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## SORTING OUT "MATERIAL PARTICIPATION": THE TRAP IN FOBD

— by Neil E. Harl\*

The term "material participation" has become a standard component of tests to determine whether a "business" exists.<sup>1</sup> Generally, for an arrangement to be a business, the owner (or someone on behalf of the owner)<sup>2</sup> must be (1) bearing the risks of production, (2) bearing the risks of price change and (3) involved significantly in management. Material participation is used as a standard for determining whether there is sufficient involvement in management to meet that part of the test.

Unfortunately, the requirements are not uniform for the various provisions and tend to confuse both clients and practitioners.

### Origins of "material participation"

The term "material participation" gained visibility with extension of the social security system to farmers in 1955. The statute imposing self-employment tax, Section 1402 of the Internal Revenue Code, used material participation as a requirement for determining net earnings from self-employment.<sup>3</sup> That meaning of material participation governs also for material participation for purposes of special use valuation<sup>4</sup> and the family-owned business deduction (FOBD).<sup>5</sup> Thus, the *amount or degree* of involvement should be the same for both tests. However, the *time* during which material participation must occur is different for the two provisions.<sup>6</sup>

Another definition of material participation is prescribed for purposes of the passive loss rules.<sup>7</sup> Under that provision, which is more demanding than the Section 1402 meaning of the term, a taxpayer is treated as 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."<sup>8</sup>

### Pre-death test: Special use valuation and FOBD

For purposes of special use valuation, the time when the material participation test must be met in the pre-death period was originally expressed as five or more years "during the 8-year period ending on the date of the decedent's death."<sup>9</sup> In 1981, the provision was amended to require material participation for five or more years during the eight-year period ending with *the earlier of retirement, disability, or death*.<sup>10</sup> Thus, if a decedent had five or more years of material participation before beginning

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See the back page for details of the  
**Agricultural Tax and Law Seminar**  
by Dr. Neil Harl and Prof. Roger McEowen,  
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to receive social security benefits in retirement,<sup>11</sup> eligibility is assured for life so long as the individual continues to receive social security benefits.<sup>12</sup>

For purposes of the family-owned business deduction, the requirement is different. The drafters of the FOBD provision patterned the material participation test after the *original* special use valuation enactment (passed in 1976) in requiring material participation for five or more years “during the 8-year period ending on the date of the decedent’s death.”<sup>13</sup> The drafters did not include the 1981 amendment easing the pre-death requirement by requiring material participation only for five or more years during the eight year period ending with the earlier of retirement disability or death.<sup>14</sup> This is a significant (and dangerous) difference in the two tests, particularly in light of the statutory statement for FOBD that the material participation requirement is imposed “within the meaning of section 2032A(e)(6).”<sup>15</sup> Clearly, section 2032A(e)(6) only specifies the standard for determining the adequacy of involvement, not the standard in determining the *period* when material participation is required.<sup>16</sup>

#### Post-death test: Special use valuation and FOBD

The post-death or recapture tests for material participation appear to be identical for purposes of special use valuation and FOBD.

For special use valuation, absence of material participation for more than three years in any eight-year period ending after death results in recapture of special use valuation benefits.<sup>17</sup> The FOBD rules state that recapture occurs if, within 10 years after the date of the decedent’s death, “the material participation requirements described in section 2032A(c)(6)(B) are not met....”<sup>18</sup> Thus, the FOBD rules basically adopt the post-death material participation requirement, both with respect to the amount of involvement required and with respect to the period when material participation is required.<sup>19</sup> The two tests are identical.

#### In conclusion

The differences in the pre-death test for the material participation requirement are particularly unfortunate in light of the obvious resemblance of the rules in the pre-death period and in the assurance in the post-death period that the FOBD rules are to utilize the special use valuation rules.

Quite clearly, the wise approach would be to amend the FOBD material participation test as was done in 1981 for special use valuation<sup>20</sup> to require material participation only for five or more years before the earlier of retirement, disability or death.<sup>21</sup> Unless so amended, some decedents are likely to fail the pre-death material participation test for FOBD.

#### FOOTNOTES

<sup>1</sup> See, e.g., I.R.C. §§ 2032A(b)(1)(C)(ii) (special use valuation), 2057(b)(1)(D)(ii). See 5 Harl, *Agricultural Law* §§ 43.03[2], 44.03 (2000); Harl, *Agricultural Law Manual* §§ 5.03[2], 50.04[7] (2000).

<sup>2</sup> See 5 Harl, *Agricultural Law* § 41.06 (2000) (rules on imputation of activities by employee or agent to property owner as principal).

<sup>3</sup> I.R.C. § 1402(a)(1).

<sup>4</sup> I.R.C. § 2032A(e)(6).

<sup>5</sup> I.R.C. § 2057(b)(1)(D)(ii).

<sup>6</sup> See notes 9-16 *infra* and accompanying text.

<sup>7</sup> I.R.C. § 469(h)(1).

<sup>8</sup> *Id.*

<sup>9</sup> I.R.C. § 2032A(b)(1)(C), before enactment of Economic Recovery Tax Act of 1981, Sec. 421(b)(2), adding I.R.C. § 2032A(b)(4), (5). See 5 Harl, *supra* note 1, § 43.03[2][d][vi].

<sup>10</sup> I.R.C. § 2032A(b)(1)(C), 2032A(b)(4).

<sup>11</sup> I.R.C. § 2032A(b)(4)(A)(i).

<sup>12</sup> See note 9 *supra*.

<sup>13</sup> I.R.C. § 2057(b)(1)(D).

<sup>14</sup> I.R.C. § 2032A(b)(1)(C), (4).

<sup>15</sup> I.R.C. § 2057(b)(1)(D)(ii).

<sup>16</sup> See I.R.C. § 2032A(e)(6).

<sup>17</sup> I.R.C. § 2032A(c)(6)(B).

<sup>18</sup> I.R.C. § 2057(f)(1)(A).

<sup>19</sup> *Id.*

<sup>20</sup> See note 10 *supra*.

<sup>21</sup> I.R.C. § 2032A(b)(1)(C), (4). See note 10 *supra*.

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## CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

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### BANKRUPTCY

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#### CHAPTER 12-ALM § 13.03[8].\*

**CLAIMS.** The debtors’ Chapter 12 plan had listed a creditor’s junior mortgage as an unsecured claim since the prior secured claims against the property exceeded the value of the property. The creditor had initially objected to the characterization of the claim but failed to object to confirmation of the plan. After the debtors received their

discharge, the property was sold and the creditor required a payment in order to release the lien. The debtors argued that the payment violated the discharge and sought return of the payment. The creditor argued that *Dewsnup v. Timm*, 502 U.S. 410 (1992) prohibited the stripping of the secured status of the lien. The court held that *Dewsnup* was limited to Chapter 7 cases and that lien stripping was allowed in Chapter 12 cases. The court also held that the debtors had taken affirmative action to void the lien as unsecured by filing a Section 506 motion and by including the claim as unsecured in the plan. The court held that the avoidance extinguished the lien such that, after discharge, no lien