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Recommended Citation
Available at: http://lib.dr.iastate.edu/aglawdigest/vol4/iss1/1
LEASING PERSONAL PROPERTY

— by Neil E. Harl

Appearance of the note on Part I of the 1992 edition of Schedule E, Form 1040, that taxpayers are to "report income and expense from the rental of personal property on Schedule C or C-EZ" has raised concerns about the proper reporting of rentals from personal property such as farm machinery rented after retirement to children or others. Several high profile audits in which examining agents have taken a relatively aggressive stance on the issue have added to the concerns.

Section 1402 exclusions

As discussed in the August 30, 1991, issue of Agricultural Law Digest,1 Section 1402 of the Internal Revenue Code imposes self-employment tax on "self-employment income."2 That section states that "self-employment income means —

"Net earnings from self-employment derived by an individual from any trade or business carried on by such individual...during any taxable year..." subject to various exclusions.3 Excluded from earnings from self-employment are "rentals from real estate and from personal property leased with the real estate...."4 The language does not provide an exclusion for the rental of personal property apart from the real estate.5

Merely because the statute does not provide specifically for the rental of personal property apart from the real estate does not justify the conclusion that rentals of personal property are necessarily included in self-employment income and subject to self-employment tax. Indeed, the statute itself requires that an individual be engaged in a trade or business in order for income to be self-employment income.6 If the level of activity is not sufficient to give rise to trade or business status, income is not properly includible in self-employment income.7 Therefore, a retired farmer renting machinery and equipment in a passive lease arrangement should not be considered as carrying on a trade or business; should not, therefore, have self-employment income; and should not report the rental on Schedule C or F. The rental amount should be reported on Form 4835 (if rental of a farm is involved) or on Schedule E or otherwise.

The term "trade or business" is given the same meaning in this area as when used in Section 162 relating to trade or business expense.8

Stevenson case

The recent flurry of audit activity and the emergence of language on Schedule E directing that rentals of personal property should be reported on Schedule C or C-EZ appear to be related to the 1989 case of Carl Stevenson.9 In that case, the taxpayer operated a sole proprietorship involved with the sale, rental and repair of portable advertising signs. About 72 percent of the taxpayer's gross receipts came from the rental of portable signs.

The taxpayer was not, however, a passive lessor of property. The taxpayer purchased the portable advertising signs for rental and resale, advertised the availability of the signs, received telephone calls for sign rental and sale, maintained a bank account for the venture and kept a cash receipts and disbursements journal. The taxpayer personally assembled all new portable signs and stored the signs at a warehouse, repaired used signs, maintained all signs that were rented or sold and delivered signs that had been purchased as well as those that had been rented. The taxpayer formulated and implemented marketing plans for the sale and rental of portable signs and obtained all licenses, permits and operating certificates required by units of government.

The taxpayer argued that the rentals from the portable sign activity should be excluded from self-employment income.10 IRS countered with the position that Section 1402 only excluded rentals from real estate and rentals from personal property leased with the real estate. The Tax Court held that the amounts claimed by the taxpayer as rents were includible in self-employment income and subject to self-employment tax.11

Lessons for lessors

For those renting personal property, such as an individual renting farm machinery to another, the key question is whether the individual as lessor is carrying on a trade or business. If the answer is in the affirmative, rentals should properly be included in self-employment income and should, therefore, be reported on Schedules C or F. In the event, the lessor is not carrying on a trade or business, the
rentals involved should not be included in self-employment income.

For those renting both machinery and land in retirement, including both in the same lease should buttress the argument that the amounts received are not subject to self-employment tax. In that event, the language of Section 1402 should apply which specifically excludes rentals from personal property rented with real estate from net earnings from self-employment.

Those renting personal property who do not wish to have the rentals included in self-employment income should develop the strongest possible case for passive investor status rather than trade or business status. Thus, the lease should be drafted to place responsibility on the lessee for maintenance and repair of the rental property, for example, and the lessee should avoid involvement in management or decision making relative to property under the lease. The net income could then be reported on line 22 of Form 1040 (or on Form 4835 or Schedule E) with the reported as "net income from passive rental activity."

FOOTNOTES
2 I.R.C. § 1402(a).
3 I.R.C. § 1402(b).
4 I.R.C. § 1402(a)(1).
5 Id.
6 I.R.C. § 1402(a).
7 Id.
8 I.R.C. § 1402(c).
10 See I.R.C. § 1402.

CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr.

ADVERSE POSSESSION
HOSTILE POSSESSION. The parties' lands were separated by a fence which extended onto the plaintiff's land at the northern end and extended onto the defendant's land at the southern end of the fence. The court held that neither party could claim adverse possession of the disputed areas because the possession of the disputed area was not continuously hostile by either party over a single ten year period. Blankenship v. Payton, 605 So.2d 817 (Miss. 1992).

ANIMALS
CATTLE. The plaintiff sued the owner of a bull for the death of the plaintiff's spouse who collided with the bull on a highway near the bull owner's farm. The court held that the bull's owner was not strictly liable for the accident because the plaintiff failed to show any vicious propensity of the animal known to the owner. The court found that all cattle seek to escape from fenced areas. The court also held that the mere escape of the bull was not evidence of negligence per se by the owner but that negligence required a showing of the owner's unreasonable choice of method of confinement or the owner's allowing the animal to remain at large after knowledge of the escape. Greathouse v. Armstrong, 601 N.E.2d 419 (Ind. Ct. App. 1992).

BANKRUPTCY
GENERAL EXEMPTIONS.
AVOIDABLE LIENS. The debtors sought to avoid a judicial lien against their homestead as impairing their homestead exemption. However, the debtors had no equity interest in the homestead because the amount of consensual liens against the home exceeded the fair market value of the home. The court held that the liens could not be avoided


HOMESTEAD. Prior to filing bankruptcy, the debtors sold their rural home for cash and a note and purchased a ranch. The debtors claimed as exempt the current homestead and the proceeds of the sale of the first homestead. The court held that the debtors were limited only to one exemption and denied the exemption for the remainder of the proceeds of the first residence. In re England, 975 F.2d 1168 (5th Cir. 1992), aff'g, 141 B.R. 495 (N.D. Tex. 1991).

IRA. The debtor claimed an exemption for the debtor's interest in an IRA which contained funds rolled over from an ERISA qualified pension plan. The court held that the IRA was not estate property to the extent of the rolled over plan funds but that any additional funds contributed to the IRA were not exempt. In re Morgan, 145 B.R. 760 (Bankr. N.D. N.Y. 1992).

The debtor's interests in Keogh and IRA plans were not excluded from the bankruptcy estate because the debtor failed to present evidence of any anti-alienation or transfer restrictions. The interests were eligible for the exemption under Cal. Civ. Code Proc. § 704.115(e) only to the extent reasonably necessary for the support of the debtor. In re Switzer, 146 B.R. 1 (Bankr. C.D. Cal. 1992).

PENSION PLAN. The debtor's exemption for an interest in a pension plan was denied because the funds were not reasonably necessary for the debtor's support. In re Cauvel, 146 B.R. 166 (Bankr. W.D. Pa. 1992).

TENANCY BY THE ENTIRETIES. The debtor was allowed an exemption for the debtor's interest in a residence owned with the non-debtor spouse as tenants by the entireties but only as to the amount of equity remaining after joint debts. In re Maloney, 146 B.R. 168 (Bankr. W.D. Pa. 1992).

GRAIN ELEVATORS. Prior to the debtor's filing for bankruptcy, the Missouri Department of Agriculture