



Agricultural Law Press

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The Latest on *Mizell*

— by Neil E. Harl*

The progeny of the 1995 decision in *Mizell v. Commissioner*¹ continues to ricochet through the courts with little hope that the end of the litigation is near. The latest decision of the Tax Court² agreeing with the Eighth Circuit Court of Appeals is unlikely to be the last word in the controversy.

History of *Mizell*

The decision in *Mizell v. Commissioner*³ involved an Arkansas farmer who rented 731 acres of farmland to a family partnership owned equally by Mizell and his three sons (each with a 25 percent interest).⁴ The lease of the 731 acres was on a 25 percent crop-share basis with the partnership paying all of the crop expense. The elder Mizell treated the arrangement as a non material participation lease and did not report the rental amounts as self-employment income.

The Tax Court focused on the language in the statute⁵ providing an exception to the general rule that rentals from real estate are excluded from net earnings from self-employment, if there is an “arrangement” with material participation by the owner in the “production or the management of the production” of agricultural commodities.⁶ The court noted that the elder Mizell was materially participating in the partnership operations and the statutory language referring to an “arrangement” necessarily embraced the taxpayer’s involvement in the partnership as partner as well as under the lease.⁷ Therefore, the rental income under the lease was subject to self-employment tax.

A 1996 private letter ruling⁸ reached the same conclusion with a cash rent lease to a corporation. Three Field Service Advice rulings in 1998 were in accord.⁹

Three Tax Court cases, all decided in 1999, agreed with *Mizell v. Commissioner*¹⁰ and the IRS rulings. The cases, *Bot v. Commissioner*,¹¹ *Hennen v. Commissioner*,¹² and *McNamara v. Commissioner*¹³ were appealed to the Eighth Circuit Court of Appeals. Ironically, the Eighth Circuit would have been the appellate court for the case of *Mizell v. Commissioner* had *Mizell* been appealed. The Eighth Circuit was not impressed by the taxpayer’s arguments that Section 1402(a)(1) only applies to “rental

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payments derived from sharecropping or share-farming.”¹⁴ The Eighth Circuit, not surprisingly, also gave short shrift to the argument that the instructions to Form 4835 (on which non-material participation share rent income and expenses are reported) contradicted the statute and should override I.R.C. § 1402(a)(1).

The appellate court also stated that it could not say that the Tax Court erred in holding that the taxpayer in the three cases had materially participated under the respective arrangements. However, the Eighth Circuit was impressed by another argument, that the lessor-lessee arrangements should stand on their own, apart from any employment relationship, and that if the rentals were “consistent with market rates for agricultural land”¹⁵ the rents were not “derived under an arrangement” and, therefore, self-employment tax was not due.¹⁶ Thus, the Eighth Circuit went beyond the focus up to that time, on the words “under an arrangement” in Section 1402(a)(1), and looked at the phrase “derived under an arrangement” in the statute.

The court remanded the cases to the Tax Court to provide an opportunity for IRS to show a connection between the rents and the “arrangement.”

In mid-July, 2002, the Tax Court in a brief opinion, conceded that the rentals in the three cases were fair market rentals.¹⁷

Other cases

Another case appealable to the Eighth Circuit, *Milton v. Commissioner*,¹⁸ involves the leasing of land by a family partnership to a corporation controlled by the same individuals. IRS argued that the partnership rental income was subject to self-employment tax.

A case in New York State, appealable to the Second Circuit Court of Appeals, has been docketed in the Tax Court. That case, *Fowler v. Commissioner*,¹⁹ involved the rental of land containing apple trees to a family-owned corporation. That case indicates that the Internal Revenue Service is positioned to challenge in another circuit the Eighth Circuit Court’s analysis in situations involving the rental of land to a family-owned entity as tenant.

In conclusion

While the advice to taxpayers potentially subject to challenge to be careful to set rental rates in keeping with rental rates in the area for comparable land is still good counsel,

indications that IRS is litigating another case in the Second Circuit Court of Appeals area suggests that the more general solutions to the problem continue to be relevant. Those solutions include (1) shifting ownership of rental land to the name of a spouse (who is not involved in the business); (2) conveying the land to another entity (such as an LLC or LP); (3) retiring from the business; or (4) seeking a broader solution through legislative amendment.²⁰

FOOTNOTES

¹ T.C. Memo. 1995-571. See generally 5 Harl, *Agricultural Law* § 37.03[a][i] (2002); Harl, *Agricultural Law Manual* § 4.06[3] (2002). See also 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).

² *Hennen v. Comm’r*, T.C. Docket No. 7535-98 (July 10, 2002). The Tax Court opinion has not, as of August 20, 2002, been posted on the Tax Court web site (www.ustaxcourt.gov) or released by the major tax services.

³ T.C. Memo. 1995-571.

⁴ *Id.*

⁵ I.R.C. § 1402(a)(1).

⁶ *Id.*

⁷ *Id.*

⁸ Ltr. Rul. 9637004, May 1, 1996.

⁹ FSA Ltr. Rul. 9917008, Dec. 10, 1998; FSA Ltr. Rul. 9917005, Dec. 10, 1998; FSA Ltr. Rul. 9917006, Dec. 10, 1998.

¹⁰ T.C. Memo. 1995-571.

¹¹ T.C. Memo. 1999-256.

¹² T.C. Memo. 1999-306.

¹³ T.C. Memo. 1999-333.

¹⁴ 236 F.3d 410 (8th Cir. 2000).

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ See n. 2 *supra*.

¹⁸ T.C. Docket No. 13594-01.

¹⁹ T.C. Docket No. 013920-01 (Dec. 14, 2001).

²⁰ 5 Harl, *Agricultural Law* § 37.03[3][a] (2002).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-ALM § 13.03.*

ESTATE PROPERTY. The Chapter 7 debtors operated a business which purchased agricultural commodities and was subject to PACA. Several creditors had claims against the PACA trust and filed claims in the bankruptcy case. The

bankruptcy trustee filed proceedings to recover preferential transfers made by the debtors for goods and services provided by third parties. The trustee negotiated a settlement for an amount which was paid to the bankruptcy estate. The PACA trust creditors sought to recover the preferential transfer amount as part of the PACA trust. The bankruptcy trustee agreed that the recovered amount was subject to the PACA trust but argued that the amount should be reduced by the costs of the recovery. The bankruptcy trustee proposed paying 83 percent of the recovery amount to the PACA trust.