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LIMITING SELF-EMPLOYMENT TAXATION OF ACTIVELY FARMING LANDLORDS

JON J. JENSEN*

I. INTRODUCTION

In the mid to late 1990s, the Internal Revenue Service (Service) began widespread assessment of the self-employment tax on active farmers who rented agricultural real property to their spouses, farming partnerships, or agricultural corporations.[1] The Service asserted that rental payments by farming entities to individuals actively engaged in farming were subject to self-employment taxation pursuant to § 1402(a)(1) of the Internal Revenue Code (Code), which imposes a self-employment tax on the net earnings of every individual from self-employment.[2] Section 1402(a)(1) specifically excludes all real estate rentals from the definition of self-employment income except agricultural rentals where there is an agreement requiring material participation by the owner.[3] The Service interpreted § 1402(a)(1)

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1. *See, e.g.*, Wuebker v. Commissioner, 205 F.3d 897, 899-900 (6th Cir. 2000) (determining that Conservation Reserve Program payments were rentals from real estate includable within self-employment income because the payments had a direct nexus to the taxpayers' farming business); McNamara v. Commissioner, 236 F.3d 410, 410 (8th Cir. 2000) (stating that rental payments must be "derived under" arrangements requiring material participation in agricultural production and the taxpayers' material participation in the absence of a nexus between the rents and the arrangement is not dispositive).

2. *See McNamara*, 236 F.3d at 411 (stating the Commissioner determined that the McNamaras' receipt of rental payments was earnings from self-employment under § 1402(a)(1)). The inclusive portion of § 1402(a) reads as follows:

> (a) Net earnings from self-employment.
>
> The term "net earnings from self-employment" means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member; except that in computing such gross income and deductions and such distributive share of partnership ordinary income or loss . . .

I.R.C. § 1402(a) (2002). Unless otherwise indicated, all references to sections of laws in this article indicate a section of the Internal Revenue Code.

3. I.R.C. § 1402(a)(1). Section 1402(a)(1) states:

> (1) there 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

as rendering all agricultural rental payments to active farmers who materially participated in the farming enterprise as subject to self-employment taxation.[4]

Several taxpayers resisted the Service's position by asserting that a nexus had to exist between the rents received by the taxpayers and the arrangement that required their material participation.[5] The taxpayers maintained that imposing the self-employment tax was only appropriate when the rent payments were tied to and derived from the arrangement that required material participation.[6] Unable to reconcile these adverse positions, several taxpayers exhausted their administrative remedies and sought judicial resolution.[7]

The family farm has come under increased financial pressure because of depressed agricultural markets. The increase in government regulation and taxation has compounded this financial pressure. The knowledge that agriculture is the only industry in which an owner of a business cannot be a landlord without subjecting the rental payments to self-employment taxation further frustrates the family farmer.[8] For example, as this article was compiled, the author utilized an office that was maintained by and rented

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> 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.

Id. Net earnings from self-employment do not generally include rentals from real estate. *Id.*; Wuebker v. Commissioner, 110 T.C. 431, 436 (1998), *rev'd*, 205 F.3d 897 (6th Cir. 2000); Treas. Reg. § 1.1402(a)-4(d) (as amended in 1980). Section 1402(a)(1) also provides an exception to the general rule that rentals from real estate are excluded from net earnings from self-employment. *Wuebker*, 110 T.C. at 436; I.R.C. § 1402(a)(1)(A)-(B). The exception to the exclusion results in the inclusion of certain rental arrangements with respect to the production of agricultural and horticultural commodities within net earnings from self-employment. *Wuebker*, 110 T.C. at 436; I.R.C. § 1402(a)(1)(A)-(B).

4. *McNamara*, 236 F.3d at 410; *Wuebker*, 205 F.3d at 901.

5. *McNamara*, 236 F.3d at 411-13.

6. *Id.* at 410 (grouping three separate taxpayers in a consolidated appeal challenging the Tax Court's affirmance of the Service's imposition of the self-employment tax on agricultural rental payments).

7. *Id.* at 412. A taxpayer may file a petition with the United States Tax Court for a redetermination of any tax deficiency asserted by the Service. I.R.C. § 6213(a) (2002). Tax Court review of an Internal Revenue Service decision is allowed prior to paying the tax. *Id.* Alternatively, the taxpayer may pay the tax and initiate a claim for a refund in a federal district court or the United States Claims Court. I.R.C. § 7422 (2002); 28 U.S.C. §§ 1346, 1341 (2000).

8. I.R.C. § 1402(a). The definition of self-employment income excludes rental income except for rental income classified as includable farm rental income. Treas. Reg. § 1.1402(a)-4(b) (as amended in 1980).

from a limited liability company in which the author had an ownership interest. The rental payments under this structure were not subject to self-employment taxation. This is true for every other business where the operator of the business is also the owner of the real property from which the business is operated; agricultural production is the sole exception.[9]

II. THE STATUTORY FRAMEWORK EXCLUDES REAL ESTATE RENTAL PAYMENTS FROM SELP-EMPLOYMENT TAXATION WITH THE EXCEPTION OF "INCLUDABLE FARM RENTAL INCOME"

A. THE INTENT TO PROTECT THE AGRICULTURAL INDUSTRY

Taxes are imposed upon the self-employment income of individuals pursuant to § 1401 of the Code.[10] The self-employment tax provides a vehicle for funding social security benefits of self-employed individuals.[11] An individual's self-employment tax liability is based on the self-employment income generated by the individual.[12] Self-employment income is defined by reference to §§ 1402(a) and 1402(b) of the Code.[13] It encompasses the "net earnings from self-employment derived by an individual."[14] Net earnings from self-employment are defined as "the gross income derived by any individual from any trade or business carried on by such individual" less any expenses attributable to the trade or business.[15]

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9. I.R.C. § 1402(a)(1).

10. I.R.C. § 1401 (2002).

11. Newberry v. Commissioner, 76 T.C. 441, 443 (1981). The social security system was modified to include the self-employment tax through the enactment of the Social Security Act Amendments of 1950, which functioned as a vehicle for financing the extension of social security benefits to self-employed individuals. S. REP. NO. 81-1669 (1950). As noted by the Tax Court in *Newberry*, "[f]or individuals who operate their own trades or businesses, it [the self-employment tax] is the counterpart of the taxes imposed on the wages of employees by FUTA and FICA." *Newberry*, 76 T.C. at 443.

12. I.R.C. § 1401(a). Section 1401 imposes a tax of 12.4%, in addition to other taxes, on the self-employment income of every individual for the purpose of providing "old age survivors" and "disability insurance." *Id.* An additional 2.9% tax is imposed on the self-employment income of every individual for "hospital insurance." *Id.* § 1401(b).

13. *Id.* § 1402(a)-(b).

