

# Agricultural Taxation - Selected Issues

C. ALLEN BOCK\*  
PHILIP E. HARRIS\*\*  
JOHN DEERY-SCHMITT\*\*

## I. ALTERNATIVE MINIMUM TAX - DEFERRED PAYMENT GRAIN SALES - TAX TRAP

### A. Introduction

Cash-basis taxpayers must recognize income from the sale of property in the taxable year in which they actually or constructively receive payment for the property.<sup>1</sup> Treasury Regulation § 1.451-2(a) provides that taxpayers must declare "constructive income" in the taxable year that the income was set aside or was made available for the taxpayer, even though the taxpayer did not actually possess the income, unless the taxpayer's ability to recover the money was substantially limited.<sup>2</sup> The Internal Revenue Service (I.R.S.) has approved, in some circumstances, a farmer's practice of deferring recognition of income from sales of crops or livestock by entering into deferred payment contracts.<sup>3</sup> In addition, a farmer may be able to defer recognition of income for regular tax purposes, though not for purposes of alternative minimum taxes,<sup>4</sup> if the farmer enters into a

---

\* Professor of Agricultural Law, University of Illinois.

\*\* Associate Professor of Agricultural Economics and Law, University of Wisconsin-Madison.

\*\*\* Research Assistant, Agricultural Law, University of Illinois.

1. I.R.C. § 451(a) (1988); Treas. Reg. § 1.451-1(a) (as amended in 1978).

2. Treas. Reg. § 1.451-2(a) (as amended in 1979). The regulation states in part: Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

*Id.*

3. See, e.g., Rev. Rul. 58-162, 1958-1 C.B. 234. A deferred payment contract is "an agreement, usually in writing, between the farmer and the purchaser or processor of his crops to postpone payment from one taxable year into a later year." Fishman, *Revised Installment Provisions Breathe New Life into Farmers' Deferred-Payment Contracts*, 54 J. TAX'N 94, 94 (1981).

4. I.R.C. § 56(a)(6) (1988).

qualified installment sale.<sup>5</sup> The following two sections describe these practices and potential pitfalls.

### *B. Deferred-Payment Contracts*

If a cash-basis farmer or rancher enters into a written deferred-payment contract with the purchaser of crops or livestock that calls for payment at a certain time in the subsequent year and is also not assignable or usable as collateral for a loan,<sup>6</sup> the farmer may report the income in the subsequent year.<sup>7</sup> This deferred-payment contract delays the constructive receipt of the income until the year in which the taxpayer receives payment for the property.<sup>8</sup>

The contract must be a bona fide arm's length agreement and also must be entered into before the crop is delivered to the purchaser.<sup>9</sup> In Revenue Ruling 58-162, the farmer entered into deferred-payment contracts with a commercial grain elevator that provided the farmer would "receive payment for this grain on January -, 19 —."<sup>10</sup> The I.R.S. ruled that because the farmer's contract was an arm's length agreement and did not entitle the farmer to payment until a fixed date in the subsequent year, the contract did not constitute constructive income under Treasury Regulation § 1.451-2(a).<sup>11</sup> A written contract complying with the requirement of Revenue Ruling 58-162 delays constructive receipt for both regular tax and alternative minimum tax purposes.<sup>12</sup>

If the purchaser is the farmer's agent, the agent's receipt of income for the sale of the property will be equivalent to receipt by the farmer-principal.<sup>13</sup> For instance, in Revenue Ruling 79-379 the farmer sold cattle to a licensed dealer under a deferred-payment contract.<sup>14</sup> The contract provided that the dealer would pay the farmer the price equal to the amount the dealer received for resale at the auction.<sup>15</sup> The resale was conducted by another dealer, an affiliate of the first dealer, who deducted

---

5. See, e.g., *Applegate v. Commissioner*, 94 T.C. 696 (1990); see also I.R.C. § 453(a), (l)(2)(a) (1988).

6. I.R.C. § 453A(a)(2), (d) (1988).

7. *Id.* § 453(a), (c).

8. *Id.*

9. See *Reed v. Commissioner*, 723 F.2d 138, 143 (1st Cir. 1983); *Schniers v. Commissioner*, 69 T.C. 511, 516 n.2 (1977); Rev. Rul. 58-162, 1958-1 C.B. 234, 235.

10. Rev. Rul. 58-162, 1958-1 C.B. 234.

11. *Id.*; see also Rev. Rul. 73-210, 1973-1 C.B. 211 (application of doctrine of constructive receipt to deferred payment contracts with farmer cooperatives).

12. Rev. Rul. 58-162, 1958-1 C.B. 234.

13. Rev. Rul. 79-379, 1979-2 C.B. 204.

14. *Id.*

15. *Id.*

from the amount to be paid to the farmer the auction price of fees, expenses, and charges, and who bore the risk of loss while the cattle were at the stockyards awaiting auction.<sup>16</sup> The I.R.S. ruled that the dealer acted as the farmer's agent because the initial purchaser of the farmer's cattle gained nothing from the transaction except use of the money until it was paid to the farmer, bore no risk of loss, and was statutorily barred from sharing in the profits from the sale with its affiliated dealer.<sup>17</sup> The I.R.S. concluded that the dealer "acted as the agent of the taxpayer for the purpose of holding the proceeds of the auction sale for the [farmer] in order to defer receipt of the proceeds . . .,"<sup>18</sup> and thus, the dealer's receipt of the proceeds was equivalent to the farmer's receipt, barring deferment of the income to the farmer until the year the dealer paid the farmer.<sup>19</sup>

If the farmer's contract is assignable or transferable, however, the contract may have a cash equivalent taxable to the farmer in the year of the sale rather than in the year the income was actually received.<sup>20</sup> Likewise, if the farmer executes a price-later contract (P.L.C.) for the sale of crop shares, the special privilege granted to sharecrop landlords of deferring recognition of rental income<sup>21</sup> may not apply because the P.L.C. may constitute a sale.<sup>22</sup>

---

16. *Id.*

17. *Id.*

18. *Id.*

19. *Id. But cf. Crimmins v. United States*, 655 F.2d 135 (8th Cir. 1981) (deferred-payment contracts entered into by cattle ranchers with livestock marketing agency that unconditionally deferred the payment purchase price until the subsequent year was a bona fide agreement).

