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Overview

The Small Business and Work Opportunity Act of 2007 (Act)¹ included a provision that allows some husband-wife business ventures to elect out of the partnership rules for federal tax purposes as a qualified joint venture (QJV).² While the election will ease the tax reporting requirements for husband-wife joint ventures that can take advantage of the election, the Act also makes an important change to I.R.C. §1402 as applied to rental real estate activities that can lay a trap for the unwary. Thus, it is important to consider the situations in which a QJV election may be a good planning move, and when the election should be avoided.

Joint ventures and partnership returns

A joint venture is simply an undertaking of a business activity by two or more persons where the parties involved agree to share in the profits and loss of the activity. That is similar to the Uniform Partnership Act's definition of a partnership.³ The Internal Revenue Code defines a partnership in a negative manner by describing what is not a partnership,⁴ and the IRS follows the UPA definition of a partnership by specifying that a business activity conducted in a form jointly owned by spouses (including a husband-wife limited liability company (LLC)) creates a partnership that requires the filing of an IRS Form 1065 and the issuance to each spouse of a separate Schedules K-1 and SE, followed by the aggregation of the K-1s on the 1040 Schedule E, page 2.⁵ The Act does not change the historic IRS position.⁶

While the IRS position creates a tax compliance hardship, in reality, a partnership return does not have to be filed for every husband-wife operation. For example, if the enterprise does not meet the basic requirements to be a partnership under the Code (such as not carrying on a business, financial operation or venture, as required by I.R.C. §7701(a)(2)), no partnership return is required. Also, a spousal joint venture can elect out of partnership treatment if it is formed for "investment purposes only" and not for the active conduct of business if the income of the couple can be determined without the need for a partnership calculation.⁷

Note: Under I.R.C. §6698, effective for returns required to be filed after December 20, 2007, the penalty for failure to file a partnership return when required is increased to \$85 per month, per partner, for a maximum of 12 months.⁸ Thus, the maximum penalty for a husband-wife partnership that fails to file a partnership return when required is \$2,040. That's up from a maximum penalty of \$500 under prior law.⁹

The new husband-wife QJV

Effective for tax years beginning after December 31, 2006, the Act allows a spousal business activity to be treated, by election, as a QJV which will not be treated for tax purposes as a partnership.¹⁰

Note: Under the provision, a qualified joint venture, includes only those businesses that are owned and operated by spouses as co-owners, and not in the name of a state law entity (including a general or limited partnership or limited liability company). So, spousal LLCs, for example, are not eligible for the election.

Instead, each spouse is to file as a sole proprietor to report that spouse's proportionate share of the income and deduction items of the business activity.¹¹ To elect QJV status, five criteria must be satisfied: (1) the activity must involve the conduct of a trade or business; (2) the only members of the joint venture are spouses; (3) both spouses elect the application of the QJV rule; (4) both spouses materially participate in the business¹²; and (5) the spouses file a joint tax return for the year.¹³

The IRS instructions to Form 1065 (which, of course, is not filed by reason of the election) provide guidance on the election. Those instructions specify that the election is made simply by not filing a Form 1065 and dividing all income, gain, loss, deduction and credit between the spouses in accordance with each spouse's interest in the venture.¹⁴ Each spouse must file a separate Schedule C, C-EZ or F reporting that spouse's share of income, deduction or loss. Each spouse also must file a separate Schedule SE to report their respective shares of self-employment income from the activity with each spouse then receiving credit for their share of the net self-employment income for Social Security benefit eligibility purposes.¹⁵ But, if the income from the business had been reported on Schedule E, a QJV election may not be possible. That's because the reporting of the income on Schedule E constitutes an election out of Subchapter K, and a taxpayer can only come back within Subchapter K (and, therefore, I.R.C. §761(f)) with IRS permission that is requested within the first 30 days of the tax year.¹⁶

Self-employment tax - the rental real estate exception

Under I.R.C. §1402(a), net earnings from self-employment are subject to self-employment tax. Net earnings from self-employment are defined as

income derived by an individual from any trade or business carried on by such individual.¹⁷ But, real estate rental income is excluded from the general definition of net earnings from self-employment.¹⁸ Thus, for rental property in a partnership (or rental real estate income of an individual), self-employment tax is not triggered.

