

Top Ten Developments in Agricultural Law and Taxation in 2023-Part 2

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Overview

With the immediately previous blog article I started the journey through what I believe are the Top Ten developments in ag law and tax of 2023. In that article I wrote about developments ten, nine and eight. Today, it's the seventh and sixth most important ones. Again, all of these make my Top Ten list because of their significance on a national level to farmers, ranchers, rural landowners and agribusiness in general.

Developments seven and six of 2023 – that's the topic of today's post.

7. Prison Sentences for Five People Involved in Billion Dollar Biofuel Tax Fraud Conspiracy (i.e., the Dermen/Kingston Conspiracy)

Number seven on my list topped the IRS Criminal Investigation Divisions case list for 2023. Involved is one of the largest tax fraud schemes in the history of the United States and it ultimately led in 2023 to the sentencing of five individuals for their roles in a \$1 billion biofuel tax conspiracy. The conspiracy occurred from 2010 to 2018 and involved money laundering, mail fraud and the fraudulent claiming of more than \$1 billion in refundable renewable fuel tax credits.

At the foundation of the criminal activity was the Renewable Fuel Standard (RFS) created in 2005 and expanded in 2007. Under the RFS, the government offers lucrative subsidies and tax credits to companies that convert crops such as soybeans and corn, as well as other products, into "renewable" fuels – the most common of which is corn ethanol. Included in the RFS are biofuel production incentives known as renewable identification numbers (RINs). Under EPA rules, a 38-digit number designed to track each gallon of ethanol or biodiesel from the producer to the point of sale. Ethanol RINs remain with the fuel until it is pumped by a consumer at the gas station. However, biodiesel RINs can be sold separately as credits that can be traded. This allows oil refiners who failed to blend the government-mandated amount of biodiesel to buy RINs to make up the difference without paying a fine. However, it also allowed for the possibility that a RIN price could be negotiated by a biofuel company with an oil refiner with the company using a fake 38-digit number. The RIN buyer would then claim to have shipped the biofuel to be refined. No fuel was actually bought or sold, and both the buyer and seller were in on the scam.



Note: Estimates are that the blending government mandate has resulted in about 40 percent of U.S. corn production being converted into ethanol annually. The estimated taxpayer subsidies of corn farmers have exceeded \$71 billion since 2005.

The biggest RFS scam ever involved the parties mixed-up in this development. The perpetrators created the appearance of biodiesel production and sale to claim the tax credits. IRS actually paid out more than \$511 million in credits to their biodiesel company that then distributed the proceeds among them as the company's owners. After pleading guilty, one conspirator was sentenced to 40 years in prison plus over \$1 million in restitution and personal financial liability. Another got 18 years in prison plus over \$500 million in restitution and another \$338 million in personal financial liability. Three others were sentenced to 12, 7 and six years in prison and ordered to pay over \$500 million in restitution combined.

The IRS said the case, "has been one of unprecedented fraud against the United States and its citizens and is one of the most egregious examples of tax fraud in U.S. history."

6. Self-Employment Tax and Limited Partners

Soroban Capital Partners LP v. Comr., 161 T.C. No. 12 (2023)

A question in self-employment tax planning is whether an LLC member is a limited partner. In 1997 the IRS/Treasury issued a proposed regulation to address the issue, but it has never been finalized. The regulation establishes a fact-based analysis based on participation in management to determine limited partner status. A limited partner doesn't participate in management. For businesses other than those providing professional services, characterization of an LLC member's interest is determinative of whether the member has self-employment tax liability on amounts distributed to the member (other than guaranteed payments). That means that proper structuring of the entity matters as does the drafting of the LLC operating agreement and the conduct of the members.

