

Self-Employment Tax on Rental and CRP Land

Abstract:

The issue of whether CRP payments and land rental payments are treated as self-employment income is discussed in this section. For several years, the IRS position was that CRP payments were self-employment income if the land owner was a materially participating farmer. In a 1998 case, *Wuebker v Commissioner*, 110 T.C. No. 31, the Tax Court agreed with the taxpayer that the payments were not self-employment income even when the taxpayer was a materially participating farmer. The 6th Circuit has reversed the decision of the Tax Court and held the CRP payments are self-employment income if made to a materially participating farmer. Taxpayers who filed amended returns to comply with the Tax Court decision are now faced with the question of whether to file a second amended return.

There has also been disagreement whether cash rental payments are self-employment income where the land owner materially participates in the crop production. The Eighth Circuit has overruled the Tax Court and returned the case to the IRS. Taxpayers in that Circuit are not held to the Tax Court decision. This material discusses the facts of both the CRP and land rental cases. It gives suggestions on how these issues should be addressed on currently filed tax returns.

ISSUE 2: SELF-EMPLOYMENT TAX

APPLICABLE LAW

Under I.R.C. §1402(a)(1), rent received on land is included in self-employment income if two conditions are met.

1. The land is used under an arrangement that provides:
 - a. That another individual will produce agricultural or horticultural commodities on the land
 - b. That the owner of the land will materially participate in the production of the agricultural or horticultural commodities
2. There is material participation by the owner of the land with respect to the agricultural or horticultural commodity.

LAND RENTED TO AN ENTITY

Until 1995, the IRS did not challenge the common practice of treating rent from an entity to an owner of the entity for farmland held outside the entity as not being subject to self-employment tax.

Example 1. 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.

Beginning in 1995, the IRS has taken 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.

Practitioner Note. The IRS argues that a partnership agreement or an employment agreement with the entity is such an arrangement.

2. The landowner materially participates in the farming business.

Authority in Support of the IRS Position

Beginning in 1995, the IRS successfully argued its position in four cases: *Mizell v. Commissioner*, T.C. Memo 1995-571; *Bot v. Commissioner*, T.C. Memo 1999-256; *Hennen v. Commissioner*, T.C. Memo 1999-306; and *McNamara v. Commissioner*, T.C. Memo 1999-333. Beginning in 1996 the IRS issued a letter ruling and three field service advisory opinions in support of its position: Ltr. Rul. 9637004, dated May 1, 1996; FSA 199917008; FSA 199917005; and FSA 199917006.

Authority in Support of the Taxpayer Position

In December 2000, the 8th Circuit Court of Appeals reversed and remanded the *McNamara*, *Bot*, and *Hennen* cases listed above [*McNamara v. Commissioner*, 87 AFTR 2d 2001-310 (8th Cir. 2000)]. In that case, the court rejected some of the taxpayer's arguments, but agreed with the taxpayer's argument that the rent must include compensation for the services that were required by the employment contract in order to make the rent subject to self-employment tax.

The case was remanded to the Tax Court for a finding on whether the rent paid was a fair rental amount. If it was a fair rental amount, then no part of the rent was compensation for services and the rent is not included in self-employment income.

How to Report Rental Income from an Entity

What position should a tax preparer take on a take return given the above authority?

It is important to note that **the only taxpayer argument that has found support in the court**

cases is the argument that the lessor-lessee relationships should stand on their own apart from the employer-employee relationships. Consequently, facts that show the rent is not in excess of a fair rental rate are critical to the use of the 8th Circuit opinion in *McNamara* as support for a position on an income tax return.

Example 2. John Brown operates his farm business as a sole proprietorship. He pays his wife, Mary, \$125 per acre cash rent for land she inherited from her parents. He also pays Mary a reasonable wage for keeping the books for his business. If John can show that \$125 per acre is a fair rental rate for the farmland, the 8th Circuit opinion in *McNamara* is authority for reporting the rent as a deduction on John's Schedule F (Form 1040) and as rental income on Mary's Schedule E (Form 1040), where it is not subject to self-employment tax.

