Tax Consequences for Owners of Farmland: Why Land Owners Who Rent Their Land to Farming Employers are Probably Liable for Self-Employment Tax on Rent Received and Why Congress Should Change the Current Policy

by

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TAX CONSEQUENCES FOR OWNERS OF FARMLAND: WHY LAND OWNERS WHO RENT THEIR LAND TO FARMING EMPLOYERS ARE PROBABLY LIABLE FOR SELF-EMPLOYMENT TAX ON RENT RECEIVED AND WHY CONGRESS SHOULD CHANGE THE CURRENT POLICY

I. INTRODUCTION

Since the 1950s, the number of farms in the United States has decreased every month.[1] Many people believe that the family farm as a way of life will be obliterated.[2] As the number of farms decreases, causing the remaining farms to become larger, farmers may rent their land to a farming operation and seek other employment such as a farm laborer, or alternatively, consolidate efforts and form family farm corporations.[3] What many landowners may not realize is that if they rent

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1. *See* VICTOR DAVIS HANSON, FIELDS WITHOUT DREAMS; DEFENDING THE AGRARIAN IDEA at xv (1996).

2. *See id.* at xi.

3. *See, e.g.*, N.D. CENT. CODE § 10-06.1-12 (Supp. 1999) which provides:

> This chapter does not prohibit a domestic corporation or a domestic limited liability company from owning real estate and engaging in the business of farming or ranching, if the corporation meets all the requirements of chapter 10-19.1 or the limited liability company meets all the requirements of chapter 10-32 which are not inconsistent with this chapter. The following requirements also apply:
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> 1. If a corporation, the corporation must not have more than fifteen shareholders. If a limited liability company, the limited liability company must not have more than fifteen members.
> 2. Each shareholder or member must be related to each of the other shareholders or members within one of the following degrees of kinship or affinity: parent, son, daughter, stepson, stepdaughter, grandparent, grandson, granddaughter, brother, sister, uncle, aunt, nephew, niece, great-grandparent, great-grandchild, first cousin, or the spouse of a person so related.
> 3. Each shareholder or member must be an individual or one of the following:
>   a. A trust for the benefit of an individual or a class of individuals who are related to every shareholder of the corporation or member of the limited liability company within the degrees of kinship or affinity specified in this section.
>   b. An estate of a decedent who was related to every shareholder of the corporation or member of the limited liability company within the degrees of kinship or affinity specified in this section.
> 4. A trust or an estate may not be a shareholder or member if the beneficiaries of the trust or the estate together with the other shareholders or members are more than fifteen in number.
> 5. Each individual who is a shareholder or member must be a citizen of the United States or a permanent resident alien of the United States.
> 6. If a corporation, the officers and directors of the corporation must be shareholders who are actively engaged in operating the farm or ranch and at least on the corporation's shareholders must be an individual residing on or operating the farm or ranch. If a limited liability company, the governors and mangers of the limited liability company must be members who are actively engaged in operating the farm or ranch and at least one of its members must be an

land to a farming operation, by which they are also employed, they will likely incur self-employment tax on the rental income they receive.[4] Whether rental income is subject to self-employment tax is an important consideration for landowners because it is a tax on self-employment income in addition to the standard federal income tax.[5]

Part II of this Note discusses the statutory language of the Internal Revenue Code as it relates to farm rental income and the imposition of the self-employment tax. Part III examines cases from the United States Tax Court, which illustrate the development of the current tax policy. Finally, Part IV demonstrates the failure of the current policy to recognize that a farmer may "wear more than one hat" by playing the distinctive roles of an employee, a landowner, and a shareholder of a farming operation.

II. THE INTERNAL REVENUE CODE

To understand when rental income is considered earnings from self-employment and when it is not, it is helpful to start by examining the language of the Internal Revenue Code, as well as Treasury Regulations. The intent of Congress in adopting the current language of the Code must also be considered.

A. STATUTORY LANGUAGE AND TREASURY REGULATIONS

A farmer's income from farming is subject to self-employment income tax in addition to all other applicable taxes.[6] Section 1402 of the Internal Revenue Code (Code) defines net earnings from self-employment and explicitly excludes most income received from the rental of real estate, such as when an owner of farmland rents his or her land to a farmer so that the land may be used for agricultural production.[7] As a general rule, farm rental income is not subject to the additional self-employment tax.[8] However, if the farm rental income meets certain

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individual residing on or operating the farm or ranch.

7. An annual average of at least sixty-five percent of the gross income of the corporation or limited liability company over the previous five years, or for each year of its existence, if less than five years, must have been derived from farming or ranching operations.
8. The income of the corporation or limited liability company from nonfarm rent, nonfarm royalties, dividends, interest, and annuities cannot exceed twenty percent of the gross income of the corporation or limited liability company.

