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RENTING FARM MACHINERY AT RETIREMENT OR OTHERWISE

— by Neil E. Harl*

The 1989 Tax Court case of *Carl Stevenson*¹ has raised questions as to whether self-employment tax is due on rental income where farm machinery is rented to others (usually children) after retirement or is retained at the time of incorporation and rented to the newly-formed corporate entity.

Stevenson case. The case of *Carl Stevenson*² involved a taxpayer operating as a sole proprietorship who leased portable advertising signs to others. The taxpayer argued that the rentals were not subject to self-employment tax and relied upon I.R.C. Section 1402 excluding rentals from self-employment tax. The Tax Court held for IRS and agreed that the rentals were subject to self-employment tax.

The facts in *Stevenson* are important. In that case, the taxpayer purchased the portable advertising signs for rental or resale, received all telephone orders for the rental and sale of signs, advertised the availability of the portable signs, maintained a bank account for the venture and kept a cash receipts and disbursement journal. The taxpayer personally assembled all new portable signs and stored the signs at a rented warehouse. The taxpayer stored used portable signs at the warehouse. The taxpayer repaired the used signs and maintained all signs that were rented or sold. The taxpayer personally delivered signs that had been purchased or rented. The taxpayer formulated and implemented marketing plans for the sale and rental of the portable signs and obtained all of the necessary licenses, permits and operating certificates required by units of government. The court pointed out that 72 percent of the taxpayer's gross receipts came from the rental of portable signs. In short, the taxpayer was carrying on a trade or business. The taxpayer was not a mere passive lessor of property.

Section 1402. The taxpayer argued that the rentals from the portable sign activity were excluded from self-employment income because of the language of I.R.C. Section 1402 that imposes a tax on "self-employment income."³ That section states that "self-employment income

means —

"Net earnings from self-employment derived by an individual...during any taxable year...."

subject to various exclusions.⁴ Excluded from "net earnings from self-employment" are "rentals from real estate and from personal property leased with the real estate...."⁵ The exclusion does not provide an exclusion for the rental of personal property apart from the real estate.

The Tax Court decision in *Stevenson*, however, held that the taxpayer was conducting a trade or business and so the amounts were involved were subject to self-employment tax.⁶

Lessons from *Stevenson*. Several lessons can be derived from the case of *Carl Stevenson*.

- Anyone conducting a "trade or business" is subject to self-employment tax.⁷

- Anyone receiving payments under an arrangement that does not constitute a trade or business should not be subject to self-employment tax.⁸ Thus, an individual who retires and rents farm machinery to another, family member or otherwise, should not be subject to self-employment tax unless the lessor is active under the rental arrangement. This is not because of the exclusion of rents from self-employment income — that exclusion is only for rentals from real estate and from personal property leased with the real estate.⁹ That outcome is because an individual who retires and leases the farm machinery to another in a passive rental arrangement should not be considered engaged in a trade or business.

- A taxpayer renting land under a material participation crop share or livestock share lease is subject to self-employment tax.¹⁰

- Anyone renting land under a crop share or livestock share lease under a non-material participation arrangement should not be subject to self-employment tax.¹¹ Rental for the land, and from any personal property leased with the land, is excluded from net earnings from self-employment.¹²

- What about an individual leasing personal property to an entity for which they are active employees? In theory, the answer should depend upon whether the lessor is sufficiently involved under the lease for the leasing activity

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to be considered a trade or business.¹³ For a lessor who is the sole employee of the entity as lessee, the task of resisting an I.R.S. assertion of trade or business status for the lessor is the most difficult. Certainly anyone leasing personal property — or even real property — to a lessee for which they are rendering services should use care to develop

the strongest possible case for passive investor status rather than trade or business status. That means the lease should be drafted to place responsibility for maintenance and repair on the lessee, for example, and the lessee should avoid involvement as lessee in management or decision making relative to the property under the lease.

FOOTNOTES

¹ T.C. Memo. 1989-357.

² *Id.*

³ I.R.C. § 1402(a).

⁴ I.R.C. § 1402(b).

⁵ I.R.C. § 1402(a)(1).

