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FARM LEASES AND PASSIVE ACTIVITY LOSSES

— by **Neil E. Harl***

Enactment of the passive activity loss rules in 1986[1] was motivated by a desire to curb tax shelter abuses and to correct the misallocation of resources caused by tax-induced investment in agriculture and elsewhere in the economy. Thus, it is not surprising that the provisions have caused economic pain. One provision, involving the deduction of up to $25,000 for losses attributable to "rental real estate activities," has led to taxpayer confusion and uncertainty for their tax advisors.[2]

Tests for deductibility. In general, losses from passive trade or business activities, to the extent deductions exceed income from all passive activities (exclusive of portfolio income), may not be deducted against other income unless the taxpayer is "materially participating."[3] A taxpayer is considered to be materially participating in an activity only if the person "is involved in the operations of the activity on a basis which is regular, continuous, and substantial."[4]

Temporary regulations published in 1988 lay out seven tests for material participation.[5] All of the tests focus to a degree on the time devoted to the operation by the taxpayer. Here are the seven tests—

• Under the first test, an individual is considered to be materially participating if the individual participates in the activity for more than 500 hours during the year.[6]

• The second test is for situations requiring less than 500 hours of involvement, or less than 500 hours by any one individual, during the year.[7] If the individual's participation in the activity constitutes "substantially all of the participation" in the activity by all individuals during the year, it is considered material participation.[8]

• Under the third test, an individual is considered to be materially participating if the individual puts more than 100 hours per year into the activity and the individual's participation is not less than that of any other individual.[9] This rule would not apply if a tenant was involved who put 500 hours per year into the activity and the owner put 300 hours per year into the venture, for example.

• Under the fourth test, an individual is treated as materially participating in "significant participation activities" if the individual's aggregate participation in significant participation activities for the year exceeds 500 hours.[10] A "significant participation activity" or SPA is a trade or business activity in which the individual participates for more than 100 hours for the taxable year.[11] This rule is intended to reach those individuals who devote more than 500 hours per year spread over several activities. The idea is to treat that individual as favorably as someone who devotes an equivalent amount of time to a single activity.

• With the fifth test, an individual is treated as materially participating if the individual materially participated in the activity for any five of the ten taxable years immediately preceding the taxable year.[12] The regulations point out that material participation for years before 1987 requires more than 500 hours' involvement during the year.[13]

• The sixth test is for those involved in personal service activities (involving the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting or any other trade or business in which capital is not a material income producing factor.[14] Under that rule, an individual is treated as materially participating in a personal service activity if the taxpayer materially participated in the activity for any three taxable years preceding the taxable year in question.[15]

• The seventh and final test specifies that an individual may be treated as materially participating in an activity based on all the facts and circumstances.[16] The regulations do not specify what facts and circumstances are to be considered, but the regulations do point out several factors to keep in mind—

(1) The fact that an individual is materially participating for purposes of self-employment tax or special use valuation for federal estate tax purposes is not taken into account for purposes of the passive loss rules.[17] This seems inconsistent with a passage in the Senate Finance Committee report that stated,

> "in the case of farming, the committee anticipates that an individual who does not perform physical work relating to a farm, but who is treated as having self-employment income with respect to the farm under section 1402, generally will be treated as materially participating."[18]

(2) An individual who does not participate in an activity for more than 100 hours per year cannot meet the facts and circumstances test.[19]

(3) An individual's participation in management of an activity *is not taken into account* in applying the facts and circumstances test *if a paid manager participates in the activity*.[20] The outcome is the same if the management services performed by the individual are exceeded by those performed by any other individual.[21]

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This rule is clearly the most difficult to meet of the three rules governing the imputation of activities from agent to principal—(a) under the general rule, activities of an agent are imputed to the principal except where provided otherwise by statute or regulation;[22] (b) where the question of material participation is routed through I.R.C. § 1402, a 1974 amendment bars imputation of the activities of an agent to the principal;[23] and (c) for purposes of the passive loss rules, the mere presence of a paid manager or agent bars even the principal's involvement in management from counting toward the material participation requirement.[24] The latter rule is indeed harsh, particularly considering that even where imputation of an agent's activity to the principal is blocked, it has been possible to achieve material participation despite the presence of a paid manager or agent, such as a farm manager.[25]

Several additional rules impact on the question of material participation.

