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MORE ON LEASES OF PERSONAL PROPERTY

— by Neil E. Harl*

The apparent position of the Internal Revenue Service in audits and in informal communications from the National Office in recent months has been that all leases of personal property produce income subject to self-employment tax.¹ The note on Part I of the 1992 edition of Schedule E, Form 1040, that taxpayers are to "report income and expense from the rental of personal property on Schedule C or C-Z" has provided confirming evidence of the IRS position. This is particularly important to farmers who lease farm machinery in retirement to a tenant.

Section 1402

Section 1402 of the Internal Revenue Code² imposes self-employment tax on "self-employment income." That section states that self-employment income means —

"Net earnings from self-employment derived by an individual from any trade or business *carried on by such individual...* during any taxable year...." (Emphasis added)³

The same code section specifies that the term "trade or business" has, with some exceptions not relevant here, "the same meaning as when used in section 162...."⁴

Meaning of trade or business

There is no doubt that a taxpayer receiving income from allowing others to use property is subject to self-employment tax if the operation constitutes a trade or business.⁵ Similarly, an individual rendering services is subject to self-employment tax if the activity rises to the level of a trade or business.⁶

As noted above, the term "trade or business" has the same meaning as when used in I.R.C. § 162 involving deductibility of trade or business expenses.⁷ Note, however that the statute does not define "trade or business carried on by such individual"⁸ although the wording suggests that the trade or business must be carried on by the taxpayer and involve some taxpayer activity.

In cases decided under Section 162, the courts have generally held that continuity and regularity of activity were necessary before a venture could be considered a trade or business⁹

An inactive venture generally has not been considered to be a trade or business.¹⁰ Even significant levels of taxpayer activity have not been sufficient for trade or business status.¹¹ The U.S. Supreme Court has stated that "expenses incident to caring for one's own investments, even though that endeavor is full-time, are not deductible as paid or incurred in carrying on a trade or business."¹²

Conclusion

If an operation does not constitute a trade or business, and passive rental of personal property such as farm machinery could seemingly be so characterized, self-employment tax should not be due and routing such income through Schedules C, F or CZ would be inappropriate. In addition, "rentals from real estate *and from personal property leased with the real estate*" (emphasis added) are specifically excluded from net earnings from self-employment.¹³ Thus, leasing machinery with the land is a relatively safe solution to the problem until the matter is clarified by cases or rulings.

FOOTNOTES

¹ See Harl, "Leasing Personal Property," 4 *Agric. L. Dig.* 1 (1993).

² I.R.C. § 1402(a).

³ *Id.*

⁴ I.R.C. § 1402(c).

⁵ I.R.C. § 1402(a). See *Stevenson v. Comm'r, T.C. Memo. 1989-357* (business of leasing and selling portable advertising signs).

⁶ *Batok v. Comm'r, T.C. Memo. 1992-727* (one month's work installing windows not continuous and regular activity and not trade or business).

⁷ I.R.C. § 1402(c).

⁸ I.R.C. § 1402(a).

⁹ *Stanton v. Comm'r, 399 F.2d 326* (5th Cir. 1968) (efforts were "irregular and sporadic" as inventor; no trade or business); *Sloan v. Comm'r, T.C. Memo. 1988-294*, (attorney not involved in law practice "with continuity and regularity;" not trade or business). See *Charlton v. Comm'r, T.C. Memo. 1988-515* (expenses incurred seeking work as plumber); *Heinemann v. Comm'r, T.C. Memo. 1988-164* (activity as inventor while working for U.S. Government; no trade or business).

¹⁰ *Id.* See *Heim v. Comm'r, T.C. Memo. 1978-137* (corporation kept in existence to collect interest and

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principal payments on installment note; not engaged in trade or business); *Est. of Sussman v. Comm'r, T.C. Memo. 1978-344* (retired CPA who earned no income as accountant no longer engaged in trade or business).

- ¹¹ *Jones v. Comm'r, T.C. Memo. 1988-393* (full time auditor at college not engaged in trade or business of gambling even though substantial activity involved). See

Rev. Rul. 58-112, 1958-1 C.B. 323 (corporate officer who negotiated sale of corporate stock not in trade or business).

- ¹² *Commissioner v. Groetzinger*, 480 U.S. 23 (1987) ("constant and large-scale effort" by taxpayer in gambling activity was trade or business).