14. *Id.* § 1402(b). The pertinent part of § 1402(b) states: "The term 'self-employment income' means the net earnings from self-employment derived by an individual (other than a non-resident alien individual, except as provided by an agreement under § 233 of the Social Security Act) during any taxable year," except for the listed exceptions. *Id.* The term "self-employment income" does not include net earnings that exceed the contribution and benefit base defined by § 230 of the Social Security Act, which is $83,900 for the year 2002. *Id.*

15. *Id.* § 1402(a). Section 1402(a) excludes rentals from real estate (with the exception of certain agricultural rental payments), dividends, gain or loss from the sale or exchange of capital assets, gain or loss from the cutting of timber, and a number of other items from the definition of net earnings from self-employment. *Id.*

The self-employment tax structure was established to finance the extension of social security benefits to self-employed individuals.[16] Despite the extension of social security benefits to self-employed individuals by the Social Security Act Amendments of 1950, self-employed farmers remained excluded from social security benefit coverage.[17] However, in 1954, social security benefits were extended to self-employed farmers.[18] Prior to 1954, agricultural labor was expressly excluded from self-employment income.[19]

Prior to including agricultural labor within the definition of self-employment income, § 1402(a)(1) excluded real estate rental payments from the definition of self-employment income.[20] As part of the enactment extending the definition of self-employment income to include agricultural labor, Congress expanded the exclusion of rental income from "self-employment income" to "rentals paid in crop shares."[21]

Congress subsequently became concerned that the exclusion of all rental income from the definition of self-employment income would have a harsh impact on landlords actively involved in commodity production.[22] In order to temper the harsh results of a blanket exclusion of rental income from the definition of self-employment tax income, "Congress included the 'material participation' exception to the exclusion of real estate rentals."[23]

16. Social Security Act Amendments of 1950, ch. 809, § 208, 64 Stat. 477; S. REP. NO. 81-1669.

17. Henderson v. Fleming, 283 F.2d 882, 884 (5th Cir. 1960). In *Henderson*, the Fifth Circuit recognized that all self-employed farmers had been excluded from coverage under the old age and survivors insurance program by excluding "income derived by a self-employed individual from a business which if carried on by employees would constitute agricultural labor" from net earnings from self-employment. *Id.*

18. *Id.*; Social Security Act Amendments of 1954, ch. 809, § 211, 68 Stat. 1052, 1055. The Fifth Circuit noted that despite the 1954 amendments, rentals from real estate and personal property leased with the real estate were still excluded from self-employment income. *Henderson*, 283 F.2d at 884. Subsequent amendments broadened coverage to include farm owners and farm tenants who materially participated in the production of agricultural commodities. Celebrezze v. Maxwell, 315 F.2d 727, 728 (5th Cir. 1963).

19. *Celebrezze*, 315 F.2d at 728.

20. I.R.C. § 1402(a)(1).

21. Social Security Act Amendments of 1954 § 211, 68 Stat. at 1055.

22. *Celebrezze*, 315 F.2d at 728. As noted by the Fifth Circuit, "in 1956, in order not to treat so harshly landlords who were actively involved in commodity production, and who would have an income loss with the onset of old age or disability, Congress included the 'material participation' exception to the exclusion of real estate rentals." *Id.* The Fifth Circuit also noted that "[t]he 1956 Amendments were to give the farmer 'equitable treatment as compared with those brought in earlier.'" *Id.* at 728 n.1 (citing S. REP. NO. 81-1669 (1950)).

23. *Id.* at 728. The material participation exception to the exclusion for real estate rentals provided that crop-share income would be includable within the definition of self-employment income if

> (A) such income is derived under "arrangement" between the owner and another individual, which provides that the other individual shall produce agricultural commodities and that there shall be "material participation by the owner" in the production

The material participation exception to the exclusion of real estate rentals from the definition of self-employment income requires the following: 1) the income must be derived under an arrangement that requires material participation by the owner of the property; and 2) the owner must materially participate in the commodity production.[24]

The history of § 1402 demonstrates that its initial intent was to benefit the agricultural community by providing a funding mechanism to extend old age and survivors insurance program benefits to the agricultural industry. However, that extension occurred at a time when the self-employment tax rate was between 1% and 2%, and the maximum annual self-employment tax ranged from $30 to $72.[25] In contrast, the self-employment tax is now 15.3%, and the maximum annual self-employment tax exceeds $10,527.[26] Many see the increased tax burden as a detriment to family farms as opposed to the benefit it was originally intended to be.

B. SECTION 1402 PRECLUDES REAL ESTATE RENTALS, INCLUDING AGRICULTURAL RENTALS THAT DO NOT REQUIRE MATERIAL PARTICIPATION BY THE OWNER, FROM SELF-EMPLOYMENT EARNINGS

The Service interpreted § 1402 as requiring all rental payments by farming entities to active individual farmers as subject to self-employment taxation.[27] Individual farmers countered that the rental payments were exempt from self-employment taxation because they were real estate rental payments excluded from self-employment taxation by § 1402(a)(1).[28]

> or management of the production of such commodities *and* (B) in fact there is material participation by the owner.

Id. (emphasis added) (citing 42 U.S.C. § 411(a)(1) (as amended in 1954); the predecessor to I.R.C. § 1402 (2002)).

24. *Id.* Despite the confused wording in the "form of an exception to an exclusion," the Fifth Circuit was able to determine that the congressional intent was to protect persons whose income diminishes because of old age or disability and to exclude individuals whose income continues in spite of old age or disability. *Id.* "In other words the fruits of someone else's labor or talents were not to be included in 'net earnings from self-employment' of self-employed farmers any more than income from dividends or shares of stock or interest on bonds." *Id.* (citing 42 U.S.C. § 411(a)(2)).

25. *See* I.R.C. § 1401 (2002) (setting forth the history of the self-employment tax rate).

26. *See Id.* §1402(a)-(b) (defining the tax rate).

27. McNamara v. Commissioner, 236 F.3d 410, 413 (8th Cir. 2000). The Commissioner's analysis ignored the requirement that there be a nexus between the rents received by a taxpayer and the arrangement requiring the taxpayer (as a landlord) to materially participate. *Id.*

28. *Id.* Agricultural land rental payments are not self-employment income unless the payment is part of an agreement that requires the landlord to materially participate in the agricultural production. *Id.*

Section 1402 defines net earnings from self-employment, thereby establishing the amount of income subject to self-employment taxation.[29] Subsection (a)(1) excludes all real estate rentals except agricultural rentals where there is an agreement requiring material participation by the owner from the definition of self-employment income.[30] The exception to the exclusion of real estate rental income from self-employment taxation is referred to as "includable farm rental income."[31] Real estate rental income derived from the rental of agricultural land is subject to the self-employment tax only if it is includable farm rental income.[32] Active farmers have recently challenged whether cash rental payments are includable farm rental income by asserting that the cash rental agreements never give rise to includable farm rental income because they do not compel the individual's participation in the farming activity.[33]

The Service has promulgated regulations defining includable farm rental income as payments derived from share-farming or other arrangements that contemplate or require material participation by the recipient of the rental income.[34] When considering what is includable farm rental income, those same regulations establish a clear intent to target sharecropping or joint farming by including the requirement that the landlord must be compelled to materially participate.[35] There are no regulations suggesting

29. I.R.C. § 1402(b) (2002).

30. *Id.* § 1402(a)(1).

31. Treas. Reg. § 1.1402(a)-4(b) (as amended in 1980) (providing special rules for determining includable farm rental income).

32. *Id.*

33. McNamara v. Commissioner, 236 F.3d 410, 410-11 (8th Cir. 2000).

34. Treas. Reg. § 1.1402(a)-4(b)(2). There are three types of Treasury Regulations: 1) legislative or substantive, 2) interpretive, and 3) procedural. MICHAEL I. SALTZMAN, IRS PRACTICE AND PROCEDURE ¶ 3.02(4) (2000). Treasury Regulation 1.1402(a)-4(b) can be characterized as an interpretive regulation that explains or construes the meaning of § 1402. An interpretive regulation is not controlling on the judiciary. Nat'l Muffler Dealers Ass'n. v. United States, 440 U.S. 472, 477 (1979); Rowan Cos. v. United States, 452 U.S. 247, 263 (1981).

