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RENTING LAND TO A FAMILY PARTNERSHIP, CORPORATION OR LLC

— by Neil E. Harl

Farmers typically have several objectives in setting up multiple entities with the land rented to the production entity.\(^1\) One objective, in at least some instances, is to supplement retirement income with rents.\(^2\)

A Tax Court case, decided in late 1995,\(^3\) has called into question a strategy of receiving rents from a family-owned entity under what would appear to be a non-material participation lease entered into to avoid payment of self-employment tax on the rental payments (and, possibly, to avoid loss of social security benefits in retirement). Unless reversed on appeal, the case poses a significant risk to multiple entity arrangements treating lease payments as rent.

The Mizell case

The Tax Court decision, *Lee Mizell*,\(^4\) involved an Arkansas farmer who rented 731 acres of farmland to a family partnership operated with his three sons. The elder Mizell owned a 25 percent interest in the partnership. In typical fashion, the partnership agreement specified that each partner had an equal voice in the management of the partnership operation and in the conduct of the business. Each partner was required to devote full time to the operation. The elder Mizell was active in the partnership in the years in question and reported the distributive share of partnership income as net earnings from self-employment.

The lease of the 731 acres was on a 25 percent crop-share basis with the partnership paying all of the crop expense. The elder Mizell treated the lease as a non-material participation lease and did not report the rental amounts as self-employment income.

The Tax Court focused on the language in the statute\(^5\) providing an exception to the general rule that rentals from real estate are excluded from net earnings from self-employment if there is an “arrangement” with material participation by the owner in the “production or the management of the production” of agricultural commodities.\(^6\) The court noted that the elder Mizell was materially participating in the partnership operations and the statutory language referring to an “arrangement” necessarily embraced the taxpayer’s involvement in the partnership as well as under the lease. Therefore, the rental income under the lease was subject to self-employment tax.\(^7\) The court specifically declined to say whether the lease itself was a material participation or non-material participation lease, reasoning that was no longer an issue in light of the court’s holding.

Is the Mizell holding correct?

The critical question with *Mizell*\(^8\) is whether involvement of a lessor of property in the operations of the lessee constitutes or contributes to “material participation” for purposes of imposition of self-employment tax.

As discussed in a 1995 article,\(^9\) for one to determine that service as a partner in a partnership, employee of a corporation or member of a limited liability company constitutes self-employment income under a lease would require that the landlord-tenant relationship be ignored as a relationship separate and distinct from the partner, employee or member relationship.

There is some authority for the “two hat” theory that a taxpayer may occupy two different positions without suffering an aggregation of effort.

• First, the regulations 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 the estate or trust.\(^10\) This provides some support for the position that the intention is not to ignore established legal relationships.

• Second, the regulations recognize the possibility for separate 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.”\(^11\)

• Finally, the holdings in two 1960 revenue rulings are consistent with maintaining the integrity of relationships. In *Rev. Rul. 60-170*,\(^12\) payments received by farmers under a “lease” agreement with a steel company were to compensate the farmers for damages to livestock, crops, trees and other vegetation because of chemical fumes and gases from a nearby plant. Even though the landowners continued to have full use of the land and the
improvements, the payments were not considered income from self-employment.\textsuperscript{15} By continuing to carry on farming operations and to raise whatever was possible under the circumstances, the landowner was arguably materially participating in the farming operation separately from the status of the individual as lessee of interests in the land to the steel company. In effect, the landowner-farmer was both lessor and farm tenant. The important point is that the taxpayer was allowed to wear two hats for purposes of liability for self-employment tax.

In the other 1960 ruling,\textsuperscript{14} a gasoline station owner had leased the station to an oil company under an “owner’s lease.” The station owner received a flat rental plus a percentage of gasoline sales. The rental payments were not considered to be income from self-employment regardless of whether the station owner or a third party operated the station. The station owner was materially participating in the business to which the station was effectively leased.\textsuperscript{15}

**Importance of formalities**

For any situation in which an individual occupies a dual status, one status being a lessor, it is important for the lease to be in writing with standard terms and conditions calling for a reasonable rental. At the same time, it is important for the status as partner, employee or LLC member to be formally established and maintained.

**In conclusion**

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**CASES, REGULATIONS AND STATUTES**

by Robert P. Achenbach, Jr.

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**ADVERSE POSSESSION**

**POSSESSION.** The disputed strip of land was used by the plaintiffs or their predecessors for over 70 years for pasturing livestock, hunting, fishing, and harvesting timber. The disputed land was not fit for cultivation or development because it often flooded; thus, the primary usefulness of the land was for the purposes for which the plaintiffs used it. The court held that although the plaintiffs’ use of the land was sporadic, the plaintiffs’ use was sufficient given the nature of the land. The plaintiffs exercised exclusive possession by prohibiting the defendants from removing timber from the land. Until a few years before the action was brought and a survey was completed, the defendants and everyone else in the area considered the land as belonging to the plaintiffs. The court held that the plaintiffs had established title to the land by adverse possession. 

**Whiteside v. Rottger,** 913 S.W.2d 114 (Mo. Ct. App. 1995).

**BANKRUPTCY**

**GENERAL-ALM § 13.03.**

**ESTATE PROPERTY.** The debtor operated an auction business and performed an auction of a third party’s personal business property. The debtor deposited the proceeds of the auction in the debtor’s general bank account and later issued a check to the third party for the net proceeds. The check was issued within 90 days before the debtor filed for bankruptcy. The bankruptcy trustee sought to recover the payment as a preferential transfer. The lower courts had held that the transfer was not preferential because the relationship between the debtor and third party was an agent-principal relationship and not a debtor-creditor relationship. The trustee appealed, arguing that once the auction was over and the proceeds were deposited in he debtor’s bank account, the agency relationship terminated and the debtor and third party became debtor and creditor. The appellate court agreed with the trustee, noting that the debtor’s account showed a negative balance during a portion of the time between the deposit of the proceeds and the issuance of the check and the proceeds were not identifiable in the account. The court also placed emphasis on the third party’s lack of control over the proceeds once deposited by the debtor. The court acknowledged that an auctioneer is an agent of the owner of the property auctioned, but there is no discussion of how depositing the proceeds in a general bank account terminates the agency relationship. The holding here seems to have resulted from the court’s isolation of the issuance of the check from the auction transaction, based on a termination of the agency relationship sometime after the auction ended. **In re Rine & Rine Auctioneers, Inc.,** 74 F.3d 854 (8th Cir. 1996).

**JURISDICTION.** The debtor was a produce dealer licensed under the Perishable Agricultural Commodities Act. Several sellers of produce had filed claims against the PACA trust. The trust res was held by a secured creditor of **FOOTNOTES**

2. See 6 Harl, supra n. 1, § 50.02[2].
4. Id.
5. I.R.C. § 1402(a)(1).
6. Id.
7. Id
8. Id
10. Treas. Reg. § 1.1402(a)-2(b).
12. 1960-1 C.B. 357.
13. Id.
15. Id.