

McNamara v. Commissioner

Abstract:

The IRS has held that partners or shareholders that own land outside of the partnership or corporation they own and operate are subject to self-employment tax on the rents they receive from that same partnership or corporation. The issue is that they are continuing to farm the land the same as if they were farming it as a sole proprietor. The Tax Court has agreed with the IRS. The Eighth Circuit has reversed and remanded the Tax Court decision and has given the IRS an opportunity to show a connection between the rents and the production arrangement. This material discusses the facts of the cases.

360 ACTIVITIES NOT FOR PROFIT

McNamara v. Commissioner

[I.R.C. §1402]

The Eighth Circuit reverses and remands on farmland rentals subject to self-employment tax in <i>McNamara, Hennen, and Bot</i>.
--

Facts. Each of the three couples, McNamara, Bot, and Hennen, had owned farmland for many years. Each of the couples rented the farmland to the farm activity for at or below market rates, and each had employment contracts requiring material participation by the landlord. For the years at issue the couples reported real estate rental income and wages paid on their joint returns. The IRS determined deficiencies for self-employment tax on the rental payments. The Tax Court agreed with the IRS.

Issue. Whether rental payments received by taxpayers from the farm activity are includable in taxpayers' net earnings from self-employment under I.R.C. §1402(a)(1) and thus subject to self-employment taxes.

Analysis. The court noted that generally taxable self-employment income excludes sources that do not depend on an individual's labor, including rentals from real estate. Under I.R.C. §1402(a)(1), however, rents are included if, "derived under an arrangement, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities . . . on such land, and that there shall be material participation by the owner or tenant . . . in the production or the management of the production of such agricultural or horticultural commodities, and . . . there is material participation by the owner or tenant . . . with respect to any such agricultural or horticultural commodity."

The court disagreed with taxpayers' contention that §1402(a)(1) applies only to rental payments derived from sharecropping or share-farming, stating that no such restriction appears in the Code. The court also rejected taxpayers' contention that the instructions accompanying Form 4835 (Farm Rental Income and Expenses) contradict and therefore override §1402(a)(1).

Further, the court acknowledged that the Tax Court did not clearly err in concluding that the wives were required by the employment arrangements to materially participate. However, the court found compelling the taxpayers' argument that the lessor-lessee relationships should stand on their own apart from the employer-employee relationships. The court acknowledged that **rents consistent with market rates very strongly suggests that the rental arrangement stands on its own** as an independent transaction and not part of an "arrangement" for participation in agricultural production. The court found missing from both the IRS's and the Tax Court's analyses any mention of a nexus between the rents received by taxpayers and the "arrangement" that requires the landlords' material participation. The court remarked, "mere existence of an arrangement requiring and resulting in material participation in agricultural production does not automatically transform rents received by the landowner into self-employment income. It is only where the payment of those rents comprise part of such an arrangement that such rents can be said to derive from the arrangement."

Holding. The **Eighth Circuit reversed and remanded** the Tax Court's decisions to give the IRS an opportunity to show a connection between those rents and the production arrangement.

[*McNamara v. Commissioner*, 236 F.3d 410 (8th Cir. 2000), reversing and remanding 78 T.C.M. (CCH) 530 (1999); *Hennen v. Commissioner*, 78 T.C.M. (CCH) 445 (1999); and *Bot v. Commissioner*, 78 T.C.M. (CCH) 220 (1999)]