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The Two-Entity Business Model

-by Neil E. Harl*

Without much doubt, one of the most difficult issues in farm estate and business planning, after the parents are either deceased or inactive, is leaving as direct heirs some of which are anticipating carrying on the farming (or ranching) operation and some of which are interested in obtaining a fair shake in terms of land ownership only.

The key question is whether to continue the one entity model (which they usually have been using before the parents receded from the scene) or shift to two entities. The basic decision is whether the family should aim for a single entity with off-farm heirs assuming proportionate ownership of all assets alongside the on-farm heirs or whether the off-farm heirs should settle for an appropriate ownership of the land only and leave the ownership of the operating entity assets to the on-farm heirs. The decision is often shaped by personalities and by long-held expectations.

By one entity is meant that the overall operation is to be carried on in a single corporation, partnership, limited liability company or other option available in their state. A two entity model is usually structured with one legal entity owning the real estate and the other entity owning the machinery, livestock and other non-real estate investments.

Configuration of a two-entity operation

One overall objective is to create a fair division of assets with the off-farm heirs holding ownership interests appropriate for their inherited share of the real estate inherited by the off-farm heirs and shifted to a newly formed entity devoted to land ownership only. The other overall objective is to clear the way for the on-farm heir or heirs to conduct the farming operations in the most efficient (and profitable) manner possible.

Basically, the result would be to create a two-entity structure with the off-farm heirs, as a group, acting as landlords (along with, in some instances, some or all of the on-farm heirs) who are renting the land to the operating entity at a negotiated rental figure each year or for a longer term.

Potential problems

The most visible problem, which should be avoidable, is that the Internal Revenue Service, commencing in 1995 in Mizell v. Commissioner1 was successful in the Tax Court in arguing that the lease of property to an entity in which the lessee is also an employee is also an employee or partner results in treatment of the lease payments as self-employment income. The Mizell case involved a partnership but the IRS applied the same analysis of

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rental of land and personal property to a corporation.\footnote{3}

However, three cases were litigated with the same outcome at the Tax Court level\footnote{1} but all three cases were overturned by the Eighth Circuit Court of Appeals.\footnote{5} The Eighth Circuit focused on the “nexus” between the farming operation and stated that “…the mere existence of an arrangement requiring and resulting in material participation…does not automatically transform rents received” into self-employment income. The Court pointed out 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.\footnote{5}

However, on October 20, 2003, IRS entered a non-acquiescence in the appellate court case of McNamara v. Commissioner as well as the Hennen and Bot cases.\footnote{4} That signaled that the McNamara case did not bar cases in other Circuit Courts of Appeal. Since then, there has been a scattering of audits until late this year.

On September 27, 2017, in a surprise move, the United States Tax Court in a Texas case,\footnote{7} approved by a 12 to 3 margin, the holding and rationale of McNamara, et al. v. Commissioner.\footnote{8} The Martin case is appealable to the Fifth Circuit Court of Appeals with the potential to widen the authority of the McNamara court’s use of fair market rent as the test for self-employment treatment of inter-entity rental of farmland.s

The clear warning (which may or may not fend off litigation) is to set rents at a reasonable level, at least where there was a direct nexus between the operating entity and the taxpayer’s material participation in the operation.\footnote{9}

On this issue, taxpayers in the Eighth Circuit Court of Appeal jurisdiction have an advantage, of course. It is apparent that the Internal Revenue Service has been seeking a case which is strong factually in their favor in order to overturn the Eighth Circuit decision.

\textbf{In conclusion}

Numerous factors are almost always in play in setting up a two entity business plan that will avoid IRS criticism, particularly if the Martin\footnote{10} case is upheld or is not appealed. However, a careful planning effort should minimize the risk.

\textbf{ENDNOTES}

\begin{enumerate}
\item T.C. Memo. 1995-571.
\item Ltr. Rul. 9637004, May 1, 1996.
\item McNamara, et al. v. Comm’r, 236 F.3d 410 (8th Cir. 2000), non-acq., I.R.B. 2003-42.
\item See 2 Harl, \textit{Farm Income Tax Manual} § 8.5[5][b] (2017 ed.).
\item See Johnson v. Comm’r, T.C. Memo. 2004-56 (land rentals found to be fair market rentals). But see Solvie v. Comm’r, T.C. Memo. 2004-55 (rental paid on hog barn at $21 per hog per rotation was above fair market rental and subject to self-employment tax).
\item Martin v. Comm’r, 149 T.C. No. 12 (2017).
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