The Farm LLC (Taxed as a Partnership): Still the Best Choice for Farmers after Tax Reform

*The outline is laid out in four main parts that coincide with the Power-point - **I**: Profits Interest**, II**: Minimizing SE Tax, **III**: Retiring Partners and **IV**: Estate Planning.*

I. **Profits Interests** – *Junior can enter the LLC and prove his worth with "sweat equity." It is also a "safe" option for Mom and Dad since a gift of equity could be harmful if it does not work out and Junior leaves the farm.*

a. Entry into the partnership for the next generation typically is a tax-free event.[1] Junior will either enter the partnership by contributing assets, through sweat equity or a combination of both.

b. If Junior has property to contribute to the partnership in exchange for an interest in the partnership, that is generally tax-free.[2]

c. Typically, Junior is a broke college graduate who will receive a profits interest into the partnership. This is generally a tax-free event under Rev Proc. 93-27.[3] The main reason for the granting of a profits interest is for Junior to begin having "skin in the game." Certainly, the goal here is to entice junior to earn equity by the labor provided, which can act as a powerful incentive.

d. Rev. Proc. 93-27 defines a profit interest by noting that it is an interest other than a capital interest. It defines a capital interest as "an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership. This determination generally is made at the time of receipt of the partnership interest."

e. Rev. Proc. 93-27 will not apply if "(1) If the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease;(2) If within two years of receipt, the partner disposes of the profits interest; or(3) If the profits interest is a limited partnership interest in a "publicly traded partnership" within the meaning of section 7704(b) of the Internal Revenue Code."[4]

   1. Essentially, the whole point here is that there is some "risk" involved in that the income stream is not guaranteed. If it were, then one could determine the value of the profits interest at the time of the granting.

f. Rev. Proc. 2001-43 clarifies Rev. Proc. 93-27 and states that the granting of the profits interest is "tested at the time the interest is granted, even if, at that time, the interest is substantially nonvested (within the meaning of §1.83-3(b) of the Income Tax Regulations). Accordingly, where a partnership grants a profits interest to a service provider in a transaction meeting the requirements of this revenue procedure and Rev. Proc. 93-27, the Internal Revenue Service will not treat the grant of the interest or the event that causes the interest to become substantially vested (within the meaning of §1.83-3(b) of the Income Tax Regulations) as a taxable event for

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[1] I.R.C. 721.
[2] I*d.*
[3] Rev. Proc. 93-27.
[4] *Id.*

the partner or the partnership. Taxpayers to which this revenue procedure applies need not file an election under section 83(b) of the Code."

1. "The service provider is treated a receiving the interest on the date of the grant as long as (1) The partnership and the service provider treat the service provider as the owner of the partnership interest from the date of its grant and the service provider takes into account the distributive share of partnership income, gain, loss, deduction, and credit associated with that interest in computing the service provider's income tax liability for the entire period during which the service provider has the interest, (2) Upon the grant of the interest or at the time that the interest becomes substantially vested, neither the partnership nor any of the partners deducts any amount (as wages, compensation, or otherwise) for the fair market value of the interest; and (3) All other conditions of Rev. Proc. 93-27 are satisfied."

2. In other words, the determination of value is done at the time the profits interest in granted even if it vests later.

II. **Minimizing self-employment tax –** *The one major benefit of an S-corporation (over a partnership) is that profits are not subject to self-employment tax, as shareholders are required to be paid reasonable compensation through a W-2. With proper planning, this benefit can be mimicked through the LLC (partnership) context, which sets up a much better estate plan long-term.*

a. LLC members may employ strategies that have the ability to limit self-employment taxes. The starting point for the analysis begins at I.R.C. 1401. I.R.C. 1401 imposes Old-Age, Survivors, and Disability Insurance tax and Hospital Insurance tax on self-employment income.[5]

b. I.R.C. 1402(a) defines self-employment income as "the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702(a) (8) from any trade or business carried on by a partnership of which he is a member."

c. Income from a farm partnership generally falls under I.R.C. 702(a) (8) and is subject to self-employment tax unless an exception applies.

