ACTION ON DECISION

Subject: Burnett Ranches, Ltd v. United States, 753 F.3d 143 (5th Cir. 2014), aff'g 113 A.F.T.R.2d (RIA) 2014-2178 (N.D. Tex. 2012)

Issue: Whether a limited partnership is excluded from the definition of a farming syndicate under I.R.C. § 464(c)(1)(B) and (c)(2)(A), [1] because the sole shareholder of a limited partner S Corporation actively participated in the farming business.

Discussion: Burnett Ranches, Ltd (the Partnership) was a limited partnership engaged in the business of farming. Burnett Ranches, Inc. was a subchapter S corporation (the S Corporation) that owned an 85.52% limited partnership interest in the Partnership in 2005 and a 99% limited partnership interest in 2006 and 2007. The S Corporation did not independently carry on a farming business. An individual was the sole owner of the S Corporation during 2005, 2006, and 2007.

The Partnership used the cash receipts and disbursements method of accounting in 2005, 2006, and 2007. The Service determined that the Partnership was a farming syndicate required to use an accrual method of accounting and issued a notice of final partnership administrative adjustment. The Partnership's tax matters partner filed a complaint in District Court, which held that the Partnership was not a farming syndicate. The Service appealed to the Fifth Circuit Court of Appeals, which affirmed the District Court.

A "farming syndicate" is prohibited from using the cash receipts and disbursements method of accounting. § 448(a)(3), (d)(3); § 461(i)(3), (4). As a general rule, a partnership in the business of farming is a farming syndicate if it allocates more than 35 percent of its losses to one or more limited partners. § 464(c)(1)(B). An exception to this general rule provides that, for purposes of calculating the 35 percent allocation,

> the following shall be treated as an interest which is not held by a limited partner or a limited entrepreneur: … in the case of any individual who has actively participated (for a period of not less than five years) in the management of any trade or business of farming, *any interest* in a

[1] Section references are to the Internal Revenue Code in effect for the years at issue in this case. The text of § 464(c) as in effect in the years at issue was moved to § 461(j)[k] by the Tax Technical Corrections Act of 2014, Pub. L. 113-295, Division A, § 221(a)(58)(B)(i). This amendment contained a typographical error that incorrectly designated the new subsection as "j" instead of "k".

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> partnership or other enterprise which is attributable to such active participation[.]

§ 464(c)(2)(A) (emphasis added).

The Fifth Circuit panel concluded that the Partnership was excluded from the definition of a farming syndicate based on the panel's expansive interpretation of the statute's reference to "any interest". The panel interpreted the meaning of interest "in the broader dictionary sense of involvement with or participation in something; a right, claim, or share in something; or 'something in which such a right, claim, or share is held,'" including "'the fact or relation of having a share or concern in, or a right to, something.... A thing which is to the advantage of someone'". 753 F.3d at 148 (citations omitted).

This interpretation by the panel overlooks the specific context of the use of the word "interest" in § 464(c)(2)(A). The reference to "any interest in a partnership or other enterprise," together with the reference in the preceding sentence to an interest "not held by a limited partner or limited entrepreneur," clearly contemplates an "interest" in the sense of a legal property interest in a partnership (or other enterprise)—a narrower concept than the generic dictionary definition relied upon by the court. Furthermore, by modifying the phrase "any interest in a partnership" with the phrase "in the case of any individual," the plain meaning of the statute is that the interest must be an interest held by an individual. This narrower reading of the statute is also consistent with the legislative history. See H.R. Conf. Rep. No. 94-1515 at 413-415 (1976) ("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," including "where an individual… has an interest attributable to his active participation".); see also Staff of the Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1976, 94th Cong., Pub. L. 94-455, at 46-48 (1976).

The panel's holding effectively allows the Partnership to recharacterize the form of its ownership to ignore the legal existence of the S Corporation. "[W]hile 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, and may not enjoy the benefit of some other route he might have chosen to follow but did not." Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974) (citations omitted). Unlike a disregarded entity, such as a disregarded single-member limited liability company, an S corporation is treated by the Internal Revenue Code as an entity separate from its owner or owners. In this case, the statute excludes a partnership interest of "any individual" who meets the active participation requirement. The statute does not exclude a partnership interest held by an S corporation, even if the S corporation is owned by an individual who has actively participated.

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Finally, in explaining why the § 464(c)(2)(A) exception could apply even though the S Corporation was interposed between the individual and the Partnership, the court stated that Congress "expressly eliminate[d] an 'S corporation' from the types of legal entities which that subsection subjects to farming syndicate status." 753 F.3d at 149 (citing § 464(c)(1)(B)). This statement reflects a misunderstanding of the statutory framework: By excluding an entity "other than a corporation which is not an S corporation," the statute eliminates C corporations from the scope of the subsection rather than S corporations. See also § 1361(a)(2) (using similar language in the definition of a C corporation).

Although we disagree with the decision of the court, we recognize the precedential effect of the decision to cases appealable to the Fifth Circuit, and therefore will follow it with respect to cases within that circuit, if the opinion cannot be meaningfully distinguished. We do not, however, acquiesce to the opinion and will continue to litigate our position in cases in other circuits. Accordingly, the Service will continue to assert that the § 464(c)(2)(A) exception must be read in reference to the statute as a whole, and that the exception applies only to an interest held by the individual meeting the active participation requirement. Thus, the exception does not apply to a limited partnership interest held by a separate legal entity such as an S corporation.

Recommendation: Nonacquiescence

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