Happenings in Agricultural Law and Tax

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Overview

The legal issues in agricultural law and tax are seemingly innumerable. The leading issues at any given point in time are often tied to the area of the country involved. In the West and the Great Plains, water and grazing issues often predominate. Boundary disputes and lease issues seem to occur everywhere. Bankruptcy and bankruptcy taxation issues are tied to the farm economy and may be increasing in frequency in 2023 – the USDA projects net farm income to be about 16 percent lower in 2023 compared to 2022. Of course, estate planning, succession planning and income tax issues are always present.

With today's post, I take a look at some recent cases involving ag issues. A potpourri of recent cases – it's the topic of today's post.

Dominant Estate's Water Drainage Permissible.

Thill v. Mangers, No. 22-0197, 2022 Iowa App. LEXIS 961 (Iowa Ct. App. Dec. 21, 2022)

The plaintiffs sued their neighbor, the defendant, for nuisance. Rainwater from the defendant's property would run off onto the plaintiffs' property. In the 1950s and 1960s the city installed a few culverts to help with the water drainage. The water drained into an undeveloped ground area where the plaintiffs later built their home. The plaintiffs tried numerous ways to block the flow, ultimately causing drainage problems for the defendant who then tried to direct the excess water back onto the plaintiffs' property. The plaintiffs claimed that defendant's activity caused even more damage to their property than had previously occurred, causing a neighbor to also complain. All of the parties ended up suing each other on various trespass and nuisance claims. The trial court dismissed all of the claims because the court believed that all of the parties' actions caused the water drainage problems. The appellate court explained that the defendant, as the owner of the dominant estate, had a right to drain water from his land to the servient estate (the plaintiffs' property) and if damage resulted from the drainage, the servient estate is normally without remedy under Iowa Code §657.2(4). The only time a servient estate could recover damages is if there is a substantial increase in the volume of the water draining or if the method of drainage is substantially changed and actual damage results. Under Iowa law, the owner of the servient estate may not interrupt or prevent the drainage of water to the detriment of the dominant owner. The plaintiffs argued that the defendant violated his obligation by installing a berm and barricade, and presented expert testimony showing that the water flow changed when the defendant added the features, but the defendant had his own expert who provided contrary testimony. The appellate court held that the defendant's expert was more reliable because the defendant's expert used more historical information and photographs to analyze how the water historically flowed rather than focusing on the current condition of the neighborhood as did the plaintiffs' expert. When the plaintiffs' expert looked at these historical photographs, he even agreed with the defendant's expert that the natural flow of water was through the culverts onto the plaintiffs' property. The appellate court affirmed the trial court's finding that the plaintiffs did not prove that the defendant substantially changed the method or manner of the natural flow of water, because the water would have flowed the same way with or without the defendant's berm and barricade.

Mortgage Interest Deduction Disallowed

Shilgevorkyan v. Comr., T.C. Memo. 2023-12

The petitioner claimed a mortgage interest deduction for 2012 associated with a home that his brother purchased for $1,525,000 in 2005. The purchase was financed with a bank loan. The brother and his wife were listed as the borrowers on the loan. The brother (and wife) and another brother also took out a $1,200,000 construction loan. Both loans were secured by the home. The construction loan was used to build a separate guesthouse on the property. In 2010, one brother executed a quit claim deed in favor of the petitioner with respect to the property. During 2012, the petitioner didn't make any loan payments and was not issued a Form 1098 for the year. While the petitioner lived in the guesthouse for part of 2012, he did not list the property as being his place of residence or address. On his 2012 return, the petitioner claimed a $66,354 deduction for one-half of the total mortgage interest paid for the year as reported on Form 1098 that was issued to his brother and his brother's wife. The IRS disallowed the deduction and the Tax Court agreed. The petitioner failed to prove that the debt on the property was his obligation, did not show ownership (legal or equitable) in the property, and the quitclaim deed did not convey title to him under state law. The Tax Court also determined that the petitioner failed to establish that the residence was his "qualified residence."

Charitable Deduction Case Will Go to Trial on Numerous Issues

Lim v. Comr., T.C. Memo. 2023-11

During 2016 and 2017, the petitioners (a married couple) were the sole shareholders of an S corporation. In late 2016, after making a presentation to the petitioners concerning "The Ultimate Tax, Estate and Charitable Plan," an attorney formed a "Charitable Limited Liability Company" for the petitioners to use as a vehicle for making charitable donations. The attorney agreed to transfer assets to the LLC, to transfer LLC units to a charity and to provide the supporting valuation documentation for the donation. He also agreed to represent them before the IRS and the Tax Court if the return(s) were later examined. His fee would be the greater of $25,000 or 6 percent of the "deductible amount" of assets capped at $1 million, plus 4 percent of the "deductible amount" of assets exceeding $1 million. The assets transferred to the LLC were five promissory notes with a face amount of $2,008,500. This generated a fee for the attorney of $84,000 based on a presupposed "deductible amount" of $1,600,000 even though the assets were not appraised until late January of 2017, which valued them at $1,600,000. The fee was to be paid in installments over six months beginning in January of 2017.

The attorney also created a second LLC in late December of 2016 with the petitioners as the managers, the attorney as registered agent, and the petitioners' S corporation as the single member. Petitioners promised to pay the second LLC $2,008,500 (the promissory notes) in seven years.

