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The Tax Court and the U.S. Court of Federal Claims agree: Members of LLCs and LLPs are not to be treated as limited partners

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In a decision in late June 2009, the United States Tax Court held that ownership interests in a limited liability company (LLC) or limited liability partnership (LLP) should not be treated as limited partners in a limited partnership. About a month later, the U.S. Court of Federal Claims decided a case that went a notch beyond the holding in the earlier Tax Court case. That provides major support for the view that the statute which states ". . .[e]xcept as provided in regulations, *no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates*" does not require members of LLCs and LLPs to be limited in how the material participation test can be met. That at least expands the opportunities to meet the material participation test to the seven tests that are ordinarily available to taxpayers rather than the three tests specified in the temporary regulations for limited partners, thus increasing the chances for meeting the required standard of material participation on a regular, continuous and substantial basis. As noted below, the decision by the U.S. Court of Federal Claims goes a step further in favoring the taxpayer.

The regulatory framework

Losses from passive trade or business activities, to the extent deductions exceed passive activity income (exclusive of portfolio income), in general may not be claimed against other income, only against passive activity income. An activity is considered to be a passive activity if the activity involves

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Handbook updates

For those of you subscribing to the handbook, the following updates are included.

Monthly Swine Farrow to Finish Returns (10 year summary) – B1-31 (2 pages)

Monthly Returns from Finishing Feeder Pigs (10 year summary) – B1-34 (1 page)

Monthly Cattle Feeding Returns (10 year summary) – B1-36 (2 pages)

Revenue Insurance for Livestock Producers – B1-50 (4 pages)

Seasonal Cattle Price Patterns – B2-19 (3 pages)

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the conduct of a trade or business and the taxpayer does not materially participate in the activity. A taxpayer is treated as materially participating in an activity only if the person ". . . is involved in the operations of the activity on a basis which is – (A) regular, (B) continuous, and (C) substantial." LLCs and LLPs are not mentioned specifically in the statute or the temporary regulations inasmuch as in 1986, when the passive activity statute was enacted, only two states (Wyoming in 1977 and Florida in 1982) authorized entities denominated as limited liability companies and LLPs did not come into existence until the 1990s.

As noted, the statute states that ". . . no interest as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates." The temporary regulations specify seven tests for material participation under the passive activity loss rules:

(1) participation for more than 500 hours during the year,
(2) for situations requiring less than 500 hours of involvement, "substantially all" of the participation in the activity,
(3) more than 100 hours per year and the participation is not less than that of any other individual,
(4) the aggregate participation in "significant participation" activities exceeds 500 hours,
(5) material participation for five of the last ten taxable years in the activity,
(6) for personal service activities, any three preceding taxable years and
(7) material participation based on all of the facts and circumstances.

Farm taxpayers are permitted to qualify as materially participating if they participated materially for five or more years in the eight year period before retirement or disability.

The temporary regulations hold limited partners to three tests for material participation:

(1) more than 500 hours during the year,
(2) the limited partner materially participated in the activity for five or more of the ten preceding years and
(3) for personal service activities, any three preceding years.

Position of LLCs and LLPs

In general, a partnership interest (and, for tax purposes, an LLC or LLP is considered a partnership) is treated as a limited partnership interest if so designated in the organizational documents or the liability of the holder of the interest is limited to a fixed, determinable amount under state law such as the amount contributed to the entity. However, a *general* partner who holds an interest in a limited partnership is not necessarily treated as a limited partner. As we noted in a 2008 article, the temporary regulations would seem to indicate that, if the focus is on limited liability of the LLC member for obligations of the LLC, an LLC member would be treated as a limited partner. However, if the focus is on participation in management, the position of an LLC member is different in that a limited partner cannot be active in the partnership's business and if a limited partner becomes active in management, the limited partner may lose the feature of limited liability.

The Congressional Committee Reports lend support to that interpretation.

A case decided in 2000, *Gregg v. United States*, recognized that LLCs are designed to permit members to engage in active management of the business without losing their limited liability feature which can occur with a limited partner. The court in *Gregg v. United States* held that, inasmuch as the regulations did not state that members of an LLC were to be treated as limited partners, it was inappropriate to treat LLC members as limited partners. The court made it clear that an LLC member could show material participation based on the seven tests in the temporary regulations rather than the higher standard specified in the temporary regulations for limited partners.

Garnett v. Commissioner

The 2009 Tax Court case of *Garnett v. Commissioner*, citing *Gregg v. United States*, involved taxpayers who owned seven limited liability partnerships and two limited liability companies in Iowa, all engaged in farming and agribusiness operations. The LLP agreements provided that each partner would actively participate in the control, management and direction of the LLP's business. The LLC operating agreements provided that business was to be conducted by a manager.

The Tax Court focused on the application of the "general partner exception" and believed the LLP and LLC members had the right to participate in management, as do general partners, which justified that exception inasmuch as state law did not preclude the members from actively participating in the management and

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operations of the LLPs and LLCs. Accordingly, the members were entitled to apply all seven of the tests for material participation and were not limited to the three prescribed for limited partners.

