B. WHETHER SHARE-CROP INCOME IS EXCLUDED FROM UNRELATED BUSINESS INCOME UNDER IRC 512(b)(3)(A) AS RENTAL INCOME

1. Introduction - Share-Crop Leases

Some exempt organizations own farms as investments and lease them to tenant farmers. In almost all cases the amount of the rental payment is based on a crop-sharing arrangement. The question that arises under these circumstances is whether income derived by an exempt organization from leasing the farm property is excluded from unrelated business tax as rental income or whether it is subject to the tax. When the exempt organization is a private foundation, resolving this issue not only determines whether the income is subject to unrelated business income tax but also whether it will be subject to the IRC 4940 tax.

In a typical crop-share arrangement, an exempt organization leases farm property to a tenant farmer and the amount of the annual lease payment is determined by a gross percentage of the proceeds of the sale of any crops grown or harvested on the property during the year. The exempt organization may or may not exercise a substantial amount of control over the farming operations. In some cases, exempt organizations share in the expenses of the farming operations. In other cases, they do not.

2. Law and Regulations

IRC 513(a) provides, in pertinent part, that the term "unrelated trade or business" means any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under IRC 501.

IRC 512(a)(1) provides, in pertinent part, that unrelated business taxable income is the gross income derived by any organization from any unrelated trade or business, as defined in IRC 513, regularly carried on by it, less certain deductions and computed with certain modifications provided in IRC 512(b).

IRC 512(b)(3)(A) provides that all rents from real property shall be excluded from unrelated business taxable income. However, IRC 512(b)(3)(B)(ii) provides that the rent exclusion does not apply if the determination of the amount of rent depends in whole or in part on the income or profits derived from the property leased (other than an amount based on a fixed percentage of receipts or sales). This latter limitation only applies to tax years beginning after 1969.

Reg. 1.512(b)-1 provides the general rule for the IRC 512(b)(3) modification for rent for taxable years beginning after December 31, 1969. It notes that whether a particular item of income falls within any of the modifications shall be determined by all the facts and circumstances of each case. For example, if a payment termed "rent" by the parties is in fact a return of profits by a person operating the property for the benefit of the exempt organization or is a share of the profits retained by such organization as a partner or a joint venturer, such payment is not within the modification for rents. Furthermore, Reg. 1.512(b)-1(c)(2)(iii)(b) provides, in part, that specific rules contained in paragraph (b)(3) of Reg. 1.856-4 should govern the interpretation of the statutory language under IRC 512(b)(3)(B)(ii).

Reg. 1.856-4(b)(3) restates the general rule that no amount received or accrued directly or indirectly with respect to any real property qualifies as "rents from real property" where the determination of the amount depends in whole or in part on the income or profits derived by any person from the property. Further, Reg. 1.856-4(b)(3) provides that any amount so accrued or received shall not be excluded from the term "rents from real property" solely by reason of being based on a fixed percentage of receipts or sales.

3. Control and Sharing of Expenses

Based on the above regulations there are two situations where income for the use of farm property would not constitute excludable rents. The first situation occurs where there is a substantial degree of control and supervision over the farming operations by the exempt organization landlord. It is the current thinking of the Service that such control and supervision indicates that the exempt organization is participating or engaging in farming operations to a significant extent. As explained in Reg. 512(b)-1, "if a payment termed 'rent' by the parties is in fact a return of profits by a person operating the property for the benefit of tax-exempt organizations. . . such payment is not within the modification for rents." The second instance occurs where there is a substantial sharing of the farming costs between the tenant farmer and the exempt organization (as in the Myra case, discussed later). Here too, Reg. 1.512(b)-1 appears to deny treatment as rent. However, an additional and more compelling argument (at least in the Service's current view) is that the determination of "rents" in this situation depends (in whole or in part) on the income or profits of the farm property and that the income is not, therefore, excludable under IRC 512(b)(3)(B)(ii). The balance of this topic will clarify these situations and arguments, and discuss relevant court decisions.

4. Control

If an examination of all the facts and circumstances of a particular case indicates that the exempt organization exercises a substantial degree of control and supervision over the farm operations, the income derived from the farm operations represents a return from its own use of the property instead of rental income paid to it for the use of the property by the tenant. This result is similar to that in Rev. Rul. 57-58, 1957-1 C.B. 270, which, while dealing with IRC 1402(a)(1) rather than IRC 512(b)(3), holds that a "material participation" test was to be used in determining whether a farmer may include income from a share-farming arrangement in his computation of net earnings from self-employment or whether such income constitutes rentals for that purpose.

