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TYPE OF LEASE FOR AN S CORPORATION

— by Neil E. Harl*

Since enactment of the S corporation concept in 1958, it has been important to give careful thought to the kind of lease entered into by S corporations as landowners.¹ In the years since the major amendments to Subchapter S of the Internal Revenue Code in 1982,² The type of lease has been less important for some S corporations but it is still a major checklist item for S corporation planning.

The rule through 1982. Under the rules applicable through 1982, the S corporation election terminated if more than 20 percent of the corporation's gross receipts came from rents, royalties, dividends, interest, annuities and sales or exchanges of stock or securities.³ The term rent, however, did not include payments for the use or occupancy of property where significant services were rendered.⁴ In a farm context, the Internal Revenue Service had ruled that income of farm corporations owning and leasing farms to tenants under a crop-share or livestock share lease was not "rental" income if the corporate officers or agents participated to a material degree in production through physical work, management decisions or both.⁵ The Tax Court agreed with that position.⁶ The purported assignment of rents to another organization was ineffective in avoiding application of the 20 percent rule.⁷

Rules applicable after 1982. Under the 1982 amendments, the limit on passive investment income is eliminated for corporations that do not have accumulated earnings and profits from years the corporation was regularly taxed.⁸

For corporations with accumulated earnings and profits from years in which the corporation was regularly taxed, a tax is imposed at the highest rate for corporate income on the passive investment income in excess of 25 percent of gross receipts.⁹ Note that the tax is not imposed because of earnings and profits accrued while the corporation was taxed as an S corporation. A Subchapter S election terminates if a corporation under a Subchapter S election has earnings and profits at the close of each of three consecutive taxable years from years the corporation was under regularly taxed or Subchapter C status and more than 25 percent of gross receipts from each of the taxable years comes from passive investment income.¹⁰ If steps are taken immediately to pay net earnings and profits as a dividend, the termination of S corpo-

ration status may be considered inadvertent.¹¹ For inadvertent terminations, IRS is authorized to waive the effects of the termination if the corporation acts in a timely fashion to correct the problem and if the corporation and the shareholders agree to be treated as though the election had been in effect for the period involved.¹²

The rules applicable since 1982 mean that newly formed S corporations and existing S corporations with no earnings and profits need not worry about the passive income limitation. As was the case before 1983,¹³ income under a crop share or livestock share lease with material participation is not considered to be passive income.¹⁴ Thus, careful attention as to type of lease is suggested for S corporations with earnings and profits from years the corporation was regularly taxed. If assets are leased, those corporation should be careful to use a crop share or livestock share lease with material participation demonstrated under the lease. The corporation should designate someone to be involved in meeting the material participation requirement with the corporate records, including the minutes, reflecting the necessary involvement under the lease.

An important point to note is that if a corporation's Subchapter S election terminates because the passive income limit is not met, the election terminates for the entire taxable year.¹⁵

FOOTNOTES

- ¹ See generally 7 Harl, *Agricultural Law* § 56.06[4] (1990).
- ² Pub.L. 97-354, 96 Stat. 1669 (1982).
- ³ I.R.C. § 1372(e)(5). *McIlhinney v. Comm'r*, T.C. Memo. 1979-473 (election terminated even though taxpayer had loss); *Masters v. U.S.*, 80-1 U.S. Tax Cas. (CCH) ¶ 9376 (E.D. Wis. 1980) (farm corporation received "rent").
- ⁴ See, e.g., *City Markets, Inc. v Comm'r*, 433 F.2d 1240 (6th Cir. 1970).
- ⁵ Rev. Rul. 61-112, 1961-1 C.B. 399.
- ⁶ See *Kennedy v. Comm'r*, T.C. Memo. 1974-149 (nonsalaried president of corporation was also tenant under crop-share lease; held, passive investment income since corporation was not actively involved in activity).
- ⁷ *Johnston v. Comm'r*, T.C. Memo. 1976-142.
- ⁸ I.R.C. § 1362(d)(3).
- ⁹ I.R.C. § 1375(a).
- ¹⁰ I.R.C. § 1362(d)(3)(A).
- ¹¹ See Ltr. Rul. 9026011, March 22, 1990 (election terminated because passive investment income exceeded 25 percent of gross receipts for three consecutive years; steps taken

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immediately to pay out earnings and profits as dividend so termination inadvertent).

¹² I.R.C. § 1362(f).

¹³ See note 5 *supra* and accompanying text.

¹⁴ Ltr. Rul. 9003056, Oct. 26, 1989.

¹⁵ I.R.C. § 1362(d)(3)(A)(ii).

