SELF-EMPLOYMENT TAX FOR FARMERS

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I. INTRODUCTION

Self-employed taxpayers pay into the social security system through the self-employment tax. The self-employment tax is the sum of the 12.4 percent old-age, survivors, and disability insurance ("OASDI") tax[1] and the 2.9 percent hospital insurance ("HI") tax.[2] In many respects, this tax parallels the Federal Insurance Contributions Act ("FICA") tax imposed on an employee's income.[3] First, the self-

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1. *See* I.R.C. § 1401(a) (1994).
2. *See id.* § 1401(b).
3. *See id.* §§ 3101-3102.

employment tax OASDI and HI rates equal the sum of the OASDI[4] and HI[5] rates imposed on employers and employees.[6] Second, self-employment income[7] and an employee's income[8] are subject to the OASDI tax only to the extent of the contribution and benefit base[9] for computing social security benefits.[10] Finally, to give self-employed taxpayers approximately equivalent treatment as employees and employers, they are allowed to deduct one-half of the self-employment tax from their taxable income for purposes of the self-employment tax[11] and the income tax.[12] That deduction approximates the income tax effect of allowing employers to deduct their share of FICA taxes when computing income for purposes of the income tax.

Many farmers pay more self-employment taxes than income taxes because the lowest self-employment tax rate (15.3 percent[13]) is higher than the lowest income tax rate (15 percent[14]) and because the personal deductions do not reduce self-employment income.[15] For example, farm couples that have two children, file a joint tax return, and claim the standard deduction will pay $7,065[16] on $50,000 of farm income in 2001. Their income tax liability on that income is $4,620.[17] Consequently, planning to reduce self-employment taxes can reduce tax liability by more than planning to reduce income taxes.

Unlike income tax planning, planning to reduce self-employment taxes must take into account the effect on social security benefits. Reducing self-employment income reduces the earnings base on which social security benefits are computed. Consequently, taxpayers must compare the self-employment tax savings with the reduction in social security benefits to maximize their after-tax wealth. Benefits are paid at a lower rate as earned income increases[18] but the self-employment tax rate remains constant.[19] Consequently, the return on each dollar of self-employment taxes in the form of social security benefits goes down as earned income goes up. Many

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4. *See id.* §§ 3101(a), 3111(a). On Form W-2, the OASDI tax is called social security tax.
5. *See id.* §§ 3101(b), 3111(b). On Form W-2, the HI tax is called the Medicare tax.
6. *Compare id.* § 1401 *with id.* §§ 3101, 3111.
7. *See id.* § 1402(b)(1) (1994 & West Supp. 2000).
8. *See id.* § 3121(a)(1).
9. *See* Social Security Act § 230, 42 U.S.C. § 430 (1994). For 2001, the limit is $80,400. *See* INTERNAL REVENUE SERVICE, TAX WITHHOLDING AND ESTIMATED TAX, PUB. 505, at 2 (2000).
10. *See* I.R.C. §§ 1402(b)(1), 3121 (a)(1) (1994 & West Supp. 2000).
11. *See id*. § 1402(a)(12). Schedule SE of Form 1040 implements this provision by allowing taxpayers to multiply their self-employment income by 92.35% before applying the OASDI and HI tax rates. *See* IRS, SCHEDULE SE (FORM 1040): SELF EMPLOYMENT TAX (2000).
12. *See* I.R.C. § 164(f) (1994 & West Supp. 2000).
13. *See id.* § 1401 (1994).
14. *See id.* § 1 (1994 & West Supp. 2000).
15. *See id.* § 1402(b).
16. $50,000 x .9235 x .153 = $7,065.
17. $50,000 - $7,600 (standard deduction) - $11,600 (personal exemption deductions) = $30,800 x 15% = $4,620.
18. *See* I.R.C. § 1401(a) (1994).
19. *See* 42 U.S.C § 415(a) (1994).

taxpayers who have earnings near the contribution and benefit base pay more in social security taxes than they will get back in benefits.

Self-employment tax on two sources of income for owners of agricultural land has been contested in the courts in recent years. One source of income that has been the subject of controversy is rent received for the agricultural land and the other is Conservation Reserve Program ("CRP") payments received by the owners of agricultural land. These two issues as well as the related issue of rent paid to retired landowners are discussed below.

II. STATUTORY FRAMEWORK

Agricultural tax law practitioners focus attention on whether or not there is material participation to determine if payments to an owner of farmland are subject to the self-employment tax. To understand why material participation is an important issue in the agricultural setting, the structure of the statutes that impose the self-employment tax must be reviewed.

A. *General Rule*

Sections 1401(a) and 1402(a) and (b) of the Internal Revenue Code ("IRC") impose the self-employment tax on net income from a taxpayer's trade or business or from a partnership in which the taxpayer is a member.[20] For purposes of this general rule, trade or business includes the business of renting property.

Rent received from personal property is subject to self-employment tax if the taxpayer is in the business of renting personal property.[21] It *does not matter* whether or not the taxpayer is materially participating in the business.[22] The instructions for Schedule E of Form 1040 state, "You are in the business of renting personal property if the primary purpose for renting the property is income or profit and you are in involved in the rental activity with continuity and regularity."[23]

Example One. Rich Mann has a speedboat that he uses for skiing and fishing. He has never rented it to anyone and has never used it in a business. In July 2000, he rented it to his neighbor who used it for a one-week vacation.

Rich is not in the rental business. He does not have to pay self-employment tax on his rental income. He must report the rental income on line 21 of Form 1040 and any deductible expenses from renting the boat on line 32 of Form 1040.

