Commentary:
New Domestic Production Deduction: What Does “Trade or Business” Mean?

By Neil E. Harl¹ and Roger A. McEowen²

The American Jobs Creation Act of 2004³ was driven by pressure from the World Trade Organization to repeal the Extra-Territorial Income Exclusion Act of 2000⁴ which had been branded in January of 2002 as “inconsistent with international trade agreements.” The resulting legislation contained far more than repeal of the 2000 Act, which the 2004 legislation accomplished.⁵ The Act also included a successor provision, a deduction for “domestic production activities” that has virtually nothing to do with international trade.

The new deduction is discussed at length in the newly revised Portfolio, Reporting Farm Income, TM 608-2d, by Neil E. Harl and Roger A. McEowen. The deduction starts out at three percent (for 2005 and 2006), rises to six percent (for 2007-2009) and plateaus at nine percent after 2009 of the lesser of (1) the “qualified production activities income” of the taxable year, or (2) the taxpayer’s taxable income for the year.⁶

This commentary focuses specifically on the uncertainty surrounding the requirement that the new deduction is limited to items attributable to the actual conduct of a trade or business.⁷ [Emphasis added.]

Interim guidance

In mid-January, 2005, the Internal Revenue Service issued interim guidance on key provisions of the domestic production deduction and announced that IRS and the Treasury Department are developing regulations regarding the deduction.⁸ The interim guidance provides some assistance in planning for the deduction, first claimable on 2005 returns, but leaves several major concerns unresolved. One of those unresolved areas is the “trade or business” requirement.⁹

Trade or business requirement

Neither the statute¹⁰ nor the interim guidance¹¹ indicate which of the numerous definitions of trade or business is to be used in implementing the provision. The choice is certain to have a significant impact on the agricultural sector and could well influence the type of farming arrangements established in the future.

Several different meanings have been given to the term in tax law in recent years. Here are some of the possibilities—
The least demanding is the meaning given to the term for purposes of income averaging for farmers and fishermen. For purposes of that provision, rental income under a share-rent lease (where the landowner obtains a share of the crops — and sometimes a share of the livestock—produced as the landowner’s rent) is treated as income from a farming business (a requirement of eligibility for income averaging is that the individual be “engaged in a farming business”). Whether a landowner is participating in the operation in terms of management is immaterial. Thus, a non-materially participating share rent landlord is eligible.

For purposes of expense method depreciation, the regulations specify that the taxpayer must “meaningfully participate” in the management or operations of the trade or business. The regulations make the point that it is a facts and circumstances test.

The standard test imposed for several purposes, including liability for self-employment tax, the material participation test for special use valuation of land and material participation for recapture under the family-owned business deduction, is the well-known test of “material participation.” That test is not met by non-materially participating landlords, who normally report lease income on Form 4835 rather than on Schedule F.

The most demanding meaning of the term “material participation” was imposed in 1986 for purposes of determining whether an activity is considered a passive activity under the passive loss rules. That meaning of the term requires that the taxpayer be involved in the activity on a basis which is “regular, continuous, and substantial.”

Conclusion

The selection of an operational meaning for the meaning of “trade or business” in the new deduction for domestic production is highly important in several sectors, including agriculture. The Internal Revenue Service is urged to resolve this issue at an early date. Rendering non-material participation landlords ineligible for the deduction essentially imposes a 3 to 9 percent “tax” on the decision to operate under a non-material participation lease.

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5 AJCA, Sec. 101.
6 §199(a).
7 §199(d)(5).
10 §199(d)(5).
§1301.
§1301(a).
Regs. §1.1301-1(b)(2).
Regs. 1.179-2(c)(6)(ii).
Id.
§1402(a).
§2032A(e)(6).
§1402(a).
§469(c)(1).
§469(h)(1).