[5] I.R.C. 1401(a) Old-Age, Survivors and Disability Insurance – "In addition to other taxes, there shall be imposed for each taxable year, on the self-employment income of every individual, a tax equal to 12.4 percent of the amount of the self-employment income for such taxable year." "In addition to the tax imposed by the preceding subsection, there shall be imposed for each taxable year, on the self-employment income of every individual, a tax equal to 2.9 percent of the amount of the self-employment income for such taxable year." I.R.C. 1401(b). For the purposes of this section of the presentation, the 0.9% Additional tax on income over $250,000 for married couples is not considered.

d. There are several exceptions from self-employment income. Of importance to many farmers is the exception for rentals.[6] This exception includes personal property leased with real estate.[7] This is why many farmers utilize the "dual-LLC" approach and pay themselves rental income. While farmers renting land from their LLCs has come under attack by the IRS, the tax court has ruled that it is not self-employment income.[8]

e. The main exception concerning farm-operating LLCs is the exception for limited partners (with the exception of a guaranteed payment for services, which would still be subject to self-employment taxes). The starting point for the exception from LLC members[9] is found in I.R.C. 1402(a)(13) which states "[t]here shall be excluded the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services"[10]

f. Under **proposed regulations** issued in 1997[11], LLC members may mitigate self-employment tax if (1) the member has no personal liability as a result of being a member, (2) has no authority to contract on behalf of the partnership and (3) doesn't participate in the trade or business for more than 500 hours during the taxable year.[12]

  1. There are two exceptions to this test: (1) the "one class of interest" exception and the (2) "more than one class of interest" exception.

  a. Under the "one class of interest" exception, a member who fails the test above solely due to working more than 500 hours will still be treated as a limited member if (1) "limited partners . . . own a substantial, continuing interest in that specific class of partnership interest"; and (2) the individual's rights and obligations with respect to the specific class of interest are identical to the rights and obligations of the specific class of partnership interest held by the limited partners . . . ."

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[6] "There shall be excluded rentals from real estate and from personal property leased with the real estate (including such rentals paid in crop shares, and including payments under section 1233(a)(2) of the Food Security Act of 1985 (16 U.S.C. 3833(a)(2)) to individuals receiving benefits under section 202 or 223 of the Social Security Act) together with the deductions attributable thereto, unless such rentals are received in the course of a trade or business as a real estate dealer; except that the preceding provisions of this paragraph shall not apply to any income derived by the owner or tenant of land if (A) such income is derived under an arrangement, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities (including livestock, bees, poultry, and fur-bearing animals and wildlife) on such land, and that there shall be material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) in the production or the management of the production of such agricultural or horticultural commodities, and (B) there is material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) with respect to any such agricultural or horticultural commodity." I.R.C. 1401(a).

[7] *Id.*

[8] Martin v. Commissioner, 149 T.C. 12 (2017).

[9] Members and partners will be used interchangeably throughout the document.

[10] I.R.C. 1402(a) (13).

[11] Prop. Treas. Reg. §1.1402(a)-2(h)(2)

[12] *Id.*

    1. A substantial interest is a facts and circumstances test. However, "ownership of 20 percent or more of a specific class of interest is considered substantial."[13]

    2. In other words, if the LLC were structured as a manager-managed LLC (not a member-managed LLC), then a limited partner who worked more than 500 hours (but who satisfied the other two criteria for limited status) would not be subject to self-employment tax on his interest so long as he held an identical interest to a limited member who owned at least 20 percent of the LLC.[14]

2. Under the "more than one class of interest" exception, a member "holding more than one class of interest in the partnership who is not treated as a limited partner . .. is treated as a limited partner . . . with respect to a specific class of partnership interest held by such individual if . . ." (1) limited members own a substantial, continuing interest in that specific class of partnership interest; and (2) the individual's rights and obligations with respect to that specific class of interest are identical to the rights of that specific class of partnership interest held by the limited partners . . . ."
    a. This is generally referred to as having a "bifurcated interest." This could occur when wife is the managing member of a farm operation and husband works off farm but they are 50-50 partners. In that case, as long as husband met the criteria for a limited partner and wife paid herself a reasonable guaranteed payment, a portion of her interest would not be subject to self-employment tax.[15]

III. Retiring Partner

a. I.R.C. 736 governs partnership redemptions.

b. Farm operations are typically governed by the general rule in I.R.C. 736(b) as farms are capital-intensive businesses.[16]

c. The general rule is that payments made in liquidation are considered as a distribution by the partnership.[17]

d. I.R.C. 736 only applies to payments made to retiring or deceased partners in liquidation of their interest.[18]

e. Unlike an installment sale to another partner, redemption payments must be made by the partnership.[19]

