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Claiming § 179 Depreciation
On Leased Property

-by Neil E. Harl

In a Tax Court case, Thomann v. Commissioner, decided November 1, 2010, a farm landlord suffered the rejection of claimed deductions for expense method depreciation over a three-year period on the grounds of failure to meet the requirements for the “non-corporate lessor” rule. The tax deficiencies ($81,043) and penalties ($16,209) totaled $97,252 for amounts claimed on cash-rented land for the open years. Although the real estate in question was admittedly leased under a cash rent lease arrangement, which the court viewed as inconsistent with the terms of the “non-corporate lessor” rule, it appears likely that the deduction would also have failed on the grounds that cash rented assets generally fall short of being “. . . purchased for use in the active conduct of a trade or business” as is required for eligibility. The more significant issue is where the line is drawn between cash-rent leases and share rent leases for purposes of claiming expense method depreciation. Certainly the Thomann case has focused attention on that issue as well as meeting the requirements under the “non-corporate lessor” rule.

The facts of the case

The taxpayer in Thomann v. Commissioner owned 504 acres of farmland near Columbus Junction, Iowa. As the Tax Court put it, “around 2000” the taxpayer agreed orally to lease 124 acres of the farmland as well as various buildings, grain storage bins and equipment to a corporation engaged in a hog farrow-to-finish operation which was owned by the taxpayer, also, at a rental of $70,000 annually. Although the lease was oral, the minutes of the corporate tenant showed the rental amount but did not identify what property was involved in the rental.

The remaining 380 acres were later leased to an unrelated party under an oral lease that was not memorialized in writing until 2006 but even then the lease terms were not included in the written farming agreement.

The taxpayer, in 2004, claimed expense method depreciation on $52,000 for drainage tile and a fence and $10,000 for materials to remodel the farm office including furniture and fixtures. For 2005, the taxpayer claimed expense method depreciation totaling $63,488 for a grain bin. For 2006, the taxpayer claimed $8,467 for a pickup truck and $31,000 for a grain bin and dryer. The parties stipulated that the grain bins and dryer were leased to the corporate tenant owned by the taxpayer.

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On audit, the Internal Revenue Service disallowed the expense method depreciation deductions for the farm-related property.\textsuperscript{10}

**The Tax Court decision**

The Tax Court disallowed the deduction for remodeling the farm office on grounds of lack of substantiation as to which materials were expensed on the tax return.\textsuperscript{11}

The Tax Court noted that the lessor (the taxpayer) was a non-corporate lessor\textsuperscript{12} and observed that leased property can be expensed by meeting a two-prong test – (1) the term of the lease, taking into account options to renew, must be less than 50 percent of the class life of the leased property,\textsuperscript{13} and (2) the sum of the management or labor input.\textsuperscript{14} The Tax Court found both leases to be oral, cash-rent leases of indefinite duration and the taxpayer could not meet the first prong of the test – that the term of the lease must be less than 50 percent of the class life of the property.\textsuperscript{15} Had it been a one-year cash rent lease, the question is whether the property would have been eligible for the claimed depreciation. The Tax Court also could find no evidence that the pickup truck, the grain bins or grain dryer were leased to the tenant of that particular tract of land. Hence, the expense method depreciation claimed was not deductible for that reason as well.

**Eligibility of cash-rented assets for § 179 depreciation generally**

The Tax Court did not mention the fact that, ordinarily, cash-rented assets are not eligible for an expense method depreciation deduction because of not being “...purchased for use in the active conduct of a trade or business.”\textsuperscript{16} The regulations state that the determination of whether a trade or business is actively conducted by the taxpayer is based on all of the facts and circumstances.\textsuperscript{17} In general, the regulations state that it requires that the taxpayer “meaningfully participates” in the management or operations of the trade or business.\textsuperscript{18} Thus, a one-year cash rent lease of the property would likely not have been eligible for the deduction, even though it might have passed muster with the non-corporate lessor rule.

With the existence of a trade or business generally believed to require that the taxpayer – (1) bears the risks of production; (2) bears the risk of price change; and (3) contributes some management or labor both to the operation, it is generally believed that a share rent lease, either crop share or livestock share, should meet the test for claiming expense method depreciation inasmuch as a share rent lease automatically meets the first two tests. The question then is the amount and significance of the management or labor input.

However, in the context of the “non-corporate lessor” rule, it is not clear whether that rule targets only cash rent leases, non-material participation share rent leases, or even material participation share rent leases. It is doubted, however, that material participation share rent leases, at least, would fall within the “non-corporate lessor” rule. The line is not clear.

The Tax Court found within the “non-corporate lessor” rule sufficient grounds for disallowing the expense method depreciation deduction. It appears that the deduction could also have been disallowed under the “active conduct of a trade or business” requirement. There is no reason to believe that a taxpayer meeting the requirements of the “non-corporate lessor” rule is necessarily assured of deductibility.

**ENDNOTES**

1. T.C. Memo. 2010-241.
7. Id.
8. Id.
9. Id.
10. Id.
11. Id.
19. Id.

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