- ¹³ I.R.C. § 1402(b).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ANIMALS

HORSES-ALM § 1.01[2].* The plaintiff's decedent was killed when the decedent's car struck the defendant's horse on a highway. The horse had been confined by a low fence and the defendant testified that the gate to the pasture was found open after the accident. The trial court granted summary judgment to the defendant because the plaintiff had failed to provide evidence of the defendant's negligence in fencing in the horse. The appellate court reversed, holding that Miss. Code § 69-13-111 provides a presumption that the owner of an escaped animal was presumed to have been negligent and required the owner to prove lack of negligence. ***Carpenter v. Nobile*, 620 So.2d 961 (Miss. 1993).**

BANKRUPTCY

GENERAL

DISCHARGE-ALM § 13.03[6].* An insurance company hired the debtor to recover and sell a stolen tractor found by the police. The debtor made the highest bid and retained the tractor but failed to make any payment to the company. The debtor sold the tractor without paying the company and the company obtained a default judgment for the price of the tractor plus punitive damages. The company claimed that the judgment was nondischargeable, arguing that the Bankruptcy Court must give the default judgment issue preclusion as to the debtor's willful and malicious injury of the company's property. The court held that a default judgment may not be accorded either claim or issue preclusion in a subsequent bankruptcy proceeding. However, the court held that the facts of the case demonstrated the debtor's willful and malicious injury of the company's property and denied the debtor's discharge of the judgment, including the punitive damages. ***In re Hale*, 155 B.R. 730 (Bankr. S.D. Ohio 1993).**

EXEMPTIONS-ALM § 13.03[3].*

AUTOMOBILE. The debtor claimed the \$2,000 exemption, under Va. Code § 34-26(8), for a vehicle which was collateral for a nonpurchase money loan. The trustee obtained an avoidance of the lien against the vehicle and sold the vehicle at an auction. The trustee argued that in avoiding the lien, the trustee became the lien holder and was entitled to the proceeds of the sale of the vehicle before the debtor could claim any exemption. The court held that under Va. Code § 34-26, nonpurchase liens against exempt

property were void; therefore, because the lien was never effective against the exemption, the trustee's lien status was junior to the exemption. The court also held that the debtor's exemption carried over to the proceeds of the vehicle. ***In re Fenessy*, 156 B.R. 22 (Bankr. E.D. Va. 1993).**

AVOIDABLE LIENS. A creditor obtained a judgment against the debtors in 1989 and recorded the judgment lien. At the time the judgment lien attached, the debtor's property was rented to third parties. The debtors moved into the property in 1992 and filed for bankruptcy in 1993. The debtors claimed the California automatic homestead exemption available in 1993 for \$100,000 for residents over the age of 55 and income of less than \$20,000. The creditor objected to the exemption, arguing that the exemption should be determined as of the date the judgment lien attached in 1989 when the property was not used as a residence. The court held that the debtors could create a homestead exemption by moving into the property pre-petition but that the lien was avoidable only to the extent of the homestead exemption available to the debtors at the time the lien attached to the property. ***In re Mayer*, 156 B.R. 54 (Bankr. S.D. Cal. 1993).**

HOMESTEAD. The debtor's mortgagee obtained a foreclosure of the mortgage against the debtors' residence. The debtors filed suit to invalidate the sale of the residence. Prior to filing for bankruptcy, the debtors had entered into a settlement with the mortgage holder to allow the debtors time to attempt to sell the residence. Before the time expired, the debtors filed for bankruptcy and the trustee renegotiated the settlement agreement and eventually sold the residence. The debtors filed an exemption for the residence. The trustee objected to the exemption, arguing that the foreclosure eliminated the debtors' interest in the residence such that on the petition date, the debtors had no interest in the residence for which an exemption was allowed. The court held that because the validity of the foreclosure was never finally litigated, the debtors had a possible interest in the residence sufficient to claim the residence as a homestead exemption. The trustee also argued that because the sale was made post-petition, the debtor could not claim the exemption in the proceeds. The court held that the debtors' exemption continued in the proceeds of the residence, whether sold pre- or post-petition. ***In re Donaldson*, 156 B.R. 51 (Bankr. N.D. Cal. 1993).**

The debtors had been residents of Wisconsin where the husband was a part owner of a small business for which the debtor had guaranteed several business loans. When the