

Office of Chief Counsel  
Internal Revenue Service  
**Memorandum**

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to: Internal Revenue Service  
Attn: Manager

from: Marc A. Shapiro  
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subject: Payments for Negative Easements

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer	=
Corporation A	=
Corporation B	=
Corporation C	=
Individual	=
State	=
D	=
Year 1	=
Year 2	=
Date 2	=
<u>a</u>	=
<u>b</u>	=
<u>c</u>	=

ISSUE

Whether the payments received by Taxpayer from Corporation A for a negative easement are rental income under section 543(b)(3), gains from the sale of capital assets or gains from the sale of section 1231(b) property, or ordinary business income (nonrental)?

CONCLUSION

The payments at issue are rental payments for purposes of section 543(b)(3).

FACTS

In Year 1, Taxpayer was incorporated in State. It filed a consolidated Form 1120 for the subject fiscal year ending Date 2, with its two subsidiary corporations, Corporation B and Corporation C. Taxpayer also is a member of a brother-sister controlled group of corporations with the related company Corporation A, which also was incorporated in Year 1. Corporation A filed a consolidated Form 1120 for the fiscal year ending Date 2, with its a subsidiary corporations.

Taxpayer and its subsidiaries engage in

. The majority of its income is from separate companies which are affiliated due to common ownership. Corporation A operates a plant.

Individual directly or indirectly owned 100% of the stock of Taxpayer and Corporation A for the entire fiscal year ending Date 2.

Taxpayer and Corporation A entered into a number of agreements between Year 2 and Date 2, pursuant to which Corporation A paid Taxpayer to place development restrictions on certain of its real estate property deeds. The restrictions were placed on the deeds and filed appropriately. These parcels are adjacent/near a plant owned by Corporation A. The restrictions will expire after b years or sooner at the option of Corporation A. In return, Corporation A agreed to make quarterly payments to Taxpayer over the entire b-year period or until Corporation A decides to terminate the agreement. The deed restrictions are copied below:

The purpose for the payments was to provide a \_\_\_\_\_ for Corporation A's \_\_\_\_\_ plant. Taxpayer's properties were adjacent to Corporation A's property containing the plant. Taxpayer provided articles showing its concern that its plant could damage adjacent properties. The articles showed a concern regarding \_\_\_\_\_ . Corporation A had not had any major incidents to date.

The Taxpayer received \$c of "deed restriction" payments from Corporation A during the subject tax year, which were included in gross profit from business for federal income tax purposes.

If the subject payments are determined to be rents or are determined to be gains from the sale of capital assets or gains from the sale of section 1231(b) property, it will result in Taxpayer's personal holding company income exceeding 60% of its adjusted ordinary gross income for the tax year.

### LAW AND ANALYSIS

In addition to the regular corporate income tax, section 541 imposes a tax on corporations that are treated as personal holding companies under section 542. Under section 542(a)(1), C corporations are to be treated as personal holding companies if both of the following occur: 1) 60% or more of the corporation's annual "ordinary gross income" (as adjusted in accordance with the rules under section 543(b)(2)) constitutes "personal holding company income"; and (2) more than 50 percent of the corporation's stock is owned by five or fewer shareholders at any time during the last half of the taxable year.<sup>1</sup>

Ordinary gross income means gross income, excluding gains from the sale of capital assets and gains from the sale of section 1231(b) property, i.e., property used in a trade or business. Section 543(b)(1).

Personal holding company income includes, among other items, rents. Section 543(a)(2). Rent is defined as amounts received "for the use of, or right to use, property" of the corporation. Section 543(b)(3). Treas. Reg. Section 1.543-(1)(b)(10) basically restates this definition, providing that "[r]ents which are to be included as personal holding company income consist of compensation (however designated) for the use, or right to use, property of the corporation." In White's Ferry, Inc. v. Commissioner, T.C. Memo. 1993-639, the court stated that in determining, for Federal income tax purposes, whether amounts received constituted rent, the substance of the transaction and not the form of the contract or agreement is controlling. Furthermore, the definition of rent for purposes of section 543 is defined in its broadest sense. See, e.g., Eller v. Commissioner, 77 T.C. 934, 950 (1981).

In the subject case, Corporation A owned a \_\_\_\_\_ plant. It made quarterly payments to Taxpayer in exchange for Taxpayer placing development restrictions on its deeds to certain property (negative easements) that it owned adjacent/near to the D plant. The restrictions will expire in b years or sooner at Corporation A's option. The issue is whether the payments are for rent under section 543(b)(3).

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<sup>1</sup> We were not asked to give an opinion on stock ownership and assume that the 50% stock ownership requirement is satisfied.