CASES, REGULATIONS AND STATUTES

BANKRUPTCY

GENERAL

ADMINISTRATIVE EXPENSES. The debtor leased grain and manure storage equipment and continued to possess and use the equipment during the bankruptcy case. Two of the leases were in default prior to the bankruptcy filing and all three leases terminated by their terms after the filing. The debtor did not assume the leases and agreed to return the equipment to the lessor. The court held that although the debtor did not make full use of the equipment during the debtor's post-petition possession, the lessor was entitled to an administrative expense claim for the fair rental value of the equipment while the debtor possessed it post-petition. **Matter of Thayn Farms, Inc., 117 B.R. 5120 (Bankr. D. Neb. 1988).**

AVOIDABLE LIENS. The Chapter 7 farm debtors claimed a disc, planter and tractor as exempt under the federal tools of the trade and wild card exemptions in Section 522(d). The debtors also sought to avoid liens against the equipment to the extent of the exemptions. The court held that large farm machinery such as the equipment here are eligible for the tools of the trade exemption for farm debtors. **In re Sugarek, 117 B.R. 271 (Bankr. S.D. Tex. 1990).**

EXEMPTIONS. The debtor owned an interest in a state mandated retirement account which was accumulated while the debtor was a public school teacher. On the date the petition was filed, the debtor was no longer employed as a teacher and had the right to withdraw amounts the debtor had contributed to the account. The court held that the state retirement account was a spendthrift trust under Iowa law and excludible from the debtor's estate except that because the debtor's employment had terminated and the debtor could withdraw funds from the account, the account was no longer a spendthrift trust and was included in the debtor's estate. The court also held that the debtor's interest in the account which could be withdrawn was exempt under the special exemption provided in the law creating the retirement account, Iowa Code Chapter 97B. **Matter of Carver, 116 B.R. 985 (Bankr. S.D. Iowa 1990).**

The debtor lived in Iowa and owned an interest in a Nebraska city employee retirement account which prohibited assignment or attachment. The debtor could not make any withdrawals from the account before termination of employment or retirement, and at the date of the bankruptcy petition, the debtor was still employed with the city. The court held that the retirement account was a spendthrift trust under Nebraska law and excluded from the debtor's bankruptcy estate. The court provided an alternative analysis that if the account was includible in the estate, the debtor would not be entitled to an exemption under Iowa Code 627.6(8)(e),

because the amount in the account was not reasonably necessary for the support of the debtor. **Matter of Layton, 116 B.R. 995 (Bankr. S.D. Iowa 1990).**

The debtor lived in Iowa and owned an interest in a Nebraska state employee retirement account which was exempt from taxes, execution and attachment and which prohibited assignment. The debtor could not make any withdrawals from the account before termination of employment or retirement, and at the time of the petition, the debtor was still employed. The court held that the retirement account was a spendthrift trust under Nebraska law and excluded from the debtor's bankruptcy estate. The court provided an alternative analysis that if the account was includible in the estate, the Iowa exemption for interests in retirement accounts was not preempted by ERISA. The court found insufficient evidence on the record to determine whether the account was necessary for the support of the debtor. **Matter of Gouker, 116 B.R. 1005 (Bankr. S.D. Iowa 1990).**

The debtor owned an interest in an employer funded ESOP which was qualified under ERISA. The debtor was prohibited from assigning her interest in the plan and could not make withdrawals until termination of employment or retirement, and at the time of the petition, the debtor was still employed. The court held that the ESOP was a spendthrift trust under Iowa law and excluded from the bankruptcy estate. The court provided an alternative analysis that the Iowa exemption for the plan was not preempted by ERISA but that the debtor's interest in the plan would not be exempt because it was not necessary for the support of the debtor. **Matter of Bartlett, 116 B.R. 1015 (Bankr. S.D. Iowa 1990).**

The debtor claimed a homestead exemption in a rural home and farmland acquired by will from a parent. At the time of the petition, however, the debtor and family lived in an urban home several miles from the claimed homestead. Although the debtor farmed the land, the debtor never lived in the claimed homestead but only filed a statement of intended homestead prior to filing bankruptcy. The court denied the homestead exemption and found that the urban residence was the debtor's homestead for exemption purposes because the debtor did not take any overt actions which established homestead qualities on the claimed homestead or established abandonment of the old residence. **In re Bohac, 117 B.R. 256 (Bankr. W.D. Tex. 1990).**

The debtor owned an interest in an employee annuity plan provided by the employer and claimed the interest as an exempt annuity under Ohio Rev. Code §§ 2329.66(A)(6)(b), 3911.10. The court held that the debtor's interest in the annuity was not eligible for the exemption because payment of the annuity did not depend upon the death of the debtor but was a pension savings plan based upon employment. **In re Cullison, 117 B.R. 314 (Bankr. S.D. Ohio 1990).**