⁶ I.R.C. § 1402(a).

⁷ *Id.*

⁸ *Id.*

⁹ I.R.C. § 1402(a)(1).

¹⁰ *Id.* See 4 Harl, **Agricultural Law** § 37.03[3] (1991).

¹¹ *Id.*

¹² I.R.C. § 1402(a)(1).

¹³ I.R.C. § 1402(a).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL

EXEMPTIONS. The debtor claimed as a business homestead property leased to the debtor's wholly-owned corporation. The court held that the debtor was allowed a business homestead exemption in the property. *In re John Taylor Co.*, 935 F.2d 75 (5th Cir. 1991).

The debtor claimed a rural homestead exemption for two lots of land in a rural subdivision located outside a city limits. The lots were contiguous except that a county road by easement passed over the line between the lots. The court held that the debtor was entitled to a rural homestead exemption because the subdivision did not have the characteristics (no local government, businesses or schools) of a city, town or village. Both lots were included in the exemption because the lots were contiguous except for the road and the debtor treated the properties as one. *In re Weaver*, 128 B.R. 234 (Bankr. W.D. Ark. 1991).

Although the debtors signed an agreement with the trustee that the debtors' interests in an ERISA-qualified retirement plan were estate property and not exempt, the employer and plan administrator argued that the interests were exempt under Missouri law. The court held that the Missouri exemption for retirement plans was pre-empted by ERISA. *In re Carver*, 128 B.R. 239 (Bankr. W.D. Mo. 1990).

The trustee filed an objection to the debtor's claimed exemption of an interest in a pension plan. The objection was denied because the trustee failed to file the proof of service. The trustee filed a second objection, with proof of service, after the date for filing objections. The bankruptcy court had allowed the late objection, holding that the objection related back to the timely first objection. The district court held that the second objection did not relate back and was untimely. The case did not raise the issue of whether the exemption would be allowed even without a proper objection as was discussed in a couple of recent cases. (See *In re Peterson*, 920 F.2d 1389 (8th Cir. 1990) p. 47 *supra* and *In re Kazi*, 125 B.R. 981 (Bankr. S.D. Ill.

1991) p. 99 *supra*) *Nuttleman v. Myers*, 128 B.R. 254 (D. Neb. 1991).

The debtor had filed a Chapter 13 case in which the plan was confirmed. The debtor had claimed as exempt interests in two IRA's. The debtor converted the case to Chapter 7 and the trustee objected to the exemptions for the interests in the IRA's, arguing that a recent state case had declared the exemptions unconstitutional. The court held that the debtor was not entitled to the exemptions because as of the date of the conversion, the exemptions were not allowed. *In re Marcus*, 128 B.R. 294 (Bankr. D. Colo. 1991).

The debtor claimed the Massachusetts \$100,000 exemption for a homestead with a fair market value of \$140,000 and \$50,000 of equity, with the intent to avoid liens against the home. A creditor with a lien against the home argued that the exemption be applied to the fair market value of the home before deducting any liens against the home. The court held that the exemption applied to the debtor's equity and that liens could be avoided to the extent the debtor's exemption would be impaired. *In re Giarrizzo*, 128 B.R. 321 (Bankr. D. Mass. 1991).

The debtor claimed an exemption, under Ohio law, of a homestead and sought avoidance of a lien impairing the exemption. The lien creditor had obtained relief from the stay to proceed to foreclosure on the home. The court held that the homestead exemption does not arise until execution, attachment or sale of the residence and that the lien may not be avoided until one of those actions has been taken. However, because an attempt to avoid a lien at the time of sale would be difficult, the court held that upon the filing of the praecipe for issuance of the order for the sale, the debtor may file for lien avoidance. *In re Cardwell*, 128 B.R. 427 (Bankr. S.D. Ohio 1991).

SALE OF ESTATE PROPERTY. The debtor owned a residence with the nondebtor spouse as tenants by the entirety and the trustee sought court approval for the sale of the debtor's interest to the nondebtor spouse for the fair market value of the debtor's interest, as an entirety interest in the property. The sole creditor objected to the sale by claiming that the sale would remove estate property