The 8th Circuit **rejected the following taxpayer arguments** in *McNamara*:

1. That I.R.C. §1402(a)(1) applies only to rental payments derived from sharecropping or sharefarming.
2. That the instructions accompanying Form 4835 (Farm Rental Income and Expenses) contradict and therefore override I.R.C. §1402(a)(1).
3. That the Tax Court clearly erred in concluding, as a factual matter, that Mrs. McNamara, Mrs. Bot, and Mrs. Hennen were required—by their respective employment agreements or by more informal “arrangements”—to materially participate in agricultural production and management, and that all three did in fact materially participate in those activities.

Taxpayers in the Eighth Circuit. The IRS and the Tax Court are bound by the holding of the 8th Circuit Court of Appeals Taxpayers opinion in *McNamara* with respect to taxpayers who are in the jurisdiction of the 8th Circuit (North Dakota, South Dakota, Nebraska, Minnesota, Iowa, Missouri, and Arkansas). Consequently, taxpayers in the 8th Circuit have substantial authority for excluding rental income from self-employment tax if the rent is a fair rental rate. That means they will not be subject to an underpayment penalty for not disclosing their position on a tax return by filing Form 8275 even if the IRS is ultimately successful on this issue and assesses a self-employment tax liability for the rent.

Example 3. Assume John and Mary Brown from Example 2 live in the 8th Circuit. They report the rental income on Mary's Schedule E (Form 1040) as not being subject to self-employment tax. The IRS successfully litigates its position in other circuits and the U.S. Supreme Court resolves the conflict between the 8th Circuit and the other circuits in favor of the IRS. Based on the Supreme Court opinion, the IRS successfully assesses self-employment tax liability on Mary's rental income. John and Mary are not subject to the 20% penalty under I.R.C. §6222 because they had substantial authority for their position when they reported it on their income tax return [Treas. Reg. §1.6222 - 4(d)(1)].

Taxpayers Outside the Eight Circuit. The IRS and the Tax Court are not bound by the holding of the 8th Circuit Court of Appeals Taxpayers opinion in *McNamara* with respect to taxpayers who are outside the jurisdiction of the 8th Circuit Court of Appeals. Consequently, taxpayers who are outside the 8th Circuit and follow the holding of the 8th

Circuit opinion in *McNamara* may be challenged by the IRS, and the Tax Court could rule in favor of the IRS as it did in *Bot*, *Hennen*, and *McNamara*. If taxpayers in other circuits lose in the tax court, they can appeal to the Circuit Court of Appeals for their circuit.

Taxpayers outside the 8th Circuit can argue that the 8th Circuit opinion in *McNamara* is substantial authority for not including rent in self-employment income on their income tax returns. Even though the Tax Court opinion is not overruled outside the 8th Circuit, Treas. Reg. §1.6222-4(d)(3)(iv)(B) says the taxpayer's residence is not to be 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. Consequently, taxpayers outside the 8th Circuit can weigh the authority of the Tax Court opinions and the 8th Circuit opinions when deciding whether there is substantial authority for their position. Since the 8th Circuit is a higher court, there is clearly substantial authority for a position that is consistent with the 8th Circuit opinion.

Example 4. Assume John and Mary Brown from Example 2 live outside the 8th Circuit. They report the rental income on Mary's Schedule E (Form 1040) as not being subject to self-employment tax. The IRS challenges that position in the Tax Court, and the Circuit Court of Appeals for the circuit in which John and Mary live upholds the Tax Court opinion. John and Mary are not subject to the 20% penalty under I.R.C. §6222 because they had substantial authority for their position when they reported it on their income tax return [Treas. Reg. §1.6222-4(d)(1)].

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 I.R.C. §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.

