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Neil Harl
Iowa State University, harl@iastate.edu

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RECHARACTERIZATION OF INCOME: TREACHEROUS RULES

— by Neil E. Harl*

In 1986, Congress enacted the passive loss rules1 barring the deduction of passive trade or business losses to the extent deductions exceed income from all passive activities (exclusive of portfolio income) against other income.2 It was widely agreed that the limits on deductibility of passive losses would be met by attempts to generate passive income to absorb the passive losses. As a consequence, the Department of the Treasury used its rule making power3 to identify specific income areas which would produce non-passive income. What would otherwise be passive income is subject to recharacterization.4 About 10 major areas of recharacterization have been identified in regulations issued to date.5 This article examines the more significant areas of recharacterization for farm and ranch taxpayers.

Lease of farm when the farmer materially participates

A farmer or rancher who leases property to a trade or business in which the farmer materially participates may find rental income or gain recharacterized as nonpassive income.6 That provision has been invoked in a case of rentals to a taxpayer's C corporation,7 rental of a building to a personal service corporation in which the taxpayer materially participated in the lessee corporation,8 rentals received by a wife from her husband's corporation where the husband materially participated in corporate operations,9 and gains from the sale of passive activity property.10 This rule does not apply to income earned pursuant to a written contract entered into before February 19, 1988, when the regulations were first published.11 A taxpayer's activities include those conducted through a C corporation subject to I.R.C. § 469 (if five or fewer persons own more than 50 percent of the stock).12

Net income from rental of nondepreciable property

A second area of recharacterization of particular interest to farm and ranch taxpayers involves the net income of an activity where non-depreciable property is held "for use by customers" in a rental activity.13 Property is treated as non-depreciable if less than 30 percent of the property's unadjusted basis is subject to depreciation.14 This catches virtually all farmland rentals except for the most heavily improved tracts. Indeed, this income recharacterization rule has been imposed on cash rented farmland to transform the rentals into nonpassive income so that the income cannot be used to offset passive losses.

The income recharacterization rule has been applied to ground rents from the leasing of undeveloped property15 and to an aircraft leasing activity.16 The phrase "for

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* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
use by customers” has apparently not limited the application of the provision to a significant degree. The rental of land has satisfied that requirement.17

Self-developed rental property

Net rental income from self-developed rental property may be recharacterized as nonpassive income if the property is sold within 24 months after first being used as rental property and the taxpayer materially or significantly participated for any year in enhancing the property value.18

Sale of "substantially appreciated" property

Gains from the sale of "substantially appreciated" property used in a passive activity may be recharacterized as income from a nonpassive activity unless the property was used for either—(1) 20 percent of the period during which the taxpayer held an interest in the property or (2) the entire 24-month period ending on the date of the disposition.19 "Substantially appreciated" property is defined as property whose fair market value exceeds 120 percent of its adjusted income tax basis.20

"Significant participation" activities

The regulations recharacterize the net income from a "significant participation activity" (SPA) as not from a passive activity.21 A SPA is a trade or business in which the taxpayer participates for more than 100 hours in an activity during the taxable year but fails to reach the 500 hour level which is required for material participation.22 The rule is an aggregate concept for individuals who devote more than 500 hours spread over several activities and meet the 100 hour test for each separate activity.23 The idea is to treat individuals with several activities as favorably as someone who devotes an equivalent amount of time to a single activity.

If the taxpayer's aggregate SPAs do not constitute activities in which the taxpayer materially participates (the 500 hour test is not met), an amount of the taxpayer's gross income from each SPA equal to the taxpayer's net income from the SPA may be recharacterized as income from a nonpassive activity.24

In conclusion

Planning to assure deductibility of passive activity losses is a challenge. The income recharacterization rules have added another complicating dimension to the problem. Thus far, the courts have upheld the regulations and have generally supported the IRS interpretation of the rules.

FOOTNOTES

2 I.R.C. § 469(a)(1), (c). See Char-Lil Corp., T.C. Memo. 1998-457 (interest from sales contract was portfolio income).
3 I.R.C. § 469(l)(3).
4 Treas. Reg. § 1.469-2(f).
5 Id.
7 See Sidel v. Comm’r, T.C. Memo. 1999-301 (regulations valid with income recharacterized as non-passive income).
10 Ltr. Rul. 9406010, Nov. 9, 1993 (taxpayer materially participated in lessee corporation).
14 Id.
15 Wiseman v. Comm’r, T.C. Memo. 1995-203.
17 Wiseman v. Comm’r, T.C. Memo. 1995-203.
19 Treas. Reg. § 1.469-2(c)(2)(iii).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ADVERSE POSSESSION

PAYMENT OF TAXES. The parties’ properties were originally deeded erroneously by a previous owner such that both parties had title to an 11 acre parcel of land. The defendant’s title was created first in 1944, however, the plaintiff had paid the taxes on the disputed property from 1958 through 1994. The disputed property was unimproved and unfenced until 1996 when the defendant fenced in the disputed tract. The evidence also showed that the tax assessor had alerted the parties’ predecessor in interest about the title problem in 1980. Under Ark. Code § 18-11-102, the payment of taxes for seven consecutive years on