



# Ag Decision Maker

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### Self-employment tax for spouses receiving farm program payments?\*

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Recent audit activity by the Internal Revenue Service suggests that IRS believes that spouses who receive farm program payments under the current farm program legislation are liable for self-employment tax on the amounts received. That position, while justified if the spouse has "net earnings from self-employment" from a "... trade or business carried on by such individual. . . .", does not appear to be justified if the involvement by the spouse falls short of that standard. The question is whether, if the only participation by the spouse is that sufficient to meet the minimum requirements to be eligible to receive government farm program payments, the spouse is subject to self-employment tax.

#### The test for spousal eligibility for farm program payments

Since 1991, when the Secretary of Agriculture exercised the authority from Congress to allow each spouse

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to be considered a separate "person," in the case of a married couple consisting of spouses who do not hold, directly or indirectly, a substantial beneficial interest in more than one entity (including the spouses themselves) engaged in farming operations that also receives farm program payments as separate persons, the spouses may be considered separate persons if each spouse meets the other requirements necessary to be considered separate persons. That rule did not change the already existing exception allowing a married couple who were engaged in separate farming operations before marriage and continue to operate separately after marriage to be considered separate persons for purposes of the payment limitation provision.

To be eligible for farm program payments, an individual or entity must be "actively engaged in farming." To be actively engaged in farming, three conditions must be met—

- The individual's share of profits or losses from the farming operation must be commensurate with the

individual's or entity's contribution to the operation; *continued on page 2*

#### Handbook updates

For those of you subscribing to the handbook, the following updates are included.

**Group Risk Insurance (GRP) and Group Risk Income Protection (GRIP)** – A1-58 (2 pages)

**2008 Iowa Farm Custom Rate Survey** – A3-10 (2 pages)

**Operating Leverage** – C1-45 (3 pages)

Please add these files to your handbook and remove the out-of-date material.

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- The individual's or entity's contribution must be "at risk;" and
- An individual must make a significant contribution of (1) capital, equipment or land or a combination of capital, equipment or land and (2) active personal labor or active personal management or a combination of active personal labor and active personal management.

Obviously, the last item listed – active personal labor and active personal management—is the key factor in comparing the "actively engaged" test with the "self-employment income" test. The regulations go on to state that, in determining if the individual or entity is contributing a significant amount of active personal labor or active personal management, several factors are taken into consideration—

- (1) the types of crops produced by the farming operation;
- (2) the normal and customary farming practices of the area; and
- (3) the total amount of labor and management which is necessary for such a farming operation in the area.

The regulations also specify that, for farming operations conducted by persons a majority of whom are family members, "... an adult family member who makes a significant contribution of active personal management, active personal labor, or a combination of active personal labor and active personal management, shall be considered to be actively engaged in farming."

**The test for "self-employment income"**

The statute states that 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. . . ." The statute goes on to define "trade or business" as that term is used in determining the deductibility of trade or business expenses under I.R.C. § 162 with specified exceptions.

In general, continuity and regularity of activity are necessary before a venture can be considered a trade or business. Thus, ventures did not rise to the level of a "trade or business" where the taxpayer's efforts were "irregular and sporadic" as an inventor, where the sale of insider information by an investment firm's employee was involved, where the taxpayers were not actively involved in the operation of a night club and restaurant, where securities trading was not conducted with sufficient frequency to constitute a trade or business, and where an attorney was not involved in law practice sufficient to be a trade or business, to mention a few of the numerous cases litigated under I.R.C. § 162. On the other hand, the U.S. Supreme Court held in *Commissioner v. Groetzinger* that "constant

and large-scale effort" by the taxpayer in a gambling activity (60 to 80 hours per week, 48 weeks per year) was considered a trade or business. Basically, what is a "trade or business" is a facts and circumstances question as pointed out in *Commissioner v. Groetzinger*.

It should be noted that "material participation" was added to the statutory authority for self-employment income in the context of landlord-tenant relationships in 1956. That concept could be relevant in the context of a husband and wife farming operation if the relationship is characterized as a landlord-tenant relationship.

**Characterization as a partnership**

If a husband and wife farming operation is properly characterized as a partnership, as has been asserted in some audits over the issue of self-employment tax liability of spouses, there is authority that all general partners in a general partnership have self-employment tax liability. As stated in *Norwood v. Commissioner*, "It is undisputed that petitioner's interest. . . was a general partnership interest. Accordingly, his distributive share of the partnership's trade or business income is, subject to the imitations of section 1402(b), subject to the taxes imposed by section 1401 on self-employment income."

