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subject: Definition of a Farming Syndicate Under § 464(c)

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Partnership =

Individual =

Year 1 =

Year 2 =

w% =

x% =

y% =

z% =

ISSUE

For the purpose of determining whether Partnership is a farming syndicate under § 464(c), should the interest held by the S corporation be treated as an interest held by a limited partner?

CONCLUSION

Based on the facts described below, the interest held by the S corporation should be treated as an interest held by a limited partner because § 464(c)(2)(A) does not apply.

FACTS

Partnership is a limited partnership, and its principal business is breeding and raising certain types of animals (the "ranching operations"). Partnership was formed in Year 1, but the ranching operations date back much further. Partnership has three partners: (1) a trust owning a w% general partner interest, (2) an S corporation owning a x% limited partner interest, and (3) another trust owning a y% limited partner interest. Each trust is a separate legal entity for federal tax purposes. The S corporation and the trusts each conducted ranching operations prior to formation of, and transfer of their ranching operations to, Partnership in Year 1. Partnership's limited partners are allocated z% (which equals x% plus y%) of the partnership losses; x% is greater than 35%. The S corporation and the trust owning the limited partner interest do not independently carry on a trade or business of farming.

Individual is the sole shareholder of the S corporation. Individual is also a trustee and a beneficiary of the trusts. Individual was a limited partner of Partnership at the time it was formed in Year 1, but Individual is no longer a limited partner. Individual has been actively participating in the management of Partnership's ranching operations for more than five years. Individual is not an employee or independent contractor of Partnership. It appears that Individual participates in the management of Partnership's ranching operations in the capacity of being one of the trustees of the general partner trust. Individual does not receive compensation for serving as a trustee of the general partner trust. Individual and the general partner trust own the land used in the ranching operations of Partnership. It appears that Partnership does not make rental payments for the fair market value of the use of the land. Individual does not actively participate in the management of any other farming business. Individual's principal residence is not on a farm.

Partnership uses the cash receipts and disbursements method of accounting and has reported substantial losses for tax purposes since formation. An issue has arisen with respect to the Year 2 tax year concerning whether Partnership may use the cash receipts and disbursements method of accounting. Section 448 provides rules concerning limitations on the use of the cash receipts and disbursements method of accounting by certain entities that fall within the definition of a farming syndicate under § 464(c) or a tax shelter under § 6662(d)(2)(C)(ii).[1] Partnership's representative maintains that Partnership is not a farming syndicate under § 464(c), and therefore not covered by § 448(a)(3), because Individual is the sole shareholder of the S corporation and a beneficiary of the trusts, and Individual actively manages the ranching operations. The revenue agent noted that § 464(c)(2) specifically refers to "individuals" and does not specifically identify non-individuals such as S corporations or trusts.

LAW AND ANALYSIS

Section 464(c)(1) provides that, for purposes of § 464, the term "farming syndicate" means—

> (A) a partnership or any other enterprise other than a corporation which is not an S corporation engaged in the trade or business of farming, if at any time interests in such partnership or enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having authority to regulate the offering of securities for sale, or
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> (B) a partnership or any other enterprise other than a corporation which is not an S corporation engaged in the trade or business of farming, if more than 35 percent of the losses during any period are allocable to limited partners or limited entrepreneurs.

Section 464(c)(2) provides that, for purposes of § 464(c)(1)(B), the following shall be treated as an interest which is not held by a limited partner or a limited entrepreneur:

> (A) in the case of any individual who has actively participated (for a period of not less than 5 years) in the management of any trade or business of farming, any interest in a partnership or other enterprise which is attributable to such active participation,
>
> (B) in the case of any individual whose principal residence is on a farm, any partnership or other enterprise engaged in the trade or business of farming such farm,

[1] Section 448(d)(3) references § 461(i)(3) and (4), and § 461(i)(4) references the definition of farming syndicate under § 464(c).