• In determining whether a taxpayer materially participates, the participation of the taxpayer's spouse is taken into account, whether or not they file a joint income tax return.[26]

• Farm taxpayers are permitted to qualify as materially participating if they participate materially for five or more years in the eight year period before retirement or disability.[27]

• The material participation test is met by surviving spouses who inherit qualified real property from a deceased spouse if the surviving spouse engages in "active management."[28]

• A C corporation is treated as materially participating in an activity with respect to which one or more shareholders, owning a total of more than 50 percent of the outstanding corporate stock, materially participate.[29]

• An estate or trust, except for grantor trusts, is apparently treated as materially participating if a fiduciary meets the material participation test.[30]

Active participation test. A taxpayer may deduct annually up to $25,000 of passive activity losses and the deduction equivalent of passive activity credits *attributable to rental real estate* activities in which the taxpayer *actively* participates.[31] The active participation requirement applies both in the year of loss and in the year of allowance of the loss.[32] The $25,000 allowance phases out ratably as the taxpayer's adjusted gross income (determined without regard to passive activity losses) increases from $100,000 to $150,000.[33] The $25,000 allowance is not available to corporations.[34]

The crucial question for farm investors with the active participation test is whether rental farmland is a "rental real estate activity." Under the temporary regulations, a 50-50 crop share lease is treated as a joint venture and not as a rental real estate activity.[35] The regulations state—

> "The taxpayer makes farmland available to a tenant farmer pursuant to an arrangement designated a 'crop share' lease. Under the arrangement, the tenant is required to use the tenant's best efforts to farm the land and produce marketable crops. The taxpayer is obligated to pay 50 percent of the costs incurred in the activity (without regard to whether any crops are successfully produced or marketed), and is entitled to 50 percent of the crops produced (or 50 percent of the proceeds from marketing the crops)...[t]he taxpayer is treated as providing the farmland for use in a farming activity conducted by a joint venture in the taxpayer's capacity as an owner of an interest in the joint venture. Accordingly...the taxpayer is not engaged in a rental activity, without regard to whether the taxpayer performs any services in the farming activity."[36]

The regulations make it clear that a crop share or livestock share lease is a joint venture and not a rental real estate activity, regardless of the degree of involvement by the taxpayer in the operation. In contrast, the instructions to Form 4835, "Farm Rental Income and Expenses," which is used by non materially participating landowners as taxpayers, states—

> "Use this form only if the activity is a rental activity for purposes of the passive activity loss limitations....[I[f you actively participated in the operation of this activity and you show a loss...you may be able to deduct up to $25,000 of losses from all rental real estate activities."

The instructions to Form 4835 thus suggest that the deduction under the active participation test would be available for a non material participation share lease. Moreover, we had been advised in recent months by individuals in the Internal Revenue Service that the instructions to Form 4835 represented the current IRS position and that the language in the temporary regulations should not be viewed as applicable to crop share and livestock share leases.

The Department of the Treasury has now indicated that Example 8 of the regulations is the correct interpretation with no mention made of the conflict between the regulation and the Form 4835 instructions.[37] The IRS position seems inconsistent with well established tax law which has been interpreted as providing that non-material participation share leases produce rental income.[38]

Based on the current IRS position, taxpayers unable to meet the material participation test would be well advised to shift to a cash rent lease in order to become eligible for the deduction of up to $25,000 under the active participation test for rental real estate activities.