A substantial degree of control and supervision over the farm operations would exist, for example, where the exempt organization employs a farm manager who decides what crops are to be grown, consults on a regular and ongoing basis with the farmer-tenant to insure that farming operations are being conducted according to the exempt organization's satisfaction, and otherwise manages and directs the day-to-day operations of the property. Although we believe such circumstances illustrate a substantial degree of control and supervision, our experience indicates that this would be an unusual case. The more likely situation is shown by the typical farm lease described below.

A. Typical Share-Crop Lease Agreement

While share-crop lease agreements vary, under the terms of a typical farm lease, the tenant is exclusively responsible for managing and operating the farm property. The tenant is also required to prepare a farm operating plan including a schedule of crops to be grown on the real estate and seeding or planting rates, chemicals and fertilizers to be used, conservation practices and tillage plans, livestock breeding and market schedules, nutrition and feeding schedules, and harvesting and storage plans. The tenant submits the schedule to the exempt organization for review. Operation of all aspects of the farm is the sole responsibility of the tenant. The tenant is responsible for general farming operations, including cultivation of the land, planting, fertilizing, harvesting and marketing crops, and all aspects of livestock husbandry. The exempt organization is generally responsible for all of the costs associated with the land and fixed improvements including the costs of wells and pumps, irrigation equipment, and initially required limestone and rock phosphates. The tenant or the landlord may provide equipment and tools required to farm the land. The allocation of the proceeds of the sale of any crops and/or livestock raised on the property between the exempt organization and the tenant is negotiated between them and is generally comparable to percentage crop rents negotiated between other landlords and farm operators in the area.

Under the terms of these typical leases, while the tenant farmer is required to submit a detailed farm operating plan to the exempt organization for review, which provides an opportunity for control to some extent by the exempt organization over the farming operations, it does not follow that under the terms of such a farm lease the exempt organization manages and directs the operation of the property to a significant extent. The requirement of a farm operating plan is a standard feature in leases and other tenancy arrangements used in modern American agriculture. The plan permits the owner to review the tenant's proposed use of the farm property and to insure that the operator's intended use is consistent with long-term crop rotation and conservation and preservation practices. Additionally, a farm operating plan allows the owner and operator to monitor the use of pesticides which may be environmentally harmful and to monitor soil erosion prevention practices to insure the preservation of invaluable topsoil. Farm operating plans collected over a period of years create a record as to the use the property is being put to. Such a record establishes that the property has been properly cared for and shows all material that has been added to the land and all crops harvested from the property. This overall record could be important evidence in determining value when the property is sold to a third party.

Operators themselves would not be without such a plan. They need them for their own benefit to secure bank and other financing for production expenses. While the farm lease provides the exempt organization with the right to insure compliance with the lease, it also protects the exempt organization's interest in preserving the value of the land. Provisions affording farm owners such protection are found in some form in all farm leases.

Moreover, it is apparent from certain forms of the U. S. Department of Agriculture that such plans are common. These forms contain provisions dealing with the use of land. They have schedules and provide for information equivalent to that in a typical farm operating plan described above.

B. Limited Control

Even if the requirement of such a farm operating plan provides control over how a tenant conducts his farming activity, it does not rise to a level of control that would require treating crop shares as other than rental from real property as defined in IRC 512(b)(3). It is significant that under such a farm lease there is no sharing of expenses and the exempt organization does not provide financing for its tenants.

5. Sharing of Farm Costs

The Service has been advancing for some time the position that share-crop income does not constitute rental income where there is a substantial sharing of farm expenses.

A. The Myra Decision

This position was the basis of the government's appeal from a decision of the U. S. District Court for the District of North Dakota to the Court of Appeals for the Eighth Circuit. The Court of Appeals, however, affirmed the District Court's decision and held in United States v. Myra Foundation, 382 F. 2d 107 (8th Cir. 1967), that the share-crop income of the exempt organization was excludable from unrelated business income tax as rent under IRC 512(b)(3). The government had urged that the contracts were something other than a lease and that the crop-sharing income was not rental income. It argued that the exempt organization had engaged in farming as a partner or joint venturer by furnishing the seed and one-half the cost of fertilizer, weed spray, and combining.

In reaching its decision the Court of Appeals held that since Congress did not intend to give the word "rent" in IRC 512(b)(3) any restricted or unusual meaning, the exclusion applied to all rents from any property and the word "rent" was intended by Congress to be accorded its ordinary, well-understood meaning. According to the Court, the contracts in question clearly reflected the intention of the parties to create a landlord-tenant relationship, which resulted in rental income excludable from tax under IRC 512(b)(3).

