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Issue Contents

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IMPUTING ACTIVITIES FROM AGENT TO PROPERTY OWNER AS PRINCIPAL

— by Neil E. Harl*

In recent years, few issues have been more perplexing in farm estate and business planning than the circumstances under which activities of an agent, such as a farm manager, are imputed to the property owner as principal.[1] Enactment of 15-year installment payment of federal estate tax[2] and special use valuation in 1976[3] and the family owned business exclusion in 1997[4] (which was converted from an exclusion to a deduction in 1998)[5] have added to the urgency of the problem.

Actually, there are three rules on imputation of activities from an agent to a property owner[6]— (1) the general rule under which activities of an agent are imputed to the principal (property owner),[7] (2) the rule for situations routed through I.R.C. § 1402 in which imputation is blocked,[8] and (3) the passive loss rule under which the presence of a paid manager or agent destroys the principal's own record of involvement.[9]

History of the issue

The 1955 case of *Webster Corp. v. Commissioner*,[10] established the rule that activities of a farm manager are imputed to the property owner.

Some time before 1945, the family of C. Douglas Dillon acquired five farms in Iowa totaling 1,725.5 acres. The farms were located in Calhoun, Humboldt, Greene, Kossuth and Hamilton Counties. Dillon was a Wall Street investment banker and served as Secretary of the Treasury in the Kennedy Administration beginning in 1961. In 1945, the farms were conveyed to the Webster Corporation, formed under Delaware law.[11]

In less than five years, the corporation was subjected to an IRS audit. IRS was convinced the corporation had too much passive investment income—and thus had violated the personal holding company rules.[12]

The corporation defended on the grounds that the income was business income, not rents. Each of the five farms was under a crop share lease. Farmers National Company of Omaha was the manager under an agency agreement on each of the farms.

Although the Tax Court did not articulate it in so many words, to have a business generally requires that the operation bear the risks of production and the risks of price change (which is accomplished with a share lease) and someone be involved significantly in management. The court stated—

> "…where the owner…receives a percentage of the crop, takes an active part in the operation by reserving and exercising the right of detailed supervision and direction of the operation of the farm…the farmer appears to be in some category other than that of a tenant, and the money which [the landowner] received appears to be more in the nature of income from their own use of their own land than rent…."[13]

Thus, the corporation sidestepped the personal holding company tax. As a general rule, the activities of a farm manager are imputed to the landowner. Without the strong

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record of involvement by the farm manager, the Dillon family would likely have lost the case.

The Tax Court case, decided in 1955,[14] was appealed to the Second Circuit Court of Appeals and affirmed in a brief opinion in 1957.[15]

Losing social security benefits

In the early 1960s, the Internal Revenue Service and the Social Security Administration apparently concluded[16] that the *Webster Corp.* case should be applied more broadly including the area of liability for self-employment tax and loss of social security benefits from too much earned income. Farm managers were concerned because some of their clients under share leases were losing social security benefits—and paying self-employment (social security) tax—because of the high level of involvement by the farm manager.

The upshot was that a group of concerned farm managers expressed concerns to Washington in 1974, asking for relief. The Congress responded with an amendment to Section 1402 of the Internal Revenue Code. The 1974 amendment[17] added 15 words to the Internal Revenue Code section levying the tax on self-employment income. The new language barred imputation of activities of an agent, such as a farm manager, to a property owner. The amendment specified that material participation by an owner or tenant is to be determined "without regard to any activities of an agent of such owner or tenant…."[18] That entire passage, however, only applies to those producing "agricultural or horticultural commodities."[19] Thus, imputation of activities of a farm manager as agent to the landowner was barred—if the issue is routed through Section 1402. That solved a pressing problem for farm managers.

Interestingly, the language was added by the Senate Finance Committee to a bill, H.R. 8217, entitled "Vessels—Equipment and Repairs—Exemption from Duty." That touched off a lengthy, and at times acrimonious, debate in the House of Representatives on germaneness. But it passed on July 31, 1974, and was signed by President Nixon on August 7, 1974—two days before he resigned the presidency. In debate in the House it was conceded that the amendment was triggered by the *Webster* case—and that the Social Security Administration had followed the view "since 1961" that activities of an agent counted.

