Estate and Business Planning for the Farm and Ranch Family - Use of the LLC (Part 1)

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Overview

In the family business planning context for a farm and ranch, the key to success is for the senior generation to clearly express goals. Doing so assists the planning team in using entities and associated tax planning techniques to satisfy those goals. For business transition/succession purposes, the use of the limited liability company (LLC) is one entity structure that can work in the right situation and with the right set of facts.

Often, in agriculture, the entity that conducts the farming operations is established as a general partnership with each partner having his own single-member LLC. This is done in order to optimize (under most farm programs) the receipt of payment limitations. The general partnership doesn't limit liability, but it also doesn't limit at the entity level the number of "person" determinations for payment limitation purposes. Limited liability for each partner is achieved via the use of the single-member LLC to hold the partnership interest.

A single-member LLC can also be a "disregarded" entity? What does that mean? Is the entity simply disregarded for tax purposes, or is the entity respected in ways that make a big difference from a tax and estate planning perspective? How does it all fit together for a farming operation?

Utilizing an LLC as part of farm/ranch business succession – it's the topic of today's post – Part One of a two-part series.

Business/Succession Planning Goals

I have worked with farm families on estate and business succession plans for almost 30 years. Each situation is unique. There is no "one size fits all." However, I can make an observation concerning what are typical goals of the farm or ranch family, at least from the senior generation's perspective. The senior generation typically wants to retain control of the operation for as long as possible. But, along with that goal of retaining control is often the desire to transfer equity ownership in the operational entity to other family members. Any transfer is often required to be with restrictions that bar transfer outside the family. Limited liability is commonly desired, as is flexibility in any entity form to deal with changes in the family structure and the tax landscape. Also, it is a common desire to minimize taxation both upon entity formation and throughout the future; maximize government payments; and create the potential for valuation discounts – both for gifted interests and for the interests retained by the parents at death.

An LLC – What is it?

An LLC is an S corporation with fewer eligibility requirements and more flexibility with regards to the capital structure. When an LLC is taxed as a partnership, it can be more advantageous than an S corporation – debt can be included in member basis; there is more flexibility given to multiple classes of interest; and distributions are more tax advantageous. As compared to a limited partnership, LLC members can

participate in management without losing the feature of limited liability. Thus, an LLC basically blends the advantages of both the corporate and partnership form of business. It has the advantage of a flow-through entity with the structure of a corporation. An LLC's management can either be conducted by all of the members acting together or by managers that the members select. The members can choose the management structure desired, and multiple classes of ownership are allowed. If the LLC is classified as a partnership or sole proprietorship for tax purposes, the entity is not taxed on business income. All items of income, loss, deduction and credit are passed through to the member(s) and taxed at the member's individual rates. *I.R.C. 704(a)*.

What Does It Mean To Be a "Disregarded" Entity?

While it takes at least one member for an LLC to be formed there is no limitation on the number of members – unlike an S corporation which is limited to 100 shareholders. *I.R.C. §1361(b)(1)(A).* Under what are known as the "check-the-box" regulations," an LLC with only one member can elect to be treated for tax purposes an association taxable as a corporation or as an entity disregarded as an entity separate from its owner. *Regs. Secs. 301.7701-1, et seq.* If no election is made on Form 8832, the default rule is that the entity is disregarded as an entity separate from its owner if the owner does not have limited liability.

A single-member LLC is a separate entity from its owner, except when it comes to taxes. That is a distinguishing feature from a sole proprietorship, and it protects the owner from debts and liabilities of the business. But, both a single-member LLC and a sole proprietorship file a Schedule F (or C for non-farm businesses) to report business income and deductions. The amounts on the Schedule are then included with the owner's individual income tax return.

That raises a question – for tax purposes, what does the single-member of the LLC own? Is it an interest in the LLC or the underlying asset(s) of the LLC? Why might that matter?

