# Imputation – When Can an Agent's Activity Count?

*Roger McEowen (roger.mceowen@washburn.edu) – Washburn University School of Law*
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**Overview**

The tax Code often requires a taxpayer to materially participate in a farm business activity as a pre-requisite to receiving a tax benefit. This is not an issue if the taxpayer is directly involved in the farming activity. However, many farming activities are conducted by a tenant. In those situations, can the landlord receive the tax benefit or benefits that might be available? The answer is that it "depends." What it depends upon is the particular Code section involved and whether the conduct of the tenant can be imputed to the landlord for tax purposes.

The issue of imputation and the tax Code – it's the topic of today's post.

**A Bit of History**

In *Hoffman v. Gardner, 369 F.2d 837 (8th Cir. 1966)*, the court acknowledged the role of an agent in meeting the material participation requirement. The plaintiff grew up on a farm in south-central Iowa. After graduating college in 1913, he got married in 1914 and took a teaching job in Iowa almost two hours from where he grew up. That same year he bought two farms in the Iowa county where he was from. Two years later he moved to the St. Louis area where he continued to teach school for the next 40 years. He and his brother-in-law managed the farms by keeping in touch with the tenants. The brother-in-law lived near the farms. He compensated his brother-in-law with a percentage of the farms' income. In 1957, a year after retiring from school teaching, the plaintiff entered into agreements with the tenants that gave him complete managerial control, subject only to the right of the tenants to make suggestions. The agreements specified that the plaintiff would pay for all grass seed, one-half of the corn seed, one-half of the baling expense and all of the fertilizer expense. The straw, threshed hay and stalks were to be fed to livestock on the farms. The plaintiff was not required to pay for the oats seed or the expense of threshing. The agreements further provided that he controlled the place and time of crop planting and crop cultivation and harvesting. He also retained decisionmaking control over the crops to be sprayed and how they were to be tended to. The plaintiff kept charts on his farms that detailed all types of crop and soil information, and he annually sent this information to the tenants along with information on fencing and terracing. He consulted periodically with his brother-in-law and the tenants by telephone and letter, and occasionally spent time on the farms with his daughter during which times he would inspect the crops and walk the fields and provide crop growing advice to his brother-in-law and the tenants. His brother-in-law inspected the farms several times monthly during the growing season and often served as a middleman between the tenants and the plaintiff in terms of conveying information about the farms.

Also in 1957, at the age of 71, the plaintiff applied for Social Security benefits based on his self-employment earnings by virtue of his management of the farms and the conduct of his brother-in-law and the tenants. In other words, the plaintiff claimed that he had been material participating in the operation of the farms that would entitle him to Social Security benefits. The local Social Security Office denied the claim as did the Hearing Examiner on appeal. The plaintiff's request for formal review was denied, and the federal trial court also ruled against the plaintiff. On further review, the U.S. Court of Appeals noted that the facts showed that the plaintiff was the one that made the key decisions involving the production activities on the farms. The evidence also

revealed that the plaintiff kept informed of issues that arose on the farms and educated himself by reading farm production literature and by seeking input from experts at agricultural colleges. He also made decisions to start new farming practices and establish longer term farming practices and techniques to improve the farms' profitability. The appellate court also noted that the plaintiff kept close track of any new production technique or crop that was tried on the farms.

Based on the evidence, the appellate court reversed the trial court and held that the plaintiff had materially participated in crop production and in the management of crop production on the farms. Importantly, the appellate court determined that the plaintiff qualified for Social Security benefits based on his own material participation in the farming activities *and* the activities of his brother-in-law as his agent. In other words, the brother-in-law's activities were imputed to the plaintiff for purposes of the material participation test.

**Statutory Modification**

In 1974, the Congress amended the material participation statute to provide that the activities of an agent were thereafter to be irrelevant in determining whether the material participation requirement has been met. Currently, I.R.C. §1402(a)(1) reads as follows:

**"(a)Net earnings from self-employment.** The term "net earnings from self-employment" means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member; except that in computing such gross income and deductions and such distributive share of partnership ordinary income or loss—

**(1)** there shall be excluded rentals from real estate and from personal property leased with the real estate (including such rentals paid in crop shares, and including payments under section 1233(a)(2) of the Food Security Act of 1985 (16 U.S.C. 3833(a)(2)) to individuals receiving benefits under section 202 or 223 of the Social Security Act) together with the deductions attributable thereto, unless such rentals are received in the course of a trade or business as a real estate dealer; except that the preceding provisions of this paragraph shall not apply to any income derived by the owner or tenant of land if (A) such income is derived under an arrangement, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities (including livestock, bees, poultry, and fur-bearing animals and wildlife) on such land, and that there shall be material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) in the production or the management of the production of such agricultural or horticultural commodities, and (B) there is material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) with respect to any such agricultural or horticultural commodity;…"

For purposes of imputation, the key is the parenthetical language contained in §1402(a)(1)(A) – "…there shall be material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant)." In addition, when read as a whole, the bar on imputation only applies when the production of agricultural or horticultural commodities is involved.