4. *See* I.R.C. § 1402(a)(1) (1994).

5. *See* 1999 Instructions for Schedule SE, Self-Employment Tax. The self-employment tax is a Social Security and Medicare tax for individuals who work for themselves. *See* I.R.S. Publication 225, Farmer's Tax Guide, at 78 (1999).

6. *See* I.R.C. § 1401 (1994). Self-employment income consists of the net earnings derived by an individual from a trade or business carried on by the individual as a sole proprietor or by a partnership of which the individual is a member. *See* Treas. Reg. § 1.1401-1(c) (as amended in 1974).

7. *See* I.R.C. § 1402(a)(1).

8. *See id.*

requirements, an exception to the exclusion is triggered and the income is subject to the self-employment tax.[9] The exception to the exclusion of real estate rental income from self-employment taxation is referred to as "includible farm rental income."[10]

To meet the definition of "includible farm income," farm rental income must meet a two-part test.[11] First, the income must be derived "under an arrangement between the owner or tenant of land and another person."[12] This arrangement must provide that the other person shall produce agricultural or horticultural commodities on the land.[13] In addition, the first step requires that the owner or tenant materially participate in the production or the management of the production of agricultural or horticultural commodities.[14] The arrangement may be either oral or written.[15] The second part of the test requires that there be material participation by the owner or tenant in the production of commodities.[16]

Thus, for rental income received by an owner or tenant of land to be treated as includible farm rental income for self-employment taxation purposes, "such income must be derived pursuant to a share-farming or other rental arrangement which contemplates material participation by the owner or tenant in the production of agricultural or horticultural commodities."[17] The specific text of section 1402(a)(1) of the Code excluding rental income from self-employment earnings except certain farm rentals provides:

> [T]here shall be excluded rentals from real estate and from personal property leased with the estate (including such rentals paid in crop shares) together with the deductions attributable thereto, unless such rentals are received in the course of a trade or business as a real estate dealer; except that the preceding provisions of this paragraph shall not apply to any income derived by the owner or tenant of land if (A) such income is derived under an arrangement, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities (including livestock, bees, poultry, and fur-bearing animals and

9. *See id.*; Treas. Reg. § 1.1402(a)-4(b)(1) (as amended in 1980).
10. Treas. Reg. § 1.1402(a)-4(b)(1).
11. *See id.*
12. *Id.* § 1.1402(a)-4(b)(1)(i).
13. *See id.* Examples of agricultural or horticultural commodities include: livestock, bees, poultry, and fur-bearing animals, and wildlife. *See* I.R.C. § 1402(a)(1) (1994).
14. *See* Treas. Reg. § 1.1402(a)-4(b)(1)(i).
15. *See id.* § 1.1402(a)-4(b)(3)(i).
16. *See id.* § 1.1402(a)-4(b)(1)(ii).
17. *Id.* § 1.1402(a)-4(b)(2).

> wildlife) on such land, and that there shall be material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) in the production or the management of the production of such agricultural or horticultural commodities, and (B) there is material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) with respect to any such agricultural or horticultural commodity . . . .[18]

The Code may impose a self-employment tax on rental income that may not have been anticipated.[19] For example, in its current application, the law could impose a tax on rental income that a retired farmer receives from a child to whom the retired farmer passed his operation, simply because the retired farmer helped the child in the operation.[20]

The Code and the Treasury Regulations also appear to indicate that a shareholder in a family farm corporation, who individually owns land and rents it to the corporation, may be required to pay self-employment tax on the rental income if the shareholder materially participates in the corporation's operations.[21] The same could hold true for a farm laborer who owns land that the laborer rents to the employer, because, as an employee, the laborer would be materially participating in the production of commodities on the land.[22] Thus, farm rental income may be taxed differently depending upon the arrangement between the farmland owner and the renter and the level of participation by the landowner.[23]

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18. I.R.C. § 1402(a)(1). Consider this hypothetical which illustrates the law:

> E owns a grain farm and turns its operation over to his son, F. By the oral rental arrangement between E and F, the latter agrees to produce crops of grain on the farm, and E agrees that he will be available for consultation and advice and will inspect and help to harvest the crops. E furnishes most of the equipment, including a tractor, a combine, plows, wagons, drills, and harrows; he continues to live on the farm and does some of the work such as repairing barns and farm machinery, going to town for supplies, cutting weeds, etc.; he regularly inspects the crops during the growing season; and he helps F to harvest the crops. Although F makes the final decisions, he frequently consults with his father regarding the production of the crops. An evaluation of all of E's actual activities indicates that they are sufficiently substantial and regular to support a conclusion that he is materially participating in the crop production operations and the management thereof. If it can be shown that the degree of E's actual participation was contemplated by the arrangement, E's income from the grain farm will be included in computing net earnings from self-employment.

