



Farm Tax Network™
AGRIBUSINESS GROUP

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Passive Activity Grouping Planning for NIIT

The final regulations for Section 1411, the Net Investment Income Tax (NIIT), were released on November 26, 2013 [TD 9644, 12/02/2013]. Although effective December 2, 2013, the regulations generally apply to taxable years beginning after December 31, 2013. Taxpayers may apply them to taxable years beginning after December 31, 2012 [Reg. 1.1411-1(g)]. The final regulations are much more taxpayer favorable than the proposed version released in November 2012.



FTN Release 2013-010 provided details of the NIIT and the application of the final regulations. This FTN focuses on a grouping opportunity under the Section 469 passive activity rules that may reduce potential Net Investment Income (NII).

Background

Farming operations are often structured with land held by the individual taxpayer or a family LLC or other Subchapter K entity (partnership). The separation of the land from the operating entity provides opportunities to reduce self-employment income and aids in family estate planning. The land is usually leased to the farm operating entity, which may be another partnership, S or C corporation. Leasing from the family partnership to the farmer's sole proprietorship is also common. Leasing to an entity in which the taxpayer owns an interest and materially participates in the trade or business activity (e.g., farming) generates self-rental income. Under the final regulations, this type of self-rental income is excluded from NII [Reg. 1.1411-4(g)(6)].

Due to the benefits of crop rotation, the land may be leased to other entities that are not part of the family group. For example, the taxpayer's farming operation focuses on raising corn. Neighbors who raise potatoes offer to lease the ground for a significantly higher rental payment if potatoes have not been grown on the land in the prior three or more years. The corn farmer leases the land to the potato farmer for one year, receiving rental income. The self-rental exclusion from NII won't apply. If the farmer has AGI greater than \$200,000 (\$250,000 if married filing jointly), he may be liable for NIIT.

Grouping the Rental Activity with the Farm

As we mentioned in FTN Release 2013-010, a rental activity grouped with a trade or business activity in which the taxpayer materially participates also results in the rental income being excluded from NII [Reg. 1.1411-4(g)(6)]. (Grouping a rental activity with a trade or business operated in a C corporation is

not allowed.)

Grouping multiple activities is permitted if the activities constitute an “appropriate economic unit.” A taxpayer may use any reasonable method to make the grouping determination, although the following factors are given the greatest weight:

- Similarities and differences in the types of business
- The extent of common control
- The extent of common ownership
- Geographical location; and
- Interdependence between the activities [Reg. 1.469-4(c)(2)].

A rental activity ordinarily cannot be combined with a business activity, although such grouping is allowed if the rental and business constitute an appropriate economic unit and either the business or rental activity is insubstantial in relation to the other, or each owner of the business activity has the same proportionate ownership interest in the business activity and rental activity [Reg. 1.469-4(d)(1)].

The examples under Reg. 1.469-4(d)(1) that address the grouping of a business and real estate clearly infer that the real estate should be leased to the business in order to meet the appropriate economic unit test. And all three court cases that have favorably interpreted this regulation (*Glick, Schumacher and Candelaria*) involved real estate leased to the business activity. Nevertheless, these temporary crop land leases to third parties should be able to meet the appropriate economic unit test. The taxpayer continues to own and control the real estate; there is common ownership and control with the farming activity. In addition, the crop rotation provides benefits to the soil by breaking disease cycles, adding an element of interdependence with the farming activities. The geographic location factor applies if the land is usually part of the taxpayer’s farming activities.

Assuming the appropriate economic unit test is met, one of the two secondary tests represents a much lower hurdle. The farming activity and rental property often have identical ownership, but if not, the real estate rental gross receipts are usually insubstantial in relation to the farming activity gross receipts.

Grouping the real estate, albeit leased periodically to outsiders, provides an opportunity to exclude the net rental income from NII.

See FTN Release 2013-010 for the guidance on grouping and the opportunity to accomplish a re-grouping in a current return due to the new NII tax.

Summary

We shouldn’t overlook the possibility of grouping rental activities with materially participating business activities in order to exclude the rental income from NII. If the rental activity and farming activity are an appropriate economic unit, and a secondary test of either identical ownership or insubstantiality is met, the grouping is allowed. Generally the real estate must be leased to the business activity. However, our view is that a crop lease that rotates between self-rental and third party rental, such as occurs with leases to potato and sugar beet producers, will satisfy the appropriate economic unit test.

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