**Satisfying Material Participation**

For purposes of Social Security and "net earnings from self-employment" material participation must be achieved personally when agricultural or horticultural crop production is involved. How is that

accomplished? The IRS has offered three safe harbors and one catchall for determining whether the material participation test has been satisfied. *See Farmers Tax Guide, IRS Pub. 225, page 75 (2019).* The first test requires the landlord to satisfy any three of the following: (1) advance, pay, or stand good for at least half of the direct costs of producing the crop; (2) furnish half of the tools, equipment and livestock used in producing the crop; (3) advise and consult with the tenant periodically; or (4) inspect production activities periodically. The second test requires the landlord to regularly and frequently make, or take an important part in making, management decisions substantially contributing to the success of the enterprise. Under this test, it appears that decisions should be made throughout the year, such as when to plant, cultivate, dust, spray, or harvest; what items to buy, sell or rent; what records to keep; what reports to make; and what bills to pay and when. Establishing a lease arrangement at the beginning of the season probably will not be regarded as making management decisions. The third test requires the landlord to work 100 hours or more over a period of five weeks or more in activities connected with producing the crop. The fourth test requires the landlord to do things which, in total affect, show that the landlord is materially and significantly involved in the production of farm commodities. This fourth test is the catchall that a landlord can attempt to utilize if the landlord is not able to satisfy any of the first three tests. The litigated cases on the material participation issue have arisen primarily from this catchall provision.

**Other Code Provisions**

"Material participation" is required by other tax provisions which are not subject to the 1974 amendment. In other words, when the issue of material participation does not route through I.R.C. §1402, imputation is not blocked. For example, the qualified business income deduction of I.R.C. §199A does not bar the imputation of an agent's activity to the principal for purposes of the principal claiming the 20 percent deduction. There is also no specific statutory bar of imputing an agent's activity to the principal for purposes of the passive loss rules of I.R.C. §469 (although Committee Report language seems to indicate that there is a bar).

Whether the landlord materially participates in the tenant's farming business is irrelevant for farm income averaging purposes. *I.R.C. §1301*. Thus, non-materially participating landlords are eligible for income averaging if the landlord's share of a tenant's production is set in a written rental agreement before the tenant begins significant activities on the land. That places a premium on written leases.

There are other sections of the Code where the imputation issue also matters.

**The Type of Lease Matters**

If a landowner is in the business of farming, the landowner's expenses and income are reported on Schedule F where the net income is subject to self-employment tax. Income and expenses associated with a material participation crop share lease are reported on Schedule F. The rental income is subject to self-employment tax and the owner is able to deduct soil and water conservation expenses attributable to the real estate, as well as qualify for the exclusion of cost-sharing payments associated with the rented real estate. Similarly, the landlord could qualify for expense method depreciation under I.R.C. §179. In addition, CRP payments received by a materially participating landlord are subject to self-employment tax only if there is a nexus between the CRP land and the materially participating landlord's farming operation. The IRS continues to deliberately misstate this point in IRS Publication 225.

A landlord who is not materially participating under a crop share lease receives the income from the lease not subject to self-employment tax. While the landlord still qualifies for special treatment of soil and water conservation expenses and is eligible for exclusion of cost-sharing payments, and may, as noted below, be

eligible for expense method depreciation, the income is to be reported on IRS Form 4835 rather than the Schedule F.

Income under a cash rent lease is income from a passive rental arrangement and is not subject to self-employment tax. Cash rent landlords do not qualify for special treatment of soil and water conservation expenses but apparently qualify for the exclusion of cost sharing payments received from the USDA. At least that the conclusion to be drawn from an IRS Private Letter Ruling from 1990. *See, e.g., Priv. Ltr. Rul. 9014041 (Jan. 5, 1990).* In the ruling, there was no mention of the type of lease involved.

As for expense method depreciation, the landlord must be "meaningfully participating" in the management or operations of the trade or business, *(Treas. Reg. §1.179-2(c)(6)(ii))* and avoid the "noncorporate lessor" rules. *I.R.C. §179(d)(5).* Income from a cash rent lease is to be reported on the Schedule E -Supplemental Income and Loss.

**Conclusion**

Imputation is a key concept in several areas of farm income taxation. It's made trickier because sometimes it applies and sometimes it does not. It's all a matter of which Code section applies and how the material participation requirement is routed through the Code.