Tax Aspects of Leasing

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I. Lease or Purchase

Every year taxpayers face the problem of determining whether payments are for rent or for the purchase of property. The issue is whether the transaction is a valid tax lease or a conditional sales contract.

Whether the agreement is a conditional sales contract depends upon the intent of the parties. Intent is based upon all of the facts and circumstances existing at the time the agreement is made.

Determining Intent

Generally, an agreement will be considered a conditional sales contract rather than a lease if any of the following is true (these factors are based on a lack of "economic substance" for a lease to exist):

1. The agreement applies part of each payment toward an equity interest the "lessee" will receive.
2. The "lessee" gets title to the property upon the payment of a stated amount required under the contract.
3. The amount the "lessee" pays to use the property for a short period of time is a large part of the amount that would have to be paid to get title to the property.
4. The "lessee" pays much more than the current fair rental value of the property.
5. The "lessee" has the option to purchase the property at a nominal price compared to the value of the property at the time the purchase option is exercised.
6. The "lessee" has the option to buy the property at a nominal price compared to the total amount the "lessee" has to pay under the lease.
7. The lease designates some part of the payments as interest, or part of the payments are easy to recognize as interest.

Example 1. Facts: Fred Smith is a farmer who needs to acquire a building in which to store his equipment. Fred has determined that there are two options available to him. He could have the building built by a local contractor or enter into a contract with a leasing company that would have the building built for him and lease the building from that company. After a review of both options, Fred has decided to enter into the leasing contract. The lease that Fred signs contains the following terms and conditions:

- Fred gives the leasing company rights of access to the property.
- The lease is for seven years beginning November 1, 1996, and ending October 31, 2003. The lease payments are even amounts of $4,800, payable on November 1 of each year.
- Fred is required to pay all real estate taxes, insurance, and repairs on the building.
- At the end of the lease term, the lease may be renewed for additional periods of one year, each at a rental equivalent to the fair rental value of the building at that time; the building may be purchased for the fair market value; or the lease is terminated and lessor maintains the ownership of the building.

Answer: Fred may treat this as a true tax lease. The transaction described above meets the lease requirements. In addition, Fred does not have a bargain purchase option, Fred did not furnish any cost of the building to the leasing company, and he did not lend any of the funds necessary to acquire the building to the leasing company (or guarantee the debt). Because there is an option to purchase at fair market value, the transaction is classified as a lease for tax purposes.

II. Self-Employment Tax Consequences

In a valid lease situation, the question arises as to the applicability of self-employment taxes to the lessor on the net profits from the lease payments. Self-employment tax will result if the leasing of personal property is a trade or business of the taxpayer. On the other hand, rental of real estate and personal property leased with real estate is not subject to self-employment tax unless the individual is considered a real estate dealer.

Net earnings from self-employment. 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 that are attributable to the trade or business. The rental from real estate and personal property leased with real estate is not self-employment income except:

1. Rentals received in the course of a trade or business as a real estate dealer.

2. Share rentals received by an owner or tenant of land producing agricultural or horticultural commodities where there is material participation.

Two definitional issues are important. One is the definition of a "trade or business." This is significant in that self-employment taxes result only from net income from a "trade or business" carried on by an individual.

Many references to the definition of a "trade or business" rely on the language of one case, Groetzinger v. Commissioner, 87-1 USTC §9191 (1987). In that case, the Supreme Court stated that in order to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and the taxpayer's primary purpose for engaging in the activity must be for income or profit.

The second definitional issue is the definition of a "real estate dealer." The regulations provide that an individual who is engaged in the business of selling real estate to customers with the intentions of making a profit from such sales is a dealer. On the other hand, an individual who merely holds real estate for investment or speculation and receives rentals from the property is not considered a real estate dealer. The regulations also provide than an individual who is a real estate dealer may hold property(s) for investment or speculation, and with respect to these properties, that individual is not considered a real estate dealer.

Self-Employment Tax Issue—Example 2

- Ace rents his equipment to Tom under a net lease that requires Tom to keep the machinery in good repair, purchase insurance on the machinery, and pay the personal property taxes on the machinery.

Ace provides no personal services with regard to the lease of the property.

Where should Ace report his rental income?

- The only issue for Ace is whether or not there is a trade or business.
- If there is a trade or business, his level of participation is not an issue. He must report his income and expenses on Schedule C or C-EZ (Form 1040) and the net income is subject to the self-employment tax.
- If there is no trade or business, his income is not subject to the self-employment tax and Ace should report his income on Form 1040, line 22. Expenses are reported on line 30.
- The instructions for Schedule E (Form 1040) state that all income and expenses from a trade or business of renting personal property is reported on Schedule C or C-EZ (Form 1040) unless the personal property is leased with real estate.
- With some exceptions, §1402(c) states that the term trade or business has the same meaning for purposes of §1402 as it has for purposes of §162. Therefore, whether or not Ace has a trade or business is determined by looking at the rulings and cases under §162.
- There is no authority on point for Ace's facts. In Stevenson v. Commissioner, 57 TCM 1032 (1989), the court held that income from rental of portable advertising signs was subject to self-employment tax.
- However, unlike Ace, the taxpayer in Stevenson was personally involved in renting and maintaining the personal property.
- Therefore, Ace could argue that Stevenson is not binding precedent because he is not personally involved in the activity.
- Similarly, Ace could argue that he is not active in the management or leasing of his equipment and, therefore, is not subject to the self-employment tax.