Guaranteeing debt. Insight into precisely what a single-member LLC owner owns can be gleaned from IRS guidance on the handling of debt in a single-member LLC. Under the "at-risk" rules of I.R.C. §465, a loss from an activity to which the rules apply are disallowed unless the taxpayer is "at risk" with respect to the activity. A taxpayer is "at risk" with respect to an activity to the extent that the taxpayer contributes money or basis or borrows funds that are contributed to the activity, but only to the extent that the taxpayer is personally liable for repayment or to the extent of the value of collateral pledged to secure the borrowed funds. *I.R.C. §§465(b)(1)-(2).* But, what if the member of a single-member LLC that is a disregarded entity guarantees the debt? Does that count as being "at risk" in the entity's activity? The Code doesn't address the issue. The answer to that question turns on what the single member actually owns.

In *CCA 201308028 (Nov. 14, 2012),* the taxpayer was the sole owner of an LLC that was treated as a disregarded entity. The LLC owned a second LLC that was also treated as a disregarded entity. The second LLC borrowed funds for use in its business activity. The taxpayer, the first LLC and two S corporations that the taxpayer wholly owned guaranteed the debt. The taxpayer also provided the lender with a commercial guarantee for the full loan amount. The taxpayer unconditionally guaranteed the full prepayment of the loan but did not waive subrogation or reimbursement rights against the second LLC or the right of contribution from the first LLC and the two S corporations. The IRS, following the approach of the Second, Eighth and Eleventh Circuits, determined that the taxpayer would be ultimately liable as the payor of last resort and not protected against loss and, therefore, would be "at risk" if the taxpayer did not have a right of contribution from the other co-guarantors. *See Waters v. Commissioner, 978 F.2d 1310 (2d Cir. 1992), cert. denied, 507 U.S. 1018 (1993); Young v. Commissioner, 926 F.2d 1083 (11th Cir. 1991); Moser v. Commissioner, 914 F.2d 1040 (8th Cir. 1990)*. It's an "economic realities" test. That rationale applies when a taxpayer guarantees debt of an LLC that is taxed either as a partnership or as a disregarded entity.

The IRS followed up the CCA with *A.M. 2014-3 (Aug. 27, 2013)* where the IRS concluded that an LLC member that guarantees the LLC's debt is at risk for purposes of I.R.C. §465 in the situation where the LLC is treated as a partnership or a disregarded entity. The IRS said that a member's guarantee of qualified non-recourse (debt whose satisfaction may be obtained on default only out of the particular collateral given and not out of the debtor's other assets) financing of an LLC increased the member's amount at risk to the extent of the guarantee.

With this IRS guidance in mind, transactions involving debt guarantees have more certainty. That means that planners can structure deals in accordance with the economics of the particular situation and lender requirements. The guidance also supports the notion that a member of an LLC that is treated as a disregarded entity owns an interest in the entity rather than the underlying assets in the entity. The entity is respected for tax purposes.

Employment tax. A disregarded entity is treated as a corporation for employment tax purposes. *Treas. Reg. §301.7701-2(c)(2).* Thus, the entity is responsible for paying employment taxes and any excise taxes that apply. Consequently, a single-member LLC must have an EIN and a bank account in its name. Self-employment tax also applies. If a partnership owns a disregarded entity, the partners are treated as self-employed. They are not employees of the disregarded entity. *REG-114307-15, 81 F.R. 26763 (May 4, 2016), 2016 I.R.B. 1006.*

Identification of the entity. The IRS can require the owner of a disregarded entity to report the entity's employer identification number (EIN) on the taxpayer's individual return. *I.R.C. §§6011(b); 6109(b); PMTA 2016-08.* The basic requirement is that there must be sufficient information on the return so that the taxpayer is properly identified. Because an individual taxpayer that is a member of a single-member LLC has both a social security number and an EIN, listing both numbers on the taxpayer's return could help the IRS to cross-reference the numbers and associate correct information and returns with the taxpayer. Including both numbers does not invalidate the return and could avoid confusion on the IRS part.

Conclusion

In Part Two, I will explore how a single-member LLC as a disregarded entity is treated for federal estate and gift tax purposes. If a single-member LLC is a respected entity separate from its owner, perhaps valuation discounts for entity interests can apply. Again, the outcome of the issue turns on what the owner of the single-member LLC actually owns.

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