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[13] Prop. Treas. Reg. §1.1402(a)-2(h) (6).
[14] *See Id.*
[15] The IRS has said that it will respect taxpayers utilizing these proposed regulations. "Taxpayers, however, may rely on the 1997 proposed regulations. In other words, the IRS will respect a partner's status as a limited partner if the partner qualifies as a limited partner under the 1997 proposed regulations." IRS LB&I Concept Unit, Knowledge Base- Partnerships, available at https://www.irs.gov/pub/irs-utl/pst_c_366_01_01_01.pdf. The link will also provide you with IRS interpretation of current case law in the area.
[16] I.R.C. 736(b) (3).
[17] I.R.C. 736.
[18] Treas. Reg. 1.736-1(a) (1) (i).
[19] *Id.*

f. When a partner retires when he ceases to be a partner under local law, for tax purposes, he is still considered a partner and will receive a K-1.[20]

g. If the farmer who is retiring wishes to work during this time, he will still be receiving a guaranteed payment (not a W-2) as he is still considered a partner.[21]

h. As outlined in the example below, redemption payments must be split amongst various classes of items.[22] The example below was written by me for a Farm Credit East publication:

Business Entity Trends from a Tax and Succession Perspective[23]

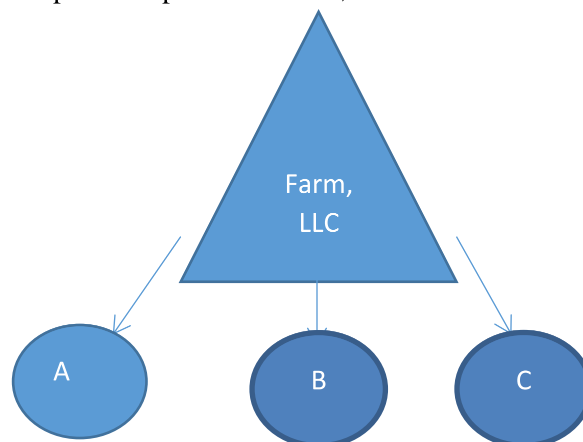
Introduction

As estate and succession planning comes to fruition for many Northeast farms, the conversation often turns to the best method of dealing with partnership interests. Once the decision is made for a partner to exit the farming operation, the remaining partners will typically traverse down one of two paths. They will either decide to purchase the exiting partner's interest on a pro-rata basis, or they will decide that the partnership will redeem the exiting partner's interest. Often times, if proper planning has been done, the partnership operating agreement will spell out the rules of the road regarding what method is employed.

When farmers meet with us, they are often surprised to learn that while either fork in the road will lead to the same result, the tax implications are very different.

Case Study

Let's assume that Farm, LLC has three members: Alice, Billy and Charlie. Each of the three members is a 33 percent owner of the capital and profits of Farm, LLC.



[20] *Id.*
[21] *Id.*
[22] *Id.*
[23] Copyright Farm Credit East, ACA.

Assets	Tax Basis	Cost	FMV	Liabilities			
Land	$1,200	$1,200	$2,700				
Accounts Receivable	$0	$0	$800				
Milking Parlor	$400	$1,600	$1,600	**Equity**			
Raised Cows	$0	$0	$300		Tax Basis	Cost	FMV
Barn	$200	$900	$900	A	$600	$1,233	$2,100
Total	**$1,800**	**$3,700**	**$6,300**	B	$600	$1,233	$2,100
				C	$600	$1,233	$2,100
				Total	**$1,800**	**$3,700**	**$6,300**

If Alice and Billy decide to equally purchase Charlie's interest for $2,100 cash (the value of his 1/3 share), then Charlie would have gain on the sale calculated as follows:

Cash Paid:	$2,100
Charlie's Basis:	$600
Total Gain:	**$1,500**

When Charlie sells his partnership interest, to determine the character of the gain, we must "look through" to the partnership's underlying assets.[24] In Charlie's case, since he is a 33 percent owner, his share of the partnership's ordinary income (i.e. accounts receivable and depreciation recapture on the milking parlor) would be ordinary income.[25] The accounts receivable is an ordinary income item because as that money comes in, it is treated as ordinary farm income. Additionally, because the farm received depreciation deductions (which lowered farm taxable income) on the milking parlor, any income up to the original price would be ordinary income. General purpose barns are treated differently under the depreciation tax

[24] I.R.C. 741
[25] I.R.C. 751.

rules that we won't get into here, but the recapture portion is generally taxed at 25 percent.[26] In this case, Charlie's share of the barn recapture ($233) would be subject to the 25 percent tax rate.