The QJV election and rental real estate. Once a QJV election is made, the exception from self-employment tax for real estate rentals is lost. The Act adds I.R.C. §1402(a)(17) which specifies that in a QJV, each spouse's share of income or loss is taken into account as provided for in I.R.C. §761(f) in determining self-employment tax.¹⁹ That means that the QJV election triggers self-employment tax, and the exception from self-employment tax for rental real estate income is lost. Indeed, the IRS instructions for the 2007 Form 1065 state that if the QJV election is made for a husband-wife rental real estate business, "you each must report your share of income and deductions on Schedule C...you and your spouse each must take into account your share of the income and deductions from the rental real estate business in figuring your net earnings from self-employment on Schedule SE."

While the QJV election may not be a problem in a year when a loss results, the self-employment tax complication can be problematic when there is positive income for the year. That's because it is not possible to simply elect out of QJV treatment in an attempt to avoid self-employment tax by filing a Form 1065.²⁰ Likewise, it's probably not possible to intentionally fail to qualify for QJV status (by transferring an interest in the business to a non-spouse, for example) to avoid self-employment tax in an income year after a year (or years) of reducing self-employment by passed-through losses.²¹ Such a move would allow IRS to assert that the transfer of a minimal interest to a disqualified person or entity violates the intent of Subchapter K.²² But remember, for taxpayers in community property states, the option to use either Rev. Proc. 2002-69 (which means that rental income from real estate is not subject to self-employment tax) or elect QJV is available.

Note: A spousal real estate rental business involving co-owned real estate is not impacted by new I.R.C. §1402(a)(17), which means that

the rental income is not subject to self-employment tax pursuant to I.R.C. §1402(a)(1) if a QJV election is *not* made. The instructions to IRS Form 1065 state that a mere co-ownership of property that is maintained and leased or rented is not a partnership.²³ But, a partnership exists if the spouses provide services to the tenant.²⁴

Irrespective of the clear statutory language, the Chief Counsel's Office of IRS has issued guidance reversing the position IRS took in the instructions to the 2007 Form 1065.²⁵ In the guidance, IRS clarifies that a spousal QJV election for a rental real estate business does not convert the income derived from the business into net earnings from self-employment, when the income otherwise would be excluded from self-employment tax.²⁶ So, the QJV election does not negate the rental real estate exception of I.R.C. §1402(a)(1). Instead, the guidance notes that the legislative history of the QJV election indicates that its sole purpose is to simplify the reporting burden for spousal business activities. Thus, rental income from rental activities in which the taxpayer does not materially participate is not subject to self-employment tax.

Note: Even though the QJV election does not eliminate the rental real estate exception when it would otherwise apply without the election in place, IRS still maintains that when a QJV election is made, the rental real estate income must be reported on a separate Schedule C for each spouse rather than on Schedule E - even though the income is not subject to self-employment tax. In those situations, IRS instructs that taxpayers should enter "Exempt-QJV" on their Form 1040, line 58, and should not file Schedules SE, unless either or both spouses have other income subject to self-employment tax.²⁷

Tax reporting and federal farm program participation

For farm couples that participate in federal farm programs where both spouses satisfy the "active engagement" test,²⁸ each spouse *may* qualify for a payment limitation.²⁹ To be deemed to be actively engaged in farming as a separate person, a spouse must satisfy three tests: (1) the spouse's share of profits or losses from the farming operation must be commensurate with the spouse's contribution to the operation;³⁰ (2) the spouse's contributions must be "at risk;"³¹ and (3) the spouse must make a significant contribution of capital, equipment or land (or a combination thereof) *and* active personal labor or active personal management (or a combination thereof).³² For the spouse's contribution to be "at risk," there must be a possibility that a non-recoverable loss may be suffered. Similarly, contributions of capital, equipment, land, labor or management must be material to the operation to be "significant contribution." Thus, the spouse's involvement, to warrant separate person status, must not be passive. For example, for a contribution of labor to be significant, it must be the lesser of 1,000 hours per calendar year or 50 percent of the total hours required to conduct a farming operation comparable in size to the spouse's commensurate share in the farming operation.³³ For a contribution of management to be significant, the spouse must be engaged activities which are critical to the farming operation's profitability³⁴ For contributions of land, capital or equipment, the contribution must have a value of at least 50 percent of the spouse's commensurate share of the total value of capital or the total rental values of either land or the equipment necessary to conduct the farming operation.³⁵