20. See Priv. Ltr. Rul. 80-01-001 (Sept. 4, 1979) (the absence of evidence that the contract was not assignable, the ability and willingness of the buyer to pay cash for the grain at the time of the sale, and the fact that the contract was acceptable as collateral for loans by lending institutions in the farmer's area all signified that the deferred-payment contract between farmer and buyer had a cash equivalent taxable in the year of sale and resulted in constructive income).

21. Treas. Reg. § 1.61-4(a) (as amended in 1972). This regulation provides an exception to the requirement of reporting gross income for crop shares. *Id.* The crop shares are includible in gross income in the year in which the crop shares "are reduced to money or the equivalent of money." *Id.* (emphasis added).

22. See Priv. Ltr. Rul. 87-26-007 (Mar. 23, 1987). In this ruling, the farmer collected rent from tenant farmers in the form of crop shares. *Id.* The farmer executed several P.L.C.s by exchanging warehouse receipts evidencing the farmer's ownership of stored grain with the commercial grain elevator for a contract that allowed the farmer to set the price during a 365-day pricing period. *Id.* The contracts did not bear interest nor contain any restrictions on transferability. *Id.* The I.R.S. ruled that the P.L.C.s constituted a sale of grain, even though the sale price was not included in the contract, and disallowed the farmer from coming within the special provisions of Treas. Reg. § 1.61-4. *Id.*

### C. *Installment Sales Contracts*

In the Installment Sales Revision Act of 1980,<sup>23</sup> Congress made several changes that allow cash-basis farmers to report on the installment basis. Thus, if the farmer contracts to sell property and be paid in the subsequent taxable year, and the constructive receipt doctrine does not allow the farmer to recognize the income in a subsequent year, the contract may still be a qualified installment sale.<sup>24</sup> However, for alternative minimum tax purposes, the installment sales contract will still be taxable in the year of sale.<sup>25</sup> This obligation is tempered by section 53's provision for a regular tax credit usable in a subsequent year.<sup>26</sup>

The importance of the installment sales provisions is illustrated in *Applegate v. Commissioner*.<sup>27</sup> In *Applegate*, the taxpayer delivered his grain to the elevator and entered into a P.L.C.<sup>28</sup> The I.R.S. contended that the taxpayer, being able to price the grain and receive the proceeds at any time, constructively received the income.<sup>29</sup> The taxpayer argued that the installment sale provisions applied and that the income was properly reported in the year it was priced.<sup>30</sup> The tax court determined that the contracts the taxpayer held were not "evidences of indebtedness payable on demand,"<sup>31</sup> were not readily marketable, and therefore the sale qualified as an installment sale.<sup>32</sup> The proceeds were reportable as income for regular tax purposes in the year the price was determined.<sup>33</sup>

Thus, the installment sales provisions of I.R.C. § 453 and the constructive receipt doctrine provide effective means of deferring recognition of income; however, the taxpayer must not have the ability to transfer or assign the contract, and the requirements for an installment sales contract under section 453 must be met.

---

23. See generally I.R.C. § 453 (1988).

24. *Id.* § 453(a), (1)(2)(a). Section 453 allows income from an installment sale to be recognized under the installment method. *Id.* § 453(a). "Installment sale" is defined as "a disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs" but does not include "dealer dispositions." *Id.* § 453(b)(1), (1)(2)(A). "Dealer dispositions" are expressly defined to exclude "[t]he disposition . . . of any property used or produced in the trade or business of farming . . . ." *Id.* § 453(1)(2)(a).

25. I.R.C. § 56(a)(6) (1988).

26. *Id.* § 53 (the credit arises from a prior year minimum tax liability).

27. 94 T.C. 696 (1990).

28. *Id.* at 700-03.

29. *Id.* at 704.

30. *Id.*

31. *Id.*

32. *Id.*

33. *Id.*

## II. DEPRECIATION UNDER SECTION 168

### A. *Changes Affecting Agriculture Under Section 168*

Under the accelerated cost recovery system provided for in section 168,<sup>34</sup> the depreciation deduction for trees or vines bearing fruit or nuts will be calculated using the straight-line method over a ten-year recovery period.<sup>35</sup> This method is applicable for property placed in service after December 31, 1988.<sup>36</sup> In addition, single-purpose agricultural structures are assigned a recovery period of ten years if placed in service after 1988.<sup>37</sup>

For property placed in service beginning in 1987, taxpayers may elect for regular tax purposes the depreciation rules that apply for alternative minimum tax purposes.<sup>38</sup> For taxable years beginning after March 31, 1988, property purchased and sold in the same tax year is not considered for purposes of calculating the 40% midquarter convention.<sup>39</sup> For property that is used in the trade or business of farming, the applicable depreciation method is the 150% declining-balance method, switching to the straight-line method at the appropriate time to maximize the depreciation allowance.<sup>40</sup> This is a limitation on the modified accelerated cost recovery system (MACRS) method available to other types of businesses. Depreciation Guides 1, 2, 3, and 4 are included in the appendix to assist the practitioner in sorting through the MACRS depreciation system maze.

### B. *Expensing Election Under Section 179*

The taxable income limitation provides that the amount eligible to be expensed is limited to the taxable income derived from the active conduct of all trades or businesses.<sup>41</sup> Several examples help illustrate this limitation. Suppose Jayne Brennan has two separate businesses. In business number one, she has a taxable loss of \$10,000. In 1990, she placed in service in that business a \$6,000 machine qualifying for section 179 expensing. In business number two, she has taxable income of \$19,000. Jayne can combine the taxable income from the two businesses, \$9,000 net income, and expense the \$6,000 machine purchased for use in business number one.

---

34. I.R.C. § 168 (West Supp. 1990).

35. *Id.* § 168(b)(3)(E), (e)(3)(D)(ii).

36. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 6029(d), 102 Stat. 3694 (1988).

37. I.R.C. § 168(e)(3)(D)(i) (West Supp. 1990).

38. *Id.* § 168(b)(2) (150% declining balance over the class life).

39. *Id.* § 168(d)(3)(B)(ii).

40. *Id.* § 168(b)(2)(B).

41. *Id.* § 179(b)(3)(A) (1988); Prop. Treas. Reg. § 1.179-2, 56 Fed. Reg. 12,873 (1991).

Alternatively, suppose that Jayne Brennan has two separate businesses. In business number one, she has a taxable income of \$10,000. In 1990, she placed in service in that business a \$6,000 machine qualifying for section 179 expensing. In business number two, she has a \$9,000 taxable loss. Jayne must combine the taxable incomes from the two businesses. The combined amount is \$1,000 of taxable income which is the total amount she can deduct under section 179 for 1990.