(C) in the case of any individual who is actively participating in the management of any trade or business of farming or who is an individual who is described in subparagraph (A) or (B), any participation in the further processing of livestock which was raised in such trade or business (or in the trade or business referred to in subparagraph (A) or (B)),

(D) in the case of an individual whose principal business activity involves active participation in the management of a trade or business of farming, any interest in any other trade or business of farming, and

(E) any interest held by a member of the family (or a spouse of any such member) of a grandparent of an individual described in subparagraph (A), (B), (C), or (D) if the interest in the partnership or the enterprise is attributable to the active participation of the individual described in subparagraph (A), (B), (C), or (D).

For purposes of subparagraph (A), where one farm is substituted for or added to another farm, both farms shall be treated as one farm. For purposes of subparagraph (E), the term "family" has the meaning given to such term by § 267(c)(4).

Section 464(e)(2) provides that the term "limited entrepreneur" means a person who (A) has an interest in an enterprise other than as a limited partner and (B) does not actively participate in the management of such enterprise. See also Estate of Wallace v. Commissioner, 95 T.C. 525 (1990), aff'd, 965 F.2d 1038 (11th Cir. 1992), reh'g en banc denied, 977 F.2d 600 (11th Cir. 1992).

There are no regulations under § 464. In 1983, a notice of proposed rulemaking was issued, but it was withdrawn in 1998. See 48 Fed. Reg. 51,936 (November 15, 1983), 1984-1 C.B. 593, and 63 Fed. Reg. 71,047 (December 23, 1998), 1999-1 C.B. 822.

In a case construing § 464, the Tax Court stated: "We may examine the legislative history of a statute even when it is clear on its face. But we will not construe a statute so as to override the plain meaning of the words, without unambiguous evidence of legislative purpose." Hirasuna v. Commissioner, 89 T.C. 1216, 1224 (1987) (citations omitted). Subsequent to that opinion, the Supreme Court stated that "[i]t is well established that when the statute's language is plain, the sole function of the courts—at least where the disposition required by the text is not absurd—is to enforce it according to its terms." Lamie v. United States Trustee, 540 U.S. 526, 534 (2004) (internal quotation marks omitted). If the disposition required by the text leads to an absurd result, then the statute should be treated as if it were ambiguous. See id. at 536. We do not believe it is necessary to consider the legislative history of § 464(c)(2) because the statute is not ambiguous as applied to the facts of the instant case. Nevertheless, we will review the legislative history in order to provide a complete analysis.

Section 464 of the Code originated from section 207 of the Tax Reform Act of 1976, Pub. L. 94-455, 90 Stat. 1520, 1536 (1976).[2] As originally drafted, the House bill included a "limitation on artificial losses" (LAL) under which artificial deductions that did not accurately reflect current expenses could not be used to shelter unrelated income from tax. H. Rep. No. 658, 94th Cong., 1st Sess. 4, 25 (1975). The farming related provisions included a definition of "farming syndicate" and an exception for holdings attributable to active management. Id. at 47-48. The Senate amendment did not contain LAL rules. It had a narrower definition of "farming syndicate" and an exception for holdings attributable to active management. S. Rep. No. 938, 94th Cong., 2d Sess. Part I - 39, 51, 58-60 (1976).

The conference agreement generally followed the Senate amendment, but it revised the definition of "farming syndicate" and the exceptions. At that point, there were only four exceptions, which corresponded to current subparagraphs (A), (B), (C), and (E) of § 464(c)(2). The four exceptions were described as follows:

> The provision specifies four cases where an individual's activity with respect to a farm will result in his not being treated as a limited partner or limited entrepreneur. These cases cover the situations where an individual--
>
> (1) has an interest attributable to his active participation for a period of not less than 5 years in the management of a trade or business of farming;
>
> (2) lives on the farm on which the trade or business of farming is being carried on;
>
> (3) actively participates in the management of a trade or business of farming which involves the raising of livestock (or is treated as being engaged in active management pursuant to one of the first two exceptions set forth above), and the trade or business of the partnership or any other enterprise involves the further processing of the livestock raised in the trade or business with respect to which he is (actually or constructively) an active participant; or
>
> (4) is a member of the family (within the meaning of section 267(c)(4)) of a grandparent of an individual who would be excepted under any of the first three cases listed above and his interest is attributable to the active participation of such individual.

