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

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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.

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This information is intended for educational purposes only. Seek the advice of your tax professional regarding the application of these general principles to your individual circumstances.
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.
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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?
This information is intended for educational purposes only. You are encouraged to seek the advice of your tax or legal advisor, or other authoritative sources, regarding the application of these general tax principles to your individual circumstances. Pursuant to Treasury Department (IRS) Circular 230 Regulations, any federal tax advice contained here is not intended or written to be used, and may not be used, for the purpose of avoiding tax-related penalties or promoting, marketing or recommending to another party any tax-related matters addressed herein.

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