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RENTING PROPERTY TO ONE'S CORPORATION

— by Neil E. Harl*

The multiple entity approach to farm and ranch business planning with the land in one entity (or owned separately) and the production assets (machinery, livestock and equipment) in another entity has become more popular in recent years. The rise in popularity of multiple entity plans has coincided with the decline in concerns about recapture of investment tax credit and non-corporate lessor eligibility for investment tax credit on acquired assets leased to the production entity.

But one concern has continued to trouble some practitioners with the multiple entity approach — is the rental on the leased land subject to self-employment tax where the lessor is also employed by the corporation? Indeed, the issue has arisen in the course of several IRS audits in recent years.

General rule on leased property

The general rule is that rentals from real estate — and from personal property leased with the real estate — are not included in self employment income unless received in the course of a trade or business as a real estate dealer. That is the result even for crop share leases (and also, for livestock share leases) unless the lessor is materially participating in the production or the management of the production of agricultural or horticultural commodities. In determining material participation, the activities of an agent are not imputed to the landowner as principal.

Those rules are well settled and rarely pose problems.

Employment by the lessee

The question is whether employment of a lessor of property by the lessee constitutes "material participation" for this purpose. While not entirely clear, the answer would seem to be in the negative.

First, and most fundamentally, for one to determine that services as an employee constitute self-employment where property is being leased by the employee as lessor to the employer as lessee would require that the landlord-tenant relationship be ignored as a relationship separate and distinct from the employer-employee relationship.

Second, the discussion in the regulations of "trade or business" states that "the trade or business must be carried on by the individual, either personally or through agents or employees." The regulations go on to state that a trade or business carried on by an estate or trust is not included in determining the net earnings from self-employment of the individual beneficiaries of such estate or trust. This is some indication, albeit limited, that the intention is not to ignore established legal relationships.

Third, the regulations note one possibility for dual status for a lessor of property in stating, "...where an individual or partnership is engaged in a trade or business the income of which is classifiable in part as rentals from real estate, only that portion of such income which is not classifiable as rentals from real estate, and the expenses attributable to such portion, are included in determining net earnings from real estate."9

Fourth, there is no case or ruling on point, but there is limited authority consistent with maintaining the integrity of relationships. In a 1960 IRS ruling, 10 gallonage payments to a gasoline station owner who leased the station to the oil company under an "owner's lease" (a flat rental plus a percentage of gasoline sales) were not considered to be income from self-employment regardless of whether the station owner or a third party operated the station. With the owner operating the station, it is clear that the owner was materially participating in the business to which the station was effectively leased. In another ruling, 12 payments received by farmers under a "lease" agreement with a steel company as a result of damages to livestock, crops, trees and other vegetation because of chemical fumes and gases from a nearby plant were not considered income from self-employment even though the landowners had the right to continue to have full use of the land and the improvements. The payments were in exchange for a release of the landowner from liability. Arguably, the landowner was materially participating in the farming operation separately from the status of the individual as a lessor of the land to the steel company. One possible characterization of the arrangement was that the land owner-farmer was both lessor and farm tenant.

These situations should be contrasted with and distinguished from the situation where a trade or business is being carried on and rental income is buried within the trade

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or business. In that case, the rentals are subject to self-employment tax because the taxpayer is carrying on a trade or business.

In conclusion

While the question is not entirely free of doubt, it appears that convincing arguments can be made that a lessor of land under a cash rent or non-material participation share lease should not have net earnings from self-employment from the rents if the landlord-tenant and employer-employee relationships are carefully established and maintained. It is highly important, if the arrangement is to be respected, to have a written lease between lessor and lessee with standard terms and conditions, calling for a reasonable rental. Moreover, it is important that employee status be established in a written employment agreement with a reasonable salary paid and that all details of both relationships be carefully outlined in the corporate minutes.

FOOTNOTES
2 Id.
3 I.R.C. § 1402(a)(1); Treas. Reg. § 1.1402(a)-4(a).
4 See Dugan v. Comm'r, T.C. Memo. 1994-578 (taxpayer did not make decisions regarding operations and seldom inspected animals; no self-employment income under livestock-share lease).
5 I.R.C. § 1402(a)(1); Treas. Reg. § 1.1402(a)-4(b).
6 Id.
7 Treas. Reg. § 1.1402 (a)-2(b).
8 Id.
9 Treas. Reg. § 1.1402(a)-4(d).
11 Id.
13 Id.
15 Id. See I.R.C. § 1402(a).

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

ADVERSE POSSESSION

HOSTILE POSSESSION. The parties owned neighboring land and the defendants sought to quiet title to a strip of disputed land between the properties. The properties had been owned by related parties and the disputed strip had been farmed for hay by the defendants' predecessors in interest. The defendants argued that the open use of the disputed land caused a presumption of hostile use but the court held that where disputed property was owned by related parties, hostile possession cannot be presumed and does not occur until a distinct assertion of hostile possession occurs. The defendants were able to show that when the disputed land was conveyed in 1921, the plaintiff's predecessor in interest acted as probate attorney. The court held that the conveyance of the disputed property to the defendants' predecessor in interest with the knowledge of one of the defendant's predecessors in interest was a sufficient declaration of hostile title to begin the hostile possession for adverse possession purposes. Talmage v. Ronald Altman Trust, 871 F. Supp. 1577 (E.D. N.Y. 1994).

FENCE. The disputed property had once been owned by one person who split the land with a brother. A fence was constructed between the two parcels but was located a few feet on the original owner's land. The parcels were eventually sold to the parties to this suit with the successor in interest of the brother's portion claiming title to the disputed strip by adverse possession. The evidence demonstrated that the fence enclosed land which was usable only for pasture and the successor claimed that the fence created a presumption of adverse use. However, the other party presented evidence that the fence in other places followed the true boundary and that the fence deviated from the boundary line at the disputed strip because the terrain of the land made it more convenient. The court held that the evidence of convenience overcame the presumption of adverse possession created by the fence and denied the claim of title by adverse possession. Hillard v. Marshall, 888 P.2d 1255 (Wyo. 1995).

The defendant claimed title to 80 acres of land by adverse possession. The land was owned by various owners and had been leased for pasture to various parties until at least 1978. The defendant claimed to have entered the land in 1978 and grazed cattle on the land. The defendant also claimed to have raised crops on the land since 1980 and to have registered the land with the ASCS. However, the defendant provided no third party testimony or written evidence of the defendant's possession of the land until the mid 1980's. The court ruled that a fence was insufficient proof of adverse possession where the land was used for grazing cattle and that the jury was justified in finding that the defendant had not provided sufficient proof of other possession to obtain title by adverse possession. Clements v. Corbin, 891 S.W.2d 276 (Tex. Ct. App. 1994).

BANKRUPTCY

GENERAL-ALM § 13.03.*

AVOIDABLE TRANSFERS. The debtor owned a farm in which the residence was destroyed by fire. The farm was mortgaged to the FmHA (now CFSA). The debtor was able to obtain insurance proceeds after a suit against the insurance company. Almost immediately after receiving the court award, the debtor transferred the money to certificates of deposit and personal accounts. One of the CDs and the