*C. What Is an "Active" Trade or Business Under Section 179?*

The 1986 Tax Reform Act inserted the word "active" as a further definition of trade or business for purposes of a section 179 deduction.<sup>42</sup> Proposed amendments to Treasury Regulation § 1.179 provide some guidance as to the meaning of the word "active."<sup>43</sup> Generally, the term "trade or business" is defined the same as in section 162.<sup>44</sup> In determining whether there is an active trade or business, a facts and circumstances test will be applied.<sup>45</sup> An important purpose of the "active" requirement is to prevent a passive investor in a trade or business from deducting section 179 expenses against taxable income from that business.<sup>46</sup> The proposed amendments provide that a taxpayer is actively involved in a trade or business if the taxpayer meaningfully participates in the management or operations of the trade or business.<sup>47</sup> The proposed amendments provide only one example to illustrate the interpretation of active participation.<sup>48</sup> The following ex-

---

42. I.R.C. § 179(b)(3)(A).

43. *Id.*; Prop. Treas. Reg. § 1.179-2.

44. Prop. Treas. Reg. § 1.179-2(c)(5)(i).

45. *Id.* § 1.179-2(c)(5)(ii).

46. *Id.*

47. *Id.*

48. *Id.* § 1.179-2(c)(5)(iii).

(iii) Example. The provisions of paragraph (c)(5)(ii) of this section are illustrated by the following example.

Example. A owns a salon as a sole proprietorship and employs B to operate it. A periodically meets with B to review developments relating to the business. A also approves the salon's annual budget that is prepared by B. B performs all the necessary operating functions, including hiring beauticians, acquiring the necessary beauty supplies, and writing the checks to pay all bills and the beauticians' salaries. In 1991, B purchased, as provided for in the salon's annual budget, equipment costing \$9,500 for use in the active conduct of the salon. There were no other purchases of section 179 property during 1991. A's net income from the salon, before any section 179 deduction, totaled \$8,000. A also is a partner in PRS, a calendar-year partnership, which owns a grocery store. C, a partner in PRS, runs the grocery store for the partnership, making all the management and operating decisions. PRS did not purchase any section 179 property during 1991. A's allocable share of partnership net income was \$6,000. Based on the facts and circumstances, A meaningfully participates in

cerpts from a memorandum to the I.R.S. central regional counsel provide some insight into the I.R.S.'s interpretation prior to the proposed amendments, and also appear to have been used as an interpretative document in drafting the proposed amendments.

The application of section 179(b)(3)(A) involves a two-step analysis. First, the taxpayer must have taxable income from "trade or business." "Trade or business" has the same meaning for purposes of section 179 that it has for purposes of section 162. Second, the taxpayer must be engaged in the "active conduct" of the trade or business. The crucial issue is what constitutes "active conduct" of a trade or business by the taxpayer for purposes of determining which income and loss are computed in the "aggregate amount of taxable income."

The "active conduct" phrases in section 179 were added by the Tax Reform act of 1986. Congress did not specify a test for "active conduct" of a trade or business. We believe, therefore, that the proper approach to determine whether a taxpayer's activities rise to the level of active conduct of a trade or business is to apply a facts and circumstances test which includes the factors enunciated in *Groetzinger v. Commissioner*, \_\_\_ U.S. \_\_\_ 107 S.Ct. 980 (1987), *aff'g* 771 F.2d 269 (7th Cir. 1985), *aff'g* 82 T.C. 793 (1984) (taxpayer must be involved in the activity with CONTINUITY AND REGULARITY, and the primary purpose must be for INCOME OR PROFIT). Although there is nothing in the legislative history that expressly ties section 179 to section 469, for the sake of brevity we believe that the temporary regulations under section 469 suggest some additional factors which might be relevant in fashioning a facts and circumstances test under section 179. *See, e.g.*, Temp. Reg. § 1.469-5T(a). We emphasize, however, that the factors utilized in the temporary regulations under section 469 are nonexclusive, and other factors may be relevant.

Because there is no direct correlation between the material participation test under section 469 and any other participation test under another Code section, *see* Temp. Reg. § 1.469-5T(b)(2), it is conceivable that a taxpayer's income or loss from an unrelated trade or business would be includible in the "aggregate amount of taxable income" for purposes of section 179(b)(3)(A) even though

---

the management of the salon. However, A does not meaningfully participate in the management or operations of the trade or business of PRS. Under section 179(b)(3)(A) and this paragraph (c), A's aggregate taxable income derived from the active conduct by A of any trade or business is \$8,000, the net income from the salon.

such income or loss would constitute income or loss from a passive activity for purposes of section 469. For example, assume a taxpayer has businesses *C* and *D*, with taxable incomes of \$5,000 each. The taxpayer is involved in the operations of both businesses with continuity and regularity, and he looks to both businesses as sources of income or profit. Under a facts and circumstances analysis it is concluded that the taxpayer is engaged in the active conduct of each. Business *C* is in the business of property rentals; its income is reported by the taxpayer on Schedule E. The taxpayer purchases section 179 property for use in business *D* (a Schedule C business) at a cost of \$10,000. Although for purposes of section 469 income and loss from rental activities are strictly "passive" regardless of the taxpayer's material participation in the activity, we believe that the \$5,000 income from business *C* should enter into the calculation under section 179(b)(3)(A) because the taxpayer meets the "active conduct" requirement of that section.

Likewise, it is possible that income from a trade or business would be "active" income for purposes of section 469, but would be disregarded in the section 179(b)(3)(A) computation because, it is concluded after an examination of the relevant [sic] facts and circumstances that the taxpayer is not sufficiently involved in an income-seeking activity to be considered engaged in the active conduct of a trade or business. For example, under the temporary regulations under section 469, payments made to a retired partner constitute "active" income for purposes of section 469. *See, e.g.*, Temp. Reg. § 1.469-2T(c)(4). A retired partner who no longer regularly, continuously and substantially participates in the firm's operations would not be considered as engaged in the "active conduct" of a trade or business for purposes of section 179. Take the example above, but assume that the taxpayer is retired from business *C*, a law firm, and receives \$5,000 from the firm in the form of taxable distributions under a pension, profit-sharing or other retirement plan. Under these facts, only the \$5,000 income from business *D* is includible in the section 179(b)(3)(A) calculation, and the income from business *C* is disregarded.