Rev. Rul. 70-153, 1970-1 C.B. 139, addresses whether certain amounts received by a taxpayer are rents within the meaning of section 543(a)(2) or royalties within the meaning of section 543(a)(3). The taxpayer entered into a lease under which the lessee, a producer of natural gas and oil, would pay to the taxpayer as rental the sum of one dollar per acre per year semiannually in advance, commencing on the date of execution of the agreement, subject to diminution or abatement upon the bringing in of either a producing or nonproducing oil or gas well. No oil or other minerals were removed from the lands covered by the lease. The ruling holds that the amounts were rent because they were fixed and payable in advance for the use of, or the right to use, the property in question and were not a share of the product, or profit, reserved by the owner for use of the property.

We did not come across any direct authorities regarding whether payments for negative easements should be treated as personal holding company income, i.e., as rent. However, the following authorities concerning conservation payments, that are in effect negative easements, shed some light on the definition of rent.

In Wuebker v. Commissioner, 205 F.3d 897 (6<sup>th</sup> Cir. 2000), revg, 110 T.C. 31 (1998), the Sixth Circuit held that CRP payments received by a farmer actively engaged in the business of farming were includible in self-employment income and were not rentals from real estate. The CRP was established pursuant to the Food Security Act of 1985, and it authorized the Department of Agriculture to make payments to those owners and operators of land who agree to refrain from farming their property (must divert land to other uses) in order to conserve and improve the soil and water resources of such lands. *Id.* at 899. The Tax Court had held that the payments were from rentals from real estate and thus excludable from self-employment income. The Sixth Circuit reversed. It found that the taxpayer was engaged in the business of farming prior to and during the term of their CRP contract. They were required to perform several ongoing tasks with respect to the land enrolled in the CRP, the same land they already owned and had previously farmed. The Sixth Circuit noted that the taxpayers were required under the CRP contract to perform tasks intrinsic to the farming trade or business (e.g., tilling, seeding, fertilizing, and weed control) that required the use of their farming equipment. The court also found that the CRP payments to the taxpayers were in connection with and had a direct nexus to their ongoing trade or business. Accordingly, the court held that the payments were includable in self-employment income. In considering the "rental" issue, the court stated that rentals from real estate were excludable from self-employment tax. The court stated that the term rentals from real estate must be **narrowly construed** for self-employment tax purposes. The court defined rent as consideration paid for the use or occupancy of property. The court quickly determined that the taxpayer did not occupy the land. So, the question was whether the government used the land. The court specifically found that it was a close question.

Whether the CRP payments constitute consideration for the “use” of the Wuebkers' land is a closer question. Citing the many objectives of the CRP, such as the reduction of soil erosion and the protection of the nation's long-term food production capabilities, the Wuebkers assert, and the dissent agrees, that the government is “using” the land in question. We believe, however, that such an argument impermissibly stretches the plain meaning of the term “use,” especially in light of the narrow construction required of the rentals-from-real-estate exclusion. See *Johnson*, 60 T.C. at 833; *Delno*, 347 F.2d at 165. Although it is true that the Department of Agriculture is seeking, and receiving, a public benefit by conserving lands enrolled in the CRP, the Wuebkers continue to maintain control over and free access to their premises. The dissent reasons that, because the government “greatly reduced the range of uses to which the Wuebkers could put their property,” it exercised a level of control akin to “use.” We remain unpersuaded, however, that the restrictions imposed by the Department of Agriculture on a farmer's use of his own land somehow translate into “use” by the Department itself.

The essence of the program is to prevent participants from farming the property and to require them to perform various activities in connection with the land, both at the start of the program and continuously throughout the life of the contract, with the government's access limited to compliance inspections. Given this arrangement, we disagree with the Tax Court's determination that the Wuebkers' maintenance obligations were legally insignificant.

Id. at 904.

In Notice 2006-108, 2006-2 C.B. 1118, the Service sets forth a proposed revenue ruling, consistent with Wuebker, regarding payments made by the U.S. Department of Agriculture (USDA) under the Conservation Reserve Program (CRP). The Service states that a farmer actively engaged in a farming trade or business or an individual not otherwise engaged in a farming trade or business who enrolls land in the CRP and fulfills the CRP contractual obligations personally or through a third-party must include the CRP payments as self-employment income and not as income from rentals. The payments are considered derived from a trade or business; either a farming trade or business and/or a trade or business through the participation in the CRP program.

