IOWA STATE UNIVERSITY
Center for Agricultural Law and Taxation

Iowa Supreme Court Affirms That Typical Cash Rent Landlords Not Eligible for Capital Gain Deduction

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On June 19, 2020, the Iowa Supreme Court ruled that the Iowa Department of Revenue rationally interpreted Iowa Code § 422.7(21)(a) to prevent a typical cash rental landlord from taking the Iowa capital gain deduction. *Christensen v. Iowa Department of Revenue*, No. 19-0261 (Iowa Sup. Ct. June 19, 2020).

Background

Iowa—unlike some states—imposes a state tax on capital gain. The same income tax rates apply to all Iowa taxable income, regardless of whether it is ordinary or capital. Since 1990, the Iowa Legislature has carved out a small exception to this rule, allowing qualifying small business owners and farmers to deduct at least a portion of the capital gain income they realize from the sale of their business-related property. The law has evolved through the years, but with respect to the sale of “real property,” a full capital gain deduction is currently allowed for net capital gain stemming from the sale of:

Real property used in a business in which the taxpayer materially participated for 10 years immediately prior to the sale, when that property has been held for a minimum of 10 years immediately prior to its sale.

Iowa Code § 422.7(21)(a)(1) states that the term “material participation” is to be defined as it is in IRC §469(h), the federal tax law governing passive activity losses.

Facts and Procedural History

The taxpayers in this case were a married couple who lived in Illinois and worked non-farm jobs until they retired. The wife inherited the farmland at issue in 1989, and cash rented it to farm tenants until she sold the property in 2006.[i] The taxpayers claimed a deduction for the $93,036 of capital gain on their 2006 Iowa return. Upon audit, the Iowa Department of Revenue denied the deduction and assessed tax of $6,616, a penalty of $1,614.30, and interest of $296.75. The taxpayers paid the tax and filed a formal protest. The administrative law judge upheld the assessment, finding that the taxpayers did not demonstrate "material participation."

In particular, the ALJ found that the taxpayers did not provide specific details or time estimates, but merely asserted that they were responsible for "fence repairs, building maintenance, and brush clearing." The husband testified only that "they did 'whatever needed to be done.'" One tenant testified that he never witnessed the taxpayers repairing the fence or clearing brush on the property. Another tenant stated that he had completed tiling work and that the taxpayers had merely paid half the cost of the project, which in total had cost $1,300. The ALJ was concerned with the vagueness of the taxpayers' evidence.

The director adopted and approved the ALJ's findings in 2017, and the taxpayers filed a petition for judicial review with the district court. After the district court affirmed the director's decision, the taxpayers appealed and the Iowa Supreme Court retained the appeal.

Appeal to the Supreme Court

On appeal, the taxpayers challenged the Director's application of Iowa Admin. Code rule 701—40.38(1)(c) to the determination of whether the capital gain earned from the sale of the farmland was excluded from their taxable income under Iowa Code § 422.7(21)(a). They argued that by renting their farmland, they "materially participated" in a business in which the farmland was used.

The Court first determined that "material participation" is a specialized term of art in tax law which falls directly within the Department's area of expertise. For that reason, the Court found that the agency's interpretation of "material participation" was entitled to deference. The Court stated, "We are hard-pressed to find an issue more within the Department's expertise than application of 'material participation' … to the distinct context of the Iowa capital-gain deduction." As such, the Court decided that it must uphold the Department's determination of what is meant by "material participation" and its application of the law to the facts unless it was "an irrational, illogical, or wholly unjustifiable interpretation" of the statute.

Paragraph (4) of the 701—40.38(1)(c) states:

> Cash farm lease. A farmer who rents farmland on a cash basis will not generally be considered to be materially participating in the farming activity. The burden is on the landlord to show there was material participation in the cash-rent farm activity.

The taxpayers argued that they were not "farmers" to whom paragraph (4) applied, but instead they actively participated in a "rental activity or business," specifically a farm rental business, that fit the definition of paragraph (7) of the Iowa rule:

> Rental activities or businesses. … The general rule is that a taxpayer who actively participates in a rental activity or business which would be considered to have been material participation in another business or activity would be deemed to have had material participation in the rental activity unless covered by a specific exception…

In analyzing the question, the Court noted that the Iowa Legislature's reference to IRC §469(h) to define "material participation" leaves a gap when applied to rental activities of any kind because the term "material participation" as defined in §469(h) has no application to rental activities as a matter of law, except within the context of a real estate business as defined in §469(c). This is because the passive loss rules automatically deem other rental activities to be passive.

The Court explained that the evidence presented in the case revealed the limited involvement of a typical cash-rent farm landlord. Rent payments were made only twice per year, as is typical in a cash-rent farm lease. The only thing changed on the standard farm lease form from year to year was the per-acre rate, requiring at most a two-hour renegotiation, and even that did not always change. The standard lease form placed on the tenant the obligations "to keep said premises free from brush and burrs, thistles, and all noxious weeds, and [to]mow and cut near the surface of

all weeds." The Court stated, "Given the focus of a farm lease on the land rather than any incidental buildings, those terms leave little else for a cash-rent farm landlord to do."

The Court found that there was a logical reason to treat leases of farmland differently based of the minimal activities generally involved with such leases. The taxpayers, the Court stated, entered into "cash farm leases," and their attempt to recharacterize their "business" as a rental business did not take it out of the specific rule adopted for cash farm leases.

The Director's decision, the Court ruled, was well justified given the facts of the case. Although the taxpayers alleged they met the tests for material participation, the Court stated that their bare allegations, without any real quantification of the work they completed, were insufficient to satisfy any of the rule 701—40.38 material-participation tests.[ii] Their limited activities of collecting rent twice a year and renegotiating the leases, a two-hour endeavor, were not "regular, continuous, and substantial" so as to meet the requirements for material participation. The Court found that the Director's findings were supported by substantial evidence and she was within her discretion in denying the capital gain deduction, based upon the record presented. The Director's findings, the Court noted, were bolstered by the fact that the taxpayers had not attempted to quantify the time spent on the claimed tasks, such as fixing fence or clearing brush.

Given these findings, the Supreme Court affirmed the district court's judgment.

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[i] The wife and her brother inherited 93 acres of farmland that was rented to tenants. The wife owned half of this property.

[ii] These include:

- The taxpayer participated in the business activity for more than 100 hours and, based on all the facts and circumstances, the individual participated on a regular, continuous, and substantial basis.
- The taxpayer participated in the business for more than 100 hours in the tax year, and nobody else spent more time in the business activity than the taxpayer.

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