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# Agricultural Law Digest

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## More Yet on *Mizell*

— by Neil E. Harl\*

The announcement on October 20, 2003, that the Internal Revenue Service was entering a non-acquiescence in the appellate court decision of *McNamara v. Commissioner*<sup>1</sup> signaled that more cases would be filed in the long line of court decisions since *Mizell v. Commissioner*.<sup>2</sup> Two more Tax Court cases<sup>3</sup> have confirmed that the Internal Revenue Service is continuing to audit returns involving rental of land (and other property) to a family-owned entity and to assert self-employment tax liability on the rents involved.

### Background

The *Mizell* saga began in 1995 with the Tax Court decision in *Mizell v. Commissioner*.<sup>4</sup> In that case, the taxpayer leased 731 acres of land (under a crop-share lease) to a general partnership owned by the taxpayer and the taxpayer's three sons.<sup>5</sup> The Internal Revenue Service, on audit, insisted that 15.3 percent self-employment tax was due on the rents paid to the taxpayer and cited Section 1402(a)(1) in support of its position.<sup>6</sup> The position of the Service was that the relationship of the taxpayer as general partner to the general partnership and the taxpayer's relationship as lessor of land to the general partnership were both "under an arrangement" under the language of Section 1402(a)(1) and, therefore, were subject to self-employment tax because the production of "agricultural or horticultural commodities" was involved and the taxpayer was "materially participating" in the production or the management of production within the meaning of the statute.<sup>7</sup> The Tax Court agreed with the Internal Revenue Service.<sup>8</sup>

That case was followed by a letter ruling (involving cash rent),<sup>9</sup> three field service advices (FSAs),<sup>10</sup> (which were in accord with the Service position) and three more Tax Court cases.<sup>11</sup> The three Tax Court cases were all appealed to the Eighth Circuit Court of Appeals which reversed the Tax Court on December 29, 2000.<sup>12</sup> The Eighth Circuit 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."<sup>13</sup> The appellate court 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.<sup>14</sup> The three cases were remanded to the Tax Court which, more than 18 months later, without IRS responding, issued to the taxpayers<sup>15</sup> brief opinions indicating that the rents in the three cases were fair market rentals.<sup>16</sup>

A case appealable to the Second Circuit Court of Appeals, *Fowler v. Commissioner*,<sup>17</sup> was dismissed in September, 2003, in an undisclosed settlement with IRS.

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On October 20, 2003, IRS entered a non-acquiescence in the case of *McNamara v. Commissioner*,<sup>18</sup> *Hennen v. Commissioner*,<sup>19</sup> and *Bot v. Commissioner*.<sup>20</sup>

### Critique of the statute

The statute in question refers to income “derived under an arrangement” as subject to self-employment tax.<sup>21</sup> The Eighth Circuit, in *McNamara v. Commissioner*<sup>22</sup> adopted the view that rents that were fair market rentals were not subject to self-employment tax in that such rents were not “derived under . . . [the] arrangement.” Arguably, premium rentals, above a fair market rental, would be the most vulnerable to self-employment tax liability as being “derived under . . . [the] arrangement.” Rentals below the fair market value would arguably not be subject to SE tax in that such rentals are not “derived under . . . [the] arrangement.” Premium rentals represent, essentially, additional income to the lessor which is arguably not related to the lease but, provided as additional compensation to the lessor who is materially participating as a partner, employee or other status. Therefore, such additional compensation to the lessor/partner or lessor/employee is arguably subject to SE tax.

### The two 2004 cases

In the first of the two Tax Court cases, both filed on March 9, 2004, *Solvie v. Commissioner*,<sup>23</sup> the husband and wife as taxpayers, each owned 50 percent of the stock in a family farm corporation. The taxpayers leased farmland (and buildings) and some personal property to the corporation.<sup>24</sup> Later, the taxpayers built an 800-head capacity hog barn on the land in question and increased the rental by \$21 per hog per rotation of hogs passing through the barn.