However, there are several cases the IRS can cite to support an argument that the taxpayer's personal activity is not an issue in determining whether or not there is a trade or business.

- For example, in Campbell v. Commissioner, 5 T.C. 272 (1945), the taxpayer inherited his father's personal residence. The taxpayer tried to rent the residence through an agent, but no renters were found. Upon sale of the residence at a loss, the taxpayer was allowed to treat the house as being used in a trade or business.
- Similarly, in Lagreide v. Commissioner, 23 T.C. 508 (1954), the taxpayer's income from renting a single piece of property was treated as income from a trade or business.
- See also Rev. Rul 58-267, 1958-1 C.B. 327 (incompetent who was unable to conduct his own business was held liable for self-employment tax on income he received from a trade or business carried on by his guardian).

Conclusion. The IRS is likely to argue that income is subject to the self-employment tax and that Ace must report the rental income on Schedule C or C-EZ (Form 1040). The cases cited by the IRS relate to real estate rental facts. The cases dealing with working interests in oil and gas are also favorable to IRS.

Observation. If Ace leased his machinery with real estate, the machinery rental could be included in the real estate exception of §1402(a)(1) and, therefore, he would not be subject to self-employment tax. Alternatively, if Ace formed a corporation or limited liability company to own and rent the machinery, he could reduce the likelihood that the rental income would be subject to self-employment tax.

III. Renting Assets to a Farming Entity after *Mizell*

It is common for people in a partnership to individually own some of the assets used in the partnership business and rent that asset (or assets) to the partnership.

Example 3-A. Lee Adams owns a 25% interest in a farming partnership with his three sons. During 1996, he leased 750 acres of farmland to the partnership on a 50/50 crop share basis. The lease is silent on the issue of Lee's participation in the farming activity as a lessor.

The partnership agreement requires each partner to devote his full time and attention to the partnership business. Lee made management decisions and contributed physical labor to the farming operation.

These facts raise the question of whether or not Lee's rental income is subject to self-employment tax.

Applicable Law

To understand the role of material participation in the self-employment tax, the self-employment tax rules must be summarized.

I.R.C. §§1401(a) and 1402(a) impose the self-employment tax on the net income from a taxpayer's trade or business or from a partnership in which the taxpayer is a member.

I.R.C. §1402(a)(1) excludes rentals received from real estate and from personal property leased with real estate from the self-employment tax with two exception:

1. Rentals received in the course of a trade or business as a real estate dealer.
2. Income derived by the owner of land if:
   a. The land is used under an arrangement that provides:
      i. that another individual will produce agricultural or horticultural commodities on the land
      ii. the owner of the land will materially participate in the production of the agricultural or horticultural commodities
   b. There is (actually) material participation by the owner of the land with respect to the agricultural or horticultural commodity.

Note the following important points about the above rules.

1. Material participation is an issue only with respect to real estate used in farming.
2. For rent from land used in farming to be subject to the self-employment tax, there must be both an arrangement providing for the owner's material participation and there must be actual material participation.

Arrangement

In the above partnership example, was there an arrangement providing for the owner's material participation?

In Mizell v. Commission, T.C. Memo 1995-571 (Nov. 29, 1995) the taxpayer argued that since the lease was silent on the issue of the landowner's participation in the farming activity, there was no "arrangement" for purposes of I.R.C. a)(1)(A).

The Commissioner argues that "arrangement" should be construed to take into account the entire understanding between the landowner and the operator of the farming activity. Since the partnership agreement required the landowner to materially participate, the Commissioner argued that the "arrangement" requirement was met.

The Court agreed with the Commissioner and held that the landowner and his sons understood and contemplated that petitioner was to "engage to a material degree in the physical work related to the production of agricultural commodities."

Therefore, based on the Mizell case, it is likely that there is an arrangement providing for Lee's material participation in the farming activity.

Material Participation

Was there material participation?

Lee clearly materially participated in the farming activity, since he made management decisions and contributed physical labor to the farm operation. In the Mizell case, the parties stipulated that the taxpayer materially participated in the farm business, so this issue was not contested.

Lee could argue that his role as a landowner and his role as a partner should be separated, and that as a landowner he did not materially participate in the farming activity. However, the tests for material participation for purposes of the self-employment tax as set out in IRS Publication 225, Farmer's Tax Guide, do not mention any separation of the taxpayer's role as an owner and his or her role as a partner.

Conclusion. It may be difficult for Lee or others in his situation to avoid the conclusion that he materially participated in the farming activity.

Application to Cash Leases

The Mizell case dealt with a crop share lease, not a cash lease. However, the IRS may attempt to apply Mizell to owners of land rented on a cash basis to a partnership in which the owner is a materially participating partner.

Query: Will the IRS attempt to apply the Mizell case reasoning to similar rental arrangements between individuals and closely held family corporations for which they are also employees?

Answer: Probably, but this is a horse of a different breed and there are other distinctions. Expect this issue to be litigated.

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