



Tax Consequences Cash vs. Crop Share Leases

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Tax consequences associated with landlord-tenant leases include income, self-employment, estate, and gift taxes. In general, all lease arrangements between agricultural landlords and tenants fall into one of three categories—cash, crop share with material participation, and crop share with no material participation.

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

When Can You Use Form 4835 Instead of Schedule F?

Form 4835 is designed to be used by landowners who pay a share of the expenses of the farm and/or receive a part of the crop as their rental payments, but who are not in the business of farming. If a landowner is in the business of farming, his or her expenses and income are reported on Schedule F where the net income is subject to self-employment tax. A landowner is allowed to report on Form 4835 only if he or she is not materially participating in the farm business.

Table 1.

| 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 exception to estimated tax penalty? | No | Yes | Yes |
| Does owner qualify for treatment of soil and water conservation expenses? | No | Yes | Yes |
| Does owner qualify for exclusion of cost sharing payments? | Yes | Yes | Yes |
| Do passive loss rules limit losses? | Yes | Yes | No |
| Does \$25,000 rental real estate exception apply? | Yes | Yes ³ | N/A |
| Does owner qualify for the expense election deduction? | No | Yes | 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 answers below 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 to 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-IT(e)(3)(viii), Example 8.

Material Participation

A person materially participates if:

- a. 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.
- b. 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.
- c. There is material participation.

The following definitions help interpret the above rules.

1. The arrangement, whether oral or written, must contemplate material participation by the landlord.
2. The participation must be material as to either the production or the management of production of the crops.
3. The term production refers to the physical work performed and the expenses incurred in producing a commodity.
4. The term management of production refers to services performed in making managerial decisions relating the production.
5. Services performed by an employee or agent are not considered services performed by the owner in determining the extent to which the owner has participated in the production or management of production of a commodity.

Guidelines

The guidelines for determining what constitutes material participation (assuming there is an arrangement that contemplates that participation) are generally provided by the Regulations pertaining to Section 1402.

- a. "If the owner...shows that he periodically advises or consults with the other person, who under the arrangement produces the agricultural or horticultural commodities, as to the production of any of these commodities and also shows that he periodically inspects the production activities of the land, he will have presented strong evidence of the existence of the degree of participation contemplated by section 1402(a)(1). If, in addition to the foregoing, the owner...shows that he furnishes a substantial portion of the machinery, implements, and livestock used in the production of the commodities or that he furnishes or advances funds, or assumes financial responsibility, for a substantial part of the expense involved in the production of the commodities, he will have established the existence of the degree of participation contemplated by section 1402(a)(1)."
- b. "The term 'management of the production'...refers to services performed in making managerial decisions relating to the production, such as when to plant, cultivate, dust, spray, or harvest the crop, and includes advising and consulting, making inspections, and making decisions as to matters such as rotation of crops, the type of crops to be grown, the type of livestock to be raised, and the type of machinery and implements to be furnished."
- c. "The services which are considered of particular importance in making such management decisions are those

services performed in making inspections of the production activities and in advising and consulting with such person as to the commodities" (emphasis added).

Tests

The Farmer's Tax Guide (IRS Publication 225) explains the four tests for material participation of a farm landlord as follows.

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

Test No. 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; and 4) inspect the production activities periodically.

Test No. 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 No. 3. You work 100 hours or more spread over a period of five weeks or more in activities connected with crop production.

Test No. 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.

These tests may be used as general guidelines for determining whether you are materially participating. For further information, contact your Social Security office. Doubtful cases may be submitted to the district director of Internal Revenue for advice.

Examples 1 through 6 below are from Treas. Reg. §1402(a)-4(6).

Example 1. After the death of her husband, Mrs. A rents her farm, together with its machinery and equipment, to B for one-half of the proceeds from the commodities produced on such farm by B. It is agreed that B will live in the tenant house on the farm and be responsible for the overall operation of the farm, such as planting, cultivating, and harvesting the field crops; caring for the orchard and harvesting the fruit; and caring for the livestock and poultry. It also is agreed that Mrs. A will continue to live in the farm residence and help B operate the farm. Under the agreement, it is contemplated that Mrs. A will regularly operate and clean the cream separator and feed the poultry flock and collect the eggs. When possible, she will assist B in such work as spraying the fruit trees, penning livestock, culling the poultry, and controlling weeds. She will also assist in preparing the meals when B engages seasonal workers. The agreement between Mrs. A and B clearly provides that she will materially participate in the overall production operations to be conducted on her farm by B. In actual practice, Mrs. A performs such regular and intermittent services. The regularly performed services are material to the production of an agricultural commodity, and the intermittent services performed are material to the production operations to which they relate. The furnishing of a substantial portion of the farm machinery and equipment

also adds support to a conclusion that Mrs. A has materially participated. Accordingly, the rental income Mrs. A receives from her farm should be included in net earnings from self-employment.