Treas. Reg. § 1.1402(a)-4(b)(6), Example (3).

19. *See* I.R.C. § 1402(a)(1).

20. *See* Treas. Reg. § 1.1402(a)-4(b)(6), Example (3).

21. *See* I.R.C. § 1402(a)(1); Treas. Reg. § 1.1402(a)-4(b)(1).

22. *See* I.R.C. § 1402(a)(1); Treas. Reg. § 1.1402(a)-4(b)(1).

23. *See* I.R.C. § 1402(a)(1); Treas. Reg. § 1.1402(a)-4(b)(1).

This concept seems illogical, and the few cases that have been decided on the issue of self-employment taxation of farm rental income have done little to clarify the dividing line between which rental arrangements trigger taxation and which do not.[24] The language of the Code may be interpreted to require inclusion of rental income in determining self-employment income whenever the landowner has participated in the production of agricultural commodities with the renter.[25] Unfortunately, the legislative history of section 1402(a)(1) does not indicate whether Congress ever contemplated that owners of farmland would become employed by their renters.[26]

B. LEGISLATIVE HISTORY OF INTERNAL REVENUE CODE SECTION 1402(A)(1)—TAX ON SELF-EMPLOYMENT INCOME

The provision excepting includible farm income from the exclusion of rentals from self-employment income was adopted in 1956 and remains the same today.[27] This provision was part of a bill that contained amendments to the Social Security Act[28] and the Internal Revenue Code of 1954.[29] The purpose of the bill was to improve the Social Security Act.[30] However, the reason for including certain farm rentals in determining self-employment is unclear.[31] The Senate Finance Committee was of the opinion that the amendment covered participation when the landowner consults with the renter concerning the production of the commodities and periodically inspects the production activities on the land, thus these types of activities would result in the income being included.[32] The committee also defined material participation by the owner to include furnishing the renter with a "substantial portion of the machinery, implements, and livestock used in the production of the commodities" or assuming financial responsibility for a substantial part of the expense involved in the production of the commodities.[33] No

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24. *See e.g.*, Wuebker v. Commissioner, 110 T.C. 431, 439 (1988) (holding that payments received under the conservation reserve program are not subject to self-employment tax), *rev'd*, 205 F.3d 897 (6th Cir. 2000).

25. *See* I.R.C. § 1402(a)(1).

26. *See* Social Security Amendments of 1956, S. REP. No. 84-2133 (1956), *reprinted in* 1956 U.S.C.C.A.N. 3877, 3930-31.

27. *See* Act of Aug. 1, 1956, ch. 836, tit. II, § 201(e)(2), 1956 U.S.C.C.A.N. (70 Stat. 840) 3930-31.

28. Act of Aug. 14, 1935, ch. 531, 49 Stat. 620 (1935).

29. S. REP. No. 84-2133 (1956), *reprinted in* 1956 U.S.C.C.A.N 3877, 3877.

30. *See id.* at 3877. The Social Security Act was intended "to provide partial protection against loss of earned income upon the retirement or death of a worker." *Id.*

31. *See generally* S. REP. No. 84-2133 (1956), *reprinted in* 1956 U.S.C.C.A.N. 3877, 3877.

32. *See id.* at 38, 1956 U.S.C.C.A.N. at 3930.

33. *Id.* at 3930-31. This did not, however, include labor expense. *See id.*

further information or guidance is provided in the legislative history concerning the purpose for including some farm rentals in determining self-employment income and not including others.[34]

The language of the Code indicates that a self-employment tax may be imposed on rental income received when the landowner has arranged to participate in the production of agricultural commodities.[35] The Code does not include the Senate Finance Committee's definition of what constitutes material participation.[36] The legislative history of section 1402 states that material participation may include investment on the part of the landowner, but it does not provide any guidance beyond this.[37] The United States Tax Court was faced with these issues in 1995.[38]

III. CASE LAW

The cases resolving the imposition of self-employment tax to farm rental income indicate that the term "arrangement" refers to the overall scheme of a farming operation.[39] Furthermore, the receipt of wages in exchange for participation in the production of agricultural commodities is immaterial in determining whether an arrangement exists.[40] Any participation on the part of a farming corporation's shareholder will likely be deemed material participation, and any rent the shareholder receives from the farming corporation will be subject to self-employment tax.[41]

A. *MIZELL V. COMMISSIONER*

The first case which addressed this issue was *Mizell v. Commissioner*.[42] The taxpayers, the Mizells, were farmers; Lee Mizell had farmed for most of his adult life.[43] Mizell had purchased various pieces of land in Arkansas over several years and had initially farmed the land

