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Recharacterizations in the Tax World: Cause for Surprise

-by Neil E. Harl*

Although the first major curbs on deductibility of passive activity losses and credits were enacted in 1986 as part of the Tax Reform Act of 1986,[1] the rules on "recharacterizations" were not enacted until 1987 in the Revenue Act of 1987[2] which gave authority to the Secretary of the Treasury to prescribe regulations ". . . requiring net income or gain from a limited partnership or other passive activity to be treated as *not* from a passive activity."[3] Those regulations were adopted in 1992.[4] The "recharacterization" rules are outlined in the regulations.

The objective of the regulations

The apparent objective of the regulations was to counter attempts to use "passive income generators" to circumvent the passive loss rules. The result was 10 specific provisions designed precisely to accomplish that result. Essentially, the regulations were designed to recharacterize targeted transactions to prevent an end-run around the statutory framework. For those who were not familiar with the "recharacterization" rules the results have often been surprising and disappointing.

The major recharacterization provisions

Of the 10 recharacterization rules featured in the regulations, about half have had an impact on farm and ranch firms. The paragraphs following discuss those more significant provisions.

The self-rental rule. The rule that has had probably the greatest impact on the agricultural sector is the "self-rental" rule.[5] A farmer or rancher who leases property to a trade or business in which the farmer or rancher materially participates may find rental income or gain recharacterized as non-passive income.[6] In a 2015 Tax Court case, *Williams v. Commissioner,* the income from an S corporation's rental activities were recharacterized as nonpassive under the regulations. There was "material participation" under the self-rental rule. Under the general passive loss provisions*, losses attributable to passive activities can only be deducted from income attributable to passive activities*.[7] So the strategy of planning by a taxpayer for passive income to be generated where passive losses were anticipated is thwarted by the recharacterization rules.

A 1988 case, well before the advent of the recharecterization regulations, *Dudden v. Commissioner,*[8] illustrates one possible place for imposing the "self-rental" rule. In that

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decision, the taxpayer formed a corporation to carry on the farming operation but retained ownership of the sow herd in the individual taxpayer with the animals leased to the family corporation under a sow lease agreement. The sale of cull sows (and boars) produced Section 1231 income which was subject to more favorable income tax treatment than would be expected with sale of the same animals by the corporation. The corporation was entitled to all pigs farrowed except for the replacement gilts. However, the individual taxpayer did not account for the value of the replacement gilts. The Tax Court held that the lessors (the individual taxpayers) realized rental income on receipt of the replacement gilts at their fair market value at the time of the transfer and additional rental income when the sows, at 270 pounds, were reintroduced into the herd. The question, under the "self-rental" rule is whether the additional income to the individual taxpayers was passive income which could be used to offset passive losses.elsewhere in their portfolio. The short answer is that the additional income would be nonpassive income by virtue of the regulations and could not be used to offset passive losses.

In another case, *Krukowski v. Commissioner,*[9] the self-rental regulation was declared valid in a setting where a building was rented to a C corporation with the taxpayer who owned the building as the sole shareholder of the corporation. This case illustrates that many farm and ranch operations under a "two entity" business plan, which has become popular in recent years, could encounter the "self-rental" rule.[10] A taxpayer's activities include those conducted through a C corporation subject to I.R.C. § 469 if five or fewer persons own more than 50 percent of the stock and the material participation rules apply.

Note that the provision does not recharacterize losses.

The rule for "net rental income" from self-developed rental property. Another of the 10 "recharacterization" rules applies to self-developed rental property if sold within 24 months after first being used as rental property and the taxpayer materially or significantly participated in any year in enhancing the property value.[11]

Non-depreciable property held for use by customers in a rental activity. This provision has been invoked in audits of cash rent landlords to tenants with the net income recharacterized as portfolio income.[12] The property is treated as non-depreciable if less than 30 percent of the property's unadjusted basis is subject to depreciation.[13]

Recharacterization for net income from a "significant participation" activity. This is the provision that treats an individual as "materially participating" if the individual's aggregate participation in "significant participation" activities for the year exceeds 500 hours.[14] A "significant participation" activity is a trade or business activity in which the individual participates for more than 100 hours for the taxable year.[15]

If the taxpayer's aggregate "significant participation" activities do not constitute activities in which the taxpayer materially participates, an amount of the taxpayer's gross income from each such activity equal to the net income from the significant participation activity may be recharacterized as income from a nonpassive activity.[16] Where the taxpayer participates in more than one significant participation activity, the amount of gross income recharacterized from each such activity is a ratio based on the total net passive income relative to the total net passive income from positive sources.[17]

In conclusion

There are six more "recharacterization" rules but the ones discussed here are the ones that are most likely to arise in a farm or ranch setting. However, it is a good idea, occasionally, to review all of the rules for possible applicability in one's tax practice.

ENDNOTES

[1] Pub. L. No. 99-514, § 501, 100 Stat. 2085, 2233 (1986). See generally 4 Harl, *Agricultural Law* § 30.08 (2015); 2 Harl, *Farm Income Tax Manual* § 4.08 (2015 Ed.)

[2] Pub. L. No. 100-203, § 10212(a), 101 Stat. 1330-284 (1987), enacted as the Omnibus Reconciliation Act of 1987, enacting I.R.C. § 469(l)(3).

[3] I.R.C. § 469(l)(3), *emphasis added*.

[4] T.D. 8417, 1992-1 C.B. 173, May 12, 1992, *amended by* T.D. 8477, 1993-1 C.B. 82, February 22, 1993, *and further amended by* T.D. 8495, 1993-2 C.B. 226, November 3, 1993, with Temp. Treas. Reg. § 1.469-2T.

[5] Treas. Reg. § 1.469-2(f)(6).

[6] *Id*. See Williams v. Comm'r, T.C. Memo. 2015-76.

[7] I.R.C. § 469(d)(1).

[8] 893 F.2d 174 (8th Cir. 1990), *aff'g,* 91 T.C. 642 (1988). The case of *Strong v. Comm'r*, 91 T.C. 627 (1988) has similar facts and result.

[9] 279 F.3d 547 (7th Cir. 2002).

[10] Treas. Reg. § 1.469-2(f)(6).

[11] Treas. Reg. § 1.469-2(f)(5).

[12] Treas. Reg. § 1.469-2(f)(3).

[13] *Id*.

[14] Temp. Treas. Reg. § 1.469-5T(a)(4).

[15] Temp. Treas. Reg. § 1.469-5T(c)(1).

[16] Treas. Reg. § 469-2(f)(ii).

[17] Treas. Reg. § 1.469-2(f)(i).