The key question, of course, is whether a husband and wife carrying on a farming operation with the wife involved only to the extent of being "actively engaged in the farming operation" for purposes of eligibility for farm program payments, are a partnership. Although courts in a few states have held that husband-wife partnerships are recognized even if the formalities of partnership organization are not in evidence, the Uniform Partnership Act defines a partnership as an association of two or more persons to carry on as co-owners a business for profit. The sharing of gross returns does not, in itself, establish a partnership. However, receipt of a share of the profits is prima facie evidence of partnership existence.

If the spouse receiving farm program payments under the "actively engaged in farming" test receives only a portion of the government payments, that does not indicate a sharing of net income and, therefore, is not indicative of a partnership.

**Electing out of partnership status**

A provision has been available for several years to allow the members of an unincorporated organization to elect not to be treated as a partnership. However, that election only applies to organizations "... availed of for investment purposes only and not for the active conduct of a business. Therefore, that provision is of little help to a

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husband and wife facing an assertion that the spouse has self-employment income as a general partner in a general partnership for receiving farm program payments.

Another provision, enacted in 2007, perhaps with an objective of addressing the problems now faced on audit, affords another opportunity for husbands and wives to elect out of partnership status. That enactment, involving “qualified joint ventures,” specifies that, in the case of a qualified joint venture conducted by a husband and wife who file a joint return for the taxable year, an election may be made to elect not to be treated as a partnership. The husband and wife can be the only members of the electing joint venture and both must be materially participating within the meaning of section 469(f). That meaning of “material participation” requires material participation on a regular, continuous and substantial basis. That provision is unlikely to be helpful in husband-wife situations inasmuch as the spouse qualifying for farm program payments under the “actively engaged” test would generally not be sufficiently involved to meet the higher standard of material participation on a regular, continuous and substantial basis. If that test were met, the spouse would be subject to self-employment tax under the lesser rule of material participation. If the statute providing for the election out of partnership status had specified that the election could be made if one of the spouses is materially participating under that higher standard, the election out would provide a good defensive opportunity for the couple.

**In conclusion**

Until litigated, it will likely not be known with certainty whether the “actively engaged” test requires less (or more) than the “trade or business” test. Based on the way the

two tests have been administered, it appears that the “actively engaged” test requires significantly less involvement than the trade or business test. The one exception to that is the recent controversy over taxation of Conservation Reserve Program (CRP) payments where the Internal Revenue Service has taken the position, which has been roundly criticized, that merely signing up for the program is sufficient for the imposition of self-employment tax on annual CRP payments.

If that is the case, and if the facts support lesser involvement than is required for the trade or business test, the only remaining argument for self-employment tax liability is the argument that the husband-wife arrangement is a partnership. That assertion should be effectively countered with a showing that no partnership exists under state law and that the requirements for a partnership under the Uniform Partnership Act have not been met. However, in a different setting, eligibility of co-owned property for like-kind exchange treatment, IRS has persisted in its belief that use of a partnership tax return as a convenient way to report income and deductions makes the property ineligible for like-kind exchange treatment as an interest in a partnership even though no partnership was intended and no partnership existed under state law. That position by IRS has not been litigated nor has the position that all CRP payments are subject to self-employment tax regardless of the relationship to a trade or business.

IRS seems to be attempting to redraw the line between what is a trade or business and what is an investment asset. Unless Congress steps in, which appears unlikely, litigation is the only way to resolve the issue.



**Global warming – impact of greenhouse gases**

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*(Second in series)*

**G**lobal warming will have a profound impact on global agriculture, with yet unknown influences on Midwest agriculture. As with most changes, this will provide both opportunities and threats for Midwest agricultural producers. This article discusses the role greenhouse gases play in global warming.

Solar energy heats the earth’s surface. But the energy does not stay bound up in the earth’s environment forever. Instead, as the earth warms, it emits thermal radiation.

This thermal radiation, which is largely in the form of long-wave infrared rays, eventually finds its way out into space, leaving the earth and allowing it to cool. However, not all of the infrared rays pass into space. Some of the infrared rays are absorbed by greenhouse gases and warm the atmosphere. So the amount of greenhouse gases in the atmosphere is directly related to the temperature of the atmosphere. Increased concentrations of greenhouse gases increase the temperature of the atmosphere leading to the warming of the earth’s surface.