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LIMITED LIABILITY COMPANIES: ELIGIBILITY FOR CASH ACCOUNTING

(Third of three parts)

— by Neil E. Harl*

For farm operations, which historically have been permitted to use the cash method of accounting even though inventories are a material income determining factor,¹ a major concern with limited liability companies (LLCs) is whether the cash method of accounting is available to such entities.² At the moment, a substantial question exists about eligibility for cash accounting, particularly if LLC members are viewed as limited partners in the event the LLC is classified as a partnership for federal income tax purposes.

Farming syndicate. If an LLC is classified as a "farming syndicate," some of the features of the cash method of accounting are likely not available.³ A farming syndicate is prevented from deducting feed, seed, fertilizer and other farm supplies until used or consumed.⁴

A farming syndicate is defined as a partnership or other enterprise (other than a regularly taxed corporation) engaged in farming if ownership interests have been offered for sale—

- In an offering required to be registered with state or federal securities agencies, or
- Any other enterprise (other than a regularly taxed corporation) engaged in farming if more than 35 percent of the losses are allocable to limited partners or limited entrepreneurs.⁵ The first test is not likely to be met but the second test poses a potential threat to classic cash accounting for some LLCs.

Proposed regulations take the position that a farming syndicate may include a general or limited partnership, a sole proprietorship involving an agency relationship created by a management contract, a trust, a common trust fund or an S corporation.⁶ LLCs are not mentioned. However, the term "limited entrepreneur," which is a key term in the farming syndicate statute, is defined in the regulations as —

"...a person who has an interest in an enterprise other than as a limited partner and who does not actively participate in the management of such enterprise. The determination of whether a person actively participates in management or operation of a farming enterprise depends on the facts and circumstances of each case. Factors which tend to indicate

active participation include participating in the decisions involving the operation or management of the farm, actually working on the farm, living on the farm, or hiring and discharging employees (as compared to only the farm manager). Factors which tend to indicate a lack of active participation include lack of control of the management and operation of the farm, having authority only to discharge the farm manager, having a farm manager who is an independent contractor rather than an employee, and having limited liability for farm losses...[I]ack of fee ownership of the farm land shall not be a factor indicating a lack of active participation."⁷

Farming syndicate rules not applicable. The rules limiting deductibility for the cost of inputs do not apply to— (1) amounts on hand at the end of the year because of fire, storm, flood or other casualty or because of disease or drought or (2) amounts charged to capital account.⁸ Moreover, several categories of individuals are not considered to be limited partners or limited entrepreneurs for this purpose —

- Individuals who have participated for not less than five years in the management of the business of farming,
- Individuals residing on the farm,
- Individuals actively participating in the farming business or in the further processing of livestock raised in the business
- Individuals whose principal business activity involves active participation in the business of farming (even though it is not the business in question), and
- Any interest held by a member of the family (or a spouse) of a grandparent of an individual described above who is actively participating in the business.⁹

The key question is whether members of an LLC with limited liability are considered to be limited partners (inasmuch as an LLC is presumably taxed as a partnership), limited entrepreneurs or some other category of owner. If LLC members are deemed to be limited partners or limited entrepreneurs, the question is whether a sufficient number are residing on the farm or are actively participating (or have actively participated) in a farm business or whether close relatives are so involved.

It appears that eligibility for full cash accounting necessarily requires a case by case review of whether the operation is a farming syndicate.

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FOOTNOTES

- ¹ See 4 Harl, **Agricultural Law** § 25.03 (1993).
² See generally 8 Harl, **Agricultural Law** § 61.03 (1993).
³ See I.R.C. § 464.
⁴ *Id.*
⁵ I.R.C. § 464(c)(1). See *Est. of Wallace v. Comm'r*, 95 T.C. 525 (1990), *aff'd*, 92-2 U.S. Tax Cas. (CCH) ¶ 50,387 (11th Cir. 1992) (medical doctor who owned cattle feeding business was limited entrepreneur who did

not actively participate in cattle feeding business and profit motive was irrelevant; only feed actually consumed during year was deductible).

⁶ Prop. Treas. Reg. § 1.464-2(a)(1).

⁷ Prop. Treas. Reg. § 1.464-2(a)(3).

⁸ I.R.C. § 464(d).