35. Treas. Reg. § 1.1402(a)-4(b)(3)(i)-(ii). "The mere undertaking to furnish machinery, implements, and livestock and to incur expenses is not, in and of itself, sufficient" to satisfy the requirement that there be an arrangement contemplating that the owner will materially participate in the production of commodities. *Id.* § 1.1402(a)-4(b)(3)(ii). The Federal District Court for the District of South Dakota affirmed an administrative decision denying a taxpayer old age insurance benefits when the taxpayer sought to include, as self-employment income, receipts from her farmland. Clark v. Celebrezze, 208 F. Supp. 505, 508 (D.S.D. 1962). In *Clark*, the court concluded that the predecessor to I.R.C. § 1402 (42 U.S.C. § 411(a)(1)) required "an arrangement between the owner and the operator of the land that the owner shall materially participate in the production or the management of production of agricultural commodities on the land." *Id.* at 507. Because the record failed to disclose any evidence that an agreement requiring the taxpayer to materially participate in the production or management of the production of crops existed between the taxpayer and the tenant, it was appropriate to deny benefits. *Id.* The Federal District Court for the District of Oklahoma similarly determined that a taxpayer's insubstantial physical participation and questionable managerial relationship with the tenant did not provide significant value to the

that cash rental arrangements for farmland, separate and apart from a requirement to materially participate in the agricultural production, should be included in self-employment income as farm rental income. To the contrary, the regulations clearly anticipate that in order to be includable farm rental income, the arrangement between the lessor and lessee must be an arrangement of joint farming or share-farming.[36]

Material participation in the "management of the production" must exist to meet the requirement of material participation.[37] Management of the production requires material participation in management decisions related to production.[38] Material participation must be derived from or pursuant to an arrangement between the parties.[39] Therefore, if the rental agreement does not require that the taxpayer participate in the farming operation, the rental payments should not be considered includable farm rental income.

The legislative history supporting the enactment of the provisions for including rental payments from agricultural land in self-employment earnings referenced only "share-farming arrangements."[40] In House of Representatives Report for Bill 1189, the Ways and Means Committee for the House discussed the Social Security Amendments of 1955.[41] Each paragraph in House Report 1189 that discussed the amendments for including agricultural rents in the calculation of self-employment income was referenced by the title "Share-Farming Arrangements."[42] Additionally, the report from the Committee on Finance, which accompanied House of Representatives Bill 7225, also provided specific references to "Share-Farming

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tenant, and therefore, "there was no joint activity in the entire enterprise of substantial value or importance." Millemon v. Sec'y of Health, Educ. & Welfare, 256 F. Supp. 938, 940 (D.C. Okla. 1966) (citing Hoffman v. Celebrezze, 246 F. Supp. 380, 384 (E.D. Mo. 1965)).

36. Treas. Reg. § 1.1402(a)-4(b).

37. *Id.* § 1.1402(a)-4(b)(3)(iii). Providing physical labor, paying production expenses, or participating in activities such as planting, cultivating, harvesting, and furnishing of equipment, seed, or livestock is material participation in the production. Treas. Reg. § 1.1402(a)-4(b)(3)(ii). If the activity has substantial value and importance, the amount of participation is not determinative. Conley v. Ribicoff, 294 F.2d 190, 193 (6th Cir. 1961); Hoffman v. Gardner, 369 F.2d 837, 841 (8th Cir. 1966).

38. *Hoffman*, 369 F.2d at 841. "Management of the production" includes making managerial decisions regarding planting, cultivating, or harvesting. Treas. Reg. § 1.1402(a)-4(b)(3)(ii).

39. McNamara v. Commissioner, 236 F.3d 410, 413 (8th Cir. 2000); Treas. Reg. § 1.1402(a)-4(b)(4). As noted in the applicable Treasury Regulation, rental income received by the owner of land must be derived pursuant to an agreement that the owner materially participate in the agricultural production before rental payments can be treated as includable farm rental income. Treas. Reg. § 1.1402(a)-4(b)(4).

40. Social Security Amendments of 1955, 1956-2 C.B. 1250, 1253 (amending Social Security Act of 1950 §§ 104(c)(1), 201(e)(1)(2) (1955)).

41. *Id.*

42. *Id.*

Arrangements."[43] Specifically, the report for Bill 7225 referenced "share farmers," "sharecroppers," and "landowners participating in production."[44] The report accompanying House Bill 7225 noted that the amendments were intended to include arrangements whereby "the agricultural or horticultural commodities produced by such individual, or the proceeds therefrom, are to be divided between him and the owner or tenant and the amount of such individual's share depends solely on the amount that the agricultural or horticultural commodities produced" are within net earnings from self-employment.[45] The House reports indicate that the amendments were drafted to include sharecropping instead of cash rents. The focus on sharecropping indicates that not all rental arrangements where the landlord participates in the commodity production should be subject to self-employment taxation.

The Code, the applicable regulations, and the legislative history did not contemplate including cash rent to determine net earnings from self-employment absent an arrangement requiring participation to receive the rent. To the contrary, the precise language of § 1402 specifically excludes real estate rental income from self-employment income.[46] The only exception to the general rule excluding real estate rental income from self-employment taxation is the exception for agricultural rentals when there is an agreement requiring material participation by the owner of the land.[47]

III. THREE "LANDLORD" FARMERS CHALLENGED THE IMPOSITION OF THE SELF-EMPLOYMENT TAX

Several taxpayers and the district counsel for the Service agreed to submit three representative cases for determination by the Tax Court.[48] Those cases included the rental of agricultural property to a sole proprietorship,[49] a partnership,[50] and a corporation.[51] The parties intended to establish a baseline for resolving the numerous pending cases that involved imposing the self-employment tax on landlord farmers.

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43. *Id.* at 1255-56.
44. *Id.* at 1256-57.
45. *Id.* at 1262.
46. I.R.C. § 1402(a)(1) (2002).
47. *Id.*
48. McNamara v. Commissioner, 236 F.3d 410, 410-11 (8th Cir. 2000).
49. Hennen v. Commissioner, 78 T.C.M. (CCH) 445, 445 (1999).
50. Bot v. Commissioner, 78 T.C.M. (CCH) 220, 221 (1999).
51. McNamara v. Commissioner, 78 T.C.M. (CCH) 530, 531 (1999), *rev'd*, 236 F.3d 410 (2000).

A. FACTS

1. McNamara v. Commissioner

During 1993, 1994, and 1995, Michael McNamara and Nancy B. McNamara cash rented farmland to McNamara Farms, Inc., a corporation in which Michael McNamara was the sole stockholder.[52] During those years, McNamara Farms, Inc., rented approximately 460 acres of farmland and a house from the taxpayers.[53] In 1993, 1994, and 1995, McNamara Farms, Inc., paid $45,620, $56,168, and $57,000 respectively.[54] The lease between McNamara Farms, Inc., and the McNamaras was a common cash rent lease.[55] These payments represented the farm market value for rental of the farmland.[56]

Both Michael and Nancy McNamara had employment agreements with McNamara Farms, Inc.[57] They both received W-2 wage forms for the personal services they performed for McNamara Farms, Inc.[58] The W-2 wage forms did not include the rent paid by the corporation.[59]

The taxpayers sought to introduce evidence of the fair market value of the rents as a method of establishing that the rent was separate and distinct from their obligations to participate in the farming activities.[60] At trial, the McNamaras provided uncontradicted testimony that the rent for the property was at or slightly below fair market value.[61] The taxpayers established that their participation in the agricultural production and management decisions of the farming activities were required by employment agreements that were separate from the rental agreements.[62] They argued that if the material participation requirement was separate and distinct from the rental agreement, the rental payments could not satisfy the agricultural

52. *McNamara*, 236 F.3d at 411.