Utilizing such a facts and circumstances approach, we believe that Schedule C and Schedule F income will generally be includible in the computation under section 179(b)(3)(A); the taxpayer who is a sole proprietor or a farmer is generally active in the conduct of his business or farm. As discussed more fully in part B below, wage and salary income is includible in the computation. The taxpayer who reports rental income on Schedule E may or may not be engaged in the active conduct of a trade or business, depending upon whether he actively participates in the management

of the rental property. Income received through a pass-through entity such as a partnership or subchapter S corporation likewise may or may not be includible, depending upon the taxpayer's degree of participation in the trade or business of the partnership or subchapter S corporation . . . .<sup>49</sup>

An employee's wage income is income from an active trade or business. The proposed amendments to the regulations under section 179 indicate that an employee is engaged in a trade or business.<sup>50</sup> Therefore, the wage income qualifies as taxable income from a trade or business and could be combined, for example, with a net loss from a Schedule C or Schedule F business so that the aggregate taxable income is positive, permitting a section 179 deduction for an asset acquired in the Schedule C or Schedule F business.<sup>51</sup>

### III. NEW LIMITATIONS ON LIKE-KIND EXCHANGES BETWEEN RELATED PERSONS

Generally, when related persons<sup>52</sup> exchange like-kind property, no gain

---

49. Memorandum from Director, Tax Litigation Division to Regional Counsel, Central Region (Sept. 14, 1988).

50. Proposed Amendments to Treas. Reg. § 1.179-2(c)(5)(iv).

51. *Id.*

52. I.R.C. § 1031(f)(3) (1988). This section provides that a "related person" is defined by section 267(b). Section 267(b) defines "related person[s]" as:

- (1) Members of a family, as defined in subsection [267] (c)(4);
- (2) An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;
- (3) Two corporations which are members of the same controlled group (as defined in subsection [267] (f));
- (4) A grantor and a fiduciary of any trust;
- (5) A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;
- (6) A fiduciary of a trust and a beneficiary of such trust;
- (7) A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;
- (8) A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;
- (9) A person and an organization to which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual;
- (10) A corporation and a partnership if the same persons own—
  - (A) more than 50 percent in value of the outstanding stock of the

or loss is included as income.<sup>53</sup> Under Section 1031(f)(1)(C), however, if either person disposes of the property within two years after the date of the last transfer that was a part of the exchange, the exchange is disqualified from nonrecognition treatment.<sup>54</sup> If a disposition occurs within two years of the original disposition, the gain or loss must be recognized from the date of disposition of the property.<sup>55</sup> The tax event, however, occurs in the year of the disqualifying disposition, not the year of the original exchange.<sup>56</sup>

Several statutory exceptions to the new rules exist. The new rules generally do not apply to dispositions due to the death of either related person,<sup>57</sup> involuntary conversions,<sup>58</sup> or exchanges or dispositions for which the main purpose is not the avoidance of federal income tax.<sup>59</sup> The senate committee explanation states that the "non-tax avoidance exception generally will apply to: (i) transactions involving an exchange of undivided interests. . . ; (ii) dispositions of property in nonrecognition transactions; and (iii) transactions that do not involve the shifting of basis between properties."<sup>60</sup>

#### IV. NEW LIMITATIONS ON DEDUCTIONS FOR TERM INTERESTS IN PROPERTY HELD BY RELATED PERSONS

Section 167(r) closes a potentially abusive tax-planning loophole in which related parties acquired property and divided the interest to provide one or the other related parties an interest, the cost of which could be amortized and deducted. Section 167(r) prohibits any depreciation or am-

corporation, and

- (B) more than 50 percent of the capital interest, or the profits interest, in the partnership;
- (11) An S corporation and another S corporation, if the same persons own more than 50 percent in value of the outstanding stock of each corporation; or
- (12) An S corporation and a C corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation.

*Id.* § 267(b).

Section 267(c)(4) defines family as "includ[ing] only [the taxpayer's] brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants . . . ." *Id.* § 267(c)(4).

53. I.R.C. § 1031(f)(1)(A), (f)(1)(B) (West Supp. 1990).

54. *Id.* § 1031(f)(1)(C).

55. *Id.*

56. *Id.*

57. *Id.* § 1031(f)(2)(A).

58. *Id.* § 1031(f)(2)(B) (applies on disposition pursuant to a compulsory or involuntary conversion as defined under § 1033, as long as the original exchange occurred prior to the threat or imminence of the conversion).

59. *Id.* § 1301(f)(2)(C).

60. Revenue Reconciliation Act of 1989 (CCH) ¶ 10,500.

ortization deduction for a term interest in property for any period during which the remainder interest in such property is held (directly or indirectly) by a related person.<sup>61</sup> A few definitions of the terms used in section 167(r) illustrate the prohibition.

A “‘term interest’ in property means a life interest in property, an interest in property for a term of years, or an income interest in a trust.”<sup>62</sup> A “‘related person’” is broadly defined under section 267(b) and (e) but does not include in-laws.<sup>63</sup> Thus, under section 167(r), the taxpayer’s basis in a term interest will be reduced by the deductions disallowed by the provision, and the remainderman’s basis in the remainder will be increased by the amount of those disallowed deductions.<sup>64</sup> This new provision applies to interests created or acquired after July 27, 1989.

#### V. INCOME TAX WITHHOLDING ON THE WAGES OF CERTAIN AGRICULTURAL WORKERS NOW REQUIRED

If an agricultural worker’s cash wages are subject to Federal Insurance Contributions Act (FICA) withholding, the agricultural worker’s cash wages are also now subject to income tax withholding.<sup>65</sup> An agricultural worker’s cash wages are subject to FICA withholding in several situations. First, if the agricultural worker earns \$150 or more, the employer now must withhold for both FICA and income tax purposes.<sup>66</sup> Second, if the employer pays \$2,500 or more in total wages for one year, FICA and income tax withholding are required for all employees, even those who are paid less than \$150.<sup>67</sup> However, if the total wages paid by a hand harvest agricultural employer in a single year are less than \$2,500, those employees receiving less than \$150 are not subject to FICA withholding.<sup>68</sup>

The “‘hand harvest laborer’” exception applies in any situation.<sup>69</sup> The exception provides that “‘wages’” do not include amounts paid if the employee is “‘a hand harvest laborer and is paid on a piece rate basis . . . ,<sup>70</sup> commutes daily from his permanent residence to the farm . . . ,<sup>71</sup> and has been employed in agriculture less than 13 weeks during the preceding

---

61. I.R.C. § 167(r) (West Supp. 1990).

62. *Id.* § 1001(e)(2) (1988).