If Rich rented his boat to his neighbor every summer for a week, the Internal Revenue Service ("IRS") is likely to argue that he is renting it "with regularity" and

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20. *See* I.R.C. §§ 1401(a) (1994); *id.* § 1402(a)-(b) (1994 & West Supp. 2000).
21. *See id.* § 1402(b)(1) (1994 & West Supp. 2000).
22. *See id*.
23. INTERNAL REVENUE SERVICE, 2000 INSTRUCTIONS FOR SCHEDULE E, SUPPLEMENTAL INCOME AND LOSS 1 (2000).

must pay self-employment tax on the net income. Therefore the rental income and deductible expenses must be reported on Schedule C of Form 1040.

There is a narrow exception from self-employment income for personal property that is "leased with the real estate" that is exempt under the first exception discussed below.[24] Rent from real estate is subject to self-employment tax unless it falls within the real estate exception discussed below.

B. *Real Estate Exception*

Generally, rent from real estate is excluded from self-employment income for purposes of the self-employment tax.[25]

Example 2. The owner of a building used in a construction business does not have to pay self-employment tax on rent received for that building. It *does not matter* whether or not the taxpayer is materially participating in the business that uses the real property.

The real estate exception includes personal property leased with the real estate. However, there is no guidance on what personal property will qualify for this exception. It is likely that personal property that uniquely fits the real property is included in this exception, such as window shades and appliances in an apartment or equipment in a feeding shed on a farm. It could also be argued that a line of farm machinery including tractors, planters, cultivators and harvesting equipment that is used solely on the rented real estate is included. It is likely that a line of farm machinery rented with a building in which it is stored does not qualify for this exception.

C. *Exceptions to the Real Estate Exception*

There are two exceptions to the general rule that rent from real estate is not subject to self-employment tax. One of the exceptions is not important in the agricultural setting. It is for rentals received in the course of a trade or business as a real estate dealer.[26] The other exception applies only in the agricultural setting. It says the real estate exception does not apply if:

1. The land is used under *an arrangement* that provides:[27]
   a. that another individual will produce agricultural or horticultural commodities on the land, and[28]
   b. the owner of the land will materially participate in the production of the agricultural or horticultural commodities.[29]

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24. I.R.C. § 1402(a)(1) (1994 & West Supp. 2000).
25. *See id.*
26. *See id.*
27. *See id.*
28. *See id.*
29. *See id*.

2. There is material participation by the owner of the land with respect to the agricultural or horticultural commodity.[30]

The exception for land used in agricultural production was added to the Internal Revenue Code in 1956, effective for tax years beginning after 1955.[31] At that time, many retired farmers had been subject to self-employment taxes for only a few years and their earnings record allowed them to draw very little, if any, social security benefits. The exception for land used in agricultural production allowed these retired farmers to treat their rental income as self-employment income. By including that rent in self-employment income, it was also included in their earnings for purposes of the social security system. The increased earnings increased their social security benefits.

III. LAND RENTED TO AN ENTITY

Taxpayers who own farmland and use it in their sole proprietorship farming business pay self-employment tax on the rental value of their farmland because that rental value is included in the farm profits that are reported on Schedule F of Form 1040, which are included in self-employment income.[32] Taxpayers are not allowed to deduct rent paid to themselves.[33] Therefore, they cannot reduce their self-employment income by deducting a rental expense on Schedule F of Form 1040 and reporting that rent as income on Schedule E of Form 1040.

One method of reducing self-employment tax for taxpayers who own and operate a farm is putting the farming operation into an entity such as a partnership, corporation or a limited liability company but not the land. The land was leased to the entity, which allowed the entity to deduct the rent from its income.[34] Until 1995, the IRS did not challenge the common practice of treating rent from the entity to the owner of the entity for farmland held outside the entity as not being subject to self-employment tax.[35]

Example 3. Cliff Hanger is a partner in a farming partnership. His three sons are the other partners. Cliff owns farmland in his own name and rents that land to the partnership. Before 1995, the IRS did not require Cliff to pay self-employment tax on his rental income.[36]

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30. *See id.*

31. *See* Social Security Amendments of 1956, Pub. L. No. 84-880, § 201(e)(2), 70 Stat. 807, 840 (1956).

32. *See* INTERNAL REVENUE SERVICE, 2000 INSTRUCTIONS FOR SCHEDULE F, PROFITS OR LOSS FROM FARMING F-3 (2000).

33. *See* Cox v. Commissioner, 121 F.3d 390, 392 (8th Cir. 1997).

34. *See* I.R.C. § 162(a)(3) (1994).

35. *See, e.g.*, Ramsay v. Commissioner, 46 T.C.M. (CCH) 1497, 1499 (1983).

36. *See id.*

Beginning in 1995, the IRS began taking the position that rent received by a landowner for land rented to an entity and used in agricultural or horticultural production is subject to self-employment tax if:

1. there is an arrangement calling for the landowner's material participation.[37] The IRS argues, and the Tax Court has agreed, that a partnership agreement or an employment agreement with the entity is such an arrangement.[38]
2. the landowner materially participates in the farming business.[39]

A. *Line of Cases, Rulings, and Advisory Opinions*

There are four tax court cases, an IRS letter ruling and three IRS advisory opinions holding that rent received by the landowner from an entity is subject to self-employment tax.