B. The El Paso Decision

Another significant court case is State National Bank of El Paso v. United States, 509 F. 2d 832 (5th Cir. 1975). In that case, a charitable trust entered into an agreement with an individual in which the trust supplied the farmland, improvements, all of the equipment, and bore all of the labor, material, maintenance, and upkeep costs for operating the farm. The individual agreed to activate and farm the premises and pay to the trust 90 percent (90%) of the income from the farm as "rent". The Service contended that this agreement constituted a management or employment contract or a joint venture, but not a rental agreement. The Court directed a verdict for the taxpayer, concluding that amounts received by the trust under the agreement were rents from real property excludable pursuant to IRC 512(b)(3). The Service did not appeal the decision, but it did not indicate that it agreed with it.

C. Current Thinking of IRC

Both Myra and El Paso involved years beginning before 1970. Whatever the merits of these cases may be prior to 1970, the decisions are not entirely pertinent today because of the amendment to IRC 512(b)(3) made by the Tax Reform Act of 1969.

As previously indicated, for years beginning after 1969, IRC 512(b)(3)(B)(ii) provides that the rent exclusion does not apply if the amount of rent depends (in whole or in part) on the income or profits from the leased property (other than an amount based on a percentage of receipts or sales).

When an exempt organization shares the crop produced by the tenant farmer, the rent is in fact based on a percentage of receipts or sales and is not barred from rental treatment under IRC 512(b)(3)(B)(ii). However, when the crop-sharing is combined with a substantial sharing of farm costs with the tenant, such as in Myra or El Paso, the rent is in effect based on the profit from the farm and such income is not entitled to the exclusion.

Although El Paso was adverse to the Service, a footnote in the decision lends support to our current thinking on the issue. It states:

> For taxable years after 1969 all income received from situations of this type will be taxed:
>
> [The rent exclusion shall not apply] "(ii) if the determination of the amount of such rent depends in whole or in part on the income or profits derived by any person from the

> property leased (other than an amount based on a fixed percentage or percentages of receipts or sales)." IRC 512(b)(3)(B)(ii).

Keep in mind that the reference to farm expenses and costs in determining whether there is substantial sharing of cost means operating costs and not costs associated with the land or fixed improvements such as wells, pumps, and irrigation equipment. See prior discussion of a typical share-crop lease agreement.

D. Revenue Ruling 58-482

In Rev. Rul. 58-482, 1958-2 C.B. 273, the Service held that rent in the form of crop shares from a tenant farmer did not constitute unrelated business taxable income for a charitable trust under specific circumstances. The trust owned orchards and farms, some of which were operated by trust employees under the trustee's direct supervision. The remaining portion was leased to a tenant who planted the crops, cared for them, and harvested them. The trust received a share of the gross products raised by the tenant. All operating expenses with respect to this portion of the orchards and farms were borne by the tenant. The tenant occupied this property under the terms of the lease which gave the tenant exclusive possession of the property and under which the trust was neither a joint venturer nor a partner.

Rev. Rul. 58-482 found that the farms and orchards operated by the trust were operated as profit-making enterprises and their operation constituted the operation of an unrelated trade or business by the trust. However, it was further held that the proceeds derived by the trust from the lease constituted rent payments and, therefore, were not unrelated business taxable income within the meaning of IRC 512.

Although the revenue ruling was published before the Tax Reform Act of 1969, the conclusion comports with the current thinking of the Service.

E. Crop-Share Leasing and Private Foundations

In general, IRC 4940(a) imposes on each exempt private foundation with respect to the carrying on of its activities, a tax (generally equal to 2 percent) on the net investment income of such foundation for the taxable year. Net investment income is the amount by which the sum of the gross investment income and the capital gain net income exceeds the deductions allowed by IRC 4940(c)(3). Gross investment income is the gross amount of income from interest, dividends, rents, payments with respect to securities loans and royalties, but not including any such income to the extent included in computing the tax imposed by IRC 511. Therefore, if the income of a private foundation, which is subject to the IRC 4940 foundation excise tax, is derived from a crop-share arrangement that comes within the exception of IRC 512(b)(3)(A) as rental income, such income will be subject to the IRC 4940 tax. If the income is deemed to be farming income, it will not be subject to such tax. The reason for this is to avoid double counting or double income taxation. If income is subject to tax under IRC 511 it should not also be taxed under IRC 4940.