63. *See supra* note 52 (listing definition of “‘related persons’” under I.R.C. § 267(b) (1988)); *see also* I.R.C. § 267(e) (1988).

64. I.R.C. § 167(r)(3)(B) (West Supp. 1990).

65. *Id.* § 3401(a)(2) (1988).

66. *Id.* § 3121(a)(8)(B)(i).

67. *Id.* § 3121(a)(8)(B)(ii).

68. *Id.*

69. *Id.*

70. *Id.* § 3121(a)(8)(B)(I).

71. *Id.* § 3121(a)(8)(B)(II).

calendar year."<sup>72</sup> However, the total paid for this labor does count toward the \$2,500 threshold test.<sup>73</sup>

Since January 1, 1988, cash wages paid to a spouse are subject to FICA tax.<sup>74</sup> Prior to that date, the wages were not FICA wages.<sup>75</sup> Since January 1, 1988, cash wages paid by a mother or father to a child under 18 years of age also are not covered FICA wages.<sup>76</sup> Prior to that date, wages paid by a mother or father to a child under 21 years of age were not covered FICA wages.<sup>77</sup> Finally, qualifying noncash wages (payments in kind) are not FICA wages.<sup>78</sup>

## VI. SELF-EMPLOYMENT TAX CALCULATION FOR 1990

The basic self-employment tax rate and sum of the employee's and employer's share of the FICA tax is 15.30% for 1990.<sup>79</sup> However, beginning in 1990, a self-employed person can deduct one-half of the self-employment tax when calculating self-employment income.<sup>80</sup> Therefore, the effective self-employment rate is  $15.30\% \times (1.00 - .0765) = 14.13\%$ . Furthermore, one-half of the self-employment tax and the employer's share of the FICA tax are an income tax deduction and therefore reduce income taxes by an amount that varies with the taxpayer's marginal income tax rate. Finally, the wage base for 1990 is \$51,300.<sup>81</sup>

## VII. SHARE LEASES AND PASSIVE LOSSES UNDER I.R.C. § 469

Regulations issued under I.R.C. § 469 include an example that describes a crop share arrangement between a landowner and tenant, and concludes that the landowner is treated as being a part of a joint venture for purposes

72. *Id.* § 3121(a)(8)(B)(III).

73. *Id.*

74. *Id.* § 3121(a).

75. *Id.* § 3121(b)(3) (1982).

76. *Id.* § 3121(b)(3)(A) (1988).

77. *Id.* § 3121(b)(3)(A) (1982).

78. *Id.* § 3121(a)(8)(A) (1988).

79. *Id.* § 1401(a), (b).

80. *See id.* § 1402(a)(12). The section provides in part:

[I]n lieu of the deduction provided by section 164(f) (relating to deduction for one-half of self-employment taxes), there shall be allowed a deduction to the product of—

(A) the taxpayer's net earnings from self-employment for the taxable year (determined without regard to this paragraph), and

(B) one-half of the sum of the rates imposed by subsections (a) and (b) of section 1401 for such year.

*Id.*

81. *Id.* § 1402(b).

of the passive loss rules.<sup>82</sup> That conclusion has two important implications. First, by treating the property as being used in a joint venture, the property does not qualify for the rule that allows \$25,000 of losses from rental real estate to be deducted against nonpassive income.<sup>83</sup> Second, the landowner's use of the property will be treated as a nonpassive activity or passive activity based upon whether the landowner materially participates in the farm business that uses the property.<sup>84</sup> By contrast, if the property is treated as rental real estate, material participation is irrelevant because rental real estate is irretrievably treated as a passive activity.<sup>85</sup> However, if the landowner *actively* participates in the use of the property and meets the other requirements of I.R.C. § 469(i), up to \$25,000 of losses from the property can be used to offset nonpassive income.<sup>86</sup>

Based on Example 8, the authors of this Article concluded that share leases would not be treated as rental real estate by the Internal Revenue Service.<sup>87</sup> Consequently, material participation would be an issue, and losses from a share lease would not qualify for the \$25,000 rental real estate exception. That conclusion is apparently inconsistent with the following statement from the instructions for Form 4835: "If you **ACTIVELY PARTICIPATED** in the operation of this activity and you show a loss on line 33c, you may be able to deduct up to \$25,000 of losses from all rental

---

82. Temp. Treas. Reg. § 1.469-1T(e)(3)(viii) (1990) (Example 8) [hereinafter Example 8].

The taxpayer makes farmland available to a tenant farmer pursuant to an arrangement designated a "crop share lease." Under the arrangement, the tenant is required to use the tenant's best efforts to farm the land and produce marketable crops. The taxpayer is obligated to pay 50 percent of the costs incurred in the activity (without regard to whether any crops are successfully produced or marketed), and is entitled to 50 percent of the crops produced (or 50 percent of the proceeds from marketing the crops). For purposes of paragraph (e)(3)(vii) of this section, the taxpayer is treated as providing the farmland for use in a farming activity conducted by a joint venture in the taxpayer's capacity as an owner of an interest in the joint venture. Accordingly, under paragraph (e)(3)(ii)(F) of this section, the taxpayer is not engaged in a rental activity, without regard to whether the taxpayer performed any services in the farming activity.

*Id.*

83. I.R.C. § 469(i) (1988). This section allows \$25,000 of losses from rental real estate to be deducted against nonpassive income if the taxpayer actively participates in the use of the property. *Id.* § 469(i)(1). The \$25,000 deduction is reduced by 50% of the amount by which the taxpayer's adjusted gross income exceeds \$100,000. *Id.* § 469(i)(3)(a).

84. I.R.C. § 469(c)(1) (1988). This section defines a passive activity as a trade or business in which the taxpayer does not materially participate. *Id.*

85. *Id.* § 469(c)(2).

86. *Id.* § 469(i)(1).

