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Recommended Citation
Available at: http://lib.dr.iastate.edu/aglawdigest/vol5/iss23/1

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RENTING LAND FROM A SPOUSE

— by Neil E. Harl*

With self-employment tax at a 15.3 percent rate on the first $61,200 (for 1995) of income from self-employment for the year, and the combined employer-employee rate for FICA tax the same, there is a great deal of incentive to reduce the amount subject to those taxes. One approach is to pay rent to a spouse for the use of the land owned by the spouse. Rent, as a business expense, is deductible and is reported as investment income, usually on Schedule E. For husbands and wives filing joint returns, schedule E income is subject to income tax but escapes self-employment tax if the lessor is not materially participating under the rental arrangement. In most instances, spousal rentals involve cash rent leases so there is usually no question raised about material participation.

IRS position on rents paid to spouse

In 1991, the Internal Revenue Service, in a private letter ruling, denied a deduction for rent paid to a spouse. That ruling alarmed many practitioners who had been deducting rent for land or other property owned by a spouse. The ruling illustrated that rents paid to a spouse, as with any spousal transaction, are subject to extraordinary scrutiny but should not be automatically disallowed. In that ruling, the parties had not consistently treated the spouse's interest in the land as separate rental property. The husband, as lessee, deducted mortgage interest on the property and in one year paid the property taxes. The ruling held that no bona fide landlord-tenant relationship existed with respect to the property. Accordingly, the rental deduction was denied.

Tax Court decision

In a 1993 Tax Court case, D. Sherman Cox, the court was faced with the question of whether a deduction should be allowed for rent paid to a husband and wife for land and a building used in the husband's law practice. The husband had deducted $18,000 of rental payments on his Schedule C; the rental was reported on their Schedule E as rental income. The couple had 28 other rental properties, the income from which was reported also on Schedule E.

Characterization of the $18,000 of rental on the law practice building as passive income was one of the objectives of claiming the rental payment on the husband's schedule C.

The lot and building in question were owned by the husband and wife as tenants by the entirety. In general, a tenancy by the entirety is treated essentially the same as a joint tenancy except — (1) the property ownership arrangement is not subject to a pre-death right to sever, as is the case with a joint tenancy, and (2) the arrangement is limited to husbands and wives married to each other. Under the state law in question (Missouri), each tenant by the entirety is entitled to one-half of the rental proceeds. The Tax Court held that the one-half of the rental payment attributable to the wife's ownership interest was properly deductible on the husband's Schedule C, and properly reported on the couple's Schedule E as rental income. That was appropriate even though the couple filed a joint income tax return. IRS had argued in the case that prior decisions allowing deductibility of the rent and reporting of the amount as rental income had involved separate returns and that those situations were distinguishable from Cox. The Tax Court, however held that such a distinction was without merit and stated that the filing of a joint return does not change "the basic tax nature of the items in question."

Other IRS rulings

The court in D. Sherman Cox cited to a 1974 revenue ruling, Rev-Rul. 74-209 which involved husband and wife ownership of land in joint tenancy. The husband used the property in his business and paid to his wife one-half of the fair rental value of the property. The husband and wife reported their income from the property in separate federal income tax returns. The ruling acknowledged that, under state law (Wisconsin), each joint tenant may report one-half of the net income from joint tenancy property for income tax purposes. The ruling held that the husband was entitled to deduct as a business expense on his separately filed income tax return the rent he paid to the wife for the use of the land in the husband's business.

The court in Cox also cited to Rev. Rul. 72-504 which allowed individual partners to deduct rents paid to their real estate partnership provided that the entire amount of the rental deduction is included in the rental income of the partnership and is included in the partners' distributive shares of the partnership income.
In conclusion

Provided the rental arrangement is handled at arm's length, under a bona fide landlord-tenant relationship, rents paid to a spouse for the spouse's solely owned property, the spouse's portion of tenancy in common property or the spouse's portion of joint tenancy or tenancy by the entirety property (if state law recognizes that each owner is entitled to a portion of the income) should be deductible by the lessor and reportable as rent by the lessee. Under D. Sherman Cox,24 that should be the outcome even if the spouses file a joint return.

FOOTNOTES

2 I.R.C. §§ 3101, 3111.
3 I.R.C. § 162(a)(3).
4 See 4 Harl, supra n. 1, § 28.05[4].
5 See I.R.C. § 1402.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

BANKRUPTCY REFORM ACT OF 1994

In addition to the provisions summarized at p. 170 supra, the 1994 Act also included the following changes. The Act provides that the automatic stay does not apply to:

1. governamental tax audits;
2. issuances of tax deficiencies;
3. demands for tax returns; or
4. tax assessments or notices and demands for payment of the assessment.

Tax liens filed after a petition do not attach to property by reason of an assessment unless the tax is nondischargeable or the property securing the lien leaves the estate or revests in the debtor. Sec. 116, adding 11 U.S.C. § 362(b)(9).

The 1994 Act also provides that a Chapter 11 plan may not modify a claim secured by the debtor’s principal residence. Sec. 206, adding 11 U.S.C. § 1123(b)(4).

The 1994 Act makes debts nondischargeable if incurred to pay a tax to the United States that would have been nondischargeable under Section 523(a)(1). Sec. 221, adding 11 U.S.C. § 523(a)(14).

In Chapter 11, 12 and 13 cases, if a plan includes the curing of a default, the amount necessary to cure the default is to be determined under the underlying debt agreement and applicable nonbankruptcy law. Sec. 305, adding 11 U.S.C. §§ 1123(d), 1222(d), 1322(e).

The 1994 Act provides that a debtor may not avoid a nonpossessory, nonpurchase-money security interest in implements, professional books, tools of the trade, farm animals or crops of the debtor or a dependent of the debtor to the extent the value of the property exceeds $5,000 if the debtor’s state law (1) allows the debtor to waive the federal exemptions or prohibits the debtor from claiming the federal exemptions and (2) permits the debtor to claim state exemptions without limitation as to the amount except against consensual liens. Sec. 310, adding 11 U.S.C. § 522(f)(3).

GENERAL-ALM § 13.03.*

DISCHARGE. The debtor was an officer, director and 50 percent shareholder of a corporation which was licensed under the Perishable Agricultural Commodities Act (PACA). The corporation purchased, but did not pay for, produce from a creditor. The creditor claimed that the debtor was liable for payment for the produce and that the debt was nondischargeable because of defalcation as a fiduciary by the debtor since the debtor failed to preserve the PACA trust to pay for the produce. The court held that in order for the nondischarge of a debt for defalcation as a fiduciary in a trust, an express or constructive trust must exist between the debtor and creditor. The court held that an express or constructive trust was not created by PACA because (1) no identifiable trust res exists since PACA allows trust assets to be commingled with the produce buyer’s other assets, (2) PACA does not impose fiduciary obligations on produce buyers, and (3) the PACA trust provisions act as a super lien on the produce buyer’s assets. The court also noted that an issue of fact remained as to whether the creditor complied with the PACA notice procedures and as to whether the sales involved contained payment provisions of 30 days or less and were, therefore, protected by PACA. In re Snyder, 171 B.R. 532 (Bankr. D. Md. 1994).

ESTATE PROPERTY. In 1965 a trust was created by the debtor’s parents, the debtor and the debtor’s sister. The settlors contributed their fractional interests in ranch land...