34. *See generally id.*, 1956 U.S.C.C.A.N. at 3877.
35. *See* I.R.C. § 1402(a)(1) (1994).
36. *See id.*
37. *See* S. REP. NO. 84-2133 (1956), *reprinted in* 1956 U.S.C.C.A.N. 3877, 3930-31.
38. *See* Mizell v. Commissioner, 70 T.C.M. (CCH) 1469 (1995).
39. *See id.* at 1472; *see also* McNamara v. Commissioner, 78 T.C.M. (CCH) 530, 532 (1999); Hennen v. Commissioner 78 T.C.M. (CCH) 445, 447 (1999); Bot v. Commissioner, 78 T.C.M. (CCH) 220, 222 (1999).
40. *See Hennen*, 78 T.C.M. (CCH) at 447; *see also Bot*, 78 T.C.M. (CCH) at 223 (1999).
41. *See McNamara*, 78 T.C.M. (CCH) at 533.
42. 70 T.C.M. (CCH) 1469 (1995).
43. *See* Mizell v. Commissioner, 70 T.C.M. (CCH) 1469, 1470 (1995).

as a sole proprietor.[44] In 1986, Mizell formed Mizell Farm, a partnership, with his three sons.[45] The purpose of the partnership was to act as a farming operation, and the partnership agreement provided that each of the partners would have an equal voice in the management of the partnership.[46] The agreement also required that each partner devote his full time and attention to the partnership.[47] In accordance with the partnership agreement, Mizell made management decisions, acquired operating capital, and contributed physical labor to the farming operation.[48] Mizell included his individual distributive share of the partnership's income as net earnings from self-employment on his federal income tax returns.[49]

On January 1, 1988, Mizell entered into a series of leases whereby he leased his individually owned farmland to Mizell Farm in return for a one-quarter crop share.[50] Mizell and his sons farmed the leased property and produced cotton, rice, and soybeans as partners of Mizell Farm.[51] The partnership was responsible for all of the expenses relating to the production and harvest of crops on the leased land.[52] Mizell received rental income from the leases based upon the sales of the crops by the partnership.[53] Mizell included the money from his rentals as individual income, but he did not include them in determining his self-employment income.[54] The Commissioner determined deficiencies in Mizell's federal income taxes in the amounts of $160, $3,624, and $3,343, in 1988, 1989, and 1990, respectively.[55]

Mizell and the Commissioner stipulated that the leases provided for the production of agricultural products on the property by the partnership, that agricultural products were produced on the property by the partnership, and that Mizell had materially participated in the production of the agricultural products.[56] Moreover, Mizell did not dispute that he was obligated to materially participate in the production of agricultural products on his property as a member of the partnership.[57] Mizell's sole

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44. *See id.*
45. *See id.*
46. *See id.*
47. *See id.*
48. *See id.*
49. *See id.*
50. *See id.*
51. *See id.*
52. *See id.*
53. *See id.*
54. *See id.*
55. *See id.*
56. *See id.* at 1471. Mizell's wife was also a taxpayer in the case, because she had filed a joint tax return with her husband. *See id.* at 1470.
57. *See id.* at 1471.

contention was that the rental arrangement itself did not provide for material participation by him personally with respect to the production of agricultural products, but rather as a partner of Mizell Farm, meaning the rental income could not be considered self-employment income.[58] The Commissioner disagreed, arguing that the arrangement did provide for Mizell's material participation.[59]

Mizell asserted that the term "arrangement," as stated in the Code, referred only to a single contract, that being the rental agreement.[60] The Commissioner, on the other hand, contended that the term "arrangement" should be construed to take into account the entire understanding between Mizell and his sons concerning the farming operations and their partnership agreement.[61] The Commissioner further argued that the arrangement between Mizell and his sons obligated Mizell to materially participate in the production of agricultural products on the property, therefore, subjecting Mizell's rental income to self-employment taxation.[62]

The Commissioner's view was accepted by the Tax Court, which examined Mizell's whole relationship with the partnership in reaching its decision.[63] The Tax Court reasoned that "Congress had recognized a distinction between a contract and the broader concept of an arrangement, as is evident from those sections of the Internal Revenue Code that make reference to both."[64] The Tax Court found that Mizell and his sons contemplated that Mizell was required to materially engage in the physical work related to the production of crops on his property.[65] Accordingly, the Tax Court held that the rental income from the agricultural leases was includible in Mizell's net earnings from self-employment and subject to the self-employment tax.[66]

While Lee Mizell treated the partnership as a separate entity, as demonstrated by his rental agreement with Mizell Farm, the Tax Court saw no distinction between agreements with partnerships and individual

58. *See id.* For rentals to be includible in determining self-employment income, the rental arrangement must require material participation. *See* I.R.C. § 1402(a)(1)(A) (1994). However, the term "arrangement" is undefined. *See id.* Mizell's position was that while the partnership required his material participation, his rental arrangement did not. *See* Mizell v. Commissioner, 70 T.C.M. (CCH) 1469, 1471 (1995).