The exception to self-employment tax in I.R.C. §1402(a)(1) for rent paid for real estate excludes "rentals from real estate" from self-employment income. Since 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 in I.R.C. §1402(a)(1) includes "land" for which the material participation requirements are met. 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 5. Assume John and Mary from Example 4 lose on their argument that Mary's rent is not subject to self-employment tax but that part of the rent is for buildings on Mary's land. The rent for the buildings should be excluded from self-employment income

because it is rent received for real estate, but it is not rent received for land used in agricultural production.

Practitioner Note. The proposed regulations that implement the income averaging rules interpret the term “land” as used in I.R.C. §1301 to not include the improvements on the land. If that same interpretation is applied to the use of the term “land” in I.R.C. §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.

CONSERVATION RESERVE PROGRAM (CRP) PAYMENTS

Materially Participating Landowners

For several years, the IRS has taken the position that Conservation Reserve Program (CRP) payments are subject to self-employment tax if the recipient is materially participating in a farm business. See Ltr. Rul. 9637004 (May 1, 1996) and 1997 IRS Publication 225, *Farmer’s Tax Guide*, p. 17. That position was quite widely accepted by tax practitioners and commentators. Some courts also agreed with the IRS position. See *Ray v. Commissioner*, T.C. Memo 1996-436, 72 T.C.M. 780 [CCH Dec. 51,572(M)] (1996).

In *Wuebker v. Commissioner*, 110 T.C. No. 31 (June 23, 1998), the Tax Court agreed with the taxpayer that CRP payments received by a materially participating farmer are not subject to self-employment tax. In that case, the taxpayers had been farming for approximately 20 years. In 1991 they put 214 acres of their land into the CRP program and continued to farm other land under a sharecrop rental arrangement. Mr. Wuebker used his equipment to establish the required ground cover on the CRP land and performed minimal upkeep on the land each year.

The *Wuebker* court based its decision on its finding that the CRP payments are rental payments. By contrast, the *Ray* court treated the CRP payments the same as other government program payments.

Having determined that the CRP payments are rental payments, the *Wuebker* court then applied I.R.C. §1402. Since the CRP payment was found to be rental from real estate, it falls within the real estate exception discussed above. However, it did not fall into the agricultural land exception to the real estate exception since the CRP land was not used in agricultural or horticultural production. The CRP agreement prohibits the owner from using the land in agricultural production.

In *Wuebker v. Commissioner*, 85 AFTR 2d 1057 (6th Cir. 2000), the 6th Circuit reversed the decision of the Tax Court. The 6th Circuit held that CRP payments are not rent for purposes of the self-employment tax rules since the government does not occupy the CRP land. Instead, the 6th Circuit treated the payments as government payments. 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. *Ray v. Commissioner*, 72 T.C.M. 780 (1960); Rev. Rul. 60-32, 1960-1 C.B. 23.

Reporting Obligations: Returns Filed Before the 6th Circuit Opinion. Some taxpayers amended prior years' 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 and/or prior year returns to conform to the 6th Circuit opinion?

IRS Publication 17, *Your Federal Income Tax for Individuals* (2000), states at page 16,

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
- 4 You should have claimed a different filing status.

Since 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 an amended return due to a change in the law after they filed their return.

I.R.C. §6662 imposes a 20% penalty on taxpayers if they take a position on their tax return that is successfully challenged by the IRS. However, the penalty does not apply if there was substantial authority to support the position taken on the tax return. 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 [Treas. Reg. §1.6662-4(d)(3)(iv)(C); *Kretschmer v. Commissioner*, T.C. Memo 1989-242]. Since the Tax Court's *Wuebker* opinion was substantial authority at the time of filing the tax returns, no penalty will be imposed under I.R.C. §6662, even if the taxpayer does not amend the return.

Example 6. 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 20% underpayment penalty since there was substantial authority for her position at the end of the tax year for which she took that position.

