Agricultural Law Digest

An Agricultural Law Press Publication | Volume 6, No. 12 | June 16, 1995
Editor: Robert P. Achenbach, Jr. | Contributing Editor Dr. Neil E. Harl, Esq. | ISSN 1051-2780

LAND RENTAL BY S CORPORATIONS

— by Neil E. Harl*

Since enactment of Subchapter S in 1958,[1] attention has been focused on the type of lease entered into by S corporations.[2] The question has been whether the income received by the S corporation as lessor constituted "rents" for purposes of the passive income test.[3]

Current passive income rule

The pre-1983 limit on passive investment income was eliminated by the Subchapter S Revision Act of 1982[4] for corporations which do not have accumulated earnings and profits from years the corporation was regularly taxed.[5] Thus, corporations without earnings and profits face no limitations on passive investment income. Even cash rents are of no consequence tax-wise and pose no threat to the S corporation election.

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 (now 35 percent)[6] on the passive investment income in excess of 25 percent of gross receipts.[7] A Subchapter S election terminates, however, 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 the gross receipts from each of the taxable years comes from passive investment income.[8] That is the outcome even though the corporation has no taxable income for the year or years in question.[9] IRS has ruled that the termination may be deemed to be inadvertent if steps are taken immediately to pay out the accumulated earnings and profits as a dividend[10] but the termination nonetheless occurs. If a corporation's Subchapter S election terminates because the passive income limit is met, the election terminates for the entire taxable year.[11]

Meaning of "passive investment income"

The statute states clearly that if "passive investment income" exceeds 25 percent for the year, the additional tax is imposed[12] and, after three consecutive years of such tax, the election is terminated.[13] The statute defines "passive investment income" to include

> "...gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities...."[14]

Because of the frequency of land rental on the part of farm corporations and the magnitude of rental amounts, the meaning of "rents" has taken on a great deal of significance.

IRS ruled in 1961 that income under a crop share lease with significant involvement under the lease by someone acting on behalf of the corporation as lessor was not considered passive income under the pre-1983 rule.[15] That position was reiterated in a 1989 private letter ruling.[16]

In late 1994, IRS ruled[17] that rent received under even a cash rent lease was not considered to be passive investment income where representatives of the corporation visited the farm every week, consulted with the tenant, maintained and repaired the buildings and equipment, inspected and maintained the drainage ditches and tile lines and devoted several days to helping the tenant during planting and harvesting seasons.[18] The lease had previously been a crop-share lease but the corporation as lessor had shifted to a one-year cash rent lease several years earlier.[19] The ruling recites that, after the expiration of the crop share lease, the corporation sold most of its equipment. However, the ruling states —

> "...because the new tenant could not afford the farm help necessary to operate successfully, [the corporate representatives] became more involved with this tenant's operations than with those of the former tenant."[20]

The outcome was that the cash rent received was not passive investment income.

Thus, it does not appear that it is absolutely essential to be bearing the risks of production and the risks of price change in order to avoid having rents classified as passive investment income. It is, however, important to be able to demonstrate substantial involvement under the lease by someone on behalf of the S corporation. A crop share lease continues to be a notch safer than a cash rent lease, notwithstanding the 1994 ruling.[21]

FOOTNOTES

1 I.R.C. §§ 1361-1379. See generally 7 Harl, *Agricultural Law* ch. 56 (1995); Harl, *Agricultural Law Manual* § 7.02[3][c](1995).

2 See Harl, "Type of Lease for an S Corporation," 1 *Agric. L. Dig*. 197 (1990).

3 *Id*.

4 Pub. L. 97-354, 96 Stat. 1669 (1982).

5 See I.R.C. § 1362(d)(3).

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[6] I.R.C. § 11(b)(1)(D).
[7] I.R.C. § 1375(a).
[8] I.R.C. § 1362(d)(3)(A).
[9] Ltr. Rul. 9327060, April 8, 1993.
[10] Ltr. Rul. 9026011, March 22, 1990.
[11] I.R.C. § 1362(d)(3)(A)(ii).
[12] I.R.C. § 1375(a).
[13] I.R.C. § 1362(d)(3)(A)(i).
[14] I.R.C. § 1362(d)(3)(D)(i).
[15] Rev. Rul. 61-112, 1961-1 C.B. 399.
[16] Ltr. Rul. 9003056, Oct. 26, 1989.
[17] Ltr. Rul. 9514005, Dec. 23, 1994.
[18] *Id*.
[19] *Id*.
[20] *Id*.
[21] Ltr. Rul. 9514005, Dec. 23, 1994.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ADVERSE POSSESSION

