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Issue Contents

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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. Commissioner*[1] 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.[2]

However, three cases were litigated with the same outcome at the Tax Court level[3] but all three cases were overturned by the Eighth Circuit Court of Appeals.[4] 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.[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.[6] 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,[7] approved by a 12 to 3 margin, the holding and rationale of *McNamara, et al. v. Commissioner*.[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.[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.

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*[10] case is upheld or is not appealed. However, a careful planning effort should minimize the risk.

ENDNOTES

[1] T.C. Memo. 1995-571.

[2] Ltr. Rul. 9637004, May 1, 1996.

[3] Bot v. Comm'r, T.C. Memo. 1999-256; Hennen v. Comm'r, T.C. Memo. 1999-306; McNamara v. Comm'r, 1999-333.

[4] McNamara, et al. v. Comm'r, 236 F.3d 410 (8th Cir. 2000), *non-acq.,* I.R.B. 2003-42.

[5] See 2 Harl, *Farm Income Tax Manual* § 8.5[5][b] (2017 ed.).

[6] AOD CC-2003-3, October 20, 2003, I.R.B. 2003-42.

[7] Martin v. Comm'r, 149 T.C. No. 12 (2017). See Harl, "Major Reversal at the United States Tax Court," 28 *Agric. L. Dig.* 153 (2017).

[8] 236 F.3d 410 (8th Cir. 2000), *non-acq.,* I.R.B. 2003-42, *aff'g sub. nom.*, Bot v. Comm'r, T.C. Memo. 1999-256; Hennen v. Comm'r, T.C. Memo. 1999-306; McNamara v. Comm'r, T.C. Memo. 1999-333,

[9] 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).

[10] Martin v. Comm'r, 149 T.C. No. 12 (2017).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

BANKRUPTCY

CHAPTER 12

SALE OF CHAPTER 12 PROPERTY. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, *Pub. L. No. 109-8, § 1003, 119 Stat. 23 (2005)*, contained a provision allowing a Chapter 12 debtor to treat "claims owed to a governmental unit," including income tax on the gain or recapture income, as a result of ". . . the sale, transfer, exchange, or other disposition of any farm asset used in the debtor's farming operation" as an unsecured claim that is not entitled to priority under Section 507(a) of the Bankruptcy Code, provided the debtor receives a discharge. The U.S. Supreme Court in *Hall, et ux. v. United States, 566 U.S. 506 (2012)*, held that the 2005 enactment of § 1222(a)(2)(A) did not apply for post-petition taxes because there was no separate taxable entity created by the filing of the Chapter 12 petition. See Harl, "The U.S. Supreme Court Settles (for Now) One of the Chapter 12 Bankruptcy Tax Issues," 23 *Agric. L. Dig.* 81 (2012). The Congress has passed and the President signed an amendment to the 2005 Bankruptcy Act, adding Section 1232 which provides in part: "Sec. 1232. Claim by a governmental unit based on the disposition of property used in a farming operation—

(a) Any unsecured claim of a governmental unit against the debtor or the estate that arises before the filing of the petition, or that arises after the filing of the petition and before the debtor's discharge under section 1228, as a result of the sale, transfer, exchange, or other disposition of any property used in the debtor's farming operation—

(1) shall be treated as an unsecured claim arising before the date on which the petition is filed;

(2) shall not be entitled to priority under section 507;

(3) shall be provided for under a plan; and

(4) shall be discharged in accordance with section 1228.

(b) For purposes of applying sections 1225(a)(4), 1228(b)(2), and 1229(b)(1) to a claim described in subsection (a) of this section, the amount that would be paid on such claim if the estate of the debtor were liquidated in a case under chapter 7 of this title shall be the amount that would be paid by the estate in a chapter 7 case if the