Citing to the Service's position in Notice 2006-108 and adopting the Sixth Circuit's opinion in Wuebker, the Tax Court in Morehouse v. Commissioner, 140 T.C. 350 (2013), overruled its prior opinion in Wuebker, and held that the CRP payments were self-employment income and not rentals from property. On appeal, the Tax Court again was reversed. The Eighth Circuit held that the CRP payments made to non-farmers are rental income. Morehouse v. Commissioner, 769 F.3d 616 (8<sup>th</sup> Cir. 2014). In arriving at its conclusion, the court stated that it was following the Service's position that land

conservation payments made to non-farmers constitute rentals from real estate and are excluded from the self-employment tax, citing to Rev. Rul. 60-32 and Rev. Rul. 65-149.<sup>2</sup> The court also found that the proposed revenue ruling in Notice 2006-108 should not be followed as the proposed ruling was never issued. The court found that the government physically inspected the property. Further, taxpayer was required to till, seed, fertilize and weed control, demonstrating that the government likely had more physical possession of the land for its own conservation purposes than the taxpayer. Therefore, according to the court, the taxpayer had sufficient use (and possession) of the land to treat the payments as rentals from real estate.

The conservation programs described above, unlike the subject case, required the taxpayer to perform certain activities with respect to its land. The courts could find an active farming business, or an active business by virtue of following the CRP program procedures, in concluding that the income should be treated as self-employment income. The Service, in the earlier Rev. Ruls. (60-32 and 65-149; see footnote 2), appears to base its conclusion on whether there is material participation or not; if the income is received by a farm operator, or a landlord who materially participates, it should be treated as self-employment income; if it is received by a landlord who does not materially participate (and it is not related to taxpayer's business), it should be treated as rental income and excluded from net earnings from self-employment. The Wuebker court finds that an active farmer must treat the payments as self-employment income, and not as rentals, but finds the issue a close call and narrowly construes the meaning of use for purposes of the self-employment income statute. In Notice 2006-108, the Service, in a proposed revenue ruling, appears to change its position (according to the Eighth Circuit) and treat farmers and nonfarmers as receiving self-

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<sup>2</sup> In Rev. Rul. 60-32, 1960-1 C.B. 23, the Service held that annual payments received under the Soil Bank Act were includible in determining the recipient's net earnings from self-employment, if the recipient operated his farm personally or through agents or employees. This was also true if the recipient's farm was operated by others and he participated materially in the production of commodities, or management of such production. However, if the recipient did not so operate or materially participate, payments received were not to be included in determining net earnings from self-employment.

In Rev. Rul. 65-149, 1965-1 C.B. 434, the Service addressed whether grain storage fees paid to a farm operator under the price support loan program of the Commodity Credit Corporation are to be regarded as attributable to the operator's trade or business of farming and considered in computing the operator's self-employment income. The Service argued that income derived from the operation of a farm, regardless of the form of the income (cash sales, Commodity Credit Corporation loans, Government subsidies, including soil bank payments, conservation reserve payments, etc.), should be treated in a manner consistent with the position set forth in Rev. Rul. 60-32. That is, if this income is received by a farm operator, or a landlord who materially participates, it should be treated as self-employment income. If it is received by a landlord who does not materially participate, it should be treated as rental income and excluded from net earnings from self-employment. Accordingly, even though Rev. Rul. 60-32 did not explain why the IRS differentiated between farmers and non-farmers, the Eighth Circuit concluded that Rev. Rul. 65-149 indicated the IRS viewed soil bank payments to non-farmers as rental income.

employment income, but the ruling is never issued.<sup>3</sup> The Morehouse court declines to follow Wuebker or the Notice and instead follows the earlier Rev. Ruls. in concluding that the payments are rentals for the use of real property.

In the subject case, Taxpayer did not have to perform any activities with respect to its property. Therefore, the facts in our case do not provide a basis for Taxpayer arguing the payments should be treated as trade or business income. Rather, Taxpayer was prevented from actually developing the property. Corporation A paid Taxpayer not to develop its property pursuant to Corporation A's trade or business. Corporation A was concerned that if the adjacent properties were developed, its activities could subject it to additional liabilities. In effect, Corporation A was using the adjacent lands as a \_\_\_\_\_ for any potential \_\_\_\_\_/harm from its plant operation. Thus, the "use" of, or right to use, this adjacent land reduced potential liabilities from its plant. Taxpayer could not develop its land. In Black's Law Dictionary (10<sup>th</sup> ed.), use is defined as "[t]o employ for the accomplishment of a purpose; to avail oneself." Employ is defined as "[t]o make use of." Webster's New Collegiate Dictionary (1979) defines use as "the legal enjoyment of property that consists of its employment, occupation, exercise or practice." Here, Corporation A is making use of (or has the right to use) Taxpayer's property as a \_\_\_\_\_ for \_\_\_\_\_. We believe this is using/employing the property for the accomplishment of a business purpose, i.e., to avoid/limit liability.

The Field believes that the subject case is supported by Morehouse and that the Sixth Circuit's \_\_\_\_\_ opinion in Wuebker is distinguishable. In Wuebker, the court found that the government's restrictions on the land did not rise to the level of use. However, the court also stated that it was a close issue and that the term rent should be narrowly construed. In our case, the term rent is to be construed in its broadest sense, Eller, 77 T.C. at 950, and encompasses both the use or right to use property. Furthermore, in our case, the payment is for no development; and this provides a use for the payor by limiting potential liabilities and providing a \_\_\_\_\_ for its \_\_\_\_\_. Furthermore, unlike Wuebker, we are not dealing with a farmer engaged in a trade or business. Rather, we are more like the nonfarmer in Morehouse who was treated as receiving rental income.

