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Reviewing Authority in Handling LLC Losses

-by Neil E. Harl*

As is well known, a limited liability company (LLC) is a hybrid with the structural features derived heavily from corporate law and with the income taxed as a partnership¹ unless the check-the-box option is employed² to shift taxation to that of an “association”³ which is basically corporate tax treatment.⁴ The regulations make it clear that the tax treatment of a change in classification of an entity for federal tax purposes is determined under the Internal Revenue Code . . . and general principles of tax law.”⁵

Moreover, if an LLC commences operation under the so-called “default” provision (taxed as a partnership), as is often the case because of the likelihood of start-up losses, especially in the early years of the entity), the initial operating agreement typically reflects partnership tax treatment. A later election to shift taxation as an association with a filing of Form 8832 *may require amendments to the operating agreement in implementation of the shift in classification to corporate tax treatment.*

Consequences of shift in status

A shift in tax status may have profound effects on the tax treatment of the entity, especially in so-called “conversions” from partnership tax status to association or “corporate” tax status and vice versa. Thus, a partnership can be converted to an LLC without recognition of gain or loss.⁶ Upon conversion, the tax year of the converting partnership-taxed entity does not close with respect to any or all of the partners and the resulting LLC does not need a new taxpayer identification number.⁷

But on merger of an S corporation into an LLC, IRS has ruled that the transaction is treated “. . . under general principles of tax law. . .” as a transfer of assets to the LLC followed by a distribution of the interest to the S corporation shareholder with gain recognized as though the S corporation had sold the property to the shareholder at the time of the distribution.⁸ The same treatment could be expected with a C corporation except that at stake is the double tax treatment of tax on gain at the corporate level and a second tax at the shareholder level for C corporations that shift to LLC status.

Handling liabilities under the partnership regulations

The Internal Revenue Code characterizes debt as recourse or non-recourse for partnership purposes based on whether a partner bears the economic risk of loss for the debt.⁹ Within that general framework based on economic risk of loss, all LLC debt should be treated as non-recourse for purposes of Subchapter K of the Internal Revenue Code.

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However, LLC debt may not be considered non-recourse debt in four situations *for purposes of the partnership regulations*—

Loan guarantee by an LLC member or related party. If an LLC member (or a person related to the LLC member) guarantees a loan or makes a loan to an LLC., the debt may not be considered non-recourse.¹⁰

Obligation of a member exists otherwise under state law. Where an obligation of a member exists otherwise under state law, such as where a member remains liable for recourse debts of a predecessor organization, such as a partnership, the debt may not be considered non-recourse.¹¹

Debt comes within the “interest guarantee” rules or the “property-pledge” rules. If the debt comes within the interest guarantee rules or the property pledge rules, the debt may not be considered non-recourse.¹²

Debt is within the “anti-abuse” rules. If the debt, in fact, comes within the so-called “anti-abuse rules, the debt may not be considered non-recourse.¹³

Handling liabilities under I.R.C. §§ 108, 1001

Although it is not completely clear, it appears to some that the partnership regulations have not been fully applicable to the handling of non-recourse debt under I.R.C. §§ 108 (income from discharge of indebtedness) and 1001 (determination of the amount of and recognition of gain or loss).¹⁴ To the extent discharged excess non-recourse debt generates discharge of indebtedness income that is allocated under I.R.C. § 704(b), each partner treats his or hers (or its) portion of the discharged excess non-recourse debt related to the discharge of indebtedness income as a liability in measuring insolvency under I.R.C. § 108(d)(3).¹⁵ The partnership’s discharged excess non-recourse debt should be associated with the partner who, in the absence of the insolvency or other I.R.C. § 108 exclusion, would be required to pay the debt liability arising from the discharge of that debt.¹⁶

Some additional clarification as to the relationship of the partnership regulations regarding non-recourse debt to the handling of non-recourse debt under I.R.C. Sections 108 and 1001 would be helpful.

