

# DEATH IS NOT A TAX DODGE: A LOOK AT THE TAX BENEFIT RULE

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Because tax accounting is done annually, taxes are assessed on a basis that may prove inaccurate if a particular transaction is altered after the tax year has closed. For example, if a corporation deducts a state tax that it paid in one year, it would receive a windfall if the tax is invalidated and refunded in a later year. To rectify these situations, the tax benefit rule may apply to trigger income recognition if subsequent events are “fundamentally inconsistent” with a prior deduction. *Hillsboro Nat’l Bank v. Comm’r*, 460 U.S. 370, 383 (1983).

Last week, the Tax Court addressed the tax benefit rule, holding that death is not fundamentally inconsistent with a prior deduction for purchases of seed and other agricultural inputs associated with a farm; as a consequence, the farmer and his wife were able to deduct the same expenses twice in two consecutive years. *Estate of Steve K. Backemeyer v. Comm’r*, No. 147 T.C. No. 17, 2016 U.S. Tax Ct. LEXIS 35 (Dec. 8, 2016).

Steve Backemeyer was a farmer who operated as a sole proprietor in Nebraska. *Estate of Steve K. Backemeyer*, 2016 U.S. Tax Ct. LEXIS 35 at \*2. Mr. Backemeyer died in March 2011. In late 2010, he incurred expenses for seed, fertilizer, fuel and other agricultural inputs for the 2011 planting season, but he died before using the supplies. *Id.* at \*2-\*3. All of Mr. Backemeyer’s interest in the supplies passed to a trust managed by his surviving spouse. *Id.* at \*5.

Following her husband’s death, Mrs. Backemeyer began farming; she took an in-kind distribution of the supplies and other expense items and used them in her farming operation in 2011. *Id.* at \*5-\*6. She then sold her crops in 2011 and 2012, claiming a zero tax basis in the crops for both tax years. *Id.* at \*6.

Joint tax returns were filed for both 2010 and 2011. On the 2010 return, Schedule F reflected the income and deductions associated with Mr. Backemeyer’s farming activities, including the expenses he incurred in anticipation of the 2011 planting season. *Id.* at \*6-\*7. The 2011 return had a Schedule F for Mr. Backemeyer’s activity up to the date of his death, and a second Schedule F reflecting Mrs. Backemeyer’s activity. *Id.* at \*7. On her Schedule F, Mrs. Backemeyer reported the same deductions that her deceased husband had claimed in 2010. *Id.* at \*8. The IRS determined that Mrs. Backemeyer was not entitled to claim a deduction for the supplies and other agricultural inputs her husband had already deducted. *Id.* at \*8-\*9.

Before the Tax Court, the IRS conceded that the 2010 deduction by Mr. Backemeyer was proper; it also conceded that Mrs. Backemeyer took a stepped up basis in the supplies and that she properly deducted that basis in calculating her farming income for 2011. The IRS contended that the tax benefit rule required that the 2010 deduction be recouped in 2011. *Id.* at \*18. This position turned on the Supreme Court's decision in *Hillsboro Nat'l Bank*, which addressed two consolidated cases, one of which involved Bliss Dairy, Inc., a corporation engaged in dairy farming.

The Tax Court commenced its analysis by reviewing *Hillsboro*, as well as its own subsequent precedent. Based upon these sources, the court posited that the tax benefit rule called for the inclusion of an amount in the current tax year if four criteria were met:

(1) The amount was deducted in a 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) a nonrecognition provision of the Internal Revenue Code does not prevent the inclusion in gross income.

2016 U.S. Tax Ct. LEXIS 35 at \*20 (quoting *Frederick v. Comm'r*, 101 T.C. 35, 40-41 (1993)).

Next, the court focused on the Supreme Court's specific treatment of Bliss Dairy, which had transferred previously expensed agricultural inputs through a liquidating distribution to shareholders. *Id.* at \*22. There, the Supreme Court had held that the nonrecognition provision under the then-current version of section 336 of the Code yielded to the tax benefit rule in part because section 336 was overridden by the depreciation recapture provisions of the Code. *Id.* (citations omitted). The Tax Court also observed that the Supreme Court had explicitly indicated that its rationale for the treatment of Bliss Dairy in *Hillsboro* did not necessarily apply in the context of gifts and legacies. *Id.* at \*23-\*24 (discussing *Hillsboro*, 460 U.S. at 386, n. 20).

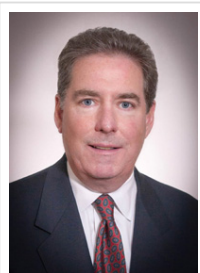
Accordingly, the Tax Court considered whether the tax benefit rule applied with equal force in the context of a transfer at death. The Tax Court recognized that two of the relevant requirements were satisfied because an amount had been deducted in a prior year that had yielded a tax benefit. *Id.* at \*26. The court then turned to the third requirement of the tax benefit rule, which is the occurrence of a subsequent event that is fundamentally inconsistent with the deduction. Here, the Tax Court concluded that neither Mr. Backemeyer's death nor the distribution of the supplies and other agricultural inputs was fundamentally inconsistent with the prior deduction. An event is only fundamentally inconsistent with a prior deduction if it would have barred the taxpayer from taking the deduction if it occurred in the year the deduction was claimed. In the Tax Court's view, this standard was not met because if Mr. Backemeyer had died in 2010, the initial deduction for the supplies and other agricultural inputs by Mr. Backemeyer and the subsequent deduction by his wife would still have been proper. *Id.*

As the Tax Court explained, this was because of the impact of the estate tax: "[T]he estate tax effectively recaptures section 162 deductions by way of its normal operation." *Id.* In the court's view, the various supplies were included in Mr. Backemeyer's gross estate and subject to tax at their fair market value, which was their purchase price. *Id.* at \*27. Since the supplies were subject to tax as part of the estate, applying the tax benefit rule would result in an assessment for estate tax and a duplicative assessment for income tax, which would be improper. *Id.* at \*28 (citing *Bull v. United States*, 295 U.S. 247, 256 (1935)). The Tax Court opined that it did not matter whether any estate tax was actually paid; all that mattered was that the estate's assets were covered by the estate tax. *Id.* at \*28-\*29.

The Tax Court also noted that the Supreme Court had directed courts considering the tax benefit rule to differentiate between events that were merely unexpected and events that were truly inconsistent with the basis for the prior deduction. *Id.* at \*29 (citing *Hillsboro*, 460 U.S. at 383 n. 15). In that context, the court observed that death was merely an unexpected event, as it would be difficult to conclude it was a tax avoidance scheme. *Id.* (citing *Estate of Peterson v. Comm’r*, 667 F.2d 675, 681-82 (8th Cir. 1981)). In contrast, the liquidating distributions at issue in *Hillsboro* were obviously the subject of planning.

For good measure, the Tax Court also considered whether there was an applicable nonrecognition provision of the Code that trumped the tax benefit rule. Here, the Tax Court commented that “nonrecognition on death is among the strongest principles inherent in the income tax.” *Id.* at \*32 (citation omitted). The court also noted that this conclusion was reinforced by the depreciation recapture rules that the Supreme Court had addressed in *Hillsboro*. While those recapture rules had operated as an exception to the nonrecognition principle for liquidating distributions in the context of Bliss Dairy, they specifically carve out transfers at death. *Id.* at \*33-\*34. Consequently, the Tax Court concluded that the principle that death does not trigger income recognition trumped the tax benefit rule.

It will be interesting to see whether the government pursues an appeal. The Tax Court’s logic is solid, but the result, an apparent doubling of deductions, is counter-intuitive.



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