59. *See id.*

60. *See id.*; *see also* I.R.C. § 1402(a)(1)(A) (1994).

61. *See Mizell*, 70 T.C.M. (CCH) at 1471.

62. *See id.*; *see also* I.R.C. § 1402(a)(1).

63. *See Mizell*, 70 T.C.M. (CCH) at 1472.

64. *Id.* at 1471-72. See, for example, section 4003(d) of the Internal Revenue Code, which includes the words "In the case of a contract, sale, or arrangement."

65. *See Mizell*, 70 T.C.M. (CCH) at 1472.

66. *See id.*

farmers.[67] Thus, Lee Mizell's material participation as a partner of Mizell Farm was sufficient to trigger the individual self-employment tax.[68] Moreover, the *Mizell* decision established that an "arrangement" might be inferred from the entire relationship of a renter with the landowner rather than restricting it to the language of the agreement.[69] *Mizell's* holding provided the basis for the decision in *Bot v. Commissioner*.[70]

B. *BOT V. COMMISSIONER*

The taxpayers in *Bot* were a married couple, Vincent and Judy Bot, who had farmed for approximately thirty-eight years.[71] Vincent operated a 460-acre crop and livestock farm in Minnesota as a sole proprietorship.[72] Vincent owned 160 acres of the farm and rented 360 acres; of this, 240 acres of farmland were rented from Judy under a cash rental agreement at $90 per acre, resulting in a rental payment of $21,600 per year.[73] Judy had inherited one-eighth of the farmland she owned from her parents and purchased the rest from her siblings around 1974.[74] Judy owned the farmland in her own name and entered into an oral agreement with Vincent to lease the farmland.[75]

From the time Vincent and Judy began farming, Judy had performed a number of duties in connection with the operation.[76] Her work included caring for the pigs, operating machinery in the yard and in the field, along with harvesting and bailing crops.[77] Judy also hauled grain to the bins during harvest and drove to town to purchase parts and supplies.[78] These duties equated to approximately 1,862 hours of work on the farm each year.[79] When Judy and Vincent entered into the oral rental agreement, they expected that Judy would continue the duties she had been performing on behalf of the farming operation.[80]

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67. *See generally Mizell*, 70 T.C.M. (CCH) at 1470-72.
68. *See id.*
69. *See id.*
70. 78 T.C.M. (CCH) 220 (1999).
71. *See* Bot v. Commissioner, 78 T.C.M. (CCH) 220, 221 (1999).
72. *See id.*
73. *See id.*
74. *See id.*
75. *See id.*
76. *See id.*
77. *See id.*
78. *See id.*
79. *See id.*
80. *See id.*

In 1992, Judy entered into a purported employment agreement with Vincent.[81] The employment agreement stated that Judy "was to perform various farming services, including raising livestock, operating machinery, and picking up supplies."[82] Essentially, the employment agreement memorialized the same duties that Judy had already been performing since she and Vincent began farming.[83]

For the years at issue, the Bots filed their Forms 1040 income tax returns on a married, filing jointly basis.[84] On their Schedules E (Supplemental Income and Loss),[85] the Bots reported that Judy received net rental income in the amounts of $17,825, $18,079, and $18,211 in 1993, 1994, and 1995 respectively.[86] On line 7 of their Forms 1040,[87] the Bots reported that Judy received wages in the amounts of $15,074, $15,165, and $15,296 for 1993, 1994, and 1995 respectively.[88] The Commissioner determined that the real estate rental payments Judy received from Vincent were includible in her net earnings from self-employment under Code section 1402(a)(1) and, therefore, subject to the self-employment tax.[89]

Vincent and Judy contended that the oral lease agreement did not require material participation by Judy in the farming operations.[90] They further asserted that the rental income Judy received from Vincent was rental from real estate, and consequently, it should be excluded in determining whether Judy had any net earnings from self-employment.[91] The issue before the Tax Court was whether or not Judy "received rental income from [Vincent] pursuant to an 'arrangement' between the parties to produce agricultural commodities on the farm within the meaning of section 1402(a)(1)(A)" of the Code.[92]

The parties entered into a stipulation which stated that the farmland rented from Judy was to be used for agricultural production.[93] Thus, the

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81. *See id.*

82. *Id.*

83. *See id.* The employment agreement also stated that Judy may participate in her husband's medical insurance and medical reimbursement plans. *See id.*

84. *See id.* The years in issue were 1993, 1994, and 1995. *See id.*

85. Schedule E is used to report income or loss from rental real estate. *See* 1999 Instructions for Schedule E, Supplemental Income and Loss.