While the active engagement test is relaxed for farm operations in which a majority of the "persons" are individuals who are family members, it is not possible for a spouse to sign up for program payments as a separate person from the other spouse based on a contribution of land the spouse owns in return for a share of the program payments. That's because, the use of the spouse's contributed land must be in return for the spouse receiving rent or income for the use of the land based on the land's production or the farming operation's operating results.³⁶

What this all means is that for spouses who sign up for two separate payment limitations under the farm programs, they are certifying that they each are actively involved in the farming operation. Under the farm program rules, for each spouse to be actively involved requires both spouses to be significantly involved in the farming operation *and bear risk of loss*. From a tax standpoint, however, the couple may have a single enterprise the income from which is reported on Form 1040 as a sole proprietorship or on a single Schedule F with the income split into two equal shares for self-employment tax purposes. In these situations, IRS could assert that a partnership filing is required (in common-law property states).³⁷ That's where the QJV election could be utilized with the result that two proprietorship returns can be filed. As mentioned above that's a simpler process than filing a partnership return, and it avoids the possibility of getting the stiffer penalty imposed for failing to file a partnership return. But, the filing of the QJV election will subject the income of both spouses (including each spouse's share of government payments) to self-employment tax.³⁸ That will eliminate any argument that at least one spouse's income should not be subjected to self-employment tax on the basis that the spouse was only actively involved (for purposes of the farm program eligibility rules), but not engaged in a trade or business.³⁹ But, that may be a very difficult argument to make in any event. That's because the active engagement rules are similar to the rules for determining whether income is subject to self-employment tax. Under those rules, as mentioned above, "net earnings from self-employment" is defined as income from a trade or business that the taxpayer conducts. That involves an element of risk taking – and that's the manner in which the active engagement test is couched. The existence of a

trade or business is determined on a case-by-case basis according to the facts and circumstances.⁴⁰ In general, the activity must be conducted on a regular and continuous basis.⁴¹ It is hard to imagine how a spouse could argue that they meet the active engagement test, but are not engaged in a trade or business on a basis that is regular and continuous.

While it is true that the question of whether it is possible for a spouse to satisfy the active engagement test (in order to qualify for two payment limits) without being deemed to be in a trade or business for self-employment tax purposes is an unresolved question, it doesn't seem likely. In any event, that issue is moot if satisfaction of the active engagement test creates a partnership for tax purposes, which it probably does.⁴² That's where the QJV election can come in handy – not as a means of avoiding self-employment tax, but as a means of avoiding the need to file as a partnership.

Summary

The QJV election can be used to simplify the tax reporting requirement for certain spousal businesses that would otherwise be required to file as a partnership. That includes spousal farming operations where each spouse qualifies as a separate person for payment limitation purposes. In those situations, there appears to be no good-faith argument that can be made for claiming that self-employment tax should not apply to each spouse's share of income from the operation. But, for rental real estate activities that are conducted in a spousal LLC, the QJV election should *not* be made and a partnership return filed to avoid the imposition of self-employment tax.

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¹ Small Business and Work Opportunity Tax Act of 2007, Pub. L. No. 110-28, enacted May 25, 2007.

² Act, §8215(a), *amending* I.R.C. §761 by changing existing subsection (f) to (g) and adding new subsection (f).

³ The 1997 version of the Uniform Partnership Act (UPA), at Section 101(6), defines a partnership as an association of two or more persons to carry on as co-

owners a business for profit formed under Section 202 of the UPA. Section 202 states that mere co-ownership of property (regardless of the particular form) is insufficient, by itself, to constitute a partnership. Section 202 also states that while a sharing of gross returns is not indicative of a partnership, the sharing of profit from the business does indicate partnership existence unless the profit is received in payment of a debt, for services as an independent contractor or as an employee, or for rent, among other things.

⁴ I.R.C. §§761(a) and 7701(a)(2).

⁵ See page 2 of the instructions to IRS Form 1065 where IRS states as follows: "Generally, if you and

your spouse jointly own and operate an unincorporated business and share in the profits and losses, you are partners in a partnership and you must file a Form 1065. See also Treas. Reg. §301.7701-3(b) (multi-member LLC).