We also believe that the authorities discussed below, dealing with temporary easements, further supports the Field's position.

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<sup>3</sup> As stated earlier, the Service states that a farmer actively engaged in a farming trade or business or an individual not otherwise engaged in a farming trade or business who enrolls land in the CRP and fulfills the CRP contractual obligations personally or through a third-party must include the CRP payments as self-employment income and not as income from rentals. The payments are considered derived from a trade or business; either a farming trade or business and/or a trade or business through the participation in the CRP program.



Ordinary business income (nonrental) versus gains from the sale of capital assets or gains from the sale of section 1231(b) property

If it is determined that the subject payments are not rental income, should they be treated as ordinary business income or gains from the sale of capital assets or gains from the sale of section 1231(b) property.

The sale of an easement is the sale of an interest in real property. See, e.g., Rev. Rul. 68-291, 1968-1 C.B. 351; Rev. Rul. 72-255, 1972-1 C.B. 221; Wickersham v. Commissioner, T.C. Memo. 2011-178. The determination then turns to whether the gain proceeds should be treated as ordinary income or capital gain under sections 1221 and 1231.<sup>4</sup>

In Nay v. Commissioner, 19 T.C. 114 (1952), the Tax Court determined that consideration received for the use of property for three years was not a sale. "The term 'sale' generally imparts the transfer of all the right, title, and interest in the property transferred." Id. at 119. Since there was no sale of a capital asset, the proceeds received were treated as ordinary income. Accord Cornish v. United States, 84-2 USTC ¶ 9692 (N.D. Ala.).

The Service has determined that payments received for temporary easements are considered rents received from real property. See, e.g., Rev. Rul. 70-153, 1970-1 C.B. 139. In Commissioner v. Gillette Motor Transport, Inc., 364 U.S. 130 (1960), the Supreme Court considered the treatment of income received as a result of a temporary taking of the taxpayer's trucking business by the United States Government during World War II. The taxpayer argued that the proceeds from the temporary taking should be treated as capital gain. The Court rejected this argument because the interest taken was neither a capital asset nor real or depreciable personal property used in a trade or business. Id. at 135. The interest taken was the right to determine freely what use to make of its transportation facilities. The Court determined the payment to be rent.


That right is not something in which respondent [taxpayer] had any investment, separate and apart from its investment in the physical assets themselves . . . Further, the right is manifestly not of the type which gives rise to the hardship of the realization in one year of an advance in value over cost built up in several years, which is what Congress sought to ameliorate by the capital-gains provisions. . . In short, the right to use is not a capital asset, but is simply an incident of the underlying physical

<sup>4</sup> In order for proceeds from the disposition of an asset to qualify as long-term capital gain, the asset must be a capital asset as defined by section 1221, the disposition must be a sale or exchange, and the asset must have been held for more than one year. Section 1222. Under section 1231, capital gain also may result from the sale or exchange of real or depreciable property used in the taxpayer's trade or business and held for more than one year, if section 1231 gains exceed section 1231 losses for the year. In the subject case, we believe that the land subject to the negative easements was held for more than one year and that the section 1231 gains would exceed the section 1231 losses.

property, the recompense for which is commonly regarded as rent. That is precisely the situation here, and the fact that the transaction was involuntary on respondent's part does not change the nature of the case.

Id. at 135. See also Gilbertz v. United States, 808 F.2d 1374, 1383 (10th Cir.1987) (payments for the grant of a right-of-way for a "finite term of years" was characterized as lease payments and treated as ordinary income).

These determinations regarding temporary easements have involved factual situations where the payor uses or has the authority to use taxpayer's property pursuant to the easement (or taking). As discussed above, if Corporation A is determined to be using (or has the right to use) the Taxpayer's property, the payment would be rent. But, if it is determined that Corporation A is not using (and does not have the right to use) the property, the issue arises how the payments should be treated. The above authorities treat the payments for the use or right to use property as rental payments. This lends further support to the argument that the payments should be treated as rent. But, if it's not rent,



Taxpayer has stated that the income is business income, without any analysis. Arguably, if Taxpayer is engaged in some type of business in which the sale of negative easements is part of that business, the income could be ordinary. For example, if the Taxpayer purchased lots for resale as its trade or business, the sale of the negative easements may be found to be business income. However, even here, if it's business income, it should be treated as rent. On the other hand, if the property is held for investment purposes, it would also be treated as a capital asset. We have insufficient information to make this determination.

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Please call (216) 858-7323 if you have any further questions.

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