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**Issue Contents**

**Bankruptcy**

Federal Tax  
Discharge **59**

**Federal Agricultural Programs**

Captive cervids **59**  
Grapefruit **59**  
Farm loans **59**  
Sheep and goats **59**  
Specialty crop block grant program **59**  
Sugar **59**  
Swine **59**

**Federal Estate and Gift Taxation**

Valuation **60**

**Federal Income Taxation**

Charitable deduction **60**  
Constructive receipt **60**  
Depreciation **60**  
Electricity production credit **61**  
Employee benefits **61**  
Federal tax deposits **61**  
Fuel credit **61**  
Gambling losses **61**  
Innocent spouse **61**  
Installment reporting **61**  
New vehicle deduction **62**  
Partnerships  
Administrative adjustment **62**  
Check-the-box election **62**  
Passive activity losses **62**  
Pension plans **62**  
Returns **62**  
S Corporations  
Election **63**  
Shareholder basis **63**  
Social security taxes **63**  
Travel expenses **63**  
Trusts **63**

**In the News**

Farm programs **63**

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## Meeting the Passive Loss Requirements as a Surviving Spouse

-by Neil E. Harl\*

The Internal Revenue Service has addressed, in a technical advice memorandum,<sup>1</sup> the cross-referencing from the special use valuation rules<sup>2</sup> to the passive activity rules<sup>3</sup> in determining whether the material participation rules (on a regular, continuous and substantial basis<sup>4</sup>) were met for a farming operation after the death of the husband and before the death of the wife.<sup>5</sup> The farm operation was conducted through a limited liability company wholly owned by a grantor trust.<sup>6</sup>

### Passive activity rules

Under the passive activity rules, losses are disallowed for any taxable year for any individual, estate or trust, any closely-held C corporation and any personal service corporation carrying on a trade or business in which the taxpayer does not materially participate on a regular, continuous and substantial basis.<sup>7</sup> Seven tests have been articulated for material participation under the passive activity loss rules.<sup>8</sup>

Farm taxpayers are permitted to qualify as materially participating if they participated materially for five or more of the eight year period before retirement or disability.<sup>9</sup> Moreover, 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."<sup>10</sup>

It is interesting to note that the cross-reference from the special use valuation rules to the passive activity rules involves a different level of participation. The special use valuation provisions refer specifically to material participation "determined in a manner similar" to the way the term is used for purposes of imposition of social security tax on net earnings from self-employment.<sup>11</sup> For passive activity loss purposes, as noted above, the meaning of "material participation" is different and more demanding, adding the requirement that the involvement in the activity must be "regular, continuous, and substantial."<sup>12</sup> Under the temporary regulations,<sup>13</sup> the fact that an individual is materially participating for purposes of social security or special use valuation of land for federal estate tax purposes is not taken into account for purposes of the passive activity loss rules. This seems inconsistent with a passage in the committee reports.<sup>14</sup> As the Senate Committee Report stated, "in the case of farming, the committee anticipates that an individual who does not perform

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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.”<sup>15</sup>

### Special use valuation rules

The special use valuation rules,<sup>16</sup> which are referred to for passive activity loss purposes,<sup>17</sup> state that farm taxpayers are permitted to qualify as materially participating if they participated materially for five or more years in the eight year period before retirement or disability.<sup>18</sup> Moreover, 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.”<sup>19</sup>

The question is whether the surviving spouse has met the material participation requirements where (1) the deceased spouse had materially participated in the farming activity for five of the eight years preceding the deceased spouse’s retirement (or disability) and (2) the retired spouse was retired from the farming activity at the time of the death of the first spouse to die (by virtue of receiving social security retirement benefits) although the surviving spouse did not actively participate in the day-to-day operations or management of the farming activity in the years prior to or after the death of the first spouse to die.

The technical advice memorandum concludes that, for purposes of determining whether the surviving spouse materially participated in a farming activity for passive activity loss purposes,<sup>20</sup> the surviving spouse met the material participation requirements because of the fact that (1) the deceased spouse had materially participated in the farming activity for five or more of the eight years preceding the deceased spouse’s retirement and (2) the surviving spouse was retired from the farming activity at the time of the deceased spouse’s death.

### In conclusion

This confirms what many had thought would be the outcome at the surviving spouse’s death. The TAM provides useful authority for situations where issues of material participation arise in farming operations where the husband and wife are retired by virtue of receiving social security retirement benefits, especially where the problem is passive activity losses.

### Endnotes

<sup>1</sup> TAM 200911009, Nov. 24, 2008.

<sup>2</sup> I.R.C. § 2032A. See generally 5 Harl, *Agricultural Law* § 43.03[2][d][vi] (2009); Harl, *Agricultural Law Manual* § 5.03[2][d][iv] (2009).

<sup>3</sup> I.R.C. § 469(h)(3). See 4 Harl, *Agricultural Law* § 30.08[1][a] (2009); Harl, *Agricultural Law Manual* § 4.05[3][a] (2009).

<sup>4</sup> I.R.C. § 469(h)(1).

<sup>5</sup> TAM 200911009, Nov. 24, 2008.

<sup>6</sup> *Id.*

<sup>7</sup> See I.R.C. § 469(c)(1).

<sup>8</sup> Temp. Treas. Reg. § 1.469-5T(a)(1) through Temp. Treas. Reg. § 1.469-5T(a)(7).

<sup>9</sup> I.R.C. §§ 469(h)(3), 2032A(b)(5).

<sup>10</sup> I.R.C. §§ 469(h)(3), 2032A(b)(5).

<sup>11</sup> I.R.C. §§ 1402(a)(1), 2032A(e)(6).

<sup>12</sup> I.R.C. § 469(h)(1).

<sup>13</sup> Temp. Treas. Reg. § 1.469-5T(b)(2)(i).

<sup>14</sup> S. Rep. 99-313, 99th Cong., 2d Sess. 733-734 (1986).

<sup>15</sup> *Id.*

<sup>16</sup> I.R.C. § 2032A(b)(5)(A).

<sup>17</sup> I.R.C. § 469(h)(3).

<sup>18</sup> I.R.C. §§ 469(h)(3), 2032A(b)(4). See Temp. Treas. Reg. § 1.469-5T(h)(2).

<sup>19</sup> I.R.C. §§ 469(h)(3), 2032A(b)(5).

<sup>20</sup> I.R.C. § 469(h)(3).

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by Neil E. Harl

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