S Corporations and Passive Income

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S CORPORATIONS AND PASSIVE INCOME  
— by Neil E. Harl*  

Passive income is a serious problem in estate and business planning.1 Too much passive income can limit or deny the use of several of the tax relief provisions otherwise available to farm and ranch operations.2 A cash rent lease causes the assets involved to be considered as business assets necessary for the provision to be available.3 Moreover, too much passive income can have negative impacts on farm and ranch operations.4

Too much passive income in S corporations falls into the latter category and can lead to additional tax to be levied and possible loss of the S corporation election.5

**The three rules of imputation**

Requirements which include an element of involvement in management of the farm or ranch business, as is the case with the S corporation passive loss rule,6 involve the question of whether an agent or employee can fulfill the requirement. There are three separate rules applicable to various tax situations —

- **The general rule** is that the activities of an agent, such as a farm manager, are imputed to the principal.7 This rule applies to whether property being leased is an interest in a closely-held business for purposes of installment payment of federal estate tax,8 whether lease income is rent for purposes of the personal holding company tax9 and whether lease income is income in respect of decedent.10

- **The second rule** is that the activities of an agent are not imputed to the principal by virtue of a 1974 amendment to Section 1402 of the Internal Revenue Code.11 This rule applies for purposes of special use valuation of land12 and for purposes of determining whether amounts received under a lease are self-employment income.13

- **The third rule** is that the mere presence of a paid manager or agent destroys the principal’s own record of involvement.14 This rule applies only for purposes of applying the passive loss rules.15

**S corporation passive income rules**

S corporations are not subject to limits on passive income if the corporation has no earnings and profits from years in which the corporation was regularly taxed.16 For corporations with accumulated earnings and profits from years in which the corporation was regularly taxed, a tax is imposed at the highest rate for corporate income (now 35 percent)17 on passive investment income exceeding 25 percent of gross receipts.18 The Subchapter S election terminates if the corporation has earnings and profits from years the corporation was regularly taxed and the 25 percent limit is exceeded for three consecutive taxable years.19

Obviously, the passive rules applicable to S corporations are important to farm and ranch corporations.

**Rent of S corporation as passive income**

Although the passive income provisions for S corporations can be activated under various fact situations, the most common is the rental of land by an S corporation under lease. An S corporation can exclude rental income from passive investment income if significant services are performed or substantial costs are incurred in the rental activity.20 Income under a crop share lease with significant participation by corporate officers or agents through physical work, management decisions or both is not passive investment income under the general rule noted above.21 In a 1974 case, rent received under a crop share lease was passive investment income where the tenant was the non-salaried president of the corporation.22 Similarly, income from storage is not passive income if significant services are provided.23

**Conclusion**

S corporations with accumulated earnings and profits should use care in setting up lease arrangements and should assure that one or more corporate officers or agents participate significantly under the lease. In general, a crop share or livestock share lease should meet the test if corporate involvement under the lease is significant and well documented.

**FOOTNOTES**

2 E.g., I.R.C. § 6166 (15-year installment payment of federal estate tax).
7 See Webster Corp. v. Comm’r, 25 T.C. 55 (1955), aff’d, 1960-2 C.B. 7. aff’d, 240 F.2d 164 (2d Cir. 1957) (income from crop share leases was not “rent” for personal holding company
purposes where land was managed by professional farm management firm).


9 See n. 7 supra.


12 I.R.C. §§ 2032A(e)(6), 1402(a)(1).

13 I.R.C. § 1402.


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

BANKRUPTCY
GENERAL-ALM § 13.03.*

DISCHARGE. The debtors had leased dairy cows from the creditor under contract. Over the several years of the contract relationship, the parties kept an informal and often inaccurate account of the number of cows under the lease. The creditor terminated the lease and recovered most of the cows and sued for damages for the missing cows. A state court judgment awarded the creditor damages and the debtor filed for bankruptcy. The creditor sought to have the judgment declared nondischargeable under Sections 523(a)(4), (6). The court held that the debt was dischargeable because (1) the lease did not give rise to a fiduciary relationship as required by Section 523(a)(4) and (2) the loss of the cows, while a breach of contract, was more the result of sloppy accounting over the years by both parties than embezzlement or larceny as required by Section 523(a)(6). In re Hoffman, 5 F.3d 1170 (8th Cir. 1993), aff’g unrep. D.Ct. dec. aff’g, 144 B.R. 459 (Bankr. D. N.D. 1992).

ESTATE PROPERTY. In 1972, the debtor and nondebtor spouse purchased a house which became community property. In 1976, the parties transmuted ownership by quitclaim deed to ownership as joint tenants. The house was sold by the bankruptcy trustee and the nondebtor spouse sought one-half of the proceeds. The court held that the quitclaim deed raised a presumption of joint ownership by quitclaim deed to ownership as joint tenants. In re Sheaffer, 159 B.R. 758 (Bankr. E.D. Va. 1993).

EXEMPTIONS

AVOIDABLE LIENS. The debtors sought to avoid a judicial lien against their residence although the debtors had no equity in the residence at the time of the bankruptcy filing or the avoidance action. The debtors argued that the exemption was impaired to the extent any post-confirmation appreciation might occur. The court held that the debtor’s exemption right and the impairment must be determined at the time of the bankruptcy filing; therefore, the lien was not avoidable because the lien did not impair any current right to an exemption. In re Romagno, 159 B.R. 439 (Bankr. S.D. N.Y. 1993). The court held that the exemption for an IRA, Nev. Rev. Stat. § 21.090, was not unconstitutional as an unreasonable impairment of contracts in existence before the passage of the exemption. In re Seltzer, 159 B.R. 329 (Bankr. D. Nev. 1993).

TRUSTEE. The debtors’ estate included a fully equipped dairy farm which was to be liquidated in the Chapter 7 case. The trustee received an offer to purchase the whole farm with equipment but before the sale could be approved, a creditor with a security interest in the milking equipment repossessed the equipment in violation of the automatic stay. The buyer reduced the offer price but before that offer could be approved, more equipment was improperly removed and the farm was eventually sold at foreclosure, leaving a deficiency claim. The original offer would have satisfied all liens and given the debtors equity for an exemption. The court held that the trustee has the duty to act expeditiously in disposing of estate assets in the best interests of the debtors and creditors. The court held that the trustee did act expeditiously and that the eight month delay from the first offer to the final petition for court approval was caused primarily by the delays of the debtors and interested creditors. The court remanded on the issue of whether the trustee breached the fiduciary duty to preserve the estate by failing to prevent the removal of equipment. In re Hutchinson, 5 F.3d 750 (4th Cir. 1993), aff’g in part and rem’g in part, 132 B.R. 827 (M.D. N.C. 1991), on remand from, 819 F.2d 74 (4th Cir. 1987).

CHAPTER 12-ALM § 13.03[8].

DISPOSABLE INCOME. After the Chapter 12 plan payments had been completed and the debtors filed for a discharge, the trustee and a creditor objected that all disposable income had not been paid to the trustee. The trustee argued that (1) the debtors’ living expenses were unreasonably high and far exceeded the projected expenses, (2) the debtors’ income should include the profit from the sale of an automobile, an ultra-light aircraft and farm equipment, (3) the debtors’ income should include money borrowed to buy farm equipment not necessary for the operation, and (4) disposable income included money borrowed to buy