53. *Id.*

54. *McNamara*, 78 T.C.M. (CCH) at 531.

55. *Id.*

56. *McNamara*, 236 F.3d at 413. At trial, the taxpayers insisted that the rents represented the fair market value for the rental of farmland. *Id.* The Eighth Circuit noted that the trial transcripts contained "uncontradicted testimony that the rents were at or slightly below fair market value." *Id.* The Tax Court failed to provide any factual finding regarding whether the rents reflected fair market value. *Id.* At trial, the Service asserted that the amount of rent was not relevant. *Id.*

57. *Id.*

58. *McNamara*, 78 T.C.M. (CCH) at 531.

59. *Id.*

60. *McNamara*, 236 F.3d at 413. The Eighth Circuit acknowledged that the taxpayers argued "that the lessor-lessee relationships should stand on their own apart from the employer-employee relationships." *Id.*

61. *Id.*

62. *Id.* at 412.

exception to the general exclusion of real estate rental from self-employment income because the agricultural exception required the rent to be "derived under" an arrangement requiring the landlord's material participation in the agricultural activities.[63]

2. *Hennen v. Commissioner*

During the tax years at issue, John Hennen conducted farming operations at or near Ghent, Minnesota.[64] During these years, he rented two hundred acres of farmland from his spouse, Teresa Hennen.[65] The lease agreement called for annual payments of $16,000.[66]

John Hennen used the land rented from Teresa Hennen to produce agricultural commodities such as livestock and crops.[67] The farmland was owned solely by Teresa Hennen.[68] She indicated that the money received from the cash rent was held in a separate account.[69]

Teresa Hennen received a separate W-2 statement, pursuant to an employment agreement, for the work she performed for the farming operation.[70] Additionally, in 1994 Teresa Hennen worked off the farm selling World books and listed her occupation as a sales person.[71]

3. *Bot v. Commissioner*

At all relevant times, Vincent and Judy Bot resided in Minnesota as husband and wife.[72] During the tax years 1993, 1994, and 1995, Vincent E. Bot conducted farming operations.[73] During these tax years, he rented 240

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63. *Id.* at 413. As subsequently noted by the Eighth Circuit, "[r]ents that are 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." *Id.*

64. Hennen v. Commissioner, 78 T.C.M. (CCH) 445, 445 (1999).

65. *Id.*

66. *Id.*

67. *Id.*

68. *Id.*

69. *Id.* at 446. Rent received by Teresa Hennen represented the fair market value of the property. McNamara v. Commissioner, 236 F.3d 410, 413 (8th Cir. 2000). The Eighth Circuit noted that "the transcripts of each trial contained uncontradicted testimony that the rents were at or slightly below fair market value." *Id.* The Service argued at trial that the amount of rent was not relevant to determine the case. *Id.* In apparent agreement, the Tax Court's decision did not contain any factual findings regarding the issue of whether the rent represented the fair market value for the property. *Id.*

70. Hennen v. Commissioner, 78 T.C.M. (CCH) 445, 446 (1999).

71. *Id.*

72. Bot v. Commissioner, 78 T.C.M. (CCH) 220, 221 (1999).

73. *Id.*

acres of farmland from his wife Judy for $21,600 per year.[74] Vincent Bot used the land to produce agricultural commodities such as livestock and crops.[75]

Judy Bot testified that the land was acquired through an inheritance and a sale from her family and that the rent income was placed into her own accounts and used for her own purposes.[76] Judy Bot was provided a W-2 for the work that she performed on the farm.[77]

B. PROCEDURAL HISTORY

The procedural histories of *McNamara*, *Hennen*, and *Bot* were nearly identical.[78] The Commissioner issued deficiencies against the McNamaras, Hennens, and Bots because he concluded that the rental payments they received from the their farming operations were subject to self-employment taxation.[79] In April 1998, the McNamaras, Hennens, and Bots filed petitions to redetermine the deficiencies in the Tax Court.[80] The Tax Court determined that the McNamaras, Teresa Hennen, and Judy Bot materially participated in the farming activities and were therefore subject to self-employment taxation for the cash rentals they received.[81] It dismissed a majority of the other arguments raised by the parties without further discussion and affirmed the deficiencies assessed by the Commissioner.[82]

IV. CASH RENTAL ARRANGEMENTS DO NOT SATISFY THE REQUIREMENTS FOR "INCLUDABLE FARM RENTAL INCOME"

This article is intended to discuss why the initial decisions in *McNamara, Hennen*, and *Bot* were not correctly decided. First, it is the author's opinion that leases which do not require material participation in agricultural activities do not meet the definition of includable farm income. Second, the Tax Court's focus on the taxpayers' material participation was inappropriate absent an agreement compelling material participation by the

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74. *Id.*
75. *Id.*
76. *Id.*
77. *Id.*
78. *See* McNamara v. Commissioner, 236 F.3d 410, 412 (8th Cir. 2000) (stating that the Tax Court determined *Bot* and *Hennen* in opinions "echoing its ruling against the McNamaras").
79. *Id.* at 411-12.
80. *Id.*
81. *Id.*
82. *See* McNamara v. Commissioner, 78 T.C.M. (CCH) 530, 533 (1999), *rev'd*, 236 F.3d 410 (2000); Hennen v. Commissioner, 78 T.C.M. (CCH) 445, 448 (1999); Bot v. Commissioner, 78 T.C.M. (CCH) 220, 223 (1999).

taxpayers as landlords. Third, the Commissioner's position ignored that a taxpayer may wear "two hats," one as a landlord and one as a participant in agricultural activities. Fourth, the Tax Court's prior decisions were not dispositive of whether § 1402 requires a landlord's material participation to be derived under the rental arrangement in order to include the rental payments within the scope of self-employment income. Fifth, a reference to the instructions for completing Form 4835 compelled the taxpayers to report cash rent leases on Schedule E (rental income) of Form 1040; Schedule E income is not subject to the self-employment tax. Sixth, distinguishing between cash rent lease arrangements and sharecropping is consistent with regulations governing other governmental agencies.

A. LEASES THAT DO NOT REQUIRE MATERIAL PARTICIPATION IN AGRICULTURAL PRODUCTION DO NOT MEET THE DEFINITION OF INCLUDABLE FARM INCOME

In *Bot, Hennen,* and *McNamara,* the Tax Court determined that the taxpayers' rental income fell under the purview of § 1402, which defines net earnings from self-employment.[83] The application of § 1402 to agricultural rentals is facilitated by Treasury Regulations that define what type of rental income is "includable farm rental income" subject to self-employment taxation.[84] Only rental income directly related to the requirement that the landlord materially participate in the production of commodities is included within the definition of includable farm rental income.[85]

The requirements to be met for "includable farm rental income" are:

> (i) The income is derived under an arrangement between the owner or tenant of land and another person which provides that such other person 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
>
> (ii) There is material participation by the owner or tenant with respect to any such agricultural or horticultural commodity.[86]

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83. *McNamara*, 78 T.C.M. (CCH) at 532 (1999), *Hennen*, 78 T.C.M. (CCH) at 446-47; *Bott*, 78 T.C.M. (CCH) at 222-23.

84. Treas. Reg. § 1.1402(a)-4(b) (as amended in 1980). Treasury Regulation § 1.1402(a)-4(b) provides specific criteria for determining the type of income to be included in the self-employment base under § 1402(a). *Id.*

85. *Id.* § 1.1402(a)-4(b)(4).

86. *Id.* § 1.1402(a)-4(b).