To breakdown Charlie's $1,500 gain from the sale of his interest, it would look as follows:

Total Gain:	$1,500	
Capital Gain:	$600	
Ordinary Gain:	$667	("Hot Assets" - share of A/R plus parlor recapture)[27]
25% Gain:	$233	(share of barn's gain)

As a result of the $1,500 gain, the remaining partners are permitted a "step up" of $1,500 on the partnership assets that will yield immediate benefits to them.[28] Looking at the milking parlor recapture as an example ($400), the partners will increase the basis of that asset through an adjustment which will provide for further depreciation deductions.[29]

The phase "retiring partner" is often thrown around by tax professionals to refer to the redemption of a partner's interest. It is important to note here that this does not mean that a partner must retire in order to utilize this feature. Any time a partner leaves the partnership and is redeemed, this provision may be utilized. When reviewing this situation with a prospective "retiring partner," Farm Credit East tax consultants will compare this sales treatment to a partnership redemption to ensure that all the options are known to the parties.

So what are some of the tax consequences above that would change if this transaction were structured as a redemption?

- Often times for liquidity reasons, farm operations will purchase a partner's interest over time. In these installment sales, the "hot asset" income above must occur immediately, even if the partner doesn't receive enough cash to cover the taxes on day one.[30] For example, the $667 worth of "hot asset" gain above would be reported in the year of sale regardless if only $100 was actually paid. With a redemption, the recapture gain only becomes taxable as payments are made.[31]

- There is no imputed interest required to be paid on a redemption.[32]

- Additionally, there is no 25 percent recapture on the buildings during a redemption for the seller.[33]

- An important consideration that arises with respect to the redemption is the fact that the partner selling out is technically, for tax purposes, still a partner in the partnership. From

[26] *See* I.R.C. 1250.
[27] 33 percent share of the accounts receivable gain ($267) plus 33 percent of the parlor recapture gain $(400).
[28] I.R.C. 754; I.R.C. 743.
[29] I.R.C. 743.
[30] I.R.C. 453.
[31] There is nothing that indicates 453(i) applies to a redemption.
[32] Reg. 1.736-1(a) (1) (ii) states that the partner being redeemed is still a partner for tax purposes. This would not be the case in an installment sale. I.R.C. 453.
[33] Reg. 1.1(h)-1(b) (3) (ii).

a credit standpoint, there are many issues that must be discussed with the loan officer in these cases. Some of these questions include how these payments affect borrowing capacity, whether or not the exiting partner will remain liable for the debt outstanding and whether or not that partner decides to sign on any new debt while they are being redeemed.

- Lastly, the "step up" of the assets from the gain to the retiring partner is recognized only as payments are made and not all up front.[34]

Conclusion

The above illustration is a very broad overview of a complicated transaction. The decision for a farmer to exit the partnership is a personal decision that is made for various reasons along the estate and succession planning road. The "tail should never wag the dog" in the sense of tax decisions driving the ultimate business goals. However, once the decision to exit from a partnership is made, Farm Credit East tax consultants will ensure that the partners know what implications will flow from either a sale or a redemption of that retiring partner's interest while closely working with their loan officer to ensure liquidity concerns are addressed.

IV. Estate Planning

a. A farmer who acquires property from a decedent generally is deemed to have held the property for more than one-year.[35]

b. Property acquired from a decedent generally is valued upon date of death. Colloquially, this is termed "stepped-up basis."

c. There are certain items that do not received a stepped up basis. These items are known as "income in respect of decedent. (IRD)"[36]

d. Payments under I.R.C. 736(b) are not IRD.[37]

e. While the IRS has attempted to attack "stepped-up basis" over the years, they have utterly failed.[38]

f. The below excerpts are from an article I wrote in State Tax Notes titled "Estate of Backemeyer: A View from New York[39]:"

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[34] A "754" election should be made so that there can be a 734 basis adjustment to the partnership. I.R.C. 754; I.R.C. 734.
[35] I.R.C. 1223(9). I.R.C. 1014 defines what property is deemed to be acquired from a decedent. There is an exception under I.R.C. 1014(e) for property that was inherited one year from making a gift.
[36] I.R.C. 691.
[37] *See* I.R.C. 753.
[38] *Estate of Backemeyer v. Commissioner*, 147 T.C. No. 17 (2016).
[39] Dario Arezzo, State Tax Notes, September 25, 2017.

Estate of Backemeyer: A View from New York

Much has been written recently about the Tax Court's decision in *Estate of Backemeyer*[40] regarding farming and the "double deduction." Tax practitioners involved in agriculture have praised the decision, while those in academic circles have tended to criticize the outcome.[41] In *Estate of Backemeyer*, a cash-basis farmer deducted $178,187 of farm inputs for expenses such as fertilizer in 2010 and then died shortly thereafter in 2011 without having used any of the inputs. The estate tax rules generally value assets at their fair market value on death. In 2011 the inputs were valued at a FMV of $178,187, and Backemeyer's wife was entitled to a step-up in basis on the inputs to that amount. Effectively, that permitted the wife to deduct those expenses again in 2011.