CONTINUOUS USE. The disputed land included 31 acres erroneously included in the plaintiff's land by surveyors. The plaintiff presented evidence of some use of the disputed land as pasture and claimed a fence on the defendant's side of the disputed land was the boundary. The court held that the plaintiff had not shown sufficient hostile use to demonstrate adverse possession as a matter of law because the plaintiff failed to show continuous use of the disputed land and failed to show that the fence was adequately maintained to as to completely separate the disputed land from the defendant's land. **Wall v. Carrell, 894 S.W.2d 788 (Tex. Ct. App. 1994)**.

BANKRUPTCY

GENERAL-*ALM* § 13.03.*

EXEMPTIONS

AVOIDABLE LIENS. The debtor filed a motion to avoid a judgment lien against the debtor's homestead. The debtor had filed an exemption for the homestead in the amount of $40,000 although Mont. Code § 70-32-104 allowed only an exemption of $20,000. However, no timely objections were filed. The court held that for avoidance purposes, the debtor was limited to the exemption amount the debtor "could claim;" therefore, the debtor could avoid judgment liens only to the extent the lien impaired the $20,000 statutory limit. ***In re* Moe, 179 B.R. 654 (Bankr. D. Mont. 1995)**.

HOMESTEAD. The debtor claimed a homestead exemption for the debtor's $39,000 of equity in the homestead. The Chapter 7 trustee objected to the exemption because there existed $36,000 of pre-homestead claims in the case. The trustee argued that the trustee had the authority to object to the exemption under either Section 544(b) or as a representative of the estate. The court held that Section 544(b) did not apply because there was no transfer by the debtor to avoid by the trustee; however, the court held that the trustee did have the authority to object to the exemption on behalf of the pre-homestead creditors. The court also held that the debtor could not claim a homestead exemption except to the extent the equity in the homestead exceeded the pre-homestead claims filed in the case. ***In re* Rye, 179 B.R. 375 (Bankr. D. Minn. 1995)**.

IRA. The debtor claimed the funds in an IRA as exempt under N.J. Stat. § 25:2-1. The trustee argued that the IRA was eligible for the exemption because the IRA funds wee not rolled over from an ERISA qualified plan and the debtor had unrestricted access to the funds. The court held that the IRA was eligible for the exemption because the state exemption did not require that the funds be derived from an ERISA qualified plan or that the debtor's access to the funds be restricted. ***In re* Lamb, 179 B.R. 419 (Bankr. D. N.J. 1994)**.

CHAPTER 11-*ALM* § 13.03.*

PLAN. The debtor operated a retail garden shop and nursery. The Chapter 11 plan provided that the debtor would retain the business property and included the property at its liquidation value, thus stripping down the secured claims to the liquidation value. The court held that the property had to be included at its fair market value because the debtor had no intention of selling the property and would continue to receive income from the property. ***In re* Winthrop Old Farm Nurseries, Inc., 50 F.3d 72 (1st Cir. 1995)**.

CHAPTER 12-*ALM* § 13.03[8].*

CONVERSION. The Chapter 7 debtor operated an exotic animal farm in which the debtors raised animals belonging to other investors in return for a partial ownership in the animals. The Chapter 7 trustee had filed a motion to reject the animal raising contracts because of the high expenses, the declining market for such animals and the debtors' interference with the trustee's operation of the business. The debtors then filed a motion to convert the case to Chapter 12. The debtors argued that they had an absolute right to convert the case at any time absent fraud. The debtors' argument was based on the legislative history of Section 706(a) in which the Senate committee report referred to the "absolute right" to convert a case. The court held that a Chapter 7 debtor did not have an absolute right to convert to Chapter 12 because the statute and legislative history provided exceptions to the conversion right. The court also held that conversion would be denied because the debtors' contracts to raise the animals could be rejected by the trustee based on the losses incurred by the estate and the debtors' actions impairing the operation of the business. ***In re* Starkey, 179 B.R. 687 (Bankr. N.D. Okla. 1995)**.

FEDERAL TAXATION-*ALM* § 13.03[7].*

ALLOCATION OF PAYMENTS FOR TAXES. The debtors' business suffered losses from embezzlement by the