87. G. BOCK, C. ALLEN, & P. HARRIS, 1988 FARM INCOME TAX SCHOOL WORKBOOK, UNIVERSITY OF ILLINOIS 40-41 (1988).

real estate activities.”<sup>88</sup> The Form 4835 instructions imply that a share lease may qualify as rental real estate because only rental real estate qualifies for the \$25,000 exception.<sup>89</sup>

Michael R. Grace, the author of both Example 8 and the instructions for Form 4835, explains in a letter to the editor of *Tax Notes* that Example 8 and the instructions for Form 4835 are not inconsistent.<sup>90</sup> He argues that *some* share leases may be rental real estate and others may be joint ventures as in Example 8.<sup>91</sup> He points out that the scheme of I.R.C. § 469 requires a two-tiered test to classify a share lease as passive or nonpassive.<sup>92</sup> The first test is whether the lease is a trade or business.<sup>93</sup> If the lease is a trade or business, the second test is whether there is material participation by the taxpayer.<sup>94</sup> If the lease is not a trade or business, it is rental real estate, and the second test is whether the landowner meets the active participation and other requirements of I.R.C. § 469 to qualify for the \$25,000 rental real estate allowance.<sup>95</sup>

Although Grace's two-tiered test appears to be the general rule for classifying property as passive or nonpassive under I.R.C. § 469, the question is whether Congress intended the general rules of I.R.C. § 469 to apply to crop share leases. In an earlier letter to the editor of *Tax Notes*, Neil Harl points out that prior to the passive loss rules, most authorities treated a material participation share lease as a business and a nonmaterial participation share lease as a rental activity.<sup>96</sup> Therefore, Congress must have intended to treat share leases differently for passive loss purposes than for all other tax purposes (such as I.R.C. §§ 1402 and 2032A) if Grace is correct that the two-tiered test is to be applied to share leases. It is possible that Congress intended such a change, but as Charles Davenport points out in still another letter to the editor of *Tax Notes*,<sup>97</sup> there is very little legislative history to support Grace's argument that Congress intended to apply a new rule to share leases.

If the two-tiered test is applied to share leases, very few share leases will be treated as rental real estate. Grace states:

---

88. 1990 I.R.S. Form 4835, p. 2 (emphasis in original).

89. An earlier statement in the instructions for the 1990 Form 4835 states that share lease income and expenses should be reported on Form 4835 only if the lease “is a rental activity for purposes of the passive activity loss limitations.” *Id.*

90. 49 TAX NOTES 1587 (Dec. 31, 1990).

91. *Id.*

92. *Id.*

93. *Id.*; see I.R.C. § 469(c)(1)(A) (1988).

94. 49 TAX NOTES 1587 (Dec. 31, 1990); see I.R.C. § 469(c)(1)(B) (1988).

95. I.R.C. § 469(i) (1988).

96. 49 TAX NOTES 1255 (Dec. 10, 1990).

97. 50 TAX NOTES 93, 93-96 (Jan. 7, 1991).

A crop share lease might appropriately be viewed as a rental activity if the land provider's potential benefits and risks are more limited than in a 50-50 joint venture, and payment for the use of land does not depend or depends less on the tenant's efforts, the production from the land, or the results of marketing crops.<sup>98</sup>

Because the nature of a share lease is to make the land owner's remuneration dependent on production and, in most cases, the price of the commodity, very few share leases would meet Grace's statement of the test for rental real estate treatment. Therefore, as a practical matter, Grace's approach treats share leases as a joint venture,<sup>99</sup> and therefore makes them ineligible for the \$25,000 exclusion.

By contrast, if share leases are treated the same under the passive loss rules as they are for purposes of I.R.C. §§ 1402 and 2032A, only one question has to be answered to categorize the lease as passive or nonpassive. That question is whether the landowner materially participates in the use of the property. If the answer is yes, the lease is a trade or business and nonpassive. If the answer is no, the lease is rental real estate and qualifies for the \$25,000 exception. The result of this approach is that no share leases fall into the middle position of being a trade or business without material participation. Consequently, no share lease is passive without the benefit of the \$25,000 exception.

Based on the above discussion, the I.R.S. can take the position that a landowner who does not materially participate in a share lease arrangement is subject to the passive loss limitations without the benefit of the \$25,000 exception. A taxpayer who wants to resist that conclusion has two arguments. First, the taxpayer may argue that Congress intended to classify share leases as passive or nonpassive using the rules of prior law. If there is no material participation, the lease is rental real estate and the taxpayer may qualify for the \$25,000 exception. If the first argument fails, the taxpayer may argue that his or her remuneration from the lease depends less on the tenant's efforts, the production from the land, or the results of marketing than the 50-50 joint venture in Example 8. Therefore, the share lease is rental real estate and qualifies for the \$25,000 exception.

## VIII. RENT PAID TO A SPOUSE

### A. Introduction

One means of reducing a farm family's social security taxes is to pay rent to the nonfarming spouse for the spouse's share of the farm property.

---

98. 49 TAX NOTES 1587, 1588 (Dec. 31, 1990).

99. See *supra* note 97, at 93-96.

The rent paid is deducted on the farmer's Schedule F, and therefore reduces self-employment taxes. Additionally, if the farmer's spouse does not materially participate in the farm business, the new rental income is reported on Schedule E, and therefore is not subject to self-employment taxes.

The I.R.S. has attacked this means of reducing social security taxes in the course of auditing farm income tax returns. Two arguments against allowing the deduction of rent paid to a spouse exist. First, the I.R.S. argues that the rent agreement is not an arm's length transaction, and therefore is not deductible.<sup>100</sup> Second, the I.R.S. argues that the rent-paying farmer has "equity" in the property, and therefore cannot deduct the rent.<sup>101</sup>

### *B. Rebutting the Arm's Length Argument*

The I.R.S.'s first argument, that paying rent to a spouse is not an arm's length transaction, confuses the existence of control with the use of the control to distort the meaning of income. The I.R.S. regulation dealing with the allocation of income and deductions among taxpayers states: "The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer."<sup>102</sup> Thus, with rent paid to a spouse, the issue is whether the same rent would have been paid to an unrelated taxpayer. In other words, if the rent claimed as a deduction is a fair rental rate for the spouse's interest in the property, the farm operator may deduct it.

In several cases supporting this reasoning, courts have held that rent paid to a married couple who owned property as joint tenants is divided between the spouses for purposes of federal income taxes.<sup>103</sup> Similarly, courts have held that interest earned on a note held jointly by husband and wife is to be divided between them.<sup>104</sup>

In a few cases, however, courts have ignored state law, and have taxed income to the party who had "control" of the income rather than the party who had legal title to the income.<sup>105</sup> In those cases, however, the taxpayer in "control" had made a gift to the other taxpayer.<sup>106</sup>

---

100. See I.R.C. § 482 (1988) (secretary given power to "distribute, apportion, or allocate . . . deductions" if it is determined that it is necessary to prevent tax evasion or to more clearly reflect the income of the parties).