⁹ I.R.C. § 464(c)(2). The term "family" has the same meaning as in I.R.C. § 267(c)(4).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ADVERSE POSSESSION

FENCE. In the 1950's a fence was constructed between the parties' pastures but from 11 to 30 feet onto the defendant's property. The defendant had the property resurveyed and discovered the error and moved the fence to the correct boundary line. The plaintiff claimed title to the portion of the defendant's property on the plaintiff's side of the fence and sought damages for the defendant's removal of a partition fence under Mo. Rev. Stat. § 537.350. The court reversed and remanded the trial court's judgment for the plaintiff, holding that the plaintiff failed to present evidence that the plaintiff openly, notoriously, exclusively and continuously used the disputed land for at least ten years. The court held that the mere existence of a fence for almost 40 years was insufficient to establish title by adverse possession. **Dorris v. Morgan**, 852 S.W.2d 194 (Mo. Ct. App. 1993).

POSSESSION. A fence constructed between the parties' properties was built 11.5 feet onto the defendant's property. The plaintiff crop farmed the disputed strip from 1943 through 1987, when the defendant began clearing the crops from the strip each year. The court held that the plaintiff's crop farming of the land for more than 20 years satisfied the requirements of open, notorious and actual possession sufficient to transfer title to the plaintiff by adverse possession. **Cobb v. Nagele**, 611 N.E.2d 599 (Ill. Ct. App. 1993).

This case involved two incidents of adverse possession. In the first incident, the defendant had raised hay for over ten years on a field which included land belonging to the plaintiff. The court held that the annual raising of crops on the disputed land was sufficient adverse possession to transfer title to the defendant. In the second incident, the defendant had erected a fence several feet onto the plaintiff's land and grown crops on the defendant's side of the fence. The plaintiff had helped maintain the fence. The court held that the defendant's use of the disputed property was sufficient adverse possession to transfer title to the defendant. **Forester v. Whitelock**, 850 S.W.2d 427 (Mo. Ct. App. 1993).

ANIMALS

HORSES-ALM § 1.01[1].* The defendant owned a thoroughbred horse which escaped from a fenced pasture during a storm. The plaintiff's car struck the horse on a highway and the plaintiff sued in strict liability the owner of

the horse and the ranch on which the horse was pastured. The court held that an owner of an escaped domestic animal, such as a horse, was not strictly liable for injuries caused by the horse unless the animal was known by the owner to have a propensity to escape. Because no evidence was presented as to the propensity of defendant's horse to escape, the defendant could not be held strictly liable for the plaintiff's injuries. **Briscoe v. Graybeal**, 622 A.2d 805 (Md. Ct. App. 1993).

BANKRUPTCY

GENERAL

AVOIDABLE LIENS. The debtor was a produce handler who purchased agricultural products from several creditors. Each creditor had perfected its statutory producer's lien after the filing of the petition. The trustee sought to avoid the creditors' security interests. The creditors argued that Section 546(b) prevented the avoidance because the post-petition perfection of the statutory lien related back to a prepetition date. The statutory lien provided that if the lien was perfected within 60 days after delivery, the lien acquired priority over all other liens against the produce. The court held that because the statute did not expressly identify a date upon which the lien became perfected, Section 546(b) did not apply to prevent the avoidance of the liens. **Matter of Peter J. Schmitt Co., Inc.**, 154 B.R. 47 (Bankr. D. Del. 1993).

EXEMPTIONS

AUTOMOBILE. The debtor had granted a security interest to the debtor's father in the debtor's automobile within one year of filing for Chapter 7 and had claimed the exemption for the automobile. The trustee sought to avoid the security interest and the debtor filed for dismissal of the case to prevent the loss of the security interest. The court held that because the debt secured by the automobile was voluntary and the security interest was avoidable, the exemption could not be allowed. The court also held that the threat of the avoidance was insufficient cause for dismissal. **In re Baumgarten**, 154 B.R. 66 (Bankr. S.D. Ohio 1993).

CHAPTER 12

SETOFF-ALM § 13.03[8].* Prior to filing bankruptcy, the debtor was indebted to the ASCS for the use of cash collateral in a previous bankruptcy case and had enrolled farm land in the conservation reserve program (CRP). The debtor had assumed the CRP contracts in bankruptcy as executory contracts. The ASCS sought to setoff the post-