FOOTNOTES

1 Tax Reform Act of 1986, Pub.L. No. 99-514, Sec. 501 100 Stat. 2085, 2233 (1986).

2 See generally 4 Harl, **Agricultural Law** § 30.08 (1990).

3 I.R.C. § 469.

4 I.R.C. § 469(h)(1).

5 Temp. Treas. Reg. § 1.469-5T.

6 Temp. Treas. Reg. § 1.469-5T(a)(1).

7 Temp. Treas. Reg. § 1.469-5T(a)(2).

8 *Id*.

9 Temp. Treas. Reg. § 1.469-5T(a)(3).

10 Temp. Treas. Reg. § 1.469-5T(a)(4).

11 Temp. Treas. Reg. § 1.469-5T(c)(1).

12 Temp. Treas. Reg. § 1.469-5T(a)(5).

13 Temp. Treas. Reg. § 1.469-5T(j).

14 Temp. Treas. Reg. § 1.469-5T(d).

15 Temp. Treas. Reg. § 1.469-5T(a)(6).

16 Temp. Treas. Reg. § 1.469-5T(a)(7).

17 Temp. Treas. Reg. § 1.469-5T(b)(2)(ii).

18 S. Rep. 99-313, 99th Cong., 2d Sess. 733-34 (1986).

19 Temp. Treas. Reg. § 1.469-5T(b)(2)(iii).

20 Temp. Treas. Reg. § 1.469-5T(b)(2)(ii)(A).

21 Temp. Treas. Reg. § 1.469-5T(b)(2)(ii)(B).

22 See Webster Corp. v. Comm'r, 25 T.C. 55 (1955), *acq.*, 1960-2 C.B. 7, *aff'd*, 240 F.2d 164 (2d Cir. 1957) (activities of professional farm manager as agent imputed to landowner as principal to transform income from crop share leases into business income (rather than rent) for personal holding company purposes); Ltr. Rul. 8244003, May 1, 1982 (management of farm by daughter and son-in-law as agents qualified property for installment payment of federal estate tax).

23 Pub. L. 93-368, amending I.R.C. § 1402(a)(1). The characterization of income as rent or self-employment income and the adequacy of material participation for purposes of special use valuation are routed through I.R.C. § 1402. See I.R.C. §§ 1402(a)(1), 2032A(e)(6).

[24] Temp. Treas. Reg. § 1.469-5T(b)(2)(ii)(A).
[25] See Treas. Reg.§ 20.2032A-3(g), Ex. 4 (eligibility for special use valuation).
[26] I.R.C. § 469(h)(5).
[27] I.R.C. §§ 469(h)(3), 2032A(b)(4).
[28] I.R.C. §§ 469(h)(3), 2032A(b)(5).
[29] I.R.C. § 469(h)(4)(A).
[30] S. Rep. 99-313, 99th Cong., 2d Sess. 735 (1986).
[31] I.R.C. § 469(i).
[32] I.R.C. § 469(i)(1), as amended by Sec. 1005(a)(6), Pub. L. 100-647, 102 Stat. 3388 (1988).
[33] I.R.C. § 469(i)(3).
[34] I.R.C.§ 469(i)(1).
[35] Temp. Treas. Reg. § 1.469-2T(e)(3)(viii), Ex. 8.
[36] *Id.*
[37] Letter dated Oct. 24, 1990, from Kenneth W. Gideon, Assistant Secretary (Tax Policy) to Senator Charles E. Grassley.
[38] See Harl, "Crop Share Leases and Material Participation Dichotomy," 49 Tax Notes 1255 (1990).

CASES, REGULATIONS AND STATUTES

ADVERSE POSSESSION

OPEN AND NOTORIOUS POSSESSION. In 1951, the plaintiffs purchased a northern portion of land owned by the seller but the southern boundary marked on the land included ten acres not included in the legal description of the land sold. The remaining southern portion was sold in 1979, and in 1985, the purchasers of the remaining portion discovered the error and claimed title to the ten acres. The plaintiffs brought a quiet title suit alleging title to ten acres of land by adverse possession. The trial court ruled that the plaintiff had title by adverse possession. The court held that sufficient evidence was presented to support the judgment because the plaintiffs and the seller had staked out the boundaries of the sold portion and the community had treated the disputed acres as owned by the plaintiffs. The court also held that sufficient evidence was presented of the plaintiff's actual possession of the ten acres from the plaintiff's use of the land for a residence, an archery range, trash burning and timber cutting. **Green v. Lange, 797 S.W.2d 765 (Mo. App. 1990)**.

