



**Agricultural Law Press**

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# Agricultural Law Digest

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## Leasing to a Family Entity: Watch the Level of Rent Closely

-by Neil E. Harl\*

The pronounced move to multiple entities in farm operations in recent years (typically one entity owning the land and the other entity carrying on the farming operation but can involve additional entities) has come under the scrutiny of the Internal Revenue Service with challenges that self-employment tax<sup>1</sup> is due on the rents paid under the I.R.S. interpretation of the statute.<sup>2</sup> Recent audits (and Tax Court filings) indicate that IRS has not given up in the long-running battle. A case decided in 2000 by the Eighth Circuit Court of Appeals<sup>3</sup> was hailed as a win for taxpayers but IRS proceeded to issue a non-acquiescence to that decision in 2003<sup>4</sup> which meant that taxpayers in the Eighth Circuit Court of Appeals area had a modicum of protection but taxpayers in the other Court of Appeal areas were placed on notice that IRS was not giving up the fight to establish its view that self-employment tax would be due on rents paid if the combined effort as lessor of the land and as partner in a partnership, employee of a corporation or member of an LLC or LLP reached the level of material participation required by the statute.<sup>5</sup>

### The IRS position

The position of the Internal Revenue Service is based on the passage in I.R.C. § 1402<sup>6</sup> that excludes some rentals from self-employment income tax but states that the exclusions do not apply to "... any income derived under an arrangement, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities ... on such land, and that there shall be material participation by the owner or tenant ...".<sup>7</sup> The key is the meaning of "under an arrangement." IRS takes the position that it means anything an individual does whether as lessor of the land or as an active member of the operating entity or both. Obviously, a member of the operating entity who is working full time in that entity would be subject to self-employment tax on the rentals paid even if there was zero involvement in the capacity of owner. That interpretation runs counter to what was considered settled law for several decades.

### The Eighth Circuit Court of Appeals decision

The decision in 2000 by the Eighth Circuit Court of Appeals,<sup>8</sup> focused on the "nexus" between the lease and the farming operation and stated that "the mere existence of an arrangement requiring and resulting in material participation ... does not automatically transform rents received. ..." into self-employment income. The Court pointed out that

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pointed out that rents consistent with market rates “very strongly suggest” that the rental arrangement should stand on its own as an independent transaction without self-employment tax being due. That has been the guiding authority in the Eighth Circuit since that decision was announced --fair market rentals should not be subject to self-employment tax unless there is material participation under the lease.

Under that approach, only excessive rents (above prevailing market rental rates) should be subject to self-employment tax. Arguably, for excessive rentals only the excess should be subject to SE tax inasmuch as a lessor is always entitled to receive a reasonable rental on the land involved, free of SE tax, unless there is material participation. The cases subsequent to the Eighth Circuit case have imposed SE tax on the entire rental amount where the rentals exceeded a reasonable rental.<sup>9</sup>

As noted, IRS in October of 2003 entered a non-acquiescence in the Eighth Circuit Court decision<sup>10</sup> which served notice that, while the Eighth Circuit decision was good authority in that circuit court area, it was not viewed as authority elsewhere.

IRS appears to be proceeding to litigate, if necessary, to establish its position as the law of the land by winning a case in another court of appeals area followed by an appeal to the United States Supreme Court. A case in Upstate New York, which would have been appealable to the Second Circuit Court, was settled out of court. Another case is developing in a situation in the Seventh Circuit Court area (Illinois, Indiana and Wisconsin) with a trial set for later this year.

#### So what's our advice?

Follow the lead of the Eighth Circuit decision and be prepared to prove that the rental paid is a reasonable rental. Also, if the situation presents itself, be prepared to argue that, even for

rentals failing the “fair market rental” test, only the excess above what would have been a reasonable fair market rental should be subject to self-employment tax. Litigating to a court of appeals level is costly with the burden of resisting the IRS position falling unevenly on those selected to test the IRS position. Strive to develop the best possible defense against an IRS challenge.

#### ENDNOTES

<sup>1</sup> I.R.C. § 1402(a).

<sup>2</sup> I.R.C. § 1402. See, e.g., *Mizell v. Comm'r*, T.C. Memo. 1995-571; *McNamara v. Comm'r*, 236 F.3d 410 (8th Cir. 2000), *rev'g*, T.C. Memo. 1999-333, *non-acq.*, I.R.B. 2004-42. See generally 2 Harl, *Farm Income Tax Manual* § 8.05[5] (2015 Ed.); 5 Harl *Agricultural Law* § 37.03[a][i] (2015); Harl, *Agricultural Law Manual* § 4.06[3] (2015). See also Harl, “Renting Land to a Family Partnership, Corporation or LLC,” 7 *Agric. L. Dig.* 49 (1996); Harl, “Renting Land to a Family Entity,” 7 *Agric. L. Dig.* 157 (1996); Harl, “More on Mizell,” 12 *Agric. L. Dig.* 9 (2001); Harl, “The Latest on Mizell,” 13 *Agric. L. Dig.* 137 (2002).

<sup>3</sup> *McNamara v. Comm'r*, 236 F.3d 410 (8th Cir. 2000).

<sup>4</sup> AOD CC-2003-3, October 20, 2003, I.R.B. 2003-42.

<sup>5</sup> I.R.C. § 1402.

<sup>6</sup> I.R.C. § 1402(a)(1) (“... under an arrangement. . .”).

<sup>7</sup> I.R.C. § 1402(a)(1).

<sup>8</sup> *McNamara v. Comm'r*, 236 F.3d 410 (8th Cir. 2000).

<sup>9</sup> *Solvie v. Comm'r*, T.C. Memo. 2004-55 (rental on hog barn (calculated at \$21 per hog per rotation) was above a fair market rental and entirely subject to SE tax).

<sup>10</sup> AOD CC-2003-3, Oct. 20, 2003, I.R.B. 2003-42.

## CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

### BANKRUPTCY

NO ITEMS.

### FEDERAL FARM PROGRAMS

**CONSERVATION RESERVE PROGRAM.** The CCC and FSA have issued interim regulations which amend the Conservation Reserve Program (CRP) regulations to implement provisions of the Agricultural Act of 2014 (the 2014 Farm Bill). The new rule specifies eligibility requirements for enrollment of grassland in CRP and adds references to veteran farmers and ranchers to the provisions for Transition Incentives Program contracts, among other changes. The provisions in this rule for eligible land primarily apply to new CRP offers and contracts. For existing contracts, this rule provides additional voluntary options for permissive uses, early

terminations, conservation and land improvements, and incentive payments for tree thinning. **80 Fed. Reg. 41987 (July 16, 2015).**

**ORGANIC FOOD.** The AMS has issued a proposed rule addressing recommendations submitted to the Secretary of Agriculture by the National Organic Standards Board (NOSB) following their October 2014 meeting. These recommendations pertain to the 2015 Sunset Review of substances on the USDA's National List of Allowed and Prohibited Substances (National List). Consistent with the recommendations from the NOSB, the proposed rule would remove two non-organic agricultural substances from the National List for use in organic handling, fortified cooking wines--marsala wine and sherry wine. The proposed rule would also remove two listings for synthetic substances allowed for use in organic crop production on the National List, streptomycin and tetracycline, as their use exemptions expired on October 21, 2014. **80 Fed. Reg. 45449 (July 30, 2015).**