RURAL TAX EDUCATION

RTE/2016-09

Revised September 2016 RuralTax.org

Materially Participate in the Business to Avoid the Passive Activity Loss Rules*

***JC Hobbs**, Assistant Extension Specialist*
Department of Agriculture Economics, Oklahoma State University

Introduction

Beginning farmers and ranchers frequently start their agricultural businesses by beginning small and keeping their day jobs. These new business activities must meet certain threshold tests to be considered active rather than passive activities. The passive activity loss rules apply to businesses including farms, limited partnerships, Limited Liability Companies (LLC's), S Corporations, and C Corporations.

A passive activity is any activity that involves the conduct of a business in which the producer does not materially participate or a rental activity (whether or not the producer materially participates or not). Should a loss occur in such a business, the passive activity loss rules limit a producer's ability to deduct losses when the producer does not materially participate or a business which is a rental activity unless the producer is a real estate professional. Losses generated from passive activities, as a general rule, can only offset income from passive activities.

Material participation most often applies to business activities, including farming or ranching. Material participation requires a producer to be involved in the operation of a trade or business activity on a regular, continuous, and substantial basis, thereby avoiding the passive activity loss rules. The level of involvement applies to the owner of the business or an owner of an interest in a partnership or an S Corporation.

Activities associated with material participation (especially for landlords) are those things that, considered in their totality, show that the producer was significantly involved in the production of farm commodities. Examples include but are not limited to:

- Paying at least half the direct production costs (operating expenses),
- Furnishing at least half the tools, equipment, and/or livestock,
- Advising the tenant, and/or
- Regularly and frequently making or taking part in management decisions.

* **In cooperation with the participating land-grant universities, this project is funded in part by USDA-Risk Management Agency under a cooperative agreement. The information reflects the views of the author(s) and not USDA-RMA. For a list of participating land-grant universities, see RuralTax.org.**

There are seven tests used by the Internal Revenue Service to determine whether or not a producer materially participates in a business activity. A producer who meets any one of these seven tests is deemed to be materially participating in the business activity.

Test 1. Participation Exceeds 500 Hours

The producer participates for more than 500 hours in the specific activity during the taxable year. If both spouses participate in the farm business, the participation of both spouses is counted, but the participation of children and employees is not counted.

Test 2. Sole Participant in the Activity for the Year

If the producer is the sole participant in an activity or performs substantially all of the services in the activity for the tax year, that person's participation is material. This test does not specify a number of hours, just that the producer does most of the work.

Test 3. More than 100 Hours and No One Else Spends More Time

A third test of material participation requires that the producer participate more than 100 hours and not less than any other individual involved in the activity. Participation by employees as well as owners must be considered.

Test 4. Significant Participation: Multiple Activities Combined

The requirements of the 500-hour test can be met by combining different and distinct activities in which the person participates for more than 100 hours each. These activities are known as *significant participation* activities, a term that has no legislative history but has materialized in the regulations. For each significant participation activity, the tax regulations require:

- the producer to participate more than 100 hours per year;
- the activity must be a business, not a rental or investment activity;
- the business must be a passive activity.

Several aspects of significant participation activities can lead to some strange results, so be sure to consult with your tax advisor.

The first four tests for material participation look for a set number of hours in the current tax year. The next two tests look at participation in previous tax years. The final test examines the facts and circumstances from a restrictive point of view.

Test 5. Material Participation for 5 of Last 10 Years

An individual who has materially participated (by tests 1 through 4) in an activity for 5 of the last 10 years will be considered a material participant in the current year. This test typically applies when the taxpayer retires from material participation but retains an ownership interest.

Example 1: Joe Williams is a partner in a swine production enterprise. He retired in 2013 after 40 years in the business. Since his retirement, his daughter has been the general manager, but Joe retains a 60% general partnership interest. He is treated as a material participant for 5 years after retirement. By 2020 he will no longer be a material participant, because he will have only participated in 4 of the last 10 years.

