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Publisher/Editor

Robert P. Achenbach, Jr.

Contributing Editor

Dr. Neil E. Harl, Esq.

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SE Tax on Contract Production “Rents”

-by Neil E. Harl*

The gradual increase in contract production in agriculture¹ has focused attention on the nature of payments made by integrators to the growers and, specifically, whether part or all of such payments could be treated as rents for self-employment tax purposes.²

The statutory framework

The statute specifies 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. . . .”³

The statute then proceeds to exclude rentals from real estate⁴ but then includes amounts paid “under an arrangement” involving the production of agricultural or horticultural commodities where there is material participation under the lease.⁵

The term “trade or business,” an important aspect of the definition, has the same meaning as when used in I.R.C. § 162 with stated exceptions.⁶ As interpreted by the cases, the term “trade or business” has come to mean that continuity and regularity of activity are necessary before a venture can be considered to be a trade or business.⁷ Note that the statute does *not* define “trade or business carried on by such individual.”⁸ Moreover, the statute does not address the self-employment tax liability of a taxpayer who is carrying on a trade or business and is also carrying on a rental activity.

Thus, the key questions with contract production involving payments for production and for use of the grower’s facilities are – (1) whether the grower was carrying on a trade or business and (2) whether the rents received are a part of that trade or business.

Guidance from the cases

In a 1965 Ninth Circuit Court of Appeals case,⁹ the court acknowledged that Congress realized that the income of self-employed persons is, in most instances, a combination of income from both labor and invested capital, and deliberately chose not to attempt the difficult, if not impossible, task of separating one from the other. The court then proceeded to explain the exclusion of rentals from self-employment income as follows –

“The Committee reports accompanying the bill which included section 211(a)(1) [42 U.S.C. § 411(a)(1)] make it clear that not all payments which might be considered “rent” in ordinary parlance are to be excluded from self-employment net income

* Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.

“The apparent intent of Congress was that section 211(a)(1) [42 U.S.C. § 411(a)(1)] should be applied *to exclude only payments for use of space*, and, by implication, such services as are required to maintain the space in condition for occupancy. If the owner performs additional services of such substantial nature that compensation for them can be said to constitute a material part of the payment made by the tenant [in this context means the one obtaining the services of the space], the “rent” received then consists in part of income attributable to the performance of labor which is not incidental to the realization of the return from passive investment. In such circumstances, the entire payment is to be included in computing the recipient’s “net earnings from self-employment.” [Emphasis added]

The 1989 Tax Court case of *Stevenson v. Commissioner*,¹⁰ involved a taxpayer who was engaged in the business of purchasing portable advertising signs for rental or for resale. The taxpayer assembled and stored at a rental warehouse all new portable advertising signs. The taxpayer also stored all used portable advertising signs, repaired them and held them for sale or rental. The taxpayer argued that income from the rental of portable advertising signs was properly excluded from self-employment income.¹¹ The taxpayer’s position was that the statutory language excluding rentals from real estate (and from personal property leased with the real estate) from self-employment income was only illustrative as to what was to be excluded.

The Tax Court held that the rental and sale of advertising signs was, overall, a trade or business and the rental income could not be excluded.¹² The court acknowledged that payments for the use of space where the labor involved was incidental to the realization of the return on an investment was not subject to SE tax but held that no part of the taxpayer’s income from the sign business fell within that exception.

In the case of *Gill v. Commissioner*,¹³ a grower who had a contract with Jack Frost, Inc. to produce broilers from baby chicks in a period of about six weeks per cycle had self-employment income for the entire payment from the integrator. The taxpayer had sufficient involvement to be considered to be carrying on a trade or business and was considered to be “materially participating” in the production of income. The taxpayer not only maintained the grow-out facility but also performed, with other family members, the tasks necessary to raise the broilers.

In another Tax Court case, *Schmidt v. Commissioner*,¹⁴ this one involving the production of beets for a canning company, the production of the beet crop under contract resulted in self-employment income, not rent for the use of the land. The proper characterization of payments is the responsibility of the grower.

In conclusion

Therefore, a taxpayer who is sufficiently active to be carrying on a trade or business in a contract venture is not permitted to carve out a portion of the payment as rent regardless of how the integrator may be reporting the payment. While the trend is toward a reduced role in management for growers under contract, and ultimately courts may view the grower’s role as that of an employee or agent, falling short of trade or business status, that is not the case at present.

Footnotes

¹ Economic Research Service, U.S. Department of Agriculture, “Agricultural Contracting Update: Contracts in 2003,” January, 2006 (contracts in 2003 covered 39 percent of the value of agricultural production in the United States, up from 36 percent in 2001, 28 percent in 1991 and 11 percent in 1969; in 2003, contracts covered one-fifth of production among farms with less than \$250,000 of sales but 53 percent of production on farms with more than \$1 million in sales).

² See I.R.C. § 1402(a). See generally 5 Harl, *Agricultural Law* § 37.03[2][a] (2006); Harl, *Agricultural Law Manual* § 4.06[3] (2006).

³ I.R.C. § 1402(a).

⁴ I.R.C. § 1401(a)(1).

⁵ *Id.*

⁶ I.R.C. § 1402(c).

⁷ E.g., *Commissioner v. Groetzinger*, 480 U.S. 23 (1987); *Stanton v. Comm’r*, 399 F.2d 326 (5th Cir. 1968) (efforts were “irregular and sporadic” as inventor).

⁸ See I.R.C. § 1401(a).

⁹ *Delno v. Celebrezze*, 347 F.2d 159 (9th Cir. 1965).

¹⁰ T.C. Memo. 1989-357.

¹¹ *Id.*

¹² *Id.*

¹³ T.C. Memo. 1995-328.

¹⁴ T.C. Memo. 1997-41.