



F Extension FactSheet

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Tax Issues for Farm Rental Agreements

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Farmland rental arrangements are either fixed-cash rent, flexible-cash rent, or some variation of a crop-share lease. Income taxes and estate taxes are affected by these types of arrangements.

Farm Landlords

Owners of farmland may or may not be treated in the same way as farm operators in tax matters. There are three different forms that may be used to report farm rental income: Schedule F (Farm Income and Expenses), Form 4835 (Farm Rental Income and Expenses), or Schedule E. Which one(s) you should use depends on whether the landlord is “**materially participating**” in the farm operation – in other words, the extent to which the landlord is involved in the management and operation of the farm(s). A landlord receiving cash rent should file Schedule E. A share-rent landlord, who meets the tests for material participation, should file Schedule F. If the share-rent landlord is not materially participating, he or she should file Form 4835.

If you file Schedule F, you must pay **self-employment tax (SE)**. The decision on which form to file depends on the type of rental agreement and the material participation test. Self-employment tax is due on the net income from the production of agricultural or horticultural commodities on the land. However, rent received from real estate improvements, such as buildings or grain bins, are not subject to SE tax.

Several other tax provisions available to operating farmers may not be available to landlords who file Form 4835 or Schedule E. Check with a tax preparer before making major decisions, if possible tax savings could sway your decision. As a qualifying landlord, you might save using the Section 179 expensing election; using the current 25 percent deduction for soil and water conservation expenses; or meeting the criterion for passive activity, which would currently enable you to deduct up to \$25,000 in losses from certain rental activities.

For example, a materially participating landlord qualifies for both expensing (Section 179) and regular depreciation on field tile, while a non-materially participating landlord only qualifies for regular depreciation.

Another issue of concern for a landlord is whether income from shared rent is from an active trade, business, or passive activity. Is the landlord’s role so minor in the generation of income that it is passive? As a result, deductions would be denied to the extent they exceed income from all such passive activities. Credits from passive activities are limited to the tax allocable to such activities. A “passive investor” is someone who does not “materially participate” in a business. Taxpayers are considered to be materially participating if they are “involved in the operations of the activity on a regular, continuous and substantial basis.”

Tests for Material Participation

The classification of crop-share lease arrangements involves the determination of two completely different tests of material participation.

- **Test No. 1.** Material participation for purposes of the **self-employment tax**. This test determines whether the landlord reports the activity on Schedule F or on Form 4835.
- **Test No. 2.** Material participation for **passive activities**. This test determines whether the income or loss of an activity reported on Schedule F is active or passive.

Material Participation for SE Tax Purposes (TEST 1)

For purposes of I.R.C. §1402, a person materially participates if all three of the following conditions are satisfied.

1. There is an arrangement between the owner of the property and another person, that provides that the other person is to produce agricultural or horticultural commodities on that land.
2. There is an “arrangement” that there is to be material participation by the owner in the production or the management of the production of the commodities.
3. There is material participation.

You are materially participating if you have an arrangement with your tenant for your participation and you meet any one of the four following tests:

Test 1. You do any *three* of the following:

1. Advance, pay, or stand good for at least half the direct cost of producing the crop.
2. Furnish at least half the tools, equipment, and livestock used in producing the crop.
3. Consult with your tenant.
4. Inspect the production activities periodically.

Test 2. You regularly and frequently make, or take an important part in making, management decisions substantially contributing to or affecting the success of the enterprise.

Test 3. You work 100 hours or more spread over a period of five weeks or more in activities connected with crop production.

Test 4. You do things that, **considered in their total effect**, show that you are materially and significantly involved in the production of the farm commodities.

Material Participation Defined Under Passive Rules (Test 2)

A person is materially participating if the person is involved in the operations of the activity on a regular, continuous, and substantial basis. (This rule is applied by considering services provided both by the taxpayer and by the taxpayer's spouse, whether or not such taxpayer and spouse file a joint return.) A taxpayer who is not a limited partner (or who owns a general partner interest in addition to a limited partner interest) is a material participant in an activity during the tax year if he or she **meets any one of the tests listed here**.