H.R. Conf. Rep. No. 1515, 94th Cong., 2d Sess. 19-20, 413-415 (1976).

After the Conference Report was issued, another exception – corresponding to § 464(c)(2)(D) -- was added to the bill. See 90 Stat. 1933; 122 Cong. Rec. 30,718-19 (1976). The brief Senate discussion on this matter included the following statement by Senator Long: "The intent is that any individual whose principal business activity is actively participating in the management of a trade or business of farming will not be considered a limited partner or limited entrepreneur with respect to any farming activity

[2] Section 447 of the Code also originated from section 207 of the Tax Reform Act of 1976 (90 Stat. 1538).

in which such individual is engaged directly or through representatives or agents." 122 Cong. Rec. 30,719.

Although it is not part of the legislative history, we will review the relevant text of the Staff of the Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1976, 94th Cong., 2d Sess. (1976) (General Explanation). Courts have considered such material "a valuable aid" in understanding a statute. See Estate of Wallace, 965 F.2d at 1050 n.15. The five exceptions were described in the General Explanation as follows:

> … the provision specifies five cases where an individual's activity with respect to a farm will result in his not being treated as a limited partner or limited entrepreneur. These cases cover situations where an individual--
>
> (1) has an interest in a trade or business of farming attributable to his active participation for a period of not less than 5 years in the management of the trade or business of farming;
>
> (2) lives on the farm on which the trade or business of farming is being carried on (but only with respect to farming activities on such farm);
>
> (3) actively participates in the management of a trade or business of farming which involves the raising of livestock (or is treated as being engaged in active management pursuant to one of the first two exceptions set forth above), and the trade or business of the partnership or any other enterprise involves the further processing of the livestock raised in the trade or business with respect to which he is (actually or constructively) an active participant;
>
> (4) actively participates, as his principal business activity, in the management of a trade or business of farming, regardless of whether he actively participates in the management of the activity in question; or
>
> (5) is a member of the family (within the meaning of section 267(c)(4)) of a grandparent of an individual who would be excepted under any of the first four cases listed above and his interest is attributable to the active participation of such individual.

(Page 47, footnote omitted.) On page 48, the General Explanation includes the following example in explaining the first exception: "Thus, for example, if A, an individual who has owned and operated a farm for more than five years, wishes to retire and forms the AB limited partnership with B, an unrelated individual, and more than 35 percent of the losses are allocated to A, the limited partner, the AB partnership will not be treated as a farming syndicate because A's interest is not treated as a limited partnership interest for purposes of determining whether losses are allocated to limited partners." Cf. § 1.464-2(a)(6) of the proposed Income Tax Regulations published in the Federal Register on November 15, 1983 (48 Fed. Reg. 51,940, withdrawn, 63 Fed. Reg. 71,047).

The only change that was made to § 464(c)(2) since its enactment was for the technical correction to include a reference to a spouse in § 464(c)(2)(E). See section 701(l)(3) of

the Revenue Act of 1978, Pub. L. 95-600, 92 Stat. 2763, 2907 (1978). The scope of § 464 was substantially changed by the addition of subsection (f) in 1986, which is the same time § 448 was added to the Code. See sections 404 and 801 of the Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085, 2223, 2345 (1986).

In the instant case, Partnership's limited partners are allocated more than 35% of the partnership losses. Consequently, Partnership is a farming syndicate under § 464(c)(1)(B) unless one of the provisions of § 464(c)(2) applies to the x% limited partner interest owned by the S corporation. Based on the facts described above, it appears that the only subparagraph of § 464(c)(2) in dispute is subparagraph (A).[3] Section 464(c)(2)(A) provides that, for purposes of § 464(c)(1)(B), the following shall be treated as an interest which is not held by a limited partner or a limited entrepreneur: "(A) in the case of any individual who has actively participated (for a period of not less than 5 years) in the management of any trade or business of farming, any interest in a partnership or other enterprise which is attributable to such active participation."