101. See *id.* § 162(a)(3) (rent may be claimed as deduction when paid on "property . . . in which [the taxpayer] has no equity").

102. Treas. Reg. § 1.482-1(b)(1) (as amended in 1968).

103. See, e.g., *Tracy v. Commissioner*, 25 B.T.A. 1055 (1932), *rev'd*, 70 F.2d 93 (6th Cir. 1934).

104. See, e.g., *Haynes v. Commissioner*, 7 B.T.A. 465 (1927).

105. See, e.g., *Lannan v. Kelm*, 221 F.2d 725 (8th Cir. 1955); *White v. Fitzpatrick*, 193 F.2d 398 (2d Cir. 1951).

106. *Lannan*, 221 F.2d at 729-30; *White*, 193 F.2d at 400.

These cases in which courts have ignored the legal obligations of the parties may be distinguished by a farmer wishing to argue that the rent paid to the farmer's spouse should be deductible. First, many farmers may argue that the joint tenancy was not created as a gift. Second, those cases in which the courts have ignored the legal obligations of the parties arguably err in reassigning income away from the legal owner of an asset that plays a material role in generating income.<sup>107</sup>

Moreover, in attacking payments made to a joint tenant, the I.R.S. adds to a long line of failed attempts to attack payments to a tenant-in-common, payments to a partner of a farm operated as a partnership,<sup>108</sup> payments to a shareholder of a farm operated by a corporation, and payments in many other related-party cases.<sup>109</sup> For instance, in *Interior Securities Corp. v. Commissioner*<sup>110</sup> the court rejected the Commissioner's arguments that a partnership was a sham and that rental income should be reallocated under section 482.<sup>111</sup> The court stated, "But common control alone is not sufficient to justify the application of this section. . . . It is only where there is a shifting of income from one controlled unit to another that any allocation is justified under section 482."<sup>112</sup> Similarly, in two different cases involving the same taxpayer,<sup>113</sup> the court rejected the Commissioner's argument that rental income should be reallocated from a corporation to its shareholders because the amount of rent paid was consistent with an arm's length transaction.

Thus, courts should focus on the legal obligations of the parties in determining whether the rental agreement is an arm's length transaction. Likewise, taxpayers should argue that payments of rent in a joint tenancy are distinguishable from payments of dividends to corporate shareholders in a farm or payments to tenants-in-common.

### C. Rebutting the Equity Argument

Section 162(a)(3) provides that rent can be claimed as a deduction when paid on "property . . . in which [the taxpayer] has no equity."<sup>114</sup> The I.R.S.'s second argument against spousal rent payment deductions is

---

107. See, e.g., *White*, 193 F.2d at 403 (Chase, J., dissenting).

108. See, e.g., *Interior Securities Corp. v. Commissioner*, 38 T.C. 330 (1962).

109. See, e.g., *Carroll v. Commissioner*, 52 T.C.M. (CCH) 1523 (1987); *Carroll v. Commissioner*, 37 T.C.M. (CCH) 736 (1978).

110. 38 T.C. 330 (1962).

111. *Id.* at 339-40.

112. *Id.* at 339 (citation to *Grenada Industries, Inc. v. Commissioner*, 17 T.C. 231, *aff'd*, 202 F.2d 873 (5th Cir.), *cert. denied*, 346 U.S. 819 (1953) omitted).

113. *Carroll v. Commissioner*, 52 T.C.M. (CCH) 1523 (1987); *Carroll v. Commissioner*, 37 T.C.M. (CCH) 736 (1978).

114. I.R.C. § 162(a)(3) (1988).

that the taxpayer cannot deduct rent paid to a spouse who owns the other share in tenancy-in-common property because the taxpayer has "equity" in that property. That argument appears to misinterpret the use of the term "equity" in section 162(a)(3).<sup>115</sup>

In *Mathews v. Commissioner*,<sup>116</sup> the court explained that the purpose of section 162(a)(3) is to distinguish payments made to purchase property (which are not deductible but are added to basis) from payments that are made to rent property (which are deductible).<sup>117</sup> Consequently, the court concluded that the species of equity that is fatal to a rent deduction is that acquired from the lessor.<sup>118</sup> Likewise, because a farmer who is renting property from his or her spouse does not acquire equity from a spouse, the farmer does not have the fatal equity according to the *Mathews* analysis.<sup>119</sup>

Unfortunately, the *Mathews* analysis is somewhat academic because the Fifth Circuit reversed the tax court in *Mathews v. Commissioner*.<sup>120</sup> The Fifth Circuit opinion in *Mathews* supports the I.R.S. position by asserting that legal rights can be ignored when determining tax consequences. The court stated, "If we stood at the top of the world and looked down on this transaction ignoring the flyspeck of legal title under state law we would see the same state of affairs the day after the trust was created that we saw the day before."<sup>121</sup>

The Fifth Circuit's opinion in *Mathews* can be distinguished factually from most cases. In *Mathews*, the rent was paid to a trust that, in the court's view, was controlled by the taxpayer.<sup>122</sup> In the instance of land owned by the farmer's spouse in joint tenancy, the spouse has a legal right to collect rent — a right that can be enforced against the wishes of the farmer. The control factor present in *Mathews* does not exist in most joint tenancy agreements.

Additionally, *Quinlivan v. Commissioner*<sup>123</sup> cited the tax court opinion in *Mathews* with approval. The *Quinlivan* opinion discusses the split among the courts of appeals on the deductibility of rent paid to a trust set up by the taxpayer, and concludes that the majority view is that the rent is deductible if four requirements are met.<sup>124</sup> First, the taxpayer must not

---

115. *Id.*

116. 61 T.C. 12 (1973), *rev'd*, 520 F.2d 323 (5th Cir. 1975), *cert. denied*, 424 U.S. 967 (1976).

117. *Id.* at 15-16.

118. *Id.* at 23.

119. *Id.* at 15-16.

120. 520 F.2d 323 (5th Cir. 1975), *cert. denied*, 424 U.S. 967 (1976).

121. *Id.* at 328.

122. *Id.*

123. 599 F.2d 269 (8th Cir.), *cert. denied*, 444 U.S. 996 (1979).

124. *Id.* at 272-73.

retain the same control over the property as that had before the property was given to the trust.<sup>125</sup> Second, the leaseback should be in writing and must require payment of reasonable rent.<sup>126</sup> Third, the leaseback must have a bona fide business purpose.<sup>127</sup> Fourth, the taxpayer must not possess a disqualifying equity in the property within the meaning of the statute.<sup>128</sup>

The requirements listed in *Quinlivan* suggest the following guidelines for renting property from a spouse. Preferably, the lease should be in writing, but at minimum the farmer and spouse should agree upon a rental rate before the lease term. Most importantly, the rental rate should be a fair rental rate.