The charitable recipient was a Foundation (an I.R.C. §501(c)(3) organization) for which the attorney was the registered agent. The petitioners claimed that their S corporation donated "units" of the second LLC to the Foundation and claimed a charitable deduction. The IRS denied the deduction, partly on the basis of a lack of evidence that any property was actually transferred to the Foundation. The petitioners did not offer any explanation as to when or how the "units" were created or what physical form they took. The petitioners also claimed that they received an acknowledgement letter of the donation from the Foundation dated January 1, 2017. The letter referred to 1,000 units of an LLC that did not exist during 2016 or as of January 1, 2017. It was not addressed to the S corporation, but to the petitioner (wife) at their residence in a different city than the S corporation. The letter also was not signed by any person and appeared to be a form letter with taxpayer-specific information in bold font. It also did not refer to property that the S corporation allegedly donated on December 31, 2016.

On January 4, 2017, the attorney submitted an appraisal, but it lacked substance. The appraisal asserted that LLC interests were donated to the Foundation in 2016, but did not denote how many interests had been contributed. The claimed charitable deduction was $1,608,808. The attorney also attached his curriculum vitae stating that he was a CPA, a certified valuation analyst and a licensed attorney in Kentucky. Also attached to the appraisal was a one-page "certification" on which the attorney stated that his fee was not contingent on the report in any manner and that he didn't have any interest or bias with respect to the parties involved. This was despite his having arranged the entire transaction and being the registered agent for the second LLC.

The S corporation filed Form 1120S for 2016 and attached a copy of the appraisal and Form 8283 which described the donated property as "LLC units" with a basis of $2,008,500 that had been acquired by purchase, and an "appraised market value" of $1,608,808. The petitioners reported a non-cash charitable deduction of $1,608,808 on Schedule A that flowed through to them from the S corporation. Because the amount of the deduction exceeded the maximum allowable deduction for 2016, they claimed a $1,195,073 deduction for 2016 and carried the balance of $415,711 to their 2017 return.

The IRS audited the petitioners' 2016 and 2017 returns and disallowed the charitable deductions for lack of substantiation. The petitioners challenged the disallowance in the Tax Court and the IRS moved for partial Summary Judgment. The Tax Court determined that the appraisal was not a "qualified appraisal" within the meaning of I.R.C. §170(f)(11)(C). Treas. Reg. §1.170A-13(c)(6)(i) requires, among other things, that "no part of the fee arrangement for a qualified appraisal can be based, in effect, on a percentage (or set of percentages) of the appraised value of the property." Accordingly, the attorney's fee was a prohibited appraisal fee within the meaning of the regulation. However, the Tax Court held that the petitioners had shown reasonable cause for failure to comply with the substantiation requirements of I.R.C. §170. They had presented sufficient proof that they relied upon professionals in claiming the charitable contribution deduction. Accordingly, the Tax Court denied the IRS summary judgment on this issue. The Tax Court also denied summary judgment to the IRS on the issue of whether the written acknowledgement was a "contemporaneous written acknowledgement" of the contribution in accordance with I.R.C. §170(f)(8)(A). Accordingly, the Tax Court granted the Summary Judgment motion of the IRS in part, while the remaining issues will be set for trial.

Note: In 2018 the Department of Justice filed a complaint against the attorney, alleging that he promoted the "Ultimate Tax Plan" as a tax evasion scheme. He was accused of running a $35 million federal tax advice scam offering fake deductions using three bogus charities for 19 years. The complaint alleged that he was at the helm of "a national charitable-giving tax scheme" that targeted "wealthy individuals in high tax brackets facing large tax liabilities." He settled with the Government and agreed to a permanent injunction. On April 26, 2019, the U.S. District Court for the Southern District of Florida entered a final judgment of permanent injunction against him, holding that he had engaged in conduct penalizable under I.R.C. §6700 by promoting the "Ultimate Tax Plan." The court permanently enjoined him from, among other things, promoting "the Ultimate Tax Plan or any plan or arrangement that is substantially similar." The court ordered the attorney to perform other actions as well in relation to the plan.

Document Filed with FSA Not a Valid Lease

Coniglio v. Woods, No. 06-22-00021-CV, 2022 Tex. App. LEXIS 8926 (Tex. Ct. App. Dec. 7, 2022)

Involved in this case was land in Texas that the landowner's son managed for his father who lived in Florida. The landowner needed the hay cut and agreed orally that the plaintiff could cut the hay when necessary. The hay was cut on an annual basis. So that he could receive government farm program payments on the land, the plaintiff filed a "memorialization of a lease agreement" with the local USDA Farm Service Agency (FSA). The landowner's son also signed the agreement at the plaintiff's request, but later testified that he didn't believe the document to constitute a written lease. After three years of cutting the hay, the landowner wanted to lease the ground for solar development, and the plaintiff was told that the hay no longer needed to be cut and there would be no hay profits to share. The plaintiff sued for breach of a farm lease agreement. The trial court ruled in favor of the plaintiff on the basis that the form submitted to the USDA was sufficient to show the existence of a lease agreement. On appeal, the defendant claimed that the document filed with the FSA did not satisfy the writing requirement of the statute of frauds. The appellate court agreed, noting that the document didn't contain the essential terms of the lease. It didn't denote the names of the parties, didn't describe the property, didn't note the rental rate, and didn't list any conditions or any consideration. Accordingly, the appellate court determined that no valid lease existed and reversed the trial court's judgment.

Conclusion

I'll provide another summary of recent cases in a subsequent post.