86. *See* Bot v. Commissioner, 78 T.C.M. (CCH) 220, 221 (1999).

87. Line 7 is used to report income from wages, salaries, and tips. *See* 1999 Instructions for Form 1040, at 20.

88. *See Bot*, 78 T.C.M. (CCH) at 221.

89. *See id.* at 221-22.

90. *See id.* at 222.

91. *See id.*

92. *Id.*

93. *See Bot*, 78 T.C.M. (CCH) at 222. This met the first part of the two-part test to be includible farm rental income, which requires that the renter produce agricultural commodities. *See* I.R.C. § 1402(a)(1)(A).

only question for resolution was whether or not the arrangement required Judy to materially participate in the farming operation.[94] In deciding this issue, the Tax Court not only examined the obligations imposed upon Judy by the oral lease, but also those obligations existing in the overall scheme of the farming operations on Judy's farmland.[95] The Tax Court considered Judy's duties as a "longstanding participant" in the farming operation.[96] The Tax Court also examined the "general understanding" between Judy and Vincent regarding the production of agricultural products.[97] Based upon these factors, the Tax Court held that "the arrangement between [Judy and Vincent either] provided [for], or contemplated, that [Judy] would materially participate in the production of agricultural commodities on the [leased] farmland."[98]

The Tax Court arrived at this decision despite Vincent's claim that he made all the management decisions and that he could operate his farming operation without the help of his wife.[99] The Tax Court indicated that it was not required to accept Vincent's "self-serving testimony . . . as gospel."[100] The Tax Court found that the record supported a finding that Judy played a material role in the production of agricultural commodities under an arrangement with Vincent.[101]

The Tax Court relied on the evidence that throughout the thirty-eight years Vincent and Judy had farmed, Judy "performed general farming services on the farm on a regular and intermittent basis."[102] The Tax Court noted that Judy undisputedly worked approximately 1,862 hours per year on the farm, farrowing and caring for their swine, operating farm machinery, harvesting and bailing crops, and picking up supplies on a semiweekly basis.[103] The Tax Court determined that Judy's receipt of salary for her services, with a corresponding deduction taken on the Bots' tax returns, was immaterial.[104] It was the opinion of

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94. *See Bot*, 78 T.C.M. (CCH) at 222. This refers to the second part of the test, requiring that the landowner materially participate in the production as required by the arrangement. *See* I.R.C. § 1402(a)(1)(A), 1402(a)(1)(B).

95. *See Bot*, 78 T.C.M. (CCH) at 222 (citing Mizell v. Commissioner, 70 T.C.M. (CCH) 1469, 1472 (1995), which determined that "arrangement" referred to the "overall scheme" of the farming operations).

96. *See id.*

97. *See id.* at 222-23 (citing *Mizell*, 70 T.C.M (CCH) at 1472, which stated that an arrangement may be inferred by the "general understanding" between the parties).

98. *Id.* at 223.

99. *See id.*

100. *Id.* (citing Tokarski v. Commissioner, 87 T.C. 74, 77 (1986), which stated that the Tax Court was not required to accept the self-serving testimony of the taxpayer and his mother that a $30,000 bank deposit was not earned as taxable income).

101. *See id.*

102. *Id.*

103. *See id.*

104. *See id.* The Tax Court does not explain why Judy's salary was immaterial. *See id.*

the Tax Court that Judy would have continued to do the same farming jobs even if there had been no employment agreement.[105] The Tax Court further found that the services Judy regularly performed were material to the production of an agricultural commodity and the intermittent services which Judy performed were material to related production operations.[106] Accordingly, the Tax Court held that the rental income Judy received from Vincent was includible farm rental income that was part of Judy's net earnings from self-employment, making it taxable as such.[107]

Bot reaffirmed the Tax Court's view that "arrangement" is broadly defined as an overall relationship.[108] Moreover, it established that receipt of wages through an employment agreement is immaterial in determining whether the landowner materially participated in the production of agricultural commodities pursuant to an arrangement with the renter.[109] Following *Bot*, the Tax Court heard *Hennen v. Commissioner*,[110] a case nearly identical in facts, issue, and holding.[111]

Presumably, it is because there is no mention of salary in section 1402(a)(1) of the Code.