BANKS

FIDUCIARY DUTY. The plaintiffs had obtained farm operating loans from the defendant bank for several years, but in 1985, the defendant refused to advance loans for the crop year and suggested that the plaintiffs obtain a loan from the FmHA. Although the plaintiffs, apparently, obtained a loan from the FmHA, the plaintiffs sued the defendant for breach of fiduciary duty, fraud, breach of implied-in-fact contract and interference with the FmHA loan contract. The court held that the defendant had no fiduciary duty toward the plaintiffs resulting from the past loans where the defendant did not assent to or become aware of any fiduciary relationship. The court also dismissed the plaintiff's fraud allegations because the allegations were based upon a breach of the fiduciary duty (which was already rejected) to inform the plaintiffs about various aspects of the FmHA loan. The court held that no contract-in-law for the defendant to lend the plaintiff operating expenses was created because both parties did not agree to any such contract and the past loans did not create any contract right to future loans. **Irons v. Community State Bank, 461 N.W.2d 849 (Iowa Ct. App. 1990)**.

BANKRUPTCY

GENERAL

AUTOMATIC STAY. At the time of filing for bankruptcy, the debtor was current on all local property taxes; however, after the filing, the taxes became delinquent and the city and county argued that the statutory liens which attached were entitled to super priority over other security interests in the debtor's land for which the taxes were owed. The court held that the statutory liens were void as violating the automatic stay because the liens did not arise until the taxes were assessed, which occurred post-petition. **Makoroff v. City of Lockport, 916 F.2d 890 (3d Cir. 1990), *aff'g* 111 B.R. 107 (W.D. Pa. 1990), *aff'g* 95 B.R. 370 (Bankr. W.D. Pa. 1989)**.

AVOIDABLE TRANSFERS. The debtors executed contracts for future delivery of grain to a creditor in return for the ability to purchase seed, fertilizer and chemicals for production of the grain during the crop year. After harvest, the debtor delivered the grain to the creditor who offset the amount owed by the debtor with the proceeds of the sale of the grain. The debtor declared bankruptcy a month after the offset and the trustee sought to avoid the offset as a preferential transfer. The court held that the date of transfer was not the date of the execution of the contracts but the date of the application of the grain proceeds to the debtors' account. The court also held that the contracts did not give the creditor any right in the grain but served only to set the price for the grain as between the debtor and the creditor and that the parties did not agree to the offset as the purpose of the contract. The court also rejected the creditor's claim that the contract and offset was a payment in the ordinary course of business because the creditor had not required the contract in previous purchases of supplies by the debtor. Thus, the court held that the offset was a preferential transfer. ***In re* Woker, 120 B.R. 454 (Bankr. S.D. Ill. 1990)**.

CLAIMS. In the debtor's Chapter 13 plan, the secured portion of a creditor's claim secured by a pickup was determined using the wholesale value of the truck. The court agreed with the use of the wholesale value of the truck because the creditor was in the business of financing automobile dealers and not in the business of buying and selling vehicles. ***In re* Owens, 120 B.R. 487 (Bankr. E.D. Ark. 1990)**.

DISCHARGE. The debtors originally filed their case under Chapter 7 but later converted the case to Chapter 11. The creditor filed a complaint against discharge of a claim 56 days after the case was converted but more than 60 days after the first meeting of creditors in the Chapter 7 case. The creditor argued that Bankr. Rule 1019(3) allowed the creditor an additional 60 day period after the conversion of the case. The court held that Rule 1019 does not refer to conversions of Chapter 7 cases to Chapter 11 and that none of the reasons for the extension of time in those situations