In *Mizell v. Commissioner*, the court held that crop share rent paid from a partnership to one of the partners for land that was used for farming is subject to self-employment tax.[40] The court treated the lease and the partnership agreement as one agreement and held that it met the requirement that there be an arrangement calling for material participation.[41] The court also held that the partner's participation in the partnership met the material participation requirement of the exception in IRC section 1402(a)(1).[42]

In Technical Advice Memorandum 96-37-004,[43] the IRS ruled that cash rent paid from a corporation to the shareholders for land that was used in farming is subject to self-employment tax.[44] The IRS followed the reasoning in *Mizell* and concluded that the shareholders met the requirements of IRC section 1402(a)(1) since they were employees of the corporation.[45] That position is consistent with Treasury Regulation section 1.1402(a)–4(b)(2), which says the rental income must be received by the owner pursuant to "a share-farming or other rental arrangement . . . ."[46]

In Field Service Advice 1999-17-005[47] and Field Service Advice 1999-17-006,[48] H rented land from W to use in his farm business.[49] The lease did not require

37. *See* Treas. Reg. § 1402(a)-4(b)(i) (as amended in 1980).
38. *See* Mizell v. Commissioner, 70 T.C.M. (CCH) 1470, 1472 (1995).
39. *See id.* at 1470.
40. *See id.*
41. *See id.* at 1472.
42. *See id.*
43. Tech. Adv. Mem. 96-37-004 (May 1, 1996).
44. *See id.*
45. *See id.*
46. Treas. Reg. § 1.1402(a)-4(b)(2) (as amended in 1980).
47. Field Serv. Adv. 1999-17-005 (Dec. 10, 1998).
48. Field Serv. Adv. 1999-17-006 (Dec. 10, 1998).
49. *See* Field Serv. Adv. 1999-17-005 (Dec. 10, 1998); Field Serv. Adv. 1999-17-006 (Dec. 10, 1998).

W to materially participate in the farm business.[50] However, H employed W to work in the farm business.[51] The IRS concluded that the rent H paid to W is subject to self-employment tax on the rent because the employment agreement is an arrangement that requires W to materially participate.[52]

In Field Service Advice 1999-17-008, H was the one hundred percent owner of a corporation that rented land from H and W for use in a farm business.[53] The lease did not require H or W to materially participate.[54] The corporation employed H and W.[55] The IRS concluded that the employment agreement required H and W to materially participate, so H and W are subject to self-employment tax on the rental income.[56]

In *Bot v. Commissioner*,[57] Mr. Bot rented land from his wife to use in his farming business, which was organized as a sole proprietorship.[58] Mrs. Bot was also paid for services she provided to the farm business under an employment agreement.[59] The court stated, "With respect to whether under the arrangement Mrs. Bot was to materially participate in the farming operations, we look not only to the obligations imposed upon Mrs. Bot by the oral lease, 'but to those obligations that existed within the overall scheme of the farming operations which were to take place' on Mrs. Bot's property."[60] The court concluded that the employment agreement called for Mrs. Bot's material participation and that she did materially participate.[61] Therefore, her rental income is subject to self-employment tax.[62]

In *Hennen v. Commissioner*,[63] Mrs. Hennen rented 200 acres to her husband for use in his farming business.[64] She also provided services to the farming business under an employment agreement and was compensated for those services.[65] The court used the same reasoning as in *Bot v. Commissioner*, and held that Mrs. Hennen's rent is subject to the self-employment tax.[66]

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50. *See* Field Serv. Adv. 1999-17-005 (Dec. 10, 1998); Field Serv. Adv. 1999-17-006 (Dec. 10, 1998).
51. *See* Field Serv. Adv. 1999-17-005 (Dec. 10, 1998); Field Serv. Adv. 1999-17-006 (Dec. 10, 1998).
52. *See* Field Serv. Adv. 1999-17-005 (Dec. 10, 1998); Field Serv. Adv. 1999-17-006 (Dec. 10, 1998).
53. *See* Field Serv. Adv. 1999-17-008 (Dec. 10, 1998).
54. *See id.*
55. *See id.*
56. *See id.*
57. Bot v. Commissioner, 78 T.C.M. (CCH) 220 (1999).
58. *See id.* at 221.
59. *See id.*
60. *Id*. at 222 (citing Mizell v. Commissioner, 70 T.C.M. (CCH) 1469, 1472 (1995)).
61. *See id.* at 223.
62. *See id.*
63. Hennen v. Commissioner, 78 T.C.M. (CCH) 445 (1999).
64. *See id.* at 445.
65. *See id*. at 446.
66. *See id.* at 448.

In *McNamara v. Commissioner*,[67] Mr. and Mrs. McNamara owned farmland as joint tenants.[68] They cash rented the land to a corporation solely owned by Mr. McNamara.[69] Mr. and Mrs. McNamara were also both employees of the corporation.[70] The court followed the reasoning of *Mizell* and found that the obligations as longstanding participants in the farming business, as well as the general understanding between the taxpayers and the corporation with respect to the production of agricultural products, was an arrangement that provided or contemplated that the taxpayers materially participate in the production of agricultural commodities on the farmland.[71] The court also found that the taxpayers did materially participate in the farming business.[72] Therefore, the rent they received was subject to self-employment tax.[73]

The *Bot, Hennen and McNamara* cases were combined on appeal to the Eighth Circuit Court of Appeals.[74] On December 29, 2000, the Eighth Circuit reversed and remanded the cases.[75] The Eighth Circuit did not agree with the taxpayers' argument that self-employment tax is imposed only on rental payments derived from sharecropping or share farming and therefore not on the cash rent paid in these cases.[76] The court also held that the Tax Court did not err in finding that the employment contracts required the respective landowners to materially participate in the farming activities.[77]

The Eighth Circuit was persuaded by the "taxpayers' argument that the lessor-lessee relationship should stand on its own, apart from the employer-employee relationship."[78] Contrary to the IRS argument and the Tax Court holdings, the Eighth Circuit is not willing to look at all of the agreements between the lessor and the lessee to find the "arrangement" calling for material participation.[79] It is willing to look at agreements other than the lease only if there is a nexus between the lease and the other agreement.[80] Indicium of a nexus, according to the Eighth Circuit, is rental payments in excess of the fair rent for the farmland.[81] If the rent is a fair rental rate, the lease is an independent transaction and not part of the employment agreement that

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67. McNamara v. Commissioner, 78 T.C.M. (CCH) 530 (1999).
68. *See id*. at 531.
69. *See id*.
70. *See id*.
71. *See id*. at 533 (citing Mizell v. Commissioner, 70 T.C.M. (CCH) 1469, 1472 (1995)).
72. *See id*. at 533.
73. *See id*.
74. *See* McNamara v. Commissioner, 2000 WL 1880242 (8th Cir. Dec. 29, 2000) (forthcoming in 87 A.F.T.R.2d).
75. *See id.* at *4.
76. *See id.* at *3.
77. *See id.*
78. *Id.*
79. *See id.*
80. *See id.*
81. *See id.* at *4.

requires the lessor's material participation.[82] Because there was no evidence presented regarding the fair rent of the farmland, the cases were remanded to give the IRS a chance to show that the rent was in excess of a fair rental rate.[83]

The Eighth Circuit opinion restores the principle that an owner of agricultural land does not have to report rent as self-employment income if the rental arrangement does not require the landowner to materially participate in the farming operation.[84] However the IRS could appeal the Eighth Circuit opinion. Furthermore, the Eighth Circuit opinion is not binding for taxpayers who are outside the Eighth Circuit, so the IRS can cite the Tax Court opinions that support its position that such rent is subject to self-employment tax for those taxpayers.

B. *Improvements on the Land*

The authorities discussed above do not address the issue of whether rent received for buildings or other improvements on the land are subject to self-employment tax.

The language of IRC section 1402(a)(1) appears to include rent on the buildings in the real estate exception but exclude that rent from the agricultural or horticultural exception to the real estate exception.[85] The real estate exception excludes "rentals from real estate" from self-employment income.[86] Because real estate includes the improvements on the land, buildings are apparently included in the real estate exception.

The agricultural and horticultural exception to the real estate exception includes "land" for which the material participation requirements are met.[87] By using a different term in the agricultural and horticultural exception, Congress must have meant something different from "real estate." A logical conclusion is that they meant to only include bare land in the agricultural and horticultural exception and not improvements. If improvements are not in the agricultural and horticultural exception, then rent received for the improvements are not subject to self-employment tax even if the material participation requirements are met.

Example 4. Fran Chise is the sole shareholder of Holstein Heaven, Inc., which operates a dairy farm. Holstein Heaven has a cash lease with Fran that calls for $24,000 of rent for 300 acres of farmland and $10,000 of rent for Fran's dairy buildings. Fran is also an employee of Holstein Heaven. The IRS is likely to argue and the Tax Court is likely to agree that the $24,000 of rent for the farmland is subject to self-employment tax. However, the $10,000 of rent for the dairy buildings

82. *See id.*
83. *See id.*
84. *See id.* at *3.
85. *See* I.R.C. § 1402(a)(1) (1994 & West Supp. 2000).
86. *See id.*
87. *See id.*

is apparently not subject to self-employment tax since that rent is not paying for "land."[88]

C. *Planning to Avoid Self-Employment Tax on Rent From an Entity*

1. *Avoiding Material Participation*

Under the reasoning of the above Tax Court cases and IRS rulings, avoiding self-employment tax on the rent paid for farmland requires the owner of the land to avoid material participation in the farming operation. One way to avoid material participation by the landowner is to shift ownership of the land to an individual who is not a part of the farming operation.

Example 5. Howie Duzzitt farms with his son in a partnership. The partnership rents land that Howie owns individually. Howie's wife, Betty, manages a retirement home and does not participate in the farming business. Rent paid from the partnership to Howie is subject to self-employment tax under the above authority. If Howie gave his land to Betty and the partnership rented it from her, the rent should not be subject to self-employment tax. The IRS may argue that the only reason for giving the land to Betty was to avoid self-employment tax and therefore treat the rent as being received by Howie. Howie and Betty should document reasons for the gift other than the self-employment tax savings such as estate planning, protection of assets from creditors, et cetera, and file applicable gift tax returns.

2. *Transferring Land to Another Entity*

Another *arguable* way to avoid material participation by the landowner is to shift ownership of the land to an entity such as a corporation or a limited partnership. If land is put into a corporation to avoid the self-employment tax problems, other tax issues should be considered to make sure putting the land into the corporation does not create more tax liability than it saves. Other tax issues to consider include recognition of gain if the land is taken out of the corporation;[89] the personal holding company tax under IRC section 541;[90] special use valuation of assets in a decedent's estate under IRC section 2032A;[91] the family owned business deduction under IRC section 2057;[92] and installment payment of estate taxes under IRC section 6166.[93]

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88. The proposed regulations that implement the income averaging rules interpret the term "land" as used in IRC § 1301 to not include the improvements on the land. *See* Prop. Treas. Reg. § 1.1301-1, 64 Fed. Reg. 54,836, 54,839-40 (1999). If that same interpretation is applied to the use of the term "land" in IRC §1401, then the rent paid for improvements on the land is not subject to the self-employment tax even if the owner of the improvements has an arrangement calling for material participation and materially participates in the farming business. *See* I.R.C. § 1401(c)(1) (1994).

89. *See* I.R.C. § 311(b) (1994).

90. *See id.* § 541 (1994 & West Supp. 2000).

91. *See id.* § 2032A.

92. *See id.* § 2057 (Supp. IV 1998).

Putting the land into a family limited partnership ("FLP") may accomplish some estate planning objectives as well as reduce self-employment tax. The FLP does not pay income or self-employment taxes on its net rental income.[94] General partners are subject to income tax and self-employment taxes on their share of the net rental income,[95] but limited partners are only subject to income tax on their share of net rental income.[96] Only the net rental income allocable to the general partnership interest would be subject to self-employment tax.[97]

Example 6. Rocky and Sandy Beach own 640 acres of land as joint tenants. They rent the land to Beach Farms, LLC under a written cash lease. Rocky owns a fifty percent interest in Beach Farms, LLC, and he materially participates in the farming activity of Beach Farms, LLC. Sandy does not participate in the farming activity. Rocky and Sandy receive $64,000 of rent each year for their land and pay $7,000 in property taxes and other deductible expenses each year. Rocky and Sandy could form a FLP and contribute their 640 acres to it. Rocky could own a one percent general partnership interest and Sandy could own a ninety-nine percent limited partnership interest. Ninety-nine percent of the FLP's $57,000 ($64,000 - $7,000) of net rental income would flow through to Sandy for income tax purposes and one percent would flow through to Rocky. Arguably, only Rocky's one percent share (1% × $57,000 = $570) as a general partner would be subject to the self-employment tax.

If both spouses materially participate in the farming business, they could still put the land in an FLP and argue that the rent they receive as limited partners is not subject to self-employment tax.[98] The proposed regulations for imposing self-employment tax on a limited partner's share of income recognize that an individual can receive income as a general partner that is subject to self-employment tax as well as income as a limited partner that is not subject to self-employment tax.[99] Those proposed regulations were put on hold by Congress and have not been issued as temporary or final regulations since the hold expired on July 1, 1998, but they do open the door to an argument that the partners of an FLP can bifurcate their ownership interest so that part of the income that flows through to them is subject to self-employment tax and some of it is not.

IV. RENT PAID TO RETIRED LANDOWNERS

Retired landowners face the same issues as landowners who rent to an entity. If the retired landowner materially participates in the farming operation under a rental

93. *See id.* § 6166 (1994 & West Supp. 2000).
94. *See id.* § 701 (1994).
95. *See id.* §§ 701, 702 (1994); *id.* § 1402(a)(13) (1994 & West Supp. 2000).
96. *See id.*
97. *See id.*
98. *See* Prop. Treas. Reg. § 1.1402(a)-2(g), 62 Fed. Reg. 1702, 1704 (1997).
99. *See id.*

arrangement providing for that material participation, the rent received for the farmland is subject to self-employment tax.[100]

Example 7. Jerry Rigg retired from farming and rented his farm to Penny Weise, a beginning farmer, under a share lease. To insure proper management, the lease stated that Jerry would advise Penny on crop and livestock management. Jerry regularly inspected the crops and livestock and advised Penny on when to plant, cultivate and harvest crops as well as the care of the livestock. Jerry's share-rent income is subject to self-employment tax.

If the lease does not provide for the landowner's participation in the farming business and there is no other arrangement providing for material participation, *the rent should not be subject to self-employment tax, even if the landowner in fact materially participates* in the farming business.

Example 8. Lilly Padd retired from farming and rented her farm to her son for cash rent. The lease gives her son complete authority to decide what crops to plant and how to care for the farm so long as he uses good management practices. Lilly enjoys being on the farm and is there about half of the time helping her son with farming activities. They regularly discuss management issues that affect the farm. Because there is no arrangement providing for Lilly's participation in the farming business, her rent is not subject to self-employment tax.

Under the IRS interpretation of IRC section 1401, with which the Tax Court has agreed[101] but the Eighth Circuit Court of Appeals has not,[102] an employment agreement meets the requirement of an arrangement providing for the landowner's participation.[103]

Example 9. If Lilly's son paid her to work on his farm, the IRS is likely to argue that there is an employment agreement (whether or not it is in writing) that meets the "arrangement" requirement.

IRS Publication 225, *Farmer's Tax Guide,* states that rent received for farmland is subject to self-employment tax "if the rental arrangement provides that the landlord will, and he or she does, materially participate in the production or management of production of the farm products on the land."[104] It also defines material participation as follows:

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100. Under the Senior Citizens Freedom to Work Act of 2000, beginning in 2000, workers who have reached age 65 can earn an unlimited amount and not be subject to a reduction in social security benefits. *See* H.R. Rep. No. 106-507, at 3 (2000), *reprinted in* 2000 U.S.C.C.A.N. (114 Stat.) 161, 162. This change in the law may cause more retired landowners to decide to participate in the farming activity on their land. That participation may increase the number of cases in which rent is subject to the self-employment tax.

101. *See* McNamara v. Commissioner, 78 T.C.M. (CCH) 530, 533 (1993).

102. *See* McNamara v. Commissioner, 2000 WL 180242, at *3 (8th Cir. Dec. 29, 2000) (forthcoming in 87 A.F.T.R.2d).

103. *See* Mizell v. Commissioner, 70 T.C.M. (CCH) 1470, 1472 (1995).

104. *See* INTERNAL REVENUE SERVICE, FARMER'S TAX GUIDE, PUB. 225, at 80 (2000).

> Material participation. You materially participate if you have an arrangement with your tenant for your participation and you meet one of the following four tests.
>
> (1) You do any three of the following.
>
> (a) Pay, using cash or credit, at least half the direct costs of producing the crop or livestock.
>
> (b) Furnish at least half the tools, equipment, and livestock used in the production activities.
>
> (c) Advise or consult with your tenant.
>
> (d) Inspect the production activities periodically.
>
> (2) You regularly and frequently make, or take an important part in making, management decisions substantially contributing to or affecting the success of the enterprise.
>
> (3) You work 100 hours or more spread over a period of 5 weeks or more in activities connected with agricultural production.
>
> (4) You do things which, considered in their totality, show that you are materially and significantly involved in the production of the farm commodities.[105]

These tests may be used as general guides for determining whether you are materially participating.

V. CONSERVATION RESERVE PROGRAM PAYMENTS

A. *Materially Participating Landowners*

For several years, the IRS has taken the position that CRP payments are subject to self-employment tax if the recipient is materially participating in a farm business.[106] That position was quite widely accepted by tax practitioners and commentators.[107] Some courts also agreed with the IRS position.[108]

In *Wuebker v. Commissioner*,[109] the Tax Court agreed with the taxpayer that CRP payments received by a materially participating farmer are not subject to self-employment tax.[110] In that case, the taxpayers had been farming for approximately twenty years.[111] In 1991 they put 214 acres of their land into the CRP program and continued to farm other land under a sharecrop rental arrangement.[112] Mr. Wuebker used his equipment to establish the required ground cover on the CRP land and

105. *Id.*
106. *See id.* at 17; Tech. Adv. Mem. 96-37-004 (May 1, 1996).
107. *See, e.g.*, PHILIP E. HARRIS ET. AL., AGRICULTURAL TAX ISSUES AND FORM PREPARATION 28–31 (1997).
108. *See, e.g.*, Ray v. Commissioner, 72 T.C.M. (CCH) 780, 781 (1996).
109. Wuebker v. Commissioner, 110 T.C. 431 (1998).
110. *See id.* at 437.
111. *See id.* at 432.
112. *See id.* at 433.

performed minimal upkeep on the land each year.[113] The *Wuebker* court based its decision on its finding that the CRP payments are rental payments.[114] By contrast, in previous cases, the Tax Court treated the CRP payments the same as other government program payments.[115]

Having determined that the CRP payments are rental payments, the *Wuebker* court then applied IRC section 1402.[116] Because the CRP payment was found to be rental from real estate, it fell within the real estate exception discussed above.[117] However, it did not fall into the agricultural land exception to the real estate exception because the CRP land was not used in agricultural or horticultural production.[118] The CRP agreement prohibits the owner from using the land in agricultural production.[119]

On appeal, the Sixth Circuit reversed the decision of the Tax Court.[120] The Sixth Circuit held that CRP payments are not rent for purposes of the self-employment tax rules because the government does not occupy the CRP land.[121] Instead, the Sixth Circuit treated the payments as government payments.[122] Accordingly, the exception for rent from real estate does not apply. If the landowner receives the payments as part of a business, then the payments are subject to self-employment tax.[123]

1. *Reporting Obligations: Returns Filed Before the 6th Circuit Opinion*

Some taxpayers amended prior year's returns and filed their 1999 income tax return relying on the Tax Court decision in *Wuebker*. That is, they reported CRP payments as not being subject to the self-employment tax. Do these taxpayers have an obligation to amend the 1999 or prior year returns to conform to the Sixth Circuit opinion?

IRS Publication 17, *Your Federal Income Tax for Individuals*, states that:

> You should correct your return if, after you have filed it, you find that:
> (1) You did not report some income,
> (2) You claimed deductions or credits you should not have claimed,
> (3) You did not claim deductions or credits you could have claimed,
> or

113. *See id.* at 434.
114. *See id.* at 437-38.
115. *See, e.g.*, Ray v. Commissioner, 72 T.C.M. (CCH) 780, 781 (1996).
116. *See Wuebker*, 110 T.C. at 438-39.
117. *See id.*
118. *See id.*
119. *See id.* at 433.
120. *See* Wuebker v. Commissioner, 205 F.3d 897, 899 (6th Cir. 2000).
121. *See id.* at 904.
122. *See id.* at 904-05.
123. *See* Ray v. Commissioner, 72 T.C.M. (CCH) 780, 781 (1996); Rev. Rul. 60-32, 1960-1 C.B. 23.

(4) You should have claimed a different filing status.[124]

Because these taxpayers have reported all of their income, the above rules do not require them to file an amended return. Similarly, nothing in the Form 1040X instructions requires taxpayers to file amended returns due to a change in the law after they have filed their original returns.

IRC section 6662 imposes a twenty percent penalty on a taxpayer if he takes a position on his tax return that is successfully challenged by the IRS.[125] However, the penalty does not apply if there was substantial authority to support the position taken on the tax return.[126] There is substantial authority for the tax treatment of an item if there is substantial authority at the time the tax return is filed or if there was substantial authority at the end of the tax year for which the position was taken.[127] Because the Tax Court's *Wuebker* opinion was substantial authority at the time of filing the tax returns, no penalty should be imposed under IRC section 6662, even if the taxpayer does not amend the return.[128]

Example 10. Anita Fixx owns and operates a farm and receives CRP payments for part of her farm. She filed her 1999 calendar year income tax return on April 1, 2000. On that return, she reported her CRP payments on Schedule E and did not pay self-employment tax on them in reliance on the Tax Court opinion in *Wuebker*. If the IRS audits her return and successfully argues that her CRP payments are subject to the self-employment tax, she will have to pay the tax with interest but will not be subject to the twenty percent underpayment penalty since there was substantial authority for her position at the end of the tax year for which she took that position.

Example 11. If Anita amended her 1997 and 1998 returns on April 1, 2000 and followed the Tax Court opinion, she would be treated as having substantial authority for the 1998 amended return but not the 1997 amended return since the Tax Court opinion was not decided until after the end of the 1997 calendar tax year.

Practitioners should note that if Anita had amended her 1997 income tax return before March 3, 2000, she would be treated as having substantial authority for following the Tax Court opinion because there was substantial authority at the time she filed the return.

2. *Reporting Obligations: Returns Filed After the 6th Circuit Opinion*

Taxpayers who file returns after the Sixth Circuit opinion was issued on March 3, 2000 must determine the effect of the opinion on the existence of

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124. INTERNAL REVENUE SERVICE, YOUR FEDERAL INCOME TAX, PUB. 17, at 16 (2000).
125. *See* I.R.C. § 6662(a) (1994 & Supp. IV 1998).
126. *See* Treas. Reg. § 1.6662-4(d)(1) (as amended in 1998).
127. *See id.* § 1.6662-4(d)(3)(iv)(C); Kretschmer v. Commissioner, 57 T.C.M. (CCH) 441, 457 (1989).
128. *See* Wuebker v. Commissioner, 205 F.3d 897, 897 (6th Cir. 2000).

substantial authority and on the existence of a reasonable basis for the contrary position.

a. *Substantial Authority*

If there is substantial authority for the contrary position, then the taxpayer is not subject to a penalty under IRC section 6662 even if he or she does not disclose the position on the tax return and is successfully challenged by the IRS.[129] For *taxpayers who are in the jurisdiction of the Sixth Circuit Court of Appeals* (Kentucky, Michigan, Ohio and Tennessee), the Tax Court case cannot be treated as authority because it was overruled by a higher court.[130] Consequently, there is no substantial authority for the position contrary to the Sixth Circuit opinion. Therefore, if taxpayers in the jurisdiction do not disclose the fact that they are taking a position contrary to the Sixth Circuit opinion, they will be subject to the twenty-percent penalty under IRC section 6662 if the IRS successfully challenges the position they take on the tax return.[131]

For *taxpayers who are outside the jurisdiction of the Sixth Circuit*, the Tax Court opinion is not considered overruled.[132] Because there can be substantial authority for more than one position,[133] it is possible that taxpayers outside the Sixth Circuit have substantial authority for the Tax Court position.[134] However, Treasury Regulation section 1.6662-4(d)(3)(iv)(B) says that the taxpayer's residence is not taken into account for purposes of the applicability of a court case in determining whether or not "there is substantial authority for the tax treatment of an item."[135] Consequently, taxpayers outside of the Sixth Circuit must consider *both the Tax Court and the Sixth Circuit opinions* when determining whether or not there is substantial authority for the Tax Court opinion.

"The substantial authority standard is less stringent than the 'more likely than not' standard (the standard that is met when there is greater than 50 percent likelihood of the position being upheld)."[136] However, the substantial authority standard is more stringent than the reasonable basis standard discussed below.[137] Based on this definition, it could be argued that there is substantial authority for the Tax Court position, but it is likely that a court will rule there is not substantial authority. Therefore, the safe position of a taxpayer outside of the Sixth Circuit is to disclose any position contrary to the Sixth Circuit opinion.

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129. *See* Treas. Reg. § 1.6662-4(d)(1) (as amended in 1998).
130. *See id*. § 1.6662-4(d)(3)(iii).
131. *See id.* § 1.6662-3(c)(1) (as amended in 1998).
132. *See id.* § 1.6662-4(d)(3)(iii) (as amended in 1998).
133. *See id.* § 1.6662-4(d)(3)(i).
134. *See id.*
135. *Id*. § 1.6662-4(d)(3)(iv)(B).
136. *Id.* § 1.6662-4(d)(2).
137. *See id.*

b. *Reasonable Basis*

If there is not substantial authority for a position contrary to the Sixth Circuit opinion and the taxpayer discloses the fact that he or she is taking a contrary position on the tax return, the IRC's section 6662 twenty percent understatement penalty will not apply if there is a reasonable basis for the contrary position.[138] "The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim."[139] It must be reasonably based on authorities that can be used to find substantial authority for a position, "taking into account the relevance and persuasiveness of the authorities and subsequent developments."[140] The reasonable basis standard apparently does not require a consideration of the weight of authority. Consequently, taxpayers outside the Sixth Circuit clearly have a reasonable basis for their position if they follow the Tax Court opinion because it is not treated as overruled by the Sixth Circuit opinion. Taxpayers in the Sixth Circuit cannot rely on the Tax Court opinion. Therefore, it is likely that they do not have a reasonable basis for taking a position contrary to the Sixth Circuit opinion.

B. *Non-Materially Participating Landowners*

The *Wuebker* case does not affect non-materially participating landowners.[141] Because the Wuebkers were not engaged in the business of farming, CRP payments they received were not subject to the self-employment tax under either the Tax Court or the 6th Circuit holding.[142]

Example 12. Lorna Buckmaster put her entire farm into the CRP. She paid her neighbor to establish the required ground cover and pays him each year to mow the land. Because Lorna is not materially participating, she is not subject to self-employment tax on the CRP payments.

Example 13. If Lorna from the previous example established the ground cover herself and mowed the land each year, she is still likely to be treated as not materially participating in a trade or business and therefore not subject to the self-employment tax under either the Tax Court or the 6th Circuit opinion.

138. *See id.* § 1.6662-3(c)(1) (as amended in 1998).
139. *Id.* § 1.6662-3(b)(3).
140. *Id.*
141. *See* Wuebker v. Commissioner, 205 F.3d 897, 902 (2000).
142. *See id.*

VI. PROPOSED LEGISLATION

A. *Self-Employment Tax on Rent*

Several bills have been introduced in Congress that would amend the self-employment tax rules.[143] The House and Senate have each introduced bills that would result in the following changes to section 1402:

> [T]here shall be excluded rentals from real estate and from personal property leased with the real estate (including such rentals paid in crop shares) together with the deductions attributable thereto, unless such rentals are received in the course of a trade or business as a real estate dealer; except that the preceding provisions of this paragraph shall not apply to any income derived by the owner or tenant of land if (A) such income is derived under ~~an arrangement~~ a lease agreement, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities (including livestock, bees, poultry, and fur-bearing animals and wildlife) on such land, and that there shall be material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) in the production or the management of the production of such agricultural or horticultural commodities, and (B) there is material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) with respect to any such agricultural or horticultural commodity.[144]

The above amendment would likely take away the IRS's argument that the required arrangement can be found in agreements other than the lease. Therefore, a partnership agreement or employment agreement that provides for material participation of the landowner would not meet the requirement that there be an arrangement providing for the landowner's material participation. The above amendment is likely to reverse the outcome in factual situations similar to those in cases such as *Mizell*, *Bot*, *Hennen*, and *McNamara* discussed above.

The above amendment would not solve the problem for all retired landowners. Landowners who want to put their right to make management decisions in the lease would still be subject to self-employment tax.[145] Similarly, *landowners who have an oral lease and materially participate* may be subject to self-employment tax because the provision for material participation may be treated as included in the oral agreement.[146]

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143. *See* H.R. 1044, 106th Cong. (1999); S. 569, 106th Cong. (1999); H.R. 4260, 106th Cong. (2000); S. 1861, 106th Cong. (2000).

144. *See* I.R.C. § 1402 (1994); H.R. 4260, 106th Cong. (2000); S. 569, 106th Cong. (1999).

145. *See* I.R.C. § 1402(a) (1994).

146. *See* Treas. Reg. § 1.1402(a)-4(b) (as amended in 1980).

A more comprehensive solution to the self-employment tax on rent problem is to repeal the agricultural and horticultural exception to the real estate exception. That would eliminate any ambiguity about the applicability of the self-employment tax on rent paid to an entity and would also solve the problem for all retired landowners. The amendment would change IRC section 1402 as follows:

> [T]here shall be excluded rentals from real estate and from personal property leased with the real estate (including such rentals paid in crop shares) together with the deductions attributable thereto, unless such rentals are received in the course of a trade or business as a real estate dealer; ~~except that the preceding provisions of this paragraph shall not apply to any income derived by the owner or tenant of land if (A) such income is derived under an arrangement, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities (including livestock, bees, poultry, and fur-bearing animals and wildlife) on such land, and that there shall be material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) in the production or the management of the production of such agricultural or horticultural commodities, and (B) there is material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) with respect to any such agricultural or horticultural commodity.~~

The more comprehensive solution puts owners of agricultural land in the same position as owners of other real estate. Consequently, it takes away the agricultural landowner's option under current law to pay self-employment tax on the rental income as a means of increasing his or her earned income for purposes of calculating social security benefits. Under the more comprehensive amendment, agricultural landowners could subject their income from the land to self-employment tax by entering into a partnership arrangement with a farm operator or by continuing to use the land in their own farming business and using custom operators to work the land.[147]

B. *Self-Employment Tax on CRP Payments*

Neither of the above legislative proposals would change the result in the Sixth Circuit opinion in *Wuebker*. Under the Sixth Circuit reasoning, the CRP payments are not rent and therefore are not included in the expanded real estate exception of either of the above amendments.[148]

147. *See supra* Part VI.A.

148. *See* Wuebker v. Commissioner, 205 F.3d 897, 904 (6th Cir. 2000).

Legislation has also been introduced that would explicitly exclude CRP payments from self-employment income.[149] These proposals would exempt CRP payments from self-employment tax regardless of the landowner's involvement in the farming business.[150]

VII. CONCLUSION

The self-employment tax creates a significant planning challenge for farmers. While it is a significant tax burden it also provides a significant benefit in the form of social security benefits.[151] Therefore, any planning to reduce self-employment taxes must include an analysis of the effect of the reduction on social security benefits to make sure the present value of the tax savings are greater than the present value of the decrease in social security benefits.

One logical way for farmers to reduce their self-employment tax liability is to separate their income into two components—the return to their labor and management and the return to their capital assets. Because the self-employment tax is the equivalent of FICA taxes on employee's income[152] and is theoretically imposed on the earned income of the self-employed taxpayer, they can then argue that the self-employment tax should be imposed only on the return to their labor and management and not on the return to their capital assets. Taxpayers other than farmers can do this sorting by putting their business into an entity such as a limited liability company, a partnership or a corporation and paying rent from the entity to themselves for real estate held outside the entity.[153] The rent reduces entity income that is subject to self-employment taxes or salary that is subject to FICA taxes and the rent income is not subject to self-employment taxes.

Under the current language of IRC section 1402(a)(1), the IRS has successfully argued that farmers who do the same sorting of income do not reduce self-employment tax because the rental income is subject to self-employment tax.[154] A recent victory by taxpayers indicates that at least one court understands the inequity for farmers and will strictly interpret the Internal Revenue Code to minimize the inequity.[155] However, uncertainty remains for farmers who want to remove the return to their land from the self-employment tax. A legislative repeal of the provision that creates the inequity would allow farmers to do the same self-

149. *See* H.R. 4260, 106th Cong. (2000); S. 2344, 106th Cong. (2000); S. 2422, 106th Cong. (2000).
150. *See supra* Part VI.A.
151. *See supra* Part I.
152. *See id.*
153. *See supra* Part II.B.
154. *See supra* Part III.A.
155. *See id.*

employment tax and Social Security benefit planning as other taxpayers who own a business, without the risk of an IRS challenge.

Repeal of the provision that treat owners of farmland differently from other taxpayers would also remove the risk that the IRS will impose the self-employment tax on retired farmers who are renting their land to a family member or other farmer. Under the current language of IRC section 1402(a)(1), a retired farmer who participates too much in the farming activity on the land he or she is renting to another farmer may be required to pay self-employment tax on that rental income.[156] Retired farmers should be treated the same as other retired business owners. They should be allowed to participate in the business activity that rents their real property without being subject to self-employment tax on that rental income.

Farmers who receive Conservation Reserve Program payments face a similar issue of being required to include the payments in self-employment income even though the payments are the equivalent of rent on land. A higher court[157] has reversed the only taxpayer victory[158] on this issue. Consequently, legislation is also needed to correct this inequity.

156. *See supra* Part IV.
157. *See supra* Part V.A.
158. *See id.*