105. *See id.*

106. *See* Bot v. Commissioner, 78 T.C.M. (CCH) 220, 223 (1999) (quoting Treas. Reg. § 1.1402(a)-4(b)(6), Example (1)). Notice the similarity between this case and the following hypothetical from the Treasury Regulations:

> After the death of her husband, Mrs. A rents her farm, together with its machinery and equipment, to B for one-half of the proceeds from the commodities produced on such farm by B. It is agreed that B will live in the tenant house on the farm and be responsible for the over-all operation of the farm, such as planting, cultivating, and harvesting the field crops, caring for the orchard and harvesting the fruit and caring for the livestock and poultry. It also is agreed that Mrs. A will continue to live on the farm residence and help B operate the farm. Under the agreement it is contemplated that Mrs. A will regularly operate and clean the cream separator and feed the poultry flock and collect the eggs. When possible she will assist B in such work as spraying the fruit trees, penning livestock, culling the poultry, and controlling weeds. She will also assist in preparing the meals when B engages seasonal workers. The agreement between Mrs. A and B clearly provides that she will materially participate in the overall production operations to be conducted on her farm by B. In actual practice, Mrs. A performs such regular and intermittent services. The regularly performed services are material to the production of an agricultural commodity, and the intermittent services performed are material to the production operations to which they relate. The furnishing of a substantial portion of the farm machinery and equipment also adds support to a conclusion that Mrs. A has materially participated. Accordingly, the rental income Mrs. A receives from her farm should be included in net earnings from self-employment.

Treas. Reg. § 1.1402(a)-4(b)(6), Example (1). Also note, however, that unlike Judy Bot, Mrs. A was not compensated for her services by wages, thus making a stronger case that the rental arrangement between Mrs. A and B was partly based upon Mrs. A agreeing to provide services. *See id.* The Tax Court does not explain why Judy's salary was immaterial, apparently seeing no difference between Judy and Mrs. A. *See Bot*, 78 T.C.M. (CCH) at 223.

107. *See Bot*, 78 T.C.M. (CCH) at 223.

108. *See id.* at 222-23.

109. *See id.* at 223.

110. 78 T.C.M. (CCH) 445 (1999).

111. *See generally* Hennen v. Commissioner, 78 T.C.M. (CCH) 445 (1999).

C. *HENNEN V. COMMISSIONER*

John and Teresa Hennen farmed for thirty-eight years raising cattle, hogs, corn, soybeans, alfalfa, and wheat in Minnesota, on an 1,100-acre farm they operated as a sole proprietorship.[112] John owned approximately 320 acres of the farm and rented the rest, including 200 acres of farmland he rented from Teresa.[113] Under an oral agreement, John paid Teresa $80 an acre, an amount comparable to that which he paid to others from whom he rented land.[114] John used the land he rented from Teresa to produce agricultural commodities, such as livestock and crops, as part of the farming operations.[115]

Teresa owned the 200 acres in her own name, having purchased the land from her uncle in 1972.[116] Teresa deposited the rent she received from her husband John into her own bank account, which was separate from his account.[117] When John and Teresa entered into the oral rental agreement, they expected that Teresa would continue to perform the various duties she had previously been performing in the farming operations.[118] For example, Teresa bought, loaded, and vaccinated cattle.[119] She also cleaned the shop, sprayed weeds, picked up parts, unloaded grain, drove a tractor, and performed the farm bookkeeping.[120] Teresa worked approximately 1,000 hours per year on the farm; however, she did not participate in making decisions concerning the type of crop to plant or any other management decisions.[121] The management decisions were made solely by John.[122]

For the years in issue, Teresa and John had also entered into an employment agreement, which provided that Teresa would perform bookkeeping tasks, run errands for the farming business, and help with livestock chores and fieldwork.[123] Effectively, the employment

112. *See id.* at 445.
113. *See id.*
114. *See id.*
115. *See id.*
116. *See id.*
117. *See id.* at 446.
118. *See id.* Since John and Teresa began farming, Teresa had done various jobs connected to the farming operations. *See id.*
119. *See id.*
120. *See id.*
121. *See id.*
122. *See id.*
123. *See id.* The years in issue were 1994, 1995, and 1996. *See id.*

agreement provided wages for the same duties Teresa had already been performing.[124]

The Commissioner contended that the real estate rental payments Teresa received from John were includible in Teresa's net earnings from self-employment and subject to the self-employment tax.[125] The Hennens argued that the oral lease agreement did not require material participation by Teresa in the farming operations.[126] They also asserted that the rental income Teresa received should be excluded in determining whether Teresa had any net earnings from self-employment.[127]

However, the Tax Court again considered the overall scheme of the farming operations, and determined that the arrangement between John and Teresa provided for or contemplated that Teresa materially participate in the production of agricultural commodities on the farmland.[128] The Tax Court determined that Teresa would have continued to do the same farming duties even if there had been no employment agreement.[129] As in *Bot*, the Tax Court deemed it immaterial that Teresa was paid a salary for her services, and that a corresponding deduction had been taken on their tax returns.[130] Accordingly, because the Hennens produced agricultural commodities and Teresa materially participated in that production, her rental income was taxed as self-employment income.[131]