⁶ The Joint Committee on Taxation's report on the new QJV provision contained in Section 8215 of the Act clearly states that I.R.C. §761(f) (the new QJV provision) is not meant to change prior law concerning the basic determination of what is a partnership.

⁷ I.R.C. §761(a). The election must be in accordance with the requirements of Treas. Reg. §1.761-2, but Treas. Reg. §1.761-2(b)(ii) bails out such entities if they were not aware of the need to make a formal election. The election, once made, is binding on the venture until the venture either no longer qualifies or gets IRS permission to revoke the election. Permission must be requested by the end of the first 30 days of the year during which the election is to apply. Treas. Reg. §1.761-2(b)(3)(i).

⁸ Late filed S corporation returns are also subject to a failure to file penalty for returns filed after December 20, 2007. The penalty is \$85 per shareholder, per month, for a maximum of 12 months. I.R.C. §6699.

⁹ The penalty is not imposed if the partnership can show reasonable cause for its failure to file a complete or timely return. Certain small partnerships (with 10 or fewer partners) meet the reasonable cause test if all of the partners are individuals (other than non-resident aliens), estates or C corporations, all of the partners have filed income tax returns fully reporting their shares of the partnership's income, deductions and credits, and the partnership has not elected to be subject to the rules for consolidated audit proceedings. A written request for relief (in accordance with Rev. Proc. 84-35, 1984-1 C.B. 509) should be sent in writing to the IRS service center where the return is filed. All partner's names and tax identification numbers should be included.

¹⁰ The provision equates the treatment of spousal LLCs in common-law property states with that of community property states. In *Rev. Proc. 2002-69, 2002-2 C.B. 831*. IRS specified that husband-wife LLCs in community property states can disregard the entity.

¹¹ Act, Sec. 8215(a) re-designating existing I.R.C. §761(f) as (g) and adding I.R.C. §761(f)(1).

¹² I.R.C. §761(f)(2). "Material participation" is defined in accordance with the passive activity loss rules of I.R.C. §469(h), except I.R.C. §469(h)(5). Thus, whether a spouse is materially participating in the business is to be determined independently of the other spouse.

¹³ In general, electing QJV status won't change a married couple's total federal income tax liability or total self-employment tax liability, but it will eliminate the need to file Form 1065 and the related Schedules K-1.

¹⁴ IRS has stated, informally, that no final Form 1065 will be filed for an entity that had previously filed Form 1065. That will likely create issues with computer-generated notices looking for the Form 1065. There is no penalty for filing, however. Thus, practitioners may want to file a "\$0 return.

¹⁵ Apparently, the same rules will apply that would have applied if a formal Form 1065 had been prepared, with each spouse reporting "line item" income and expense rather than a single number for what would have represented non-separately stated items of income and expense or the summary reports of separately stated items. Also, apparently the balance of Subchapter K's rules for recognizing the validity of allocations would also apply because I.R.C. §761(f), unlike I.R.C. §761(a), does not remove the entity from Subchapter K's applicability by its terms.

¹⁶ So, ventures that filed Schedule E for 2006 would have needed to request IRS permission to utilize Subchapter K (and the QJV provision) within the first 30 days of 2007. But, the QJV provision, even though it is effective for tax years after December 31, 2006, wasn't enacted until May 25, 2007. The problem does not occur with spousal businesses utilizing Rev. Proc. 2002-69 in community property states. Rev. Proc. 2002-69 allows a taxpayer to have a deemed formation of a partnership each year. Thus, such a taxpayer could elect to not disregard the entity and then elect to apply the QJV provisions of I.R.C. §761(f).

¹⁷ I.R.C. §1402(a).

¹⁸ I.R.C. §1402(a)(1). However, the IRS position is that passive farm rental income is subject to self-employment tax if there is an "arrangement" (or contract) requiring material participation on the landlord's part. *Mizell v. Com'r*, T.C. Memo. 1995-571; *Tech. Ach. Memo. 9637004* (May 1, 1996); but see *McNamara v. Com'r*, 236 F.3d 410 (8th Cir. 2000)(self-employment tax not due if fair market rentals charged). IRS has issued a nonacquiescence to the court's opinion. AOD CC-2003-003 (Oct. 20, 2003).

¹⁹ Act, §8215(b)(1), effective for tax years beginning after December 31, 2006.

