Renting Land to Family Entity

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RENTING LAND TO FAMILY ENTITY

— by Neil E. Harl

In late 1995, the U.S. Tax Court shocked farmers and their tax advisors with the startling news that a non-material participation crop share lease of 731 acres of land to a family partnership (in which the Arkansas landowner was a 25 percent partner) produced self-employment tax liability on the share rents paid to the landowner.¹ Now, an IRS private letter ruling ² has reached the same conclusion under a different factual situation. The growing body of authority supporting the IRS position has fueled an already burgeoning level of audit activity in the area and promises to produce a pronounced shift in estate and business planning strategies for farmers and ranchers.

The latest ruling, dated May 1, 1996,³ involved a husband and wife as officers and directors of a family ranch corporation. Formerly, the taxpayers had operated the ranch as sole proprietors. They incorporated the ranch with the livestock and farmstead transferred to the newly formed corporation. The taxpayers rented the land to the corporation under a cash rent lease. The machinery was also rented to the corporation. Both the taxpayers were employees of the corporation. IRS ruled that both the husband and wife were materially participating in the ranch operation. The taxpayers were held liable for self-employment tax on the cash rental received from the corporation.⁴ The ruling cited the late 1995 case, Lee Mizell,⁵ with approval and reached the same conclusion as the Tax Court reached in the Mizell case. The IRS ruling, however, involved a cash rent lease rather than the crop share lease in Mizell.⁶

Reasoning employed

In both the Mizell case⁷ and the 1996 ruling, the focus was on the language in I.R.C. § 1402. That section provides, in part --

“(1) The term ‘net earnings from self-employment’ means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member; except that in computing such gross income and deductions and such distributive share of partnership ordinary income or loss --

“(a) There shall be excluded rentals from real estate and from personal property leased with the real estate (including such rentals paid in crop shares) together with the deductions attributable thereto, unless such rentals are received in the course of a trade or business as a real estate dealer, except that the preceding provisions of this paragraph shall not apply to any income derived by the owner or tenant of land if (1) such income is derived under an arrangement, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities... on such land, and there shall be material participation by the owner or tenant... and there is material participation by the owner or tenant... with respect to any such agricultural or horticultural commodity...”(Emphasis added).

The Tax Court and the IRS in the letter ruling interpreted the term “under an arrangement” to include the activities of the landowner as a partner or corporate officer and director as well as the activities of the landowner as lessor under the lease. Both the Tax Court and the IRS found the material participation requirement to have been met even though the activities of the landowner as lessor alone were insufficient for material participation. The combining of activities of a landowner as lessor and as an active member of the production entity (partner or employee) has been criticized.¹⁰

Planning options

The position taken successfully by IRS in the Tax Court case and in the letter ruling suggests several planning strategies for farmers and ranchers --

• One possibility is to revert to greater use of the single entity approach to farm business planning as was the case in the 1970s and early 1980s when investment tax credit eligibility for non-corporate lessors and the potential for investment tax credit recapture on formation of multiple entities discouraged use of the multiple entity approach to planning.¹¹ The advantages of keeping the land separate from the production entity, however, are viewed as sufficiently advantageous to suggest that this planning option is expected to be an unpopular choice.

¹ Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
• Another possibility is to shift landownership to the spouse (using the 100 percent federal gift tax marital deduction)\(^2\) with the spouse renting the land to the production entity under a non-material participation crop share, livestock share\(^3\) or cash rent lease. For this strategy to succeed, it would be necessary for the land owning spouse not to be involved in the production entity as partner, employee or otherwise to the extent that the combined level of involvement constitutes material participation. No attribution rules exist to treat spousal ownership of land in this type of setting as land ownership by the non-land owning spouse.

• Another possible strategy would be to convey the land to another entity (other than a grantor trust) with the land owning entity then entering into a lease with the production entity. Although a successful outcome (in terms of avoiding self-employment tax) is not assured, it is believed that income from self-employment would not be imputed to the entity owners.

• Finally, some may prefer to simply pay the additional self-employment tax, particularly if the amount of earned income otherwise is approaching the covered amount for OASDI purposes ($62,700 for 1996). It is important to note that HI tax now continues to apply to all self-employment income.\(^4\)

FOOTNOTES
2 Ltr. Rul. 9637004, May 1, 1996.
3 Id.
4 Id.
5 T.C. Memo. 1995-571.
6 Id.
7 Id.
8 Ltr. Rul. 9637004, May 1, 1996.
9 I.R.C. § 1402(a)(1).
10 See Harl, “Renting Land to a Family Partnership, Corporation or LLC,” 7 Agric. L. Dig. 49 (1996).
11 See 6 Harl, supra n. 1, §§ 50.03, 50.04. See also Harl, supra n. 1, § 7.01.
12 I.R.C. § 2523.
13 See Dugan v. Comm’r, T.C. Memo. 1995-578 (taxpayer did not physically work on ranch, did not make decisions regarding operations and seldom inspected animals; held to be non-material participation livestock share lease).
14 Pub. L. 103-66, Sec. 13207(a), (b), (e), 107 Stat. 467 (1993).

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

ANIMALS

BULL. The plaintiff was injured when the plaintiff’s vehicle on a public highway struck a bull owned by the defendant. The bull had escaped from the defendant’s feedlot by pushing against and jumping a five foot non-electrified fence. The evidence presented by the testimony of the defendant showed that the bull had escaped from pastures twice before, the bull had a gentle nature, hay was stored just outside the feedlot fence and the bull was usually kept within pastures with electrified fences. The defendant moved for a directed verdict after the plaintiff’s case was presented and the trial court granted the motion because the plaintiff failed to show that the defendant had not exercised due care in the restraining of the bull. The appellate court reversed, holding that the plaintiff, through the defendant’s own testimony, had presented sufficient issues of fact concerning the defendant’s exercise of due care to require the defendant to demonstrate that due care was exercised. Nevious v. Bauer, 667 N.E.2d 1074 (III. Ct. App. 1996).

HORSES. The plaintiff owned nine horses which were boarded in Wisconsin. The horses were seized by the county humane society after the horses were found to be neglected by the stable. The humane society notified the plaintiff in Alaska that the plaintiff had to redeem the horses within five days by paying for their maintenance by the county and moving the horses to other quarters. After five days, the county declared the horses to be strays, under Wis. Stat. 951.15(3), and placed the horses for adoption with members of the society, their families and friends for nominal amounts. The plaintiff sued for recovery of the horses, arguing that the seizure and adoption of the horses deprived the plaintiff of property rights in the horses without due process. The court held that the seizure of the horses without allowing the plaintiff an opportunity for a hearing on the seizure was a violation of the plaintiff’s constitutional property rights. The court also held that the random or unauthorized actions of the society members did not excuse the state from liability for the constitutional violation. Porter v. DiBlasio, 93 F.3d 301 (7th Cir. 1996).

BANKRUPTCY

CHAPTER 13-ALM § 13.03.*

DISPOSABLE INCOME. The debtors had claimed $15,000 of equity in their homestead as an exemption. The exemption was allowed and the plan confirmed. During the plan, the house was sold with $2,654.07 in proceeds left after all expenses. The trustee argued that the proceeds were includible in the debtors’ disposable income and should be applied to the plan payments. The court held that, because

* Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.