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Deductibility of Passive Activity Losses
Allowed for Landowner Renting to a Tenant

by Neil E. Harl

A 2015 Tax Court case, *Leland, Jr. v. Commissioner,* involved an Internal Revenue Service objection to the deductibility of losses alleged by IRS to be passive activity losses which, if upheld, would have denied deductibility. Litigated cases involving landlord and tenant where the issue is passive activity losses are relatively rare.

The key: material participation

An activity is considered a passive activity if it involves the conduct of a trade or business and the taxpayer does not materially participate in the activity or a rental activity.

A taxpayer is treated as materially participating in an activity only if the person “. . . is involved in the operations of the activity on a basis which is regular, continuous, and substantial.”

The court opinion noted that the landowner spent 359.9 hours in “farm-related activities” counting travel time in 2009 and 209.5 hours in 2010 in “farm-related activities.” However, in a footnote to the opinion, the court stated that IRS “. . . did not dispute petitioner’s inclusion of travel time in his reconstructed logs.”

The taxpayer was reportedly practicing law in Jackson, Mississippi and the farm was in Turkey, Texas, in the Texas Panhandle, some 750 miles from Jackson.

Assuming that the taxpayer was traveling by automobile, a 1500 mile round trip at an average of 75 miles per hour would require 20 hours which, assuming several trips during the year (the exact number was not cited), reduces the number of hours annually spent on-site. Certainly, the inclusion of travel time in “farm-related activities” is a significant factor in avoiding the passive activity rules. That is not to say, of course, that future courts would agree with that determination.

The governing regulations

The Temporary Regulations, issued by the Department of the Treasury, lay out seven tests for material participation

(1) under the first test, an individual is considered to be materially participating if the individual participates in the activity for more than 500 hours during the year; (2) the second test is for situations requiring less than 500 hours of involvement -- or less than 500 hours by any one individual during the year; (3) with the third test, an individual is considered to be materially participating if the individual puts in more than 100 hours per year into the activity and the individual’s participation is not less than that of any other individual (the test relied upon in the *Leland* case); (4)
Commentary

It seems rather unbelievable that a tenant on a 1,276 acre farm devoted only 29 to 30 hours on the farm during the year; although cotton production is different than corn and soybean production, this author, who with his wife own 1,000 acres, finds that figure bordering on the unbelievable.

In conclusion

As is frequently the case, the outcome in tax cases is heavily influenced by the facts. This case, highly favorable for the taxpayer, should not be viewed as indicative of the outcome in similar cases. However, it is viewed as “substantial authority” in all 50 states unless overturned on appeal.

ENDNOTES


2  I.R.C. § 469(c)(1).

3  I.R.C. § 469(h)(1).

4  Footnote 3 to Leland, Jr. v. Commissioner, T.C. Memo. 2015-240.


6  T.C. Memo. 2015-240.

So which test was used and what was the outcome?

The taxpayer in the Leland, Jr. v. Commissioner case chose the third test. The taxpayer introduced evidence (after the fact) showing that through the taxpayer’s records and testimony the taxpayer spent 359.9 hours in “farm-related activities” (which included travel time as noted above) in 2009 and 209.5 hours in 2010, again, for “farm-related activities.” The tenant on the farm gave testimony that, in total, the tenant worked 29 to 30 hours on the farm in 2009; the cotton crop was an apparent failure in 2010. Nonetheless, the Tax Court judge held that the taxpayer’s hours of involvement handily exceeded the tenant’s hours with the result that the taxpayer’s deductions attributable to the farm were not limited by the passive activity loss rules. The taxpayer was deemed to have met the third material participation test.

CASES, REGULATIONS AND STATUTES

BANKRUPTCY

FEDERAL TAX

DISCHARGE. The debtor filed for Chapter 7 and the IRS filed claims for unpaid taxes for four years. The evidence showed that the taxes resulted from the debtor’s withdrawal of income from three corporations owned by the taxpayer. The debtor had improperly characterized all the distributions as loans. The IRS began audits of the taxpayer’s tax returns for the four years. The IRS sought to have the taxes for the four years declared nondischargeable under Section 523(a)(1)(C) for attempts to evade payment of the taxes. The evidence showed that the debtor attempted to transfer assets to family members, to place proceeds from sales in cashier’s check, to transfer stock to family members without consideration, and transfer funds to family members without consideration. The court held that the taxes were nondischargeable for the debtor’s willful attempt to evade taxes by transferring assets and failing to pay the taxes while the debtor was still solvent. In re Stephens, 2016-1 U.S. Tax Cas. (CCH) ¶ 50,202 (Bankr. W.D. Ark. 2016).

FEDERAL FARM PROGRAMS

CONSERVATION STEWARDSHIP PROGRAM. The Natural Resources Conservation Service has adopted as final regulations amending the regulations for the Conservation Stewardship Program to incorporate changes in the CSP made by the 2014 Farm Bill. 81 Fed. Reg. 12573 (March 10, 2016).

COUNTRY OF ORIGIN LABELING. The AMS has adopted as final regulations which amend the Country of Origin Labeling (COOL) regulations to remove muscle cut beef and pork, and ground beef and pork from mandatory COOL requirements to conform with the Consolidated Appropriations Act, 2016, Pub. L. No. 114-113. 81 Fed. Reg. 10755 (March 2, 2016).

LIVESTOCK. In 2001, the AMS implemented the Livestock