The Internal Revenue Service had also treated two interests in tenancy in common as limited partnerships which the Tax Court rejected.

Thompson v. United States

The decision of the U.S. Court of Federal Claims, *Thompson v. United States*, cited approvingly both *Gregg v. United States* and *Garnett v. Commissioner* but went beyond those decisions in stating that the regulation ". . . is simply inapplicable to membership interests in an LLC." That suggests that the current I.R.C. § 469 does not limit the losses in question.

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The hog industry: It wasn't supposed to happen this way!

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The vertical integration of the hog industry was supposed to lead to a more efficient, rational use of resources at the integrator level and reduce the risks at the producer level through contracts. In late August 2009, the price for hogs in the Iowa-Southern Minnesota Direct hog trade was just over $45/cwt, compared to nearly $85/cwt a year earlier. Production costs have exceeded market costs in 20 of the last 22 months.

But it wasn't supposed to happen this way. With contracts, the integrators were supposed to have greater control over the hog cycle than when there were a large number of small producers.

But things don't always work out the way they were planned.

In the mid-1990s, the North American Free Trade Agreement (NAFTA) set the framework for an integrated North American hog industry just at the time that the Canadians abolished their Crow Rate grain transportation subsidy for grain that reduced the transportation cost of getting Western Canadian grain to markets.

With the elimination of the subsidy, these Western Canadian farmers began to cast about for an alternate way to protect their income. With the encouragement of the provinces they went into hog production, adding value to their locally produced grain and oilseeds. Hog production increased, and the number of feeder pigs sold into the US increased from less than a million head in 1995 to over 6 million head in 2008.

This is the same period in which the U.S. saw dramatic gains in production efficiency as the number of sows fell and production increased. The number of active producers also fell as many smaller operators got out of hog production and others grew in size.

This increase in production was needed to meet the growing export demand that zoomed from less than a billion pounds in 1995 to nearly 5 billion pounds in 2008. At the same time, U.S. consumption continued to increase, although not as rapidly as export demand.

As long as demand was booming, the hog industry was in good condition. However, it only takes a small change at the margin to trigger dramatic results.

Some of the new markets like Russia then decided that they needed to develop their own domestic pork industry. They did not want to be at the mercy of foreign suppliers for a commodity as important as pork, so they began to find ways to restrict their imports of pork and provide incentives to domestic producers.

The financial crisis that began in 2008 started to put economic pressure on US households to reduce their total expenses, and the consumption of pork fell by 1.7 percent from 2007 to 2008.

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And if economic pressures weren't enough, 2009 saw the outbreak of a novel strain of H1N1, referred to in the press as "swine flu." Despite the fact that humans cannot get the flu from eating pork, the sale of pork dropped off, and some importers used it as a reason to restrict the importation of pork products from the US.

In the past, losses in hog production resulted in farmers hauling some of their sows to market and selling their grain instead of feeding it to their hogs. With the integration of the hog industry, some farmers got out of the meat business and concentrated on grain production. Similarly, other farmers focused their resources entirely on hog production. Those producers are now finding it difficult to reduce their production because they have no alternate source of income. As a result, the contraction of the hog industry is happening at a glacial pace. Many producers are waiting for the other person to blink first.

In all of this we have seen the development of a perfect storm that has driven hog prices sharply downward.

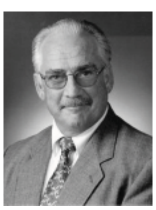
It wasn't supposed to happen this way. Ending transportation subsidies in Canada was supposed to eliminate distortions in the grain market. As a result, we ended up with increased hog production because Western Canadian farmers saw it as away to diversify their income sources and increase the value of their grains by feeding them to hogs.

Integration was designed to allow packers to more efficiently use the capacity of their plants by scheduling production to get away from the fall and winter surge in slaughter demand. Signing contracts was supposed to reduce the price risks in hog production.

NAFTA allowed for the development of a North American meat market in which each country would do what it does best—Canada produced feeder pigs, the U.S. fed those pigs to market weight, and Mexico imported pork to feed its population. Exports were supposed to be the future of the pork industry, but along came a worldwide economic crisis, import restrictions, and something called swine flu.

Any one of these issues is enough to challenge the pork industry. Taken together, they call into question some of the assumptions upon which the industry is built.

And in some ways it is less resilient than it was when farmers could switch from grains to meats and back depending on the relative profitability of each item.



Conservation Stewardship Program

by Mike Duffy, extension economist, 515-294-6160, mduffy@iastate.edu

The Conservation Stewardship Program (CSP) is a new program in the 2008 Farm Bill. It replaces the Conservation Security Program. The acronyms for the two programs are the same but the programs are entirely different. The new program is available state wide and will offer payments to farm operators based on additional conservation measures they adopt for at least five years.

CSP is a continuous sign-up program but Sept. 30, 2009 was the deadline for the first ranking to determine eligibility for payments.

Under the new CSP the operator works with an NRCS conservationist and discusses the conservation practices they currently use and the ones they intend to adopt. The current practices determine eligibility for CSP and they count in the final ranking for the operator.