In explanation of the amendment, the House managers stated—

> EXCLUSION FROM SOCIAL SECURITY COVERAGE OF CERTAIN FARM RENTAL INCOME
>
> In 1956, Congress enacted legislation providing social security coverage for farm rental income of a landowner when the landowner materially participates in the production of the commodities raised on his land. Several years after this provision was enacted, there were court decisions which held that material participation by the landowner could be established through the actions of his agent, and the Social Security Administration has conformed with these court decisions since 1961.
>
> A problem has arisen in the case of landowners who enter into an agreement with a professional farm management company or other person who has the responsibility to choose a tenant and to manage and supervise the farm operation. In such a situation, the landowner often does not consider himself to be participating in the operation of the farm and views his income as investment income rather than income from farm self-employment.
>
> In order to correct this situation, the Senate added an amendment to the bill which would exclude from coverage under social security farm rental income received by a landowner under an agreement between the landowner and another person under which the other person is to manage and supervise the production of commodities on the land if there is no personal participation in the operation of the farm by the landowner.
>
> The amendment I have offered, while it differs technically from the Senate amendment, has the same general purpose and effect. It would restore the original intention of the provision covering farm rental income under the social security system in cases in which the landowner does not materially participate in the operation of the farm.
>
> I wish to emphasize that this amendment makes no change in the law with regard to the coverage under the social security system of farm rental income in situations where the landowner does materially participate in the production of commodities on his land, which of course includes lease arrangements which provide for such material participation as in the past. The amendment is limited to excluding farm rental income only in instances in which the landowner completely turns over the management of his land to an agent, such as a professional farm management company and does not materially participate in the farming operation himself on that land.[20]

The third rule, limited to passive losses, was enacted in 1986.[21] The statute made no specific reference to the matter of imputation but the temporary regulations contained a statement that—

> "An individual's services performed in the management of an activity shall not be taken into account in determining whether such individual is treated as materially participating in such activity for the taxable year…unless, for such taxable year—
>
> "(A) No person (other than such individual) who performs services in connection with the management of the activity receives compensation…in consideration for such services; and
>
> "(B) No individual performs services in connection with the management of the activity that exceed (by hours) the amount of such services performed by such individual."[22]

Consequences of the rules

The third rule is limited to passive losses and has no effect beyond that provision.

The second rule, barring imputation, applies to all situations which are routed through Section 1402 of the Internal Revenue Code. That includes (1) the line between rent and business income for purposes of self-employment tax,[23] (2) eligibility of land for special use valuation as to the material participation test[24] and (3) the material participation test for purposes of the family-owned business deduction.[25] Note that the second rule, barring imputation, does not apply for purposes of determining whether an asset is a passive asset and thus is not included in the calculations of value of a qualified family-owned business interest.[26] For that purpose, the general rule is applicable with imputation of activities of an agent to the principal.

Wherever there is no statutory or regulatory provision routing the question of involvement through Section 1402 of the Internal Revenue Code, the general rule applies.[27]

FOOTNOTES

1 See generally 5 Harl, *Agricultural Law* § 41.06 (1999).

2 Pub. L. 94-455, Sec. 2004(a), 90 Stat. 1520, 1862 (1976), enacting I.R.C. § 6166.

3 Tax Reform Act of 1976, Pub. L. 94-455, Sec. 2003(e), 90 Stat. 1520, 1856 (1976), adding I.R.C. § 2032A.

4 Pub. L. 105-34, Sec. 105(a), 111 Stat. 788, 847 (1997), enacting I.R.C. § 2033A. See Harl, "The Family-Owned Business Exclusion: In Need of Repairs," 76 *Tax Notes* 1219 (1997).

5 Pub. L. 105-206, Sec. 6007(b), 112 Stat. 685, 807 (1998).

6 See Harl, *supra* n. 1.

7 See, e.g., Ltr. Rul. 8133015, April 25, 1981 (installment payment of federal estate tax).

8 I.R.C. § 1402(a)(1) (rent as self-employment income).

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

10 25 T.C. 55 (1955), *acq*. 1960-2 C.B. 7, *aff'd*, 240 F.2d 164 (2d Cir. 1957).