In order to satisfy the requirement that income be derived under an arrangement between the owner and another person, the income "must be derived pursuant to a share-farming or other rental arrangement which contemplates material participation by the owner or tenant in the production or management of agricultural or horticultural commodities."[87] Thus, what the regulation demands is a lease that imposes the obligations of management or material participation upon the lessor.[88] This requirement must be met for § 1402 to apply.

The applicable Treasury Regulation provides that the nature of the arrangement "must impose upon such other person the obligation" to produce the agricultural or horticultural product on the land.[89] The regulation further provides that it must be contemplated by the parties that the owner or tenant will participate in the production or management of the production of the agricultural commodities.[90]

The Tax Court failed to provide any discussion of these provisions. Rather, it highlighted the elements of the regulation that fit the taxpayers' situation (material participation) while completely ignoring the most pertinent language of the regulation. The Tax Court did not mention that if a lease does not impose an obligation upon the lessor to produce any agricultural product upon the land, the rental payments are not "includable farm rental income."[91]

The Tax Court did acknowledge that § 1402(a)(1)(A) requires the rental income to be pursuant to an arrangement between the parties to produce agricultural commodities.[92] However, it did not limit its review of the arrangement to the lease agreement.[93] Instead, it determined that the word

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87. *Id.* § 1.1402(a)-4(b)(2).

88. *Id.* § 1.1402(a)-4(b)(3)(i).

89. *Id.*

90. *Id.*

91. *Id.* § 1.1402(a)-4(b). Section 1.1402(a)-4(b) appears to cover situations in which the lease provides for some sort of revenue-sharing or sharecropping arrangement. *Id.* In sharecropping, the lease becomes an integral part of the farm's revenue sharing; the only renumeration for the landlord's efforts would be the "rent" provided for in the lease. In a sharecropping situation, self-employment taxes are a necessity because they represent the entire revenue of that combined activity. *See* Dugan v. Commissioner, 68 T.C.M. (CCH) 1251, 1252-53 (1994). If that was not true, the sharecropper's work relating to his labors would go without FICA or self-employment taxes taken out. In contrast, it is clear that a cash rent lease will never involve material participation. *See* Estate of Coffing v. Commissioner, 53 T.C.M. (CCH) 1314, 1322-23 (1987); Hoffley v. Commissioner, 884 F.2d 279, 288 (7th Cir. 1989).

92. McNamara v. Commissioner, 78 T.C.M. (CCH) 530, 532-33 (1999), *rev'd*, 236 F.3d 410 (2000); Hennen v. Commissioner, 78 T.C.M. (CCH) 445, 446-47 (1999); Bot v. Commissioner, 78 T.C.M. (CCH) 220, 222-23 (1999). For example, in *McNamara* the Tax Court noted the following: "[i]n light of all the facts and circumstances, we must decide whether petitioners received rental income from McNamara Farms pursuant to an 'arrangement' between the parties to produce agricultural commodities on the farm within the meaning of section 1402(a)(1)(A)." *McNamara*, 78 T.C.M. (CCH) at 532.

93. *McNamara*, 78 T.C.M. (CCH) at 532.

"arrangement" in § 1402(a)(1)(A) should be interpreted broadly to include other arrangements not necessarily arising from strict contractual relationships.[94] This broad definition of the word "arrangement" allowed the Tax Court to "look not only to the obligations imposed upon the written lease, 'but to those obligations that existed within the overall scheme of the farming operations which [took] place'" on the taxpayers' property.[95]

By employing an expansive definition of arrangement, the Tax Court created an overly broad net to capture agricultural rental income within the definition of self-employment income. This broad net was able to catch the McNamara's cash rental agreement with their farming corporation,[96] the Bots' cash rental with their farming partnership,[97] and the Hennens' cash rental agreement between spouses.[98]

B. THE DETERMINATION OF MATERIAL PARTICIPATION WAS IMPROPER AND IRRELEVANT ABSENT AN AGREEMENT COMPELLING PARTICIPATION BY THE LANDLORD

The Tax Court took the position that if a landlord provides personal services to a farming entity, those services integrate with the lease agreement as one overall arrangement.[99] This position was an incorrect interpretation of the two independent relationships, one as an employee and one as a landlord, that a taxpayer may have with a farming entity.[100] Personal services as an employee and duties as a landlord can be separate, independent, and enforceable relationships.[101] It was improper to recharacterize the rental payments as net earnings from self-employment absent an agreement compelling participation

94. *Id.* (quoting Mizell v. Commissioner, 70 T.C.M. (CCH) 1469, 1471 (1995)). Relying on the decision in *Mizell,* the Tax Court defined the term "arrangement" as follows:

> The word "arrangement" is defined as an agreement. While the concept of an agreement certainly includes a contractual agreement, it is a broader concept that would also include other forms of agreements not necessarily arising from strict contractual relationships. Consistent with its dictionary definition, in most of the instances where it is used in the Internal Revenue Code, the word "arrangement" refers to some general relationship or overall understanding between or among parties in connection with a specific activity or situation. Generally, it is not limited only to contractual relationships, or used in a way that suggests that its terms and conditions must be included in a single agreement, contractual or otherwise. Congress obviously recognized a distinction between a contract and the broader concept of an "arrangement," as is evident from those sections of the Internal Revenue Code that make reference to both.

Id. (citation omitted).

95. *Id.*

96. *Id.* at 533.

97. *Bot,* 78 T.C.M. (CCH) at 223.

98. Hennen v. Commissioner, 78 T.C.M. (CCH) 445, 447 (1999).

99. *McNamara,* 78 T.C.M. (CCH) at 532-33.

100. *See infra* Part IV.C.

101. *Id.*

as part of the rental arrangement simply because the taxpayers also performed personal services for the farming entity.

The case of *Foster v. Flemming*[102] provided an interpretation of the agricultural exception to the general rule that rental payments are excluded from self-employment and an alternative interpretation of the arrangement requirement of § 1402(a)(1)(A).[103] *Foster* involved an agricultural landlord who argued that she was entitled to social security retirement benefits based on rental income she had received from agricultural leases of farmland.[104] The opinion stated that Congress intended the term "arrangement" to have a broad scope.[105] However, following that statement, the district court held that the landlord did not receive net earnings from self-employment because the lease agreement did not provide for material participation by the landlord.[106] The court stated:

> the arrangement for material participation on the part of the landlord had to be found within the provisions of the lease between the plaintiff and her tenants. If the activities on her part which were provided for in that lease did not constitute material participation . . . there would be no arrangement for material participation on her part.[107]

The *Foster* court looked entirely to the written lease agreement to determine whether it required material participation.[108]

The district court's interpretation of the term "arrangement" in *Foster*, which denied benefits sought by the taxpayer,[109] and the Tax Court's different

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102. 190 F. Supp. 908 (D.C. Iowa 1960), *rev'd*, 313 F.2d 604 (1963).

103. *Foster*, 190 F. Supp. at 923-24. The district court decision in *Foster* was subsequently reversed by the Eighth Circuit Court of Appeals. Foster v. Celebrezze, 313 F.2d 604, 606 (8th Cir. 1963). The Eighth Circuit determined that broad provisions in a farm lease giving the landlord input into crop production satisfied the requirement of "an arrangement for material participation" under the Social Security Act and permitted the inclusion of rental income as self-employment income of the landlord. *Id.* at 608. The district court's decision in *Foster* is used in this article to emphasize the apparent inconsistent positions taken by the government depending on whether a taxpayer is seeking to include income within the definition of self-employment in order to qualify for benefits under the Social Security Act or seeking to avoid the imposition of self-employment taxation *Compare Foster*, 190 F. Supp. at 608, *with McNamara*, 78 T.C.M. (CCH) at 533.