The Tax Court rejected the taxpayers’ argument that there was no nexus between the hog barn and the taxpayers’ material participation in the operation, noting that had the taxpayers not performed services for the corporation, there would have been no rental on the hog building, and concluded that the rental paid for the hog building was above a fair market rental and, therefore, was includable farm rental income and subject to self-employment tax.<sup>25</sup>

The other 2004 case, *Johnson v. Commissioner*,<sup>26</sup> also involved a husband and wife as taxpayers, each owning 50 percent of the stock in their family-farm corporation. The taxpayers rented farmland and other items of personal property to the corporation.<sup>27</sup> The Tax Court found that the rentals were fair market rentals and that there was no nexus between the rent paid and the material participation by the taxpayers.<sup>28</sup> Accordingly, the rents did not constitute includible farm rental income and, therefore, were not net earnings from self-employment.<sup>29</sup>

### Lessons from the 2004 cases

Two lessons can be derived from the 2004 Tax Court cases— (1) that rentals other than fair market rentals (particularly premium rentals) are unlikely to escape SE tax and (2) rentals that depend upon the taxpayer’s material participation (as where rental levels are dependent upon production) are, in the

view of IRS, unlikely to escape SE tax liability. The latter raises a question about share-rent leases, especially those set at a premium level.

### FOOTNOTES

<sup>1</sup> 236 F.3d 410 (8th Cir. 2000), *rev’g*, T.C. Memo. 1999-333, *non-acq.*, I.R.B. 2003-42. See generally, 5 Harl, *Agricultural Law* § 37.03[a][i] (2004); Harl, *Agricultural Law Manual* § 4.06[3] (2004). See also Harl, “The Latest on Mizell,” 13 *Agric. L. Dig.* 137 (2002); Harl, “More on Mizell,” 12 *Agric. L. Dig.* 9 (2001); Harl, “Renting Land to a Family Entity,” 7 *Agric. L. Dig.* 157 (1996); Harl, “Renting Land to a Family Partnership, Corporation or LLC,” 7 *Agric. L. Dig.* 49 (1996).

<sup>2</sup> T.C. Memo. 1995-571.

<sup>3</sup> *Solvie v. Comm’r*, T.C. Memo. 2004-55; *Johnson v. Comm’r*, T.C. Memo. 2004-56.

<sup>4</sup> T.C. Memo. 1995-571.

<sup>5</sup> *Id.*

<sup>6</sup> *Mizell v. Comm’r*, T.C. Memo. 1995-571.

<sup>7</sup> I.R.C. § 1402(a)(1).

<sup>8</sup> *Mizell v. Comm’r*, T.C. Memo. 1995-571.

<sup>9</sup> Ltr. Rul. 9637004, May 1, 1996.

<sup>10</sup> FSA 9917005, Dec. 10, 1998, FSA 9917006, Dec. 10, 1998; FSA 9917007, Dec. 10, 1998.

<sup>11</sup> *Bot v. Comm’r*, T.C. Memo. 1999-256; *Hennen v. Comm’r*, T.C. Memo. 1999-306; *McNamara v. Comm’r*, T.C. Memo. 1999-333.

<sup>12</sup> *McNamara v. Comm’r*, 236 F.3d 410 (8th Cir. 2000).

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> The three Tax Court opinions were not issued formally, were not listed on the Tax Court website, [www.ustaxcourt.gov](http://www.ustaxcourt.gov), and were not published by the major tax services.

<sup>16</sup> A copy of each of the three opinions issued to the taxpayers was received by the author from the taxpayer’s counsel.

<sup>17</sup> T.C. Docket No. 013920-01, Dec. 14, 2001.

<sup>18</sup> T.C. Memo. 1999-333, *rev’d*, 236 F.3d 410 (8th Cir. 2000).

<sup>19</sup> T.C. Memo. 1999-306, *rev’d*, 236 F.3d 410 (8th Cir. 2000).

<sup>20</sup> T.C. Memo. 1999-256, *rev’d*, 236 F.3d 410 (8th Cir. 2000).

<sup>21</sup> I.R.C. § 1402(a)(1).

<sup>22</sup> 236 F.3d 410 (8th Cir. 2000).

<sup>23</sup> T.C. Memo. 2004-55.

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> T.C. Memo. 2004-56.

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

<sup>29</sup> *Id.* See I.R.C. § 1402(a)(1).