Treas. Reg. §1.469-5T(a) sets out the following seven tests for meeting the material participation requirement.

1. The individual participates in the activity for more than 500 hours during the tax year.
2. The taxpayer's participation in the activity is substantially all the participation in the activity by all individuals.
3. The taxpayer participates in the activity for more than 100 hours during the tax year and participates for at least as many hours as any other individual.
4. The activity is a significant participation activity, and the taxpayer's participation in all significant participation activities during the year exceeds 500 hours.
5. A taxpayer who materially participated in an activity during five of the past 10 years (without regard to this test) is treated as materially participating in the current year.
6. A taxpayer who has materially participated in a personal service activity for at least three years will be treated as materially participating in that activity for the rest of the taxpayer's life.
7. A taxpayer who participates for more than 100 hours and, based on the facts and circumstances, participates on a regular, continuous, and substantial basis, is treated as materially participating.

Active Participation for Rental Real Estate. The material participation rules *do not* apply to a rental activity, because all rental activities are passive by definition. Even though passive losses are usually only deductible against passive income, there is an exception that allows up to \$25,000 of rental real estate losses to be deducted against non-passive income. To qualify for this loss allowance, the taxpayer must have active participation in the rental real estate activity.

What Is Active Participation? The difference between active participation and material participation is that the active participation test can be satisfied without regular, continuous, and substantial involvement in operations, so long as the taxpayer participates in the making of management decisions or arranging for others to provide services (such as repairs), in a significant and bona fide sense. Management decisions that are relevant in this context include approving new tenants, deciding on rental terms, approving capital or repair expenditures, and other similar decisions.

Note: An individual cannot be treated as actively participating if at any time during the applicable period his interest is less than 10 percent (by value) of all interests in the activity (interests of a husband and wife are combined for this purpose).



Cash vs. Crop-Share Lease – Tax Consequences

Table 1 summarizes many of the distinctions among cash leases, nonmaterial participation share leases, and material participation share leases. This table gives general conclusions only. Specific conditions may affect the answer to some of the issues.

Estate Planning

There are three tools used in estate planning, which refer to material participation. **Special Use Valuation** of farmland permits qualified real property to be valued for federal estate taxes at perhaps substantially less than fair market value, thereby reducing federal estate taxes. Also, the CAUV value of farmland can be used for Ohio estate purposes if the criteria are met. The **installment payment** plan allows for paying federal estate taxes over a 15-year period with a low

Table 1: Cash vs. Crop Share Leases – Tax Consequences

Item	Cash Lease	Non-M. Part. ¹ Share Lease	Mat. Part. ¹ Share Lease
Where income and expenses are reported	Schedule E	Form 4835	Schedule F
Is rental income subject to SE tax?	No	No	Yes
Are CRP payments received by owner subject to SE tax? ²	No	No	Yes
Is income treated as gross farm income for the I.R.C. §6654(1) exception to estimated tax penalty?	No	Yes	Yes
Does owner qualify for I.R.C. §175 treatment of soil and water conservation expenses?	No	Yes	Yes
Does owner qualify for I.R.C. §126 exclusion of cost sharing payments?	Yes	Yes	Yes
Do passive loss rules limit deductions?	Yes	Yes	Possibly
Does \$25,000 rental real estate exception apply?	Yes	Yes ³	N/A
Does owner qualify for I.R.C. §179 deduction?	No	Generally, Yes ⁴	Yes
Do donations of commodities trigger income?	N/A	Yes	No
Are commodities owned at death treated as income in respect of a decedent?	N/A	Yes	No

¹ The definition of material participation is different for different tax provisions. The following answers assume the definition of material participation for the tax rules at issue.

² The answers to this issue assume the owner has the same level of activity with respect to the CRP land as he or she has to the land that is leased.

³ In most cases, the share lease will be treated as a rental activity, and the \$25,000 rental real estate exception will apply. See the instructions for Form 4835. However, there may be some cases where the share lease is treated as a joint venture. In those cases, the \$25,000 rental real estate exception will not apply. See Temp. Reg. §1.469-IT9e(3)(viii), Example 8.

⁴ But the taxpayer should review noncorporate lessor rules under I.R.C. §179(d)(5).