²⁰ The instructions to Form 1065 note that the election cannot be revoked without IRS consent, and that the partnership (the entity in effect before the QJV election) terminates at the end of the tax year

immediately preceding the year the QJV election takes effect.

²¹ QJV treatment ends in a manner similar to that of an S corporation, and could be terminated, for example, by transferring an interest in the QJV (such as by gift) to a third party or even to a corporation that one or both of the spouses own. That's because a QJV can only exist between spouses. Thus, any transfer of an interest to a non-spouse terminates the QJV.

²² See Treas. Reg. §1.701-2 (anti-abuse rules). That may especially be the case if the disqualification event seems designed simply to avoid self-employment tax.

²³ The income of a general partner is subject to self-employment tax. *See, e.g.,* Norwood v. Com'r, T.C. Memo. 2000-84.

²⁴ Thus, real estate that is co-owned by spouses and is leased to a separate entity or third party with minimal services provided by the co-owners does not constitute a partnership. The income from such an activity is properly reported on Schedule E.

²⁵ CCA Ltr. Rul. 200816030 (Mar. 18, 2008).

²⁶ *Id.*

²⁷ If the other net earnings from self-employment amount to \$400 or more, the spouse (or spouses) with the other net earnings from self-employment should file Schedule SE and enter "Exempt-QJV" and the amount of net profit from the rental real estate business from Schedule C (or Schedule F) on the dotted line to the left of Schedule SE, line 3 (but not on Form 1040, line 58).

²⁸ The "active engagement test" is codified at 7 U.S.C. §1308-1(b).

²⁹ 7 U.S.C. §1308(e)(2)(C)(ii); 7 C.F.R. §1400.105(a)(2). The statute specifies that qualification of spouses as separate persons under this provision *is at the Ag Secretary's discretion*. The spouses can be considered separate "persons" for the payment limitation rules if they do not hold, directly or indirectly, a substantial beneficial interest in more than one entity (including the spouses themselves) engaged in farming operations that also receive farm program payments as separate persons, if each spouse meets the other requirements necessary to be considered separate persons. A substantial beneficial interest is defined as generally between 10 percent and 50 percent, with the proviso that the Ag Secretary may reduce the level on a case-by-case basis. But, ¶ 253.5, Example 1 of 1-PL (Rev. 1), Amendment 23 (dated 4/25/94) sets forth an example of a husband and wife joint farming operation. The wife also has a 25 percent interest in another farming corporation which is receiving CRP payments. While meeting all of the other tests, the

example states that the couple is considered to be one "person" for payment limitation purposes because the wife also receives payments indirectly through the corporation which is a separate person from the wife.

³⁰ 7 U.S.C. §1308-1(b)(2)(A)(ii); 7 C.F.R. §1400.6(a).

³¹ 7 U.S.C. §1308-1(b)(2)(A)(ii); 7 C.F.R. §1400.6(b).

³² 7 U.S.C. §1308-1(b)(2)(A)(i); 7 C.F.R. §1497.6(b).

³³ 7 C.F.R. §1497.3.

³⁴ Regulations define "active personal management" to include the "marketing and promotion" of agricultural commodities produced by the farming operation. 7 C.F.R. §1400.3.

³⁵ *Id.*

³⁶ 7 C.F.R. §1400.207.

³⁷ Rev. Proc. 2002-69, 2002-2 C.B. 831 allows the couple to disregard the entity in a community property state.

³⁸ I.R.C. §1402(a)(17) states that each spouse's share of the net income from a QJV is subject to self-employment tax.

³⁹ I.R.C. §1402(a) defines self-employment income as income derived from a trade or business that the taxpayer conducts.

⁴⁰ *See* Com'r v. Groetzinger, 480 U.S. 23 (1987).

But, with respect to USDA land diversion, conservation-type programs, IRS has taken the position that payments received under such programs are subject to self-employment tax by reason of the taxpayer merely participating in the program. *See* CCA Ltr. Rul. 200325002 (May 29, 2003) and IRS Notice 2006-108, 2006-2 C.B. 1118 (specific to Conservation Reserve Program payments). But, these are low-level IRS pronouncements that do not constitute substantial authority, and IRS has declined to issue regulations taking such a position formally.

⁴¹ *See, e.g.,* Batok v. Com'r, T.C. Memo. 1992-727.

⁴² The "at risk" requirement which is part of the active engagement test indicates partnership status.