Here's what it might look like for a farming operation:

A married couple operates a farming business as an LLC. The wife works full-time off the farm and does not participate in the farming operation. But she holds a 49 percent non-manager ownership interest in the LLC. The husband conducts the farming operation full-time and also holds a 49 percent non-manager interest. But, the husband, as the farmer, also holds a 2 percent manager interest. The husband receives a guaranteed payment for his manager interest that equates to reasonable compensation for his services (labor and management) provided to the LLC. The result is that the LLC's income will be shared pro-rata according to the ownership percentages with the income attributable to the non-manager interests (98 percent) not subject to self-employment tax. The two percent manager interest is subject to self-employment tax along with the guaranteed payment that the husband receives. This produces a much better self-employment tax result than if the farming operation were structured as a member-managed LLC.



In late 2023, the U.S. Tax Court issued a fully reported opinion confirming that state law classifications of a partner's interest is not conclusive on the self-employment tax issue. ordinary income to its limited partners. However, the petitioner excluded distributions of ordinary income to its limited partners from its computation of net earnings from self-employment. Its basis for doing so was that the limited partners' interest conformed to state law. The IRS disagreed asserting that wasn't enough and that the functions and roles of the limited partners also had to be analyzed for self-employment tax purposes. The Tax Court agreed with the IRS.

At issue was the definition of a "limited partner" for purpose of the exception from s.e. tax under I.R.C. §1402(a)(13). The Tax Court noted that the proposed regulations provided a definition, that the Congress froze the finalization of the regulation for six months and has said very little about the issue since the freeze was lifted and has not provided a definition. The Tax Court noted that it had applied a "functional analysis" test in *Renkemeyer, Campbell & Weaver, LLP, 136 T.C 137 (2011)*, but that this was the first time the Tax Court was asked to determine the self-employment tax status of limited partner in a state law limited partnership (having passed on the issue in a 2020 case).

The Tax Court determined that the functional analysis test applied based largely on statutory construction of I.R.C. §1402(a)(13) which excludes from self-employment tax "the distributive share of any item of income or loss of a limited partner, as such." The Court concluded that the "as such" language meant that there wasn't a blanket exclusion for a limited partner. Instead, the statute only applies to a limited partner that is acting as a limited partner. If a limited partner is anything more than merely an investor, self-employment tax applies to the partner's distributive share.

Note: The Tax Court noted that the petitioner cited legislative history in an attempt to support its position, but that the legislative history actually supported the position of the IRS. The Tax Court also noted that the petitioner put forth "myriad other arguments" none of which were persuasive. The petitioner even cited language in the instructions for Form 1065 which it claimed defined a limited partner, but the Tax Court noted that the definition did not purport to define a limited partner.

The Tax Court held that a functional inquiry into the roles and activities of the petitioner's individual partners under I.R.C. §1402(a)(13) "involves factual determinations that are necessary to determine Soroban's aggregate amount of net earnings from self-employment." Accordingly, the Tax Court denied the petitioner's motion for summary judgment and set forth the rule going forward in evaluating the application of self-employment tax for limited partners in professional service businesses.

The manager-managed LLC provides a better result than the result produced by the member-managed LLC for LLCs that are not service partnerships. For those that are, the S corporation is the business form to use to achieve a better tax result. For an S corporation, "reasonable" compensation will need to be paid subject to S.E. tax, but the balance drawn from the entity can be received self-employment tax free. But, for farming operations with land rental income, the manager-managed LLC can provide a better overall tax result than the use of an S corporation because of the ability to eliminate the net investment income tax.



Of course, the self-employment tax and the net investment income tax are only two pieces of the puzzle to an overall business plan. Other non-tax considerations may carry more weight in a particular situation. But for some, this strategy can be quite beneficial.

Soroban Capital Partners LP lays down the rule that it's not enough to simply hold a limited partnership interest under state law (in the context of a professional service business). A limited partner must truly be acting as an investor and no more.

Proper structuring of the LLC and careful drafting of the operating agreement is important.

Conclusion

I will continue the trek through the "Top Ten" of 2023 in the next post.

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