Source: Harris, "Farm Tax Issues," 1998, *Tax Insight*, Madison, Wisconsin.

interest rate. There are different qualifying tests for Special Use and Installment payments, however. The third tool is the **Federal Family Owned Business Deduction**, which used in conjunction with the unified credit shelter exemption, may deduct \$1.3 million from the gross estate.

A landowner who qualifies for material participation under the federal special use valuation is considered as materially participating for passive activity rules. These use the Social Security tests referred to earlier but are based on any five of the eight previous years.

A surviving spouse who inherits qualified-real property also qualifies if he or she "actively participates" in the farm business.

Extended payment of federal and Ohio taxes is possible on the closely held business part of the estate. The business should qualify if rented under a share lease, which has material participation according to the Social Security rules.

For the Family Owned Business Deduction, there must have been material participation by the decedent, or a member of the decedent's family, for five or more years of the eight years prior to the decedent's death or if retired or disabled prior to the retirement or disability. Material participation is described in IRC Sections 2032A(e)(6) and 1402(a).

The changes made by the Economic Growth and Tax Relief Act of 2001 did not eliminate these two provisions so they are still currently available for planning purposes.

Effect of New Social Security Rules for Earned Income Over Age 65

The Senior Citizens' Freedom to Work Act of 2000 (Pub. Law No. 106-182) eliminates the earnings test for individuals who have reached the retirement age (currently age 65) under the Social Security rules. The new rule is effective for taxable years ending after December 31, 1999.

With the signing of the law repealing the Social Security earnings test, people age 65 through 69, who work, can receive all of their Social Security benefits, no matter how much they earn. Until this change, people age 65–69 who earned over the limit (\$17,000 in 2000) have had to give up \$1 in Social Security benefits for every \$3 they earned over that amount, from working. The new law abolishes the earnings test for people age 65–69, but the earnings test for people age 62–64 is still in effect. Therefore, people in this category (age 62–64) who earn above \$10,680 in 2001 (\$11,280 in 2002) still have to give up \$1 in benefits for every \$2 earned over this limit.

Retired workers will not receive any refund for prior years. If retired workers were age 65–69 and therefore eligible for Social Security, but did not apply for benefits due to earnings above the limit, they are eligible for benefits retroactive to the beginning of the year.

Highlights of Other Tax Issues

Cash Rent Paid to a Spouse. There have been several recent court cases on the issue of material participation and self-employment income. The issue is that if a spouse is not materially participating in the farm business, is receiving market or below market rate, and a written contract exists

limiting the spouse employment in the business, then self-employment taxes on the profit is not due. The case has been referred back to the trial court.

Land Rented to an Entity

Until 1995, the IRS did not challenge the common practice of treating rent from an entity (partnership, LLC, corporation) to an owner of the entity for farmland held outside the entity as not being subject to self-employment tax.

Example, Cliff Hanger is a partner in a farming partnership. His three sons are the other partners. Cliff owns farmland in his own name and rents that land to the partnership. Before 1995, the IRS did not require Cliff to pay self-employment tax on his rental income.

Beginning in 1995, the IRS has taken the position that rent received by a landowner for land rented to an entity and used in agricultural or horticultural production is subject to self-employment tax if:

1. There is an arrangement calling for the landowner's material participation.
2. The landowner materially participates in the farming business. (See Harris workbook for details.)

Conservation Reserve Payments. The U.S. Sixth Circuit Court of Appeals in Cincinnati has ruled that C.R.P. payments received by a materially-participating farmer are self-employment income. A retired farmland owner who is not materially participating is not subject to self-employment taxes on the income.

Summary

Since about half the farmland in Ohio is farmed by a non-owner, rental tax issues are a common area of tax management for both the owner and the lessee. Using professional services, as well as self-study by the rental participants, will help both parties make progress toward their management objectives.

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Additional Internet Resources

IRS Digital Daily
<http://www.irs.ustreas.gov>

Social Security On-line
<http://www.ssa.gov>

Ohio Department of Taxation Home Page
<http://state.oh.us/tax>

National Timber Tax Website
<http://timbertax.org>

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