thus, points and cashback earned on spending are viewed as a price adjustment. The petitioners, citing this rule, pointed out that the "manner of purchase of something…does not constitute an accession of wealth. The IRS, conversely, asserted that the rewards were taxable upon receipt because the petitioners did not purchase goods or services for which a rebate or purchase price adjustment could be applied. Instead, the IRS claimed that the petitioners purchased cash equivalents – Visa gift cards; reloadable debit cards; and money orders. *See, e.g., Tech. Adv. Memo. 200437030 (Apr. 30, 2004).* As cash equivalents, the rewards paid to the petitioners as statement credits were an accession to wealth and, thus, gross income under I.R.C. §61.

The Tax Court agreed that gift cards were a "product" – they couldn't be redeemed for cash and were not eligible for deposit into a bank account. Likewise, the Tax Court determined that that Visa gift cards provided a service to the petitioners via a product stating that, "[p]roviding a substitute for a credit card is a service via a product which is commonly sold via displays at drug stores and grocery stores." Thus, the portion of their reward dollars associated with gift card purchases weren't taxable under the "rebate rule." However, the Tax Court held that the petitioners' direct purchases of money orders and reloads of

cash into the debit cards using their credit card was different in that the petitioners were buying "cash equivalents" rather than a rebate on a purchase. They were not a product subject to a price adjustment and were not used to obtain a product or service. Because there was no product or service obtained in connection with direct money order purchases and cash reloads, the reward dollars associated with those purchases were for cash infusions.

The Tax Court also noted that the petitioners' practice would most often have been ignored if it had not been for the petitioners' "manipulation" of the rewards program using cash equivalents. Thus, the longstanding IRS rule of not taxing credit card points didn't apply. Thus, the Tax Court held that reward points become taxable when massive amounts of cash equivalents are purchased to generate wealth – buying money orders and funding prepaid debit cards with a credit card for cash back, and then immediately paying the credit card bill.

**Note:** The Tax Court also stated that it would like to see some reform in this area providing guidance on the issue of credit card rewards and the profiting from buying cash equivalents with a credit card.

**Overview: Part 5**

I continue my journey through the big developments of 2021 that didn't make my "Top 10" list. In Part 5 today, I look at two more developments – FDA rule changes to water qualify testing for ag water, and a Missouri food labeling law that was upheld as constitutional by a federal appellate court.

More not quite top 10 developments from 2021 – it's the topic of today's post.

**FDA Proposes Tightening of Water Quality Testing**

***FDA Notice of Proposed Rulemaking, 86 FR 69120 (Dec. 6, 2021)***

On December 6, 2021, the Food and Drug Administration (FDA) published proposed amendments to the agricultural water regulations contained in the Produce Safety Rule (PSR). The ag water regulations cover groundwater and numerous surface water sources including ponds, rivers, creeks, as wells as municipal and other public water supplies. According to the FDA, the proposed rule is designed to make pre-harvest testing of water more practical and less complex while simultaneously protecting public health. FDA says the proposed rule is designed to be flexible to more easily adapt to future developments in water quality science. According to the FDA, the new rule would replace the current PSR with systems-based preharvest ag water assessments designed to identify conditions that are reasonably likely to "introduce known or reasonably foreseeable hazards into or onto produce or food contact surfaces, and to determine whether corrective or mitigation measures are needed to minimize the risks associated with preharvest agricultural water."

The PSR is a rule that is part of the implementation of the Food Safety Modernization Act (FSMA), enacted in 2011 as an amendment to the Federal Food, Drug, and Cosmetic Act (FFDCA). The FSMA amended the FFDCA to require the FDA to establish minimum standards for the production and harvesting of certain fruits and vegetables that are raw ag commodities for which the Secretary determines that the minimum standards will minimize the risk of serious adverse health consequences or death. Accordingly, the FDA published a the proposed PSR in 2015 to apply to "covered produce" that are regularly consumed raw. Farmers of covered produce must ensure that there is no detectable E. coli in 100 milliliters of water used to irrigate the covered produce. "Very small producers" (those selling less than $250,000 of covered produce annually over the last three years) were to be in compliance by January 26, 2022. "Small producers (those selling annually between $250,000 and $500,000 of covered produce) had to comply by January 26, 2021. All other producers had to be in compliance by January 25, 2020. Based on producer feedback, the FDA issued a proposed rule in 2017 extending the compliance dates to January 26, 2024; January 26, 2023, and January 26, 2022, respectively.

The December 6, 2021, proposed rule would amend the ag water requirements for farmers growing covered produce other than sprouts, and would require growers to annually prepare a pre-harvest written ag water assessment and notification anytime a significant change occurs to the grower's ag water system that introduces a contamination risk. A grower must identify conditions that are reasonably likely to introduce known or reasonably foreseeable hazards into or onto covered produce. The proposal specifies five factors for consideration when composing an ag water assessment – 1) whether the water is ground water or surface water and whether the water is in an open or closed system; 2) the type of irrigation system used; 3) the characteristics of the crop(s) at issue; 4) environmental conditions (e.g., heavy rain or extreme weather events); and 5) the results of any testing the farmer conducted.

Three exemptions from conducting an ag water assessment are provided – 1) if requirements are met for water used on sprouts and in harvesting, packing and holding; 2) if the only water used is from a public water system or public water supply; and 3) if the water used on covered produce is treated according to requirements contained in the proposed rule. The FDA also stated that it anticipates publishing another

proposed rule extending the compliance dates. The comment period on the proposed rule runs until April 5, 2022. If finalized, the new rule would replace the pre-harvest microbial quality criteria and testing requirements of the PSR.

**Food Labeling Law Upheld**

***Turtle Islands Foods, SPC v. Thompson, 992 F.3d 694 (8th Cir. 2021)***

In recent years, food labeling issues have been in the courts. It is an important issue to many ag producers because of the connection to marketing of ag products and the ability to properly market those products to consumers and ensure that consumers have full knowledge of the content of what they are purchasing. In 2021, a Missouri food labeling law was challenged on constitutional grounds and upheld.

Missouri law (Mo. Rev. Stat. Sec. 265.282(7)) criminalizes the misrepresentations of a product as meat that is not derived from the harvested production of livestock or poultry. Violations are a Class A misdemeanor that are penalized by up to a year in prison plus a fine not to exceed $1,000. The law is specifically directed at Missouri businesses that market their products that are plant-based or cell-cultured as “meat-based” and sell them as “alternative” protein sources (which implies that the products contain real meat). The plaintiff, a maker of a vegetarian turkey substitute (Tofurkey), challenged the law as an unconstitutional violation of free speech, due process and the Dormant Commerce Clause and sought a preliminary injunction preventing the state from enforcing the law. The state submitted evidence showing how the plaintiff could comply with the law by labeling their products as “plant-based,” “veggie,” “lab grown,” or something similar.

The trial court denied the plaintiff’s request for an injunction on the basis that the law only barred a company from misleading consumers into believing that a product is meat from livestock when it is not. The trial court also determined that the plaintiff had failed to prove an irreparable injury by risk of prosecution because its packaging already contained the necessary disclaimers.

On further review, the appellate court affirmed. The appellate court noted that the plaintiff admitted that its products were labeled in such a way to clearly indicate that the products did not contain meat from slaughtered animals and denoted that they were plant-based, vegan or vegetarian. The appellate court noted that, on remand at the trial court, facts could be discovered that could possibly lead to a different result on appeal.


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