The practices considered are those that affect the primary resources of concern for Iowa. These resources are water quality, air quality, soil quality, and animals. The list of practices includes such things as injecting or incorporating manure, dust control on unpaved roads, extending existing filter strips, recycling farm lubricants, and going to no-till. There are many other practices for cropland, pasture and forest.

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The NRCS conservationist and the operator go through the practices using the Conservation Measurement Tool developed by NRCS. The operator must meet a minimum conservation standard to be eligible; and they must be adding new conservation practices. After evaluating the existing practices and the proposed new practices, the operator will be assigned a point total based on these practices. The operators are ranked on the basis of their point total and the operators with the highest number of points will be eligible for the per acre payments.

Currently we do not know the exact payment per acre. However, NRCS has estimated nationwide that payments will be somewhere between $12 and $22 per acre. A payment close to $16 per acre will be the most likely outcome.

There are a few things an individual producer should remember when considering CSP.

- The contracts are for five years.
- All of owned and operated land must be included.
- If rented land is to be considered as part of the operation, the producer must show proof of control for at least five years.
- Payments are based only on acres considered part of the operation.

There can be no double payments for existing land under a conservation payment program. For example, land in CRP, WRP or EQIP would not be eligible for a CSP payment.

There has to be at least some new conservation practices added. Existing practices will be factored into the ranking and will affect the operator's payment. The final ranking for the various practices has not been determined, but, the operator is required to notify NRCS they would like to apply for the program by Sept. 30. This is the cutoff date to be considered in the first ranking. The operator will be notified when the ranking has been completed and when they should schedule an appointment with the NRCS conservationist.

NRCS has developed a self-screening checklist for operators to determine if the Conservation Stewardship Program is a good program for them. All producers should complete the checklist. This is a good tool to help them decide if they are eligible and should pursue the CSP program. The checklist and other information about the Conservation Stewardship Program is available at the NRCS county offices or online at: http://www.ia.nrcs.usda.gov/programs/csp2009.html.

In addition to the annual payments there is a special provision in CSP for the operator to receive a one-time payment for a resource conserving crop rotation. A resource conserving rotation must be at least three years and include a high residue crop, a cover crop or some type of perennial grass for at least one-third of the acres. This rotation must be new to the operation. CSP will provide an additional payment to the operator for adopting this rotation.

For more information on the CSP an operator should visit the NRCS Web site or the local NRCS office Though the initial sign-up deadline was Sept. 30, 2009, continuous sign-up is available by letting the NRCS know of operator intent to apply. This will be the application; the interview with the NRCS conservationist will be scheduled for a later date.

"Choices" - online magazine discusses agricultural economic issues

Are you looking for brief, but objective analysis of important economic issues in agriculture? Then check out Choices, a new online magazine. Choices is published by the Agricultural and Applied Economics Association (AAEA), an organization of top agricultural economists from universities, public agencies, nonprofit organizations and private industry. Choices is published quarterly and typically contains two themes, each of which highlights the policy implications of an important current issue. Articles are based on the unbiased, current research results from land-grant universities and the U.S. Department of Agriculture, and are peer-reviewed before they are published.

The most recent issue of Choices highlights "Emerging Issues in Food Safety," and "Emerging Countries: Converging or Diverging Economies?" Other recent issues have addressed uncertainty in the agricultural economy, land use changes, country of origin labeling, and the economics of biofuels. Articles are generally two to four pages long.

Choices is available online at www.choicesmagazine.org; you can find a link on the Ag Decision Maker home page under Related Web sites (http://www.extension.iastate.edu/agdm/websites.html). To subscribe, simply send an e-mail to Outreach@aaea.org and ask to subscribe to Choices. You can read it online (in full color, with no ads or pop-ups) or print it.

Updates, continued from page 1

Farmland Value Survey/ Realtors Land Institute – C2-75 (2 pages)

Please add these files to your handbook and remove the out-of-date material.

Internet Updates

The following updates have been added on www.extension.iastate.edu/agdm.

Developing Enterprise Budgets for Organic Crops – A1-25 (7 pages)

Acquiring Farm Machinery Services – A3-21 (4 pages)

Estimating the Number of Field Days Required – A3-28 (3 pages)

Hog Price Changes by Two Week Period – B2-15 (2 pages)

Idea Assessment and Business Development Process– C5-02 (3 pages)

Creating a Mission Statement, Developing Strategies and Setting Goals – C5-09 (5 pages)

What is a Feasibility Study? – C5-65 (3 pages)

Recruiting, Selecting and Developing Board Members and Managers – C5-72 (3 pages)

Board of Director Evaluations – C5-73 (2 pages)

Current Profitability

The following profitability tools have been updated on www.extension.iastate.edu/agdm/info/outlook.html to reflect current price data.

Corn Profitability – A1-85

Soybean Profitability – A1-86

Ethanol Profitability – D1-10

Biodiesel Profitability – D1-15

Returns for Farrow-to-Finish - B1-30

Returns for Weaned Pigs - B1-33

Returns for Steer Calves - B1-35

Returns for Yearling Steers - B1-35