104. *Foster*, 190 F. Supp. at 910.

105. *Id.* at 924.

106. *Id.* at 930.

107. *Id.* at 924.

108. *Id.* at 928-31.

109. *See generally id.*; Clark v. Celebrezze, 208 F. Supp. 505 (D.S.D. 1962). In *Foster* and *Clark*, the taxpayers sought to receive social security benefits and asserted that rental payments received by the taxpayers should have been included within self-employment income, thereby qualifying the taxpayers for social security benefits. *Foster*, 190 F. Supp. at 912-13; *Clark*, 208 F. Supp. at 508. These arguments were rejected because no "arrangement" existed to compel the

interpretation of the same word in *Hennen, Bot, McNamara,* and *Mizell v. Commissioner*,[110] which imposed self-employment taxes on the taxpayers, benefited the Government's litigation position in each respective case.[111] In each case, the courts determined that the word should be given a broad interpretation to favor coverage for social security purposes.[112] In *Foster*, the district court was presented with a taxpayer's attempt to include agricultural rental payments within the scope of self-employment income to qualify for social security benefits.[113] The assertion was rejected by the district court because the lease did not include any requirement for material participation, and therefore, the arrangement requirement was not satisfied.[114] In contrast, the Tax Court's broad interpretation of the term "arrangement" in *Hennen, Bot, McNamara,* and *Mizell* compelled its conclusion that it must "look not only to the obligations imposed upon [the written] leases, but to those obligations that existed within the overall scheme of the farming operations which [took] place" on the taxpayers' property.[115]

In summary, when taxpayers have sought to include agricultural rental payments within the scope of self-employment income to qualify for social security benefits, courts have interpreted the term "arrangement" to require language compelling material participation within the written lease agreement itself. The Tax Court, interpreting the same provisions and the same term in the context of taxpayers who attempted to avoid paying self-employment taxes, used a definition of arrangement that extended beyond the four corners of the lease agreement. It appears that the government has historically been able to apply a limited interpretation to the term "arrangement" when denying social security benefits and an expansive definition to it when seeking to impose tax liability.

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taxpayers' material participation in the agricultural enterprise. *Foster*, 190 F. Supp. at 924-25; *Clark*, 208 F. Supp. at 508.

110. 70 T.C.M. (CCH) 1469 (1995).

111. *Mizell*, 70 T.C.M. (CCH) at 1471; McNamara v. Commissioner, 78 T.C.M. (CCH) 530, 532-33 (1999), *rev'd*, 236 F.3d 410 (2000); Hennen v. Commissioner, 78 T.C.M. (CCH) 445, 446-47 (1999); Bot v. Commissioner, 78 T.C.M. (CCH) 220, 222-23 (1999). In *Mizell*, the Tax Court applied a broad definition of the term "arrangement" in order to include agricultural rental payments within the scope of self-employment income. *Mizell*, 70 T.C.M. (CCH) at 1471-72.

112. *See, e.g., McNamara*, 78 T.C.M. (CCH) at 530 (citing Braddock v. Commissioner, 95 T.C.M (CCH) 639, 644 (1990)). The Tax Court in *McNamara, Hennen*, and *Bot* also noted that the rental exclusion in § 1402(a)(1) must be "strictly construed to prevent this exclusion from interfering with the congressional purpose of effectuating maximum coverage under the Social Security umbrella." *Id.* (citing Johnson v. Commissioner, 60 T.C.M. (CCH) 829, 832 (1973)).

113. *Foster*, 190 F. Supp. at 910.

114. *Id.* at 924.

115. *Mizell*, 70 T.C.M. (CCH) at 1471-72; *McNamara*, 78 T.C.M. (CCH) at 532-33; *Hennen*, 78 T.C.M. (CCH) at 446-47; *Bot*, 78 T.C.M. (CCH) at 222-23.

C. THE COMMISSIONER'S POSITION IGNORED THAT TAXPAYERS MAY WEAR "TWO HATS"

The United States Tax Court and other federal courts have routinely recognized that a taxpayer may wear "two hats" when determining a taxpayer's tax liability.[116] Typically, the two hat theory has arisen when discussing reasonable compensation of corporate employees who were also shareholders.[117] In those situations, the Commissioner has generally asserted that the taxpayer must recognize both wages for the employee role and constructive dividends for the shareholder role.[118]

By seeking to impose self-employment taxes on active farmers in the absence of an agreement compelling participation in the farming activity, the Commissioner was essentially arguing that a taxpayer could not wear two hats without the employee role tainting the landlord role. However, a similar argument was rejected in *Burruss Land & Lumber Co. v. United States*.[119] In *Burruss*, the court noted that "the government argues that although a person may wear two hats within the corporate framework, he can wear only one for tax purposes . . . this position rejects the realities of today's business and corporate practices."[120]

The Tax Court has also previously recognized that a taxpayer may wear two hats.[121] In *Yates Holding Corp. v. Commissioner*,[122] the Tax Court stated the following:

> The fact that some of the shareholders of King Hotels, Inc. may also be partners in AMHO Associates, trading as Hotel Empire, does not mean the two entities should be disregarded and treated as one for tax purposes. Nor does the fact that an individual may wear two hats in two different organizations mean the entities should be combined for tax purposes.[123]

In judging these cases, courts have measured the comparative reasonableness of amounts the individual received as an employee versus amounts earned (or equity growth) by the same individual as a shareholder.[124]

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116. *See, e.g.*, Peterson v. Commissioner, 74 T.C.M. (CCH) 335, 338-39 (1997) (determining the taxpayer wore "two hats," one as a shareholder-investor and one as an employee-officer).

117. *E.g.*, *id.*; Zamzam v. United States, 79 AFTR.2d (RIA) 2067 (D.C.W.D. Ca. 1997).

118. *See, e.g.*, *Peterson*, 74 T.C.M. (CCH) at 338 (stating that employee wages and corporate profits are distinct concepts).

119. 349 F. Supp. 188 (W.D. Va. 1972).

120. *Burruss*, 349 F. Supp. at 189-90.

121. Yates Holding Corp. v. Commissioner, 39 T.C.M. (CCH) 303, 304 (1979).

122. 39 T.C.M. (CCH) 303 (1979).

123. *Yates*, 39 T.C.M. (CCH) at 304 (citations omitted).

124. *E.g.*, *id.*

Nothing precludes a taxpayer from wearing two hats. The Commissioner often employs the two hat theory in assessing both wages as well as dividends against taxpayers. Rejecting the Commissioner's assertion that all active farmers are subject to self-employment taxation on agricultural rentals recognizes that taxpayers may wear two hats, one as an employee of a farming entity and one as a landlord. Had Congress intended the arrangement terminology to include situations where a taxpayer assumes dual roles as an employee and as a landlord, it would have extended this arrangement language to other non-agricultural leases. One can only conclude that the "arrangement" reference is to be confined to the terms of the lease and not other separate employment duties.

D. THE TAX COURT'S PRIOR DECISIONS DID NOT DISPOSE OF THE ISSUES PRESENTED IN *MCNAMARA*, *HENNEN*, AND *BOT*

Prior to the decisions in *McNamara*, *Hennen*, and *Bot*, the Tax Court addressed two related but not dispositive issues regarding the imposition of self-employment taxes on includable farm rental income.[125] In 1995, after reviewing the "overall scheme" of a landlord's rental relationship with a tenant, the Tax Court concluded that a partner receiving a crop share as compensation for use of land was subject to the self-employment tax on the value of the crop share.[126] In 1998, the Tax Court determined that income received by an individual for Conservation Reserve Program (CRP) payments was not subject to self-employment tax.[127] The Tax Court was subsequently reversed by the Sixth Circuit Court of Appeals.[128] Neither case addressed a situation where the landlord's receipt of agricultural rentals was separate and distinct from the landlord's participation in agricultural activities.