Example 2. D agrees to produce a crop on C's cotton farm under an arrangement providing that C and D will each receive one-half of the proceeds from such production. C agrees to furnish all the necessary equipment, and it is understood that he is to advise D when to plant the cotton and when it needs to be chopped, plowed, sprayed, and picked. It is also understood that during the growing season C is to inspect the crop every few days to determine whether D is properly taking care of the crop. Under the arrangement, D is required to furnish all labor needed to grow and harvest the crop. C, in fact, renders such advice, makes such inspections, and furnishes such equipment. C's contemplated participation in management decisions is considered material with respect to the management of the cotton production operation. C's actual participation pursuant to the arrangement is also considered to be material with respect to the management of the production of cotton. Accordingly, the income C receives from his cotton farm is to be included in computing his net earnings from self-employment.

Example 3. E owns a grain farm and turns its operation over to his son, F. By the oral rental arrangement between E and F, the latter agrees to produce crops of grain on the farm, and E agrees that he will be available for consultation and advice and will inspect and help to harvest the crops. E furnishes most of the equipment, including a tractor, a combine, plows, wagons, drills, and harrows; he continues to live on the farm and does some of the work such as repairing barns and farm machinery, going to town for supplies, and cutting weeds; he regularly inspects the crops during the growing season; and he helps F harvest the crops. Although the final decisions are made by F, he frequently consults with his father regarding the production of the crops. An evaluation of all of E's actual activities indicates that they are sufficiently substantial and regular to support a conclusion that he is materially participating in the crop production operations and the management thereof. If it can be shown that the degree of E's actual participation was contemplated by the arrangement, E's income from the grain farm will be included in computing net earnings from self-employment.

Example 4. G owns a fully equipped farm, which he rents to H under an arrangement that contemplates that G shall materially participate in the management of the production of crops raised on the farm pursuant to the arrangement. G lives in town about five miles from the farm. About twice a month he visits the farm and looks over the buildings and equipment. G may occasionally, in an emergency, discuss with H some phase of a crop production activity. In effect, H has complete charge of the management of farming operations regardless of the understanding between him and G.

Although G pays one-half of the cost of the seed and fertilizer and is charged for the cost of materials purchased by H to make all necessary repairs, G's activities do not constitute material participation in the crop production activities.

Accordingly, G's income from the crops is not included in computing net earnings from self-employment.

Example 5. I owned a farm several miles from the town in which he lived. He rented the farm to J under an arrangement that contemplated I's material participation in the management of production of wheat. I furnished one-half of the seed and fertilizer and all the farm equipment and livestock. He employed K to perform all the services in advising, consulting, and inspecting contemplated by the arrangement. I is not materially participating in the management of production of wheat by J. The work done by I's employee, K, is not attributable to I in determining the extent of I's participation. I's rental income from the arrangement is, therefore, not to be included in computing his net earnings from self-employment.

Example 6. L, a calendar year taxpayer, appointed M as his agent to rent his fully equipped farm for 1974. M entered into a rental arrangement with N under which M was to direct the planting of crops, inspect them weekly during the growing season, and consult with N on any problems that might arise in connection with irrigation, while N furnished all the labor needed to grow and harvest the crops. M did in fact fulfill his responsibilities under the arrangement. Although the arrangement entered into by M and N is considered to have been made by L, M's services are not attributable to L, and L's furnishing of a fully equipped farm is insufficient by itself to constitute material participation in the production of the crops. Accordingly, L's rental income from the arrangement is not included in his net earnings from self-employment for that year.

Observation. A taxpayer who is materially participating for purposes of the self-employment tax may or may not be materially participating for purposes of the passive loss rules. Similarly, a taxpayer who is materially participating for purposes of the passive loss rules may or may not be materially participating for purposes of the self-employment tax.

Example 7. Zoel Vautthauer owns a farm that he rents to his son under a crop share lease. Zoel's son makes all the management decisions and does all of the work on the farm except that Zoel helps out three weeks during the planting season and another three weeks during harvest. Zoel works a total of 110 hours on the farm each year.

Zoel is treated as materially participating for purposes of the self-employment tax and, therefore, must report his share of income and expenses on Schedule F. However, he is not materially participating for purposes of the passive loss rules and must answer "no" to the question on line E of Schedule F.

Treas. Reg. §1469-5T(a) sets out the following seven options 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.

Example 8. Yolanda Usery owns a farm that she operated for five of the past 10 years. She now leases it to her daughter

under a crop share lease. Yolanda's daughter makes all the management decisions and does all the work on the farm. Yolanda never visits the farm. Yolanda was the sole operator of the farm until she retired two years ago.

Yolanda is not materially participating for purposes of the self-employment tax. Therefore, she reports her income and expenses from the farm on Form 4835. However, she meets material participation test number 5 in the passive loss regulations and, therefore, her farm is not treated as a passive activity.

The two separate and distinct material participation tests have a dramatic impact on income tax, self-employment tax and thus social security benefits and estate taxes. Knowledge and application of these rules to real-world farm situations has the potential to save taxes and help individuals achieve personal goals and objectives.

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