The “small partnership” exception

Keep in mind that those with an LLC taxed as a partnership can side step much of the complexity in handling losses if the requirements are met for the “small partnership” exception.¹⁷

Discharge of recourse and nonrecourse debt

In a slightly different context, the Chief Counsel’s Office has recognized the inconsistencies in this area.¹⁸ The Chief Counsel has advised that “. . . the regulations under I.R.C. § 752 (pertaining to income tax basis of a partner in a partnership) do not determine if a debt is recourse or non-recourse to a partnership for purposes of determining whether, on foreclosure of property, the partnership has cancellation of indebtedness income under I.R.C. § 61(a)(12) or gain from a sale or other disposition of property under Section 61(a)(3). The definition of recourse liability found in the Section 752 regulations¹⁹ does

not extend to issues under I.R.C. § 61 and § 1001. A loan that is guaranteed by a partner is treated as a recourse liability for purposes of I.R.C. § 752 even though the liability might be non-recourse for purposes of the regulations under § 1001²⁰ or for non-tax purposes.”

ENDNOTES

¹ See, e.g., Rev. Rul. 93-30, 1993-1 C.B. 231; Ltr. Rul. 8106082, Nov. 18, 1980 (ruling on 1977 Wyoming enactment).

² Notice 95-14, 1995-1 C.B. 297.

³ See Treas. Reg. § 301.7701-3(g)(1)(i).

⁴ See 2 Harl, *Farm Income Tax Manual* § 6.09[1][a] (2015 ed.). See also 8 Harl, *Agricultural Law* § 61.03 (2015); Harl, *Agricultural Law Manual* § 7.05 (2014).

⁵ Treas. Reg. § 301.7701-3(g)(2)(i).

⁶ See Rev. Rul. 84-52, 1984-1 C.B. 157 (conversion of partnership to an LLC classified as a partnership without recognition of gain or loss); Ltr. Rul. 9443024, July 26, 1994 (exchange of partners’ interests for LLC interests followed by distribution of assets to LLC).

⁷ Ltr. Rul. 9809003, March 18, 1997 (conversion of two-person general partnership to LLC tax-free); Ltr. Rul. 9841030, July 14, 1998 (same).

⁸ Ltr. Rul. 9543017, July 26, 1995. See also Ltr. Rul. 200628008, March 28, 2006 (merger of S corporation into a disregarded entity (a one person LLC) treated as a deemed sale of the assets).

⁹ I.R.C. § 752(d). See Treas. Reg. § 1.752-1, -2.

¹⁰ See Treas. Reg. § 1.752-4(b)(1) for the definition of “related person” by reference to the related party rules of I.R.C. §§ 707(b)(1) and 267(b), substituting 80 percent for “more than 50 percent.”

¹¹ Treas. Reg. § 1.752-2(b)(3)(iii).

¹² Treas. Reg. §§ 1.752-2(e) (guarantee), 1.752-2(h) (pledge).

¹³ Treas. Reg. § 1.752-2(j).

¹⁴ For a discussion of the handling of non-recourse debt in a setting of debt forgiveness, see 2 Harl, *Farm Income Tax Manual* § 9.02[2][b] (2015 ed.).

¹⁵ See Rev. Rul. 2012-14, 2012-1 C.B. 1012. See also Rev. Rul. 92-53, 1992-1 C.B. 48.

¹⁶ Rev. Rul. 2012-14, 2012-1 C.B. 1012.

¹⁷ I.R.C. § 6231(a)(1)(B). See Treas. Reg. § 301.6231(a)(7)-2(b)(1). See also Harl, “The ‘Small Partnership’ Exception: A Way to Escape Partnership Tax Complexity,” 23 *Agric. L. Dig.* 1 (2012).

¹⁸ CCA 2015250010, March 6, 2015. See full summary below under “Partnerships.”

¹⁹ Treas. Reg. § 1.752-1(a)(1).

²⁰ Treas. Reg. § 1.1001-2.