1. *The Tax Court's Decision in Wuebker is Distinguishable From McNamara*

In August 1998, the Tax Court determined that income received by an individual who leased farmland to the Conservation Reserve Program was not subject to the self-employment tax.[129] In *Wuebker v. Commissioner*,[130]

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125. *See generally* Mizell v. Commissioner, 70 T.C.M. (CCH) 1469 (1995); Wuebker v. Commissioner, 110 T.C. 431 (1998), *rev'd*, 205 F.3d 897 (2000).

126. *Mizell*, 70 T.C.M. (CCH) at 1472.

127. *Wuebker*, 110 T.C. at 439.

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

129. *Wuebker*, 110 T.C. at 439. On appeal, the Sixth Circuit was not presented with whether there was a sufficient nexus between the CRP payments and the Wuebker's material participation

a farmer placed tillable acreage into the CRP program, which entitled him to annual rental payments of $85 per acre.[131] The farmer was obligated, for a period of ten years, to establish and maintain vegetative cover and prohibit grazing, harvesting, and commercial use of the cropland.[132] The farmer was also required to control weeds, insects, and other pests on the CRP land.[133]

In *Wuebker*, the Tax Court focused on whether the CRP payments fell within the general exclusion of rentals from the definition of self-employment income and noted that rent was ordinarily defined as compensation for the occupancy or use of property.[134] The court found that although the taxpayer was obligated to provide services, the payments represented compensation for the use of the land rather than the farmer's labor because the services were not substantial and were not compatible with the overall purpose of the CRP program.[135] Additionally, the court determined that the nature of CRP contracts did not contemplate the production of agricultural commodities.[136] The Tax Court concluded that the self-employment tax was only intended to apply to the payment for services or labor, neither of which was required under the lease agreement.[137] In summary, the Tax Court determined that CRP payments fell within the general exclusion of rental income from the definition of self-employment income without fully addressing the subsequent issue of whether the payments were subject to the agricultural exception to the general exclusion of rentals from the definition of self-employment income.

In *Wuebker,* the Commissioner argued that because the taxpayer was a farmer, the CRP payments had a direct nexus with his farming operation.[138] The Tax Court rejected the "nexus" argument and noted that as long as the payments were for rents of real estate as defined by § 1402(a)(1), the payments were immune from the self-employment tax even if they were derived from Wuebker's farming activities.[139]

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in farming. *Wuebker*, 205 F.3d at 905. Instead, the Sixth Circuit focused on determining whether the payments were "farm income or rental income." *Id.* at 901-03.

130. 205 F.3d 897 (6th Cir. 2000).

131. *Wuebker*, 205 F.3d at 899.

132. *Id.* at 899-900.

133. *Id.* at 900.

134. *Wuebker*, 110 T.C. at 436.

135. *Id.*

136. *Id.*

137. *Id.* at 438-39.

138. *Id.*

139. *Id.* at 436.

Wuebker did not directly address the issue that was presented to the Tax Court in *McNamara*, *Hennen*, and *Bot*. The *Wuebker* court ruled that the CRP payments were rental payments and therefore excluded from self-employment income.[140] The rental payments were determined not to be within the agricultural exception to the general exclusion of rental payments because the CRP contracts did not require the production of agricultural commodities.[141]

The Commissioner appealed the Tax Court's ruling to the Sixth Circuit Court of Appeals.[142] After analyzing the CRP payment program, the Sixth Circuit concluded that the payments were not rental payments and therefore did not fall within the exclusion of rental payments from self-employment taxation.[143] The Sixth Circuit found that the Wuebkers' continued access and control over the real property coupled with the government's limited access rights resulted in a relationship that was not a landlord-tenant relationship.[144]

The Tax Court and Sixth Circuit decisions in *Wuebker* were helpful for defining the limits of the general rental exclusion. However, those decisions did not address whether a landlord's material participation in and of itself in a farming operation was sufficient to bring rental income within the definition of self-employment income or if material participation must be required under the terms of a rental arrangement.

2. *The Commissioner's Reliance on Mizell Was Misplaced*

In *Hennen, Bot, and McNamara*, the Commissioner relied significantly on the Tax Court's decision in *Mizell*.[145] *Mizell* was the first time the Commissioner raised the issue of self-employment taxation on agricultural leases.[146] *Mizell* presented the common situation of a material participation crop-share lease where the landlord materially participated in the

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140. *Id.* at 438.

141. *Id.*

142. Wuebker v. Commissioner, 205 F.3d 897, 901 (6th Cir. 2000).

143. *Id.* at 903-04.

144. *Id.* at 904.

145. *See* McNamara v. Commissioner, 78 T.C.M. (CCH) 530, 532 (1999). The Tax Court also cited Gill v. Commissioner, 70 T.C.M. (CCH) 120 (1995) as authority for its decision. *Id.* The *Gill* decision is easily distinguished from a cash rental agreement because the taxpayers in *Gill* entered into a specific agreement that compelled their material participation in poultry production. *Gill*, 70 T.C.M. (CCH) at 120. No such agreement existed in *McNamara*, *Bot*, or *Hennen*. *See* McNamara v. Commissioner, 236 F.2d 410, 411-12 (discussing the facts of the three consolidated cases).

146. Taxpayers had previously raised the issue in an attempt to receive benefits through the social security system. Foster v. Flemming, 190 F. Supp. 909, 912-13 (D.C. Iowa 1960), *rev'd*, 313 F.2d 604 (1963); Clark v. Celebrezze, 208 F. Supp. 505, 508 (D.S.D. 1962).

production of crops.[147] The landlord leased his farmland to a partnership comprised of his three sons and himself.[148] The partnership agreement obligated Mizell to perform services for the production of crops, and more importantly, the lease provided that Mizell was to receive a share of the crop as compensation for the use of land.[149] Also, the taxpayer did not receive any rent for the first two years in which he contributed use of his land to the partnership.[150] In those two years, compensation for his participation in the partnership was the only return that he received for the real estate.[151] This fact undoubtedly aided the court in its determination that the taxpayers should have been subject to the self-employment tax.[152]

The Tax Court in *Mizell* applied the same broad definition for the term "arrangement" as was used in the *McNamara*, *Hennen*, and *Bot*.[153] Applying an expanded definition for the term "arrangement," the Tax Court concluded that the overall relationship of the parties must be considered, and the determination of whether an arrangement existed for the production of agricultural products would not be restricted to the four corners of the rental agreement.[154] It was the "overall scheme" that led to the Tax Court's conclusion that an arrangement existed.[155]

3. *Neither Mizell nor Wuebker Directly Addressed the Issue Presented in McNamara*

In *Wuebker*, neither the Tax Court nor the Sixth Circuit addressed whether agricultural rentals must be derived under an arrangement to provide material participation in order to be included within the definition of self-employment tax income.[156] The Sixth Circuit ultimately concluded that the payments were not rental payments.[157] The payments did not even qualify for the general rental exclusion making it unnecessary to address whether the payments fell within the agricultural exception to the general

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147. Mizell v. Commissioner, 70 T.C.M. (CCH) 1469, 1471 (1995).

148. *Id.* at 1470.

149. *Id.*

150. *Id.*

151. *Id.*

152. *Id.* at 1471.

