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The Case for Limiting Entities in Farm and Ranch Operations

-by Neil E. Harl*

For many years, the usual organizational structure for farm and ranch operations was a single entity, often a sole proprietorship, with a few partnerships for the larger operations. However, in recent years, the trend has been toward multiple entity operations with an array of choices for the entities. In some instances, multiple entities are warranted, such as where a high risk operation (such as a spraying operation or a transportation subsidiary) is set up as a separate entity from the core operation. In others, tax advantages are perceived.

This article focuses heavily on the possible drawbacks from using multiple entities, particularly where the perceived advantages are limited or potential tax complications cloud the advantages thought to be achievable with an array of entities.

Problems with hedging

Two recent cases and a Technical Advice Memorandum have focused attention on the potential pitfalls with multiple entities where hedging is carried on in the operation. In *Pine Creek Farms, Ltd v. Commissioner*, a C corporation was originally engaged in the production of corn, soybeans, cattle and hogs but the hog operation (which was growing rapidly) was spun off into two separate corporations. However, the hedging activity continued to be handled in the name of the C corporation which ceased to own hogs. When losses were encountered, it became clear that the losses were speculative (and not hedges) with highly disadvantageous tax consequences. The case of *Welter v. Commissioner* met a similar fate with the shareholder of two family farm corporations engaged in commodity trades in the shareholder’s own name with the result of capital gains on the security transactions that produced gains but also capital losses with limited deductibility.

Eligibility for I.R.C. § 179 deductions

It is clear that the amount eligible to be expensed under the Section 179 rules is limited to the taxable income derived from an active trade or business and, for a partnership, the test is applied at both the partner and partnership levels. In a case decided in 2000, there was insufficient taxable income at the partnership level so there was no pass-through of expense method depreciation to the partners.

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The use of multiple entities raises a serious question of whether the likely generation of income in the various entities (some of which might not meet the “active trade or business” test) could jeopardize eligibility for the deduction which, through 2014, was available at the $500,000 level and promises to return to that level or possibly higher.8

“At risk” rules

Multiple entity farming and ranching operations (except for the partial exemption for partnerships, as discussed in the next issue) must necessarily see that each entity is in compliance with the “at risk” rules.9 Farming (and presumably ranching is included in “farming”) is specifically listed as one of the five types of activities that come under the “at risk” statutory provisions.10

Self-employment tax

Ironically, although some multi-entity operations are structured with an objective of reducing self-employment tax liability,11 the outcome in some instances has been that the Internal Revenue Service position that “material participation” as a necessary element in having “self-employment income”12 in meeting the “trade or business” test can be achieved by combining the involvement from a separate land-owning entity and the entity carrying on the farming or ranching operation which virtually assures liability for self-employment tax, rather than avoidance of self-employment tax liability as anticipated.13 The Eighth Circuit Court of Appeals, however, rejected the IRS position and held that rents consistent with market rates “very strongly suggest” that the rental arrangement should stand on its own as an independent transaction without self-employment tax being due.14 On October 20, 2003, IRS entered a non-acquiescence in the appellate court case of McNamara v. Commissioner.15

Having lost at the Eighth Circuit Court of Appeals, IRS has proceeded to challenge multiple entity situations in the Second Circuit Court of Appeals area (which was settled out of court) and the Seventh Circuit Court of Appeals area (with a case set for trial in late 2015). It has become clear that IRS intends to continue pressing for self-employment tax liability in multi-entity situations under the theory advanced in the earlier case of Mizell v. Commissioner.16

Economic distortion

Setting up multiple entities has the potential to interfere with how assets are used, resulting in higher costs and lower net at the end of the year. IRS looks askance at machinery owned by one entity and used by another, at least that is the case if it appears that there is a tax advantage involved. One common example is to route ownership of expensive farm equipment into an entity and used by another, at least that is the case if it appears so as to reduce eligible expenses.17

Filing multiple tax returns and keeping separate records

The cost and inconvenience of necessarily filing federal and state tax returns for each entity (and keeping separate records for each entity) are significant factors to take into account in planning the structure of an operation. Whether it is a Form 1120 for a C corporation, a Form 1120-S for an S corporation or a Form 1065 for each of the pass-through entities taxed as a partnership (and most limited liability companies and limited liability partnerships are classified as partnerships for income tax purposes), the cost and time devoted to preparing and filing separate returns for each entity are significant, not to mention the additional record keeping.

So is there a “best” way?

As with most management issues, there is no single “best way” to structure an operation. It is a matter of weighing the pluses and minuses for each feature of the organizational chart. Our suggestion: especially when it comes to creating new entities, put the burden on new proposed entities to show that the pluses outweigh, comfortably, the minuses.

ENDNOTES

1 See generally 6 Harl, Agricultural Law Chs. 50, 51 (2015) for a discussion of the economic and legal considerations for the choice of organizational structure.
2 TAM 9720003, January 15, 1997 (dairy farm carried on by S corporation; taxpayer attempted to hedge feed ingredients but it was carried out by the wrong entity).
3 T.C. Memo. 2001-176.
4 T.C. Memo. 2003-299.
6 I.R.C. § 179(d)(8).
7 Id.
8 I.R.C. § 179(b)(2)(C).
9 I.R.C. § 465.
10 I.R.C. § 465(c)(1)(B).
11 I.R.C. § 1402(a), (b).
12 I.R.C. § 1402(a)(1).
13 See Mizell v. Comm’r, T.C.Memo. 1995-571.
16 T.C. Memo. 1995-571.

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by Neil E. Harl

See the back page for information about these seminars. Here are the cities and dates for the seminars in fall 2015:

**September 14 & 15, 2015** - Courtyard Hotel, Moorhead, MN

**September 17 & 18, 2015** - Ramkota Hotel, Sioux Falls, SD

**September 28 & 29, 2015** - Holiday Inn, Rock Island, IL

**October 13 & 14, 2015** - Atrium Hotel, Hutchinson, KS

Each seminar will be structured the same, as described on the back cover of this issue. More information will be posted on www.agrilawpress.com and in future issues of the Digest.