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ELIGIBILITY OF LANDLORDS TO CLAIM EXPENSE METHOD DEPRECIATION

— by Neil E. Harl

With the increase in the expense method depreciation allowance from $10,000 to $17,500 per year (on a joint return) beginning in 1993, the issue of availability of expense method depreciation to landlords has taken on added importance.

Property eligible

For property placed in service after 1990, the touchstone of eligibility as to the nature and type of property has been whether the items are "Section 1245" property. Prior to that time the test had been whether items were "Section 38" property. The two tests are similar but are different in several significant respects. Under either test, expense method depreciation can be claimed for fences, tile lines, feeding floors, water wells, grain bins, silos, single purpose agricultural and horticultural structures and income-producing trees. Thus, a great deal of property acquired by landlords is potentially eligible for expense method depreciation.

"Active conduct" requirement

The major obstacle for landlords to claim expense method depreciation is that the property must be used "in the active conduct of in [sic] a trade or business." The determination of whether a trade or business is actively conducted by the taxpayer is to be made based on all of the facts and circumstances. In general, it requires that the taxpayer "meaningfully participates in the management or operations of the trade or business." As the regulations point out, "...the purpose of the active conduct requirement is to prevent a passive investor in a trade or business from deducting Section 179 expenses against taxable income derived from that trade or business."

The regulations also note that the term "trade or business" has the same meaning as the term has acquired under I.R.C. § 162 specifying what expenses are deductible as "ordinary and necessary expenses paid or incurred in carrying on any trade or business...." Property held for the production of income under I.R.C. § 212 does not qualify for expense method depreciation.

Noncorporate lessors

In addition, the statute specifies that noncorporate lessors are not eligible to claim expense method depreciation unless specified conditions are met. Some of those conditions may be difficult to meet for lessors of farmland.

- The first condition, that the property subject to the lease has been manufactured or produced by the taxpayer, is rarely a factor in eligibility.
- The second condition has two parts — (1) the term of the lease must be less than 50 percent of the class life of the property (which is generally not a problem) and (2) for the first 12 months after the property is transferred to the lessee, the sum of the business deductions with respect to the property which are allowable to the lessor (other than rents and reimbursed amounts) must exceed 15 percent of the rental income produced by the property.

The question is whether that last requirement was intended to apply to the rental of real estate. Certainly the statute does not draw distinctions. But it is exceedingly difficult to see how the rule is to be applied to a section of fence, a segment of tile or even a grain bin. In most instances, expense method depreciation property rented with the land does not produce "rental income." Moreover, in most share lease arrangements, for many of the items the benefits are received by both lessor and lessee (as with tile lines) or inure solely to the lessee (as with grain bins).

Except for the noncorporate lessor rule, crop share and livestock share landlords should be eligible in general for expense method depreciation. It is questionable whether cash rent landlords can meet the "active conduct" requirement.

It could be argued that share leases are not leases but are a "joint venture." Precisely that point is made in the temporary passive activity loss regulations. An example in those regulations (which have been roundly criticized) states that —

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). For purposes of paragraph (e)(3)(vii) of this section, the 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, under paragraph (e)(3)(ii)(F) of this section, the taxpayer is not engaged in a rental activity, without regard to whether the taxpayer performs any services in the farming activity.25

Trust as lessor

Another complication for land held in trust and rented to a tenant is the statutory provision that trusts cannot claim expense method depreciation.26 The question is whether a grantor trust is a trust for this purpose.27 Under the regulations, the income, deductions and credits in a grantor trust are treated as received or paid directly by the grantor.28 Therefore, it can be argued that, for revocable inter vivos trusts, the type of trust that has been growing most rapidly in popularity in recent years, is essentially disregarded and expense method depreciation could be claimed by the grantor. It could also be argued that if the title to the property is in the name of the trustee for the trust, the statutory prohibition on expense method depreciation applies. There appears to be no authority resolving the question although the argument is compelling that, in the case of grantor trusts, expense method depreciation should be claimable.

FOOTNOTES


3 I.R.C. § 179(d)(1), before amendment by Revenue Reconciliation Act of 1990, n. 2 supra.

4 For a discussion of the differences, see 4 Harl, n. 1 supra, § 29.05[2][2].

5 Rev. Rul. 69-89, 1966-1 C.B. 7. But see Ltr. Rul. 8646011, Aug. 13, 1986 (fences and paddocks used to corral horses not “other tangible property”); GCM 39571 (same). Presumably, the inclusion of horses as Section 1245 property should change that result (horses were not Section 38 property). See Ltr. Rul. 8330011, April 25, 1983 (horses are not “livestock”).


7 Id.


10 Id.


13 I.R.C. § 179(d)(1).


15 Id.

16 Id.


18 Id.

19 I.R.C. § 179(d)(5).


22 See I.R.C. § 162.


25 Id.

26 I.R.C. § 179(d)(4).

27 See Treas. Reg. § 1.671-2(c).

28 Id.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ADVERSE POSSESSION

HOSTILE POSSESSION. The dispute involved 17 acres of hilly wooded land under title to the plaintiff. The defendant entered the land knowing that the plaintiff had title to the land. The defendant erected "no trespassing" signs on the property, blazed and painted trees and constructed roads on the property. The defendant hunted, rode horses and drove vehicles on the property. The defendant hunted, rode horses and drove vehicles on the property. The court held that the defendant had not possessed the property under a claim of right because the defendant admitted that the defendant knew who owned the property when the defendant entered onto the property. Moore v. Dudley, 904 S.W.2d 496 (Mo. Ct. App. 1995).

ANIMALS

HORSES. The plaintiff’s decedent had purchased three steers from the defendants who were tenants on a farm owned by the other defendant. While the decedent was helping the defendants load the steers on to a truck, the decedent was fatally injured by the kick of a horse in the corral with the steers. The horse was a six month old colt which was recovering from injuries. The plaintiff alleged that the defendants had told others that the colt was frisky...