11 *Id*.

12 I.R.C. §§ 541-547.

13 25 T.C. 55 (1955).

14 25 T.C. 55 (1955).

15 240 F.2d 164 (2d Cir. 1957).

16 See the 1960 acquiescence of IRS in the case of *Webster Corp. v. Comm'r*, 25 T.C. 55 (1955), *acq.*, 1960-2 C.B. 7.

17 Pub. L. 93-368, Sec. 10(b), 88 Stat. 420 (1974).

18 I.R.C. § 1402(a)(1).

19 *Id*.

20 Cong. Rec. 26082, July 31, 1974 (House).

21 Tax Reform Act of 1986, Pub. L. 99-514, Sec. 501(a), 100 Stat. 2233, 2237 (1986).

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

23 I.R.C. § 1402(a)(1).

24 See I.R.C. § 2032A(e)(6).

25 I.R.C. §§ 2057(b)(1)(D)(ii), 2057(f)(1)(A).

26 See I.R.C. §§ 2057(e)(1), 2057(e)(2), 543(a), 954(c)(1).

27 See 5 Harl, *supra* n. 1, § 41.06.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-*ALM* § 13.03.*

EXEMPTIONS

CAMPER. The debtor claimed a pop-up camper as an exempt household good under Me. Rev. Stat. § 422. The court applied a functional nexus test that required eligible household goods to contribute to the daily use, maintenance or upkeep of the debtor's household. Under that test, the court held that the camper did not qualify as an exempt household good. ***In re* Schreiber, 231 B.R. 17 (Bankr. D. Me. 1999)**.

EARNED INCOME CREDIT. The debtor claimed an exemption under La. Rev. Stat. § 46:111 for an income tax refund resulting from earned income tax credit. The state exemption included "all assistance" which was defined as "money payments under" the state public welfare and assistance programs. The court held that the EIC was not eligible for the exemption because the EIC was not a money payment under the state public welfare and assistance programs. ***In re* Collins, 170 F.3d 512 (5th Cir. 1999)**.

HOMESTEAD. The debtor filed for bankruptcy in California where the debtor had been residing for the greater portion of the pre-petition 180 days. The debtor claimed an exemption for a homestead located in Michigan under the California homestead exemption. The court held that the California exemption could apply to a residence located in another state because the intent of the state exemption was to provide a place for the debtor and family to reside. ***In re* Arrol, 170 F.3d 934 (9th Cir. 1999), *aff'g unrep. D. Ct. op. aff'g*, 207 B.R. 662 (Bankr. N.D. Calif. 1997)**.

CHAPTER 12-*ALM* § 13.03[8].*

DISMISSAL. The debtor filed for Chapter 12 hours before the commencement of an unlawful detainer action against the debtor and the debtor's mother. The debtor's mother's farm had been sold at foreclosure and the unlawful detainer action was filed to force the debtor and mother to vacate the property. The debtor had few assets, only a small amount of debt and no income. The plaintiff in the unlawful detainer action filed a motion to convert the case to Chapter 7 for fraud because the debtor was not a family farmer and failed to list assets on the schedules. The court held that the failure to list several assets was not sufficient evidence of fraudulent intent; however, the court dismissed the case for bad faith because the debtor's only reason for the bankruptcy filing was to block the unlawful detainer trial. The debtor was also required to pay the plaintiff's attorney fees associated with the bankruptcy case motions and the delay in the state action trial, and the debtor was enjoined from filing any bankruptcy petition for 180 days. ***In re* Massie, 231 B.R. 249 (Bankr. E.D. Va. 1999)**.

FEDERAL TAXATION-*ALM* § 13.03[7].*

TAX LIEN. The debtors had transferred their residence to their minor son in trust. However, no gift tax or trust returns were ever filed, the debtors claimed all deductions associated with the residence, the debtors paid all expenses associated with the residence, and the debtors claimed individual ownership of the residence on loan applications and tax returns. The court held that, although the trust was legitimate under state law because it was established well before any of the bankruptcy claims, including the tax claims, arose, the debtor's actions