Other arguments against the I.R.S. position exist. In Revenue Ruling 74-209, the I.R.S. concluded that rent paid by a husband to his wife for the use of their jointly-owned Wisconsin real estate that the husband used in his business was deductible as a business expense on the husband's separate income tax return.<sup>129</sup> On its face, this ruling seems to reject the equity argument of the I.R.S.

However, in two letter rulings,<sup>130</sup> the I.R.S. distinguished Revenue Ruling 74-209 by the fact that the taxpayers in the letter rulings filed a joint return rather than a separate return. The two distinguishing letter rulings concluded that filing a joint return makes the two taxpayers one taxable unit; therefore, the payment from husband to wife had no substance because the taxable unit merely reallocated income within itself.<sup>131</sup>

This position does not necessarily follow from the authorities the I.R.S. cites to support its position. In Private Letter Ruling 85-35-001, the I.R.S. cited *Helvering v. Janney*<sup>132</sup> to support its holding that when a married couple files a joint return, one spouse is not allowed to deduct payments made to the other spouse because they have become one taxable unit. *Helvering v. Janney*<sup>133</sup> addressed whether capital losses of one spouse could be deducted against capital gains of the other spouse. In holding that spouses could deduct capital losses, the Court pointed out that on a joint return, tax is computed on the aggregate income of the two taxpayers, which is calculated by deducting one spouse's excess deductions from the

---

125. *Id.* at 272.

126. *Id.*

127. *Id.*

128. *Id.*

129. Rev. Rul. 74-209, 1974-1 C.B. 46.

130. Priv. Ltr. Rul. 85-35-0001 (May 3, 1985) (husband paid wife for bookkeeping services); Priv. Ltr. Rul. 81-04-004 (Sept. 23, 1980) (husband paid wife rent for her separate property).

131. *See supra* note 130.

132. 311 U.S. 189 (1940).

133. *Id.*

other spouse's net income.<sup>134</sup> Thus, the issue of allowing a deduction for payments made by one spouse to the other was not before the Court, and was not addressed by the Court. The case does not lend credence to Private Letter Ruling 85-35-001.<sup>135</sup>

The taxable unit concept derived from filing a joint return has been explicitly rejected in other contexts. In *Coerver v. Commissioner*,<sup>136</sup> the tax court discussed *Helvering v. Janney*<sup>137</sup> and *Taft v. Helvering*,<sup>138</sup> and rejected the taxpayer's argument that those cases hold that a married couple filing jointly becomes one taxpayer for all purposes.<sup>139</sup> The court rejected the taxpayer's argument that filing a joint return made them a taxable unit and therefore that their tax home was in the city where the husband lived and worked:

The concept of a "taxable unit" under the joint return provision, § 6013, merely means that while there are two taxpayers on a joint return, there is only one taxable income. It does not create a new tax personality which would be entitled, in its own right, to deductions not otherwise available to the individual spouses under the pertinent sections of the statute.<sup>140</sup>

In Private Letter Ruling 85-35-001, the I.R.S. also cites three cases in which the taxpayers created trusts for the benefit of their minor children, conveyed an office building to the trusts, and then rented the office building from the trust for a medical practice.<sup>141</sup> In each of those cases, the court examined the nature of the transaction, and concluded that it had no economic substance because the taxpayer had economic control of the building before and after the transfer, the amount of rent that was paid was not set at a fair rental rate, and there was no written lease specifying the rent.<sup>142</sup> Rent paid to a spouse can be distinguished from those facts because a spouse who is a joint tenant has the legal right to collect his or her share of rent from the property. Therefore, if the standard of these three cases is applied, the rental deduction should be allowed.

---

134. *Id.* at 192.

135. *See also* *Taft v. Helvering*, 311 U.S. 195 (1940).

136. 36 T.C. 252 (1961), *aff'd*, 297 F.2d 837 (3d Cir. 1962).

137. 311 U.S. 189 (1940).

138. 311 U.S. 195 (1940).

139. *Id.* at 254.

140. *Id.*

141. *Penn v. Commissioner*, 51 T.C. 144 (1968); *Furman v. Commissioner*, 45 T.C. 360 (1966), *aff'd*, 381 F.2d 22 (5th Cir. 1967); *Van Zandt v. Commissioner*, 40 T.C. 824 (1963), *aff'd*, 341 F.2d 440 (5th Cir.), *cert. denied*, 382 U.S. 814 (1965).

142. *Furman*, 45 T.C. at 364-66; *Penn*, 51 T.C. at 151-54; *Van Zandt*, 40 T.C. at 830-31.

In addition, the I.R.S. did not follow the conclusion of Private Letter Rulings 85-35-001 and 81-04-004 that filing a joint return created a single taxable unit.<sup>143</sup> In Private Letter Ruling 87-42-007, the husband and wife filed a joint return, and the husband was allowed to deduct wages paid to his wife on his Schedule F.<sup>144</sup> Because the taxable unit concept is not discussed in the ruling, it is impossible to know if the I.R.S. has abandoned or merely forgotten that argument at the time of writing the later ruling.

Finally, if rent has not been paid to the farmer's spouse for many years and then rent is paid, the I.R.S. potentially could argue that the rental payments are illusory. The taxpayer can refute such an argument by pointing out that a spouse's failure to collect rent in past years does not prevent the spouse from collecting rent for the current and future years.

#### *D. Conclusion*

In many farm families, the farmer's spouse owns an interest in some or all of the land used in the farm business. Regardless of whether that ownership is in the spouse's name alone or as a co-owner with the farmer in the form of a tenancy-in-common, joint tenancy, tenancy-by-the-entirety, or community property, the farmer's spouse has a right to collect rent on his or her share of the property. Therefore, payment of fair-market rent by the farmer to the spouse according to a bona fide rental agreement should be allowed as a deduction on the farmer's Schedule F, which will reduce self-employment taxes if the farmer's FICA wages and self-employment income are below the social security base income. If the farmer's spouse does not materially participate in the farm business, the rental income should be reported on Schedule E where it is not subject to the self-employment tax

---

143. Priv. Ltr. Rul. 87-42-007 (June 26, 1987).

144. *Id.*