153. *Id.*; McNamara v. Commissioner, 78 T.C.M. (CCH) 530, 532-33 (1999), *rev'd*, 236 F.3d 410 (2000); Hennen v. Commissioner, 78 T.C.M. (CCH) 445, 446-47 (1999); Bot v. Commissioner, 78 T.C.M. (CCH) 220, 222-23 (1999).

154. Mizell v. Commissioner, 70 T.C.M. (CCH) 1469, 1471 (1995).

155. *Id.*

156. *See generally* Wuebker v. Commissioner, 205 F.3d 897 (2000); Wuebker v. Commissioner, 110 T.C. 431 (1998), *rev'd*, 205 F.3d 897 (6th Cir. 2000).

157. Wuebker, 205 F.3d at 904.

exclusion of rental payments.[158] Therefore, *Wuebker* did not provide guidance on whether a taxpayer can avoid self-employment tax on agricultural rentals if the taxpayer keeps the agricultural rental payments separate and distinct from any requirement to materially participate in the agricultural activities.

In *Mizell*, the taxpayer was a partner in a farming partnership that paid for the use of the taxpayer's land through a crop-share arrangement.[159] The taxpayer had a clear requirement to participate in the farming activities in order to receive compensation for the use of the land.[160] The Tax Court in *Mizell* was not presented with whether the self-employment tax should be imposed where the payment of agricultural rentals is separate and distinct from any requirement to provide material participation.

E. THE SERVICE'S INSTRUCTIONS ON FORM 4835 PRECLUDE CASH RENT LEASES FROM SELF-EMPLOYMENT TAXATION

Fixed cash rent is easily distinguished from crop sharing because crop sharing obligates the landlord to perform services in addition to providing the land. This distinguishing factor has even been recognized by the Service in its publication of Form 4835, which is utilized for non-material participation in a crop-share lease.[161] The instructions to Form 4835 preclude its use for cash rent leases and instruct the taxpayer to report the income on Schedule E of Form 1040.[162] The specific language of Form 4835 is as follows: "Land owners (or sub-lessors) must not use this form to report cash rent received for pasture or farmland if the amount is based on a flat charge. Report this income directly on Schedule E (Form 1040)."[163] Schedule E (rental income) is not subject to self-employment tax.[164] As such, the Service itself has precluded from recognition "cash rent received for pasture or farmland if the amount is based on a flat charge."[165]

Generally, only statutes, regulations, and judicial decisions are authoritative sources of federal tax law.[166] However, several cases have held that instructions to IRS forms, while not elevated to the level of statutes, regu-

158. *Id.* at 905.
159. *Mizell*, 70 T.C.M. (CCH) at 1470.
160. *Id.*
161. INTERNAL REVENUE SERVICE, FORM 4835 (2001).
162. *Id.* at 2.
163. *Id.*
164. I.R.C. § 1402(a)(1) (2002).
165. INTERNAL REVENUE SERVICE, FORM 4835, at 2.
166. Zimmerman v. Commissioner, 71 T.C. 367, 371 (1978).

lations, or judicial decisions, do have authoritative value.[167] As noted by the Federal District Court for the Middle District of Florida, "[g]eneral principles of equity dictate that the IRS should not be allowed to issue instructions for completing its forms and later disavow those instructions."[168]

The instructions accompanying Form 4835, a form entitled Farm Rental Income and Expenses, specifically preclude the imposition of the self-employment tax on cash rent leases for farmland.[169] The instructions direct the taxpayer to report the cash rent on Schedule E of Form 1040, which will exempt it from the tax.[170] These instructions are compelling evidence that the Service interpreted § 1402(a)(1) to exclude cash rent received for the rental of agricultural land from self-employment taxation.

F. DISTINGUISHING BETWEEN CASH RENT LEASE ARRANGEMENTS AND SHARECROPPING IS CONSISTENT WITH OTHER GOVERNMENT REGULATIONS

The United States Department of Agriculture also relies on the concept of material participation to determine the application of Production Flexibility Contracts (PFC) payments.[171] Pursuant to 7 C.F.R. § 1412.303, payment of PFC benefits is dependent upon whether the owner of the property is materially participating in the production of commodities.[172] Pursuant to 7 C.F.R. § 1412.303, landowners who participate through cash leases are not eligible to receive PFC payments because they are not materially participating in farming activities.[173]

Pursuant to the regulations maintained by the USDA, an individual holding a cash rent lease is not considered to be materially participating in farming activities and is denied eligibility for PFC payments.[174] A consistent definition of material participation should be used in applying the Code.

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167. Wilkes v. United States, 50 F. Supp. 2d 1281, 1287 (M.D. Fla. 1999); Estate of Merwin v. Commissioner, 95 T.C. 168, 180-81 (1990).

168. *Wilkes*, 50 F. Supp. 2d at 1287.

169. INTERNAL REVENUE SERVICE, FORM 4835, at 1-2.

170. *Id.* at 2.

171. *See* 7 C.F.R. § 1412.303(5) (2002) (stating that a landlord is not eligible for production flexibility contract payments if the lease involved is a cash lease). The Federal Agriculture Improvement and Reform Act of 1986 provided agricultural producers with an opportunity to enter into production flexibility contracts with the Commodity Credit Corporation from 1996 through 2002. *Id.* § 1412.101.

172. *Id.* § 1412.303.

173. *Id.*

174. *Id.*

V. EIGHTH CIRCUIT REVIEW

The McNamaras, Hennens, and Bots appealed their cases to the Eighth Circuit Court of Appeals.[175] The cases were consolidated for purposes of the appeal.[176] On appeal, the taxpayers asserted the Tax Court's conclusion that the rental income was includable farm rental income subject to taxation of self-employment earnings was incorrect.[177]

The Eighth Circuit noted that both the Service and the Tax Court failed to provide any analysis of a nexus between the rents received by the taxpayers and the arrangement that required their material participation as landlords in the farming operations.[178] The Eighth Circuit held that § 1402(a)(1) required rents to be "derived under" an agreement that compelled the landlord's material participation in the farming enterprise.[179] The court noted the following with respect to the "derived under" requirement of § 1402(a)(1):

> [T]he 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.
>
> Rents that are 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. Although the Commissioner is correct that, unlike other provisions in the Code, § 1402(a)(1) contains no explicit safe-harbor provision for fair market value transactions, we conclude that this is the practical effect of the "derived under" language.[180]

The Eighth Circuit remanded the case for further proceedings in the Tax Court.[181] The purpose of the remand was to provide the Service with "an opportunity to show a connection between the rents [received by the

175. *See* McNamara v. Commissioner, 236 F.3d 410 (8th Cir. 2000) (addressing three cases on appeal—McNamara v. Commissioner, 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)).

176. *Id.* at 410.

177. *Id.* at 412.

178. *Id.* at 413.

179. *Id.*

180. *Id.*

181. *Id.*

parties] and the production arrangement" that required their material participation in the farming operation.[182] The court noted that there was uncontradicted testimony that established the rents received by the parties were at or slightly below market value and concluded that "[r]ents that are consistent with market rates very strongly suggest that the rental agreement stands on its own as an independent transaction and cannot be said to be part of an arrangement for participation in agricultural production."[183]

VI. CONCLUSION

The Eighth Circuit has established a bright line test for determining whether rental payments made to active farmers should be included within self-employment tax income.[184] That bright line test requires the Service to establish a nexus between the rental payments and a production agreement requiring material participation by the landlord.[185] In the absence of any such nexus, the rental payments must be separated from the landlord's material participation in the farming enterprise, and those rental payments should be excluded from self-employment taxation.[186]

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182. *Id.*
183. *Id.*
184. *Id.*
185. *Id.*
186. *Id.*

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