The IRS's argument that this was a double deduction was rejected by the Tax Court, which concluded, "We do not think it proper to characterize the deduction claimed by Mr.Backemeyer for 2010 and the deduction claimed by Mrs. Backemeyer for 2011 as a 'double deduction,' since the estate tax intervened between the two deductions and since respondent has conceded that 'Mrs. Backemeyer's Schedule F business is treated as being separate from Mr. Backemeyer's Schedule F business, as petitioners contend.'"

While the remainder of the article will not expound on the merits of the arguments in *Backemeyer*, this author's opinion is that the court correctly decided the issue.[42] *Backemeyer* is important for the New York agricultural community not only because the starting point for New York state adjusted gross income is federal AGI, but also because other state benefits may be affected. Given the recent commentary surrounding *Backemeyer*, now is a good time to review New York conformity to some of the federal estate rules and related income tax rules in the agricultural arena.

IRC Section 179 and the Investment Tax Credit

Although *Backemeyer* did not discuss equipment, farmers should be aware that farm equipment that has been fully depreciated may receive that same step-up in basis on death, and thus depreciation can begin again. For example, if Mr. Backemeyer had died with a $100,000 piece of farm equipment that was fully depreciated, Mrs. Backemeyer would have been entitled to begin depreciating that equipment over a seven-year period. However, other tax benefits, such as IRC section 179 and New York's investment tax credit, wouldn't be permissible for reasons described below.

New York generally conforms to IRC section 179, which in 2017 permits a farmer to expense up to $510,000 of equipment, improvements, and single-purpose buildings (that is, buildings such as milking parlors and greenhouses).[43] To qualify for IRC section 179 there must be a purchase of the property as

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[40] *Estate of Backemeyer v. Commissioner*, 147 T.C. No. 17 (2016).

[41] For negative assessments, see Calvin H. Johnson, "Death and the Tax Benefit Rule," *Tax Notes*, May 29, 2017, p. 1341; and W. Eugene Seago and Edward J. Schnee, "A Tax Benefit That Survived Death," *Tax Notes*, Apr. 24, 2017, p. 529. For praise of the decision, *See* Paul Neiffer, "Tax Court Allows 'Double' Deduction of Prepaid Farm Expenses," AgWeb.com, Dec. 8, 2016.

[42] For additional discussion, see Roger A. McEowen, "IRS Continues (Unsuccessfully) Attack on Cash Accounting by Farmers," Dec. 9, 2016.

[43] For exceptions relating to sport utility vehicles of non-eligible farmers, see N.Y. Tax Law IRC section 612(b) (36).

defined in IRC section 179(d)(2), which disallows purchases from spouses, ancestors, and lineal descendants.[44] Importantly, in the context of *Backemeyer*:

> Property is not acquired by purchase if the basis of the property in the hands of the person acquiring it is determined in whole or in part by reference to the adjusted basis of such property in the hands of the person from whom acquired, or is determined under IRC section 1014(a), relating to property acquired from a decedent. For example, property acquired by gift or bequest does not qualify as property acquired by purchase for purposes of IRC section 179(d)(2).[45]

Going back to *Backemeyer*, assuming Mrs. Backemeyer also received a piece of farm equipment with an increased basis step-up, that equipment, while being permitted to be redepreciated, would not have been eligible for a IRC section 179 deduction. Why is that important from New York's ITC perspective? Because to qualify for ITC,[46] there must be a purchase as defined in IRC section 179(d)(2). If Mrs. Backemeyer lived in New York, she would also not be permitted the ITC.

IRC Section 754 elections

What if Mrs. Backemeyer had been in an limited liability company (taxed as a partnership) as a one-third member with her husband and a son when Mr. Backemeyer died? Treas. regs. 1.734-1(e)(1) and 1.743-1(j)(4)(B) state that the increased portion of basis in an IRC section 754 election is newly acquired property that may use any applicable recovery period and method for depreciation purposes. However, no change may be made for the portion of basis for which there was no increase.[47] If we assume that Mrs. Backemeyer received a $100,000 IRC section 743 adjustment as a result of a piece of equipment that was fully expensed by the LLC, she would begin receiving depreciation deductions over a seven year period. However, IRC section 179(d)'s purchase requirement would preclude IRC section 179 and the ITC in this case, as well.

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[44] Treas. reg. 1.179-4(c) (1).
[45] *Id.*
[46] N.Y. Tax Law IRC section 606(a).
[47] Treas. reg. sections 1.734-1(e) (1) and 1.743-1(j) (4) (B).