ALTB 04-07 SELF EMPLOYMENT TAX ON RENTED FARMLAND

Abstract
IRS has challenged taxpayers regarding whether rental payments for land paid to an owner who materially participates in farming the rented land is liable for self employment (SE) tax. The Courts have agreed with IRS in a number of cases. However, the Eight Circuit overruled the IRS on appeal. Relying on this successful appeal, taxpayers who did not recognize SE tax liability had an argument to avoid a negligence penalty. In 2003, IRS issued an official non-acquiescence statement regarding the appeal, making the possibility of penalties more probable for both taxpayers and tax professionals.

Renting Land to a Family Entity – The Mizell Problem
The *Mizell* case involved an Arkansas farmer who rented 731 acres of farmland to a family partnership operated with his three sons. The father owned a 25% interest in the partnership and the partnership agreement specified that each partner had an equal vote in the management of the partnership operation and in the conduct of the farming business. Each partner was required to devote full time to the operation, and the father was active in the partnership in the years in question and reported the distributive share of partnership income as net earning from self-employment. The lease was on a 25% crop-share basis with the partnership paying all of the crop expense.

The father treated the lease as a nonmaterial participation lease and did not report the rental amounts as SE income. The Tax Court focused on the language in IRC §1402(a)(1) providing an exception to the general rule that rentals from real estate are excluded from net earning from self-employment if there is an “arrangement” with material participation by the owner in the “production or the management of the production” of agricultural commodities. The court noted that the father was materially participating in the partnership operations and the statutory language referring to “an arrangement” necessarily included the father’s involvement in the partnership as well as under the lease. Thus, the rental income under the lease was subject to SE tax. The court reasoned the type of lease was immaterial where the lessor was materially participating in the lessee entity.

Subsequent Cases and Rulings
A 1996 technical advice memorandum reached the same conclusion with a cash rent lease to a corporation. Three Field Service Advice rulings in 1998 were in agreement.

In three cases decided in 1999, the Tax Court applied *Mizell* and imposed SE tax on rents from land rented to a family farming operation. On appeal, the three Tax Court cases were consolidated and were reversed in late 2000. The Eighth Circuit held that the lessor–lessee arrangements should stand on their own, apart from any employment relationship, and that if the rentals were “consistent with market rates for agricultural land” the rents were not “derived under an arrangement” and, therefore, SE tax was not due. The court pointed out that “the mere existence of an arrangement requiring and resulting in material participation in agricultural production does not automatically transform rents received” into SE income. The court noted that rents consistent with market rates “very strongly suggest” that the rental arrangement stands on its own as an
independent transaction and cannot be said to be part of an arrangement for participation in agricultural production. The court remanded the cases to the Tax Court to provide an opportunity for the IRS to show a connection between rents and the “arrangement.”

On July 10, 2002, the Tax Court rendered its remand opinion holding that the rental arrangements reflected FMV and that no SE tax should be imposed.

**Note.** Based on the Eighth Circuit’s opinion in *McNamara*, it is imperative that taxpayers who are potentially “subject to challenge,” set the rental rates in keeping with rates in the area for comparable land. In addition, it is important that evidence of rental rates be preserved for use in any later audit.

**Possible Arguments**

For taxpayers occupying a dual status as lessor and lessee, it is important for the lease to be in writing with standard terms and conditions calling for a reasonable rental. Also, it is important for the status as partner, employee, or LLC member to be formally established and maintained.

Remember, while *Mizell* involved a partnership, a more general solution to the problem may be to convey the land to another type of entity (such as an LLC or LP); however, the regulations on handling SE income for such pass-through entities are still in limbo.

The key, outside the Eighth Circuit, is to make sure that the taxpayer is not on “both sides of the equation” as both lessor and lessee. In the IRS view, supported by the Tax Court opinion in *Mizell*, the question is whether the taxpayer’s combination of involvement as lessor and lessee rises to the level of material participation. In the Eighth Circuit (Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, and South Dakota), the key is to make sure the rental rate is representative of a fair market rental for comparable land.

Another approach may be to transfer the land to a nonparticipating spouse and have the spouse lease the land to the farming business under a passive lease. There are several other income tax and estate tax implications to consider with this approach.

**Observation.** The IRS continues to litigate Mizell-type situations. A case involving an upstate New York apple tree and produce farm is currently pending in the Tax Court and would be appealable to the Second Circuit. This case was scheduled for trial September 8, 2003. The results of the appeal have yet to be released. Another case, appealable to the Eighth Circuit, involves the cash leasing of land by a family partnership to a corporation controlled by the same individuals.

The IRS argued that the partnership rental income was subject to SE tax. On January 28, 2003 a stipulated decision was entered. The IRS entirely dropped the assessment of SE tax. This case was within the same jurisdiction as *McNamara* and the taxpayer obtained independent verification each year that rental amounts were similar to other rents in the area.