The use of the term "individual" in § 464(c)(2)(A) is significant. The term "individual" has a meaning different from the term "person" or "taxpayer." See § 7701(a)(1) (definition of person) and (14) (definition of taxpayer). In Golden Rod Farms, Inc. v. Commissioner, 115 F.3d 897 (11th Cir. 1997), the court had to determine the meaning of the term "farm-related taxpayer" as used in § 464(f)(3)(B). The taxpayer argued, among other things, that such term was not limited to individuals because if Congress had intended § 464(f)(3)(B) to apply only to individuals, it would have used "individual" instead of "taxpayer" as it did in § 464(c)(2)(A)-(E). In analyzing whether the language of the statute was ambiguous, the court stated that "we construe Congress's use of 'taxpayer' instead of 'individual' in § 464(f)(3)(B) to suggest that it did not intend to limit the application of this section to individuals." 115 F.3d at 899.

If Congress had intended the § 464(c)(2)(A) exception to cover interests in limited partnerships held other than by individuals, it would have used different language. Applying the plain language of the statute does not produce an absurd result in the instant case.[4] The legislative history does not indicate why Congress chose to draft the § 464(c)(2)(A) exception the way it did. It could have been to avoid complexity (for both

[3] We do not interpret the facts described above to place subparagraph (D) in dispute because Individual's principal business activity does not involve active participation in the management of another farming business; plus the S corporation does not independently carry on a trade or business of farming. However, to the extent that subparagraph is in dispute, the use of the term "individual" in § 464(c)(2)(D) is significant, as explained below with respect to § 464(c)(2)(A). Additionally, there could be other issues, such as whether Individual's participation in the management of Partnership's ranching operations is a business activity if Individual does not receive compensation for such activity. Cf. Commissioner v. Groetzinger, 480 U.S. 23, 35 (1987).

[4] Additionally, it is important to note that the Supreme Court has stated that exceptions to a statutory general statement of policy are usually to be read narrowly in order to preserve the primary operation of the provision. Commissioner v. Clark, 489 U.S. 726, 739 (1989).

the government and businesses) in applying its provisions because a broader exception would require an analysis of the ownership of pass-through entities[5] that held a limited partner interest. Also, by limiting the exception to interests held by individuals, a limited partnership would always know whether or not it met the provisions of § 464(c)(2)(A). Whereas, if the exception applied to limited partner interests held by pass-through entities, the limited partnership would not always know whether or not it met the provisions of § 464(c)(2)(A) because it might not be aware of material changes in ownership of a pass-through entity. Furthermore, a limited partnership agreement can place certain restrictions on disposition of a limited partner interest, but a limited partnership cannot control in the same way disposition of interests in a pass-through entity that holds a limited interest in the partnership. Additionally, Congress may have considered the perceived advantages and disadvantages to different forms of business entities.

The instant case is not a situation where there is a need to fill a gap left by Congress' silence. In such situations, the Treasury Department has broad authority to issue published guidance to fill such gaps. See PSB Holdings, Inc. v. Commissioner, 129 T.C. 131, 141 (2007). As acknowledged by the Supreme Court in Lamie:

> There is a basic difference between filling a gap left by Congress' silence and rewriting rules that Congress has affirmatively and specifically enacted. …. Our unwillingness to soften the import of Congress' chosen words even if we believe the words lead to a harsh outcome is longstanding. It results from deference to the supremacy of the Legislature, as well as recognition that Congressmen typically vote on the language of a bill.

540 U.S. at 538 (internal quotation marks and citation omitted).

Accordingly, based on the plain language of § 464(c)(2)(A), which is in accord with its legislative history, we conclude that the interest held by the S corporation should be treated as an interest held by a limited partner because it is not held by an individual. The fact that Individual is the sole shareholder of the S corporation does not change the result. As stated by the Supreme Court in Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974):

> This Court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, [citations omitted] and may not enjoy the benefit of some other route he might have chosen to follow but did not.

Please call (202) 622-4950 if you have any questions.

[5] If the interest was held by a C corporation, § 447 could be applicable.