Test 6. Material Participation in Personal Service Activity for 3 Years

An individual who has materially participated in a personal service activity for at least 3 years will be treated as a material participant for the rest of his or her life. A personal service activity includes any trade or business in which capital is not a material income-producing factor or the fields of health, law, accounting, consulting, etc.

Example 2: James Johns is a retired veterinarian who retains a partnership interest in his former practice. He will always be treated as a material participant in the partnership and also subject to self-employment tax on the earnings.

Test 7. Facts and Circumstances

An individual who participates in an activity for more than 100 hours may be treated as a material participant if, based on all the facts and circumstances, he or she participates on a regular, continuous, and substantial basis. The regulations set out the following rules regarding the facts and circumstances test:

1. The fact that an individual satisfies a material participation test under **another section of the Code**, such as I.R.C. sec 1402 (self-employment) or I.R.C. sec 2032A (special-use valuation) **has no bearing** on the material participation test for passive activities.

2. Management activities of the producer are not counted if

   - anybody other than the taxpayer is compensated for management services; or
   - anybody provides more hours of management services than the taxpayer.

3. If the taxpayer participates for 100 or fewer hours, he or she cannot be treated as materially participating under the facts and circumstances test.

A log should be kept to substantiate the involvement in a business activity, recording the dates, hours spent, detailed description of the work or service performed by the husband or wife. This is important if both spouses have non-farm jobs and are getting started in farming. The following examples depict some situations that apply to beginning farmers and ranchers.

Example 3: Dan and Betty Young both have non-farm jobs and are interested in starting a farm business. Both will keep their existing employment and operate the business with the help of their children. Dan and Betty keep track of their participation in the business activities performed by each of them. At the end of the year, Dan has participated for 320 hours and Betty has participated for 200 hours. They meet test 1 since their combined number of hours (520 hours) exceeds 500. Thus, the activities' income and expenses are not considered passive.

Example 4: Fred Elder recently retired as a school teacher. He buys property and starts a vineyard growing table grapes. He does all the work of planting the grapes, putting in the trellises and irrigation lines, and maintaining the vineyard. Fred hired a company to drill the water well and put in the pump, and he hired a crop consultant to help him scout for insects and diseases for the grape production activity. Since Fred is the sole participant in the activity or performs substantially all of the services in the activity for the tax year, his participation is material and the income and expenses are not considered passive.

Frequently, a beginning farmer will rent land from a landowner due to financial constraints that prohibit the purchase of enough land for a viable farm or ranch. The rental arrangement can be either cash rent or crop-share rent. In either case, the beginning farmer or tenant is generally materially participating in the activity while the landlord, in the case of a cash rental agreement, is not materially participating. In a crop-share rental arrangement, the facts and circumstances of the rental agreement must be examined to determine whether the landlord is materially participating. Generally, in the case of either a cash or crop-share rental arrangement, the tenant is materially participating; however, the seven tests must be applied to determine whether the landlord is involved in a passive activity.

This information is provided to educate beginning farmers and ranchers as well as other taxpayers about the income tax consequences associated with passive activities. You are encouraged to contact your income tax preparer to discuss your unique facts and circumstances.

IRS Publications

To access IRS Publications go to www.irs.gov and click on “Forms and Publications.” Then click on “Publication number” under “Download forms and publications by.” Type the publication number in the find box to search for the publication. Publications may be viewed online by double clicking on the publication or downloaded.

IRS Publication 925: Passive Activity and At-Risk Rules. This publication specifically covers passive activities and income tax treatment of income and losses.

Additional Topics

This fact sheet was written as part of Rural Tax Education, a national effort including Cooperative Extension programs at participating land-grant universities to provide income tax education materials to farmers, ranchers, and other agricultural producers. For a list of universities involved, other fact sheets, and additional information related to agricultural income tax, please see RuralTax.org.

Fact sheets that might be of interest include:

- Farm Losses versus Hobby Losses: Farmers Must Plan Ahead to Avoid Adverse Tax Consequences
- How Do the At-Risk Rules Apply to a Farm Business?