Example 7. If Anita amended her 1997 and 1998 returns on April 1, 1999, and followed the Tax Court opinion, she would be treated as having substantial authority for the amended returns, since the Tax Court opinion was decided before the amended returns were filed and the 6th Circuit opinion was decided after they were filed.

<p>Practitioner Note. If Anita had amended her 1997 income tax return before June 23, 1998, she would not be treated as having substantial authority for following the Tax Court opinion since there was not substantial authority at the time she filed the amended return or at the end of the tax year.</p>

Reporting Obligations: Returns Filed After the 6th Circuit Opinion. Taxpayers who file returns after the 6th Circuit opinion was issued on March 3, 2000, must determine the effect of the opinion on the existence of substantial authority and on the existence of a reasonable basis for the contrary position.

Substantial authority. If there is substantial authority for the contrary position, then the taxpayer is not subject to a penalty under I.R.C. §6662 even if he or she does not disclose the position on the tax return and is successfully challenged by the IRS [Treas. Reg. §1.6662-4(d)(1)].

For taxpayers who are in the jurisdiction of the 6th Circuit Court of Appeals (Kentucky, Michigan, Ohio, and Tennessee), the Tax Court case cannot be treated as authority since it was overruled by a higher court [Treas. Reg. §1.6662-4(d)(3)(iii)]. Consequently, there is no substantial authority for the position contrary to the 6th Circuit opinion. Therefore, if taxpayers in the jurisdiction do not disclose the fact that they are taking a position contrary to the 6th Circuit opinion, they will be subject to the 20% penalty under I.R.C. §6662 if the IRS successfully challenges the position they take on the tax return.

For taxpayers who are outside the jurisdiction of the 6th Circuit, the Tax Court opinion is not considered overruled [Treas. Reg. §1.6662-4(d)(3)(iii)]. Since there can be substantial authority for more than one position [Treas. Reg. §1.6662-4(d)(3)(i)], it is possible that taxpayers outside of the 6th Circuit have substantial authority for the Tax Court position. However, Treas. Reg. §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. Consequently, taxpayers outside of the 6th Circuit must consider both the Tax Court and the 6th 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% likelihood of the position being upheld [Treas. Reg. §1.6662-4(d)(2)]. However the substantial authority standard is more stringent than the reasonable basis standard discussed below [Treas. Reg. §1.6662-4(d)(2)]. 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 6th Circuit is to disclose any position contrary to the 6th Circuit opinion.

Reasonable basis. If there is not substantial authority for a position contrary to the 6th Circuit opinion and the taxpayer discloses the fact that he or she is taking a contrary position on the tax return, the I.R.C. §6662 20% understatement penalty will not apply if there is a reasonable basis for the contrary position [Treas. Reg. §1.6662-3(c)(1)].

The reasonable basis standard is not satisfied by a return position that is merely arguable or is merely a colorable claim. 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 [Treas. Reg. §1.6662-3(b)(3)]. The reasonable basis standard apparently does not require a consideration of the weight of authority. Consequently, taxpayers outside the 6th Circuit clearly have a reasonable basis for their position if they follow the Tax Court opinion

since it is not treated as overruled by the 6th Circuit opinion. Taxpayers in the 6th 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 6th Circuit opinion.

Observation. Some landowners may prefer to have their CRP payments treated as self-employment income because of the effect on other tax provisions. For example, if the CRP payments are not subject to self-employment tax, the CRP land may not qualify for special use valuation or the qualified family-owned business deduction. Also, the CRP payments may not qualify as farm income for purposes of tax provisions such as the exception to the estimated tax rules or the qualified farm indebtedness rules.

Non-Materially Participating Landowners

The *Wuebker* case does not affect non-materially participating landowners. Since they are not engaged in the business of farming, CRP payments they receive are not subject to the self-employment tax under either the Tax Court or the 6th Circuit holding.

Example 8. 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. Since Lorna is not materially participating, she is not subject to self-employment tax on the CRP payments.

Example 9. 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.