The *Hennen* decision did not create any new law, but it did reaffirm *Bot*'s holding[132] that an arrangement includes the overall relationship

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124. *See id.* The employment agreement also stated that Teresa could participate in her husband's health and accident insurance plan, according to the terms and provisions of that plan. *See id.*

125. *See id.* John and Teresa filed their Forms 1040 income tax returns on a married, filing jointly basis. *See id.* On their Schedules E, Supplemental Income and Loss, they reported that they received net rental income in the amounts of $14,322, $12,940, and $12,766 in 1994, 1995, and 1996 respectively, for "FARM AND HOUSE," "FARMS" AND "FARMS," respectively. *See id.* On Line 7, Wages, salaries, tips, etc., of their Forms 1040, John and Teresa reported that Teresa had received wages in the amounts of $3,137.11, $3,250, and $3,487 for 1994, 1995, and 1996 respectively, and, in 1994, they also reported that Teresa received wages from World Book, Inc. in the amount of $221.45. *See id.* The amounts deducted as labor hired on the respective Schedules F, Profit or Loss From Farming, for the three years in issue exceeded the amounts purportedly paid to Teresa. *See id.* John failed to withhold federal income taxes, state income taxes, Federal Insurance Contribution Act taxes, and Medicare taxes for all three years in issue. *See id.*

126. *See id.* at 447.

127. *See id.*

128. *See id.* (citing Mizell v. Commissioner, 70 T.C.M. (CCH) 1469, 1472 (1995)). Thus, the rental income met the first part of the two-part test; the rental arrangement provided for the material participation of the landowner in the production of agricultural commodities. *See* I.R.C. § 1402(a)(1)(A) (1994).

129. *See* Hennen v. Commissioner, 78 T.C.M. (CCH) 445, 446 (1999).

130. *See id.* at 447; *see also* Bot v. Commissioner, 78 T.C.M. (CCH) 220, 223 (1999).

131. *See generally Hennen*, 78 T.C.M. (CCH) 445. Teresa's actual material participation met the second part of the two-part test. *See* I.R.C. § 1402(a)(1)(B) (1994).

132. *See Hennen*, 78 T.C.M. (CCH) at 448; *see also Bot*, 78 T.C.M. (CCH) at 223.

between the parties.[133] It also reaffirmed that the receipt of wages is immaterial in determining whether the landowner materially participated in producing agricultural commodities pursuant to an arrangement with the renter.[134] How the law applied specifically to farming corporations, as opposed to sole proprietorships or partnerships, would be addressed in *McNamara v. Commissioner*.[135]

D. *MCNAMARA V. COMMISSIONER*

McNamara addresses whether or not rental payments received from a family farm corporation by the owners of the corporation are includible in net earnings from self-employment.[136] In this case, the taxpayers were Michael and Nancy McNamara, a married couple.[137] Michael began farming in 1977 and operated the farm as a joint venture with Nancy until he incorporated the farm on January 17, 1992, as McNamara Farms.[138] Michael McNamara was the sole shareholder, officer, and director of McNamara Farms.[139] Throughout the year, McNamara Farms hired laborers as needed.[140] McNamara Farms operated on approximately 1,250 acres of farmland, all of which it rented from landlords.[141] One set of landlords was Michael and Nancy McNamara.[142]

McNamara Farms rented farmland and a house from Michael and Nancy through a "lease characterized as a Cash Rent Farm Lease."[143] Michael and Nancy owned the 460 acres equally as joint tenants.[144] McNamara Farms paid Michael and Nancy rent in the amounts of $45,620, $56,168, and $57,000 in 1993, 1994, and 1995 respectively.[145] The land was used by McNamara Farms to produce agricultural commodities.[146]

"On February 1, 1992, [Michael] entered into a purported Employment Agreement with McNamara Farms, signed by [him] as President

133. *See Hennen*, 78 T.C.M (CCH) at 447-48.
134. *See id.* at 447.
135. 78 T.C.M. (CCH) 530 (1999).
136. *See* McNamara v. Commissioner, 78 T.C.M. (CCH) 530 (1999).
137. *See id.* at 530-31.
138. *See id.* at 531.
139. *See id.*
140. *See id.*
141. *See id.*
142. *See id.*
143. *Id.*
144. *See id.*
145. *See id.*
146. *See id.*

[of McNamara Farms.]"[147] The employment agreement provided that Michael had certain duties and responsibilities as an employee, including: acting as the general manager of the business, performing field work, marketing the products, being responsible for the security of machinery and inventory, managing other employees, and performing such other usual and customary duties required by the agricultural production operation of McNamara Farms.[148] Effectively, the employment agreement required Michael to perform the same duties he had done since he began farming.[149] The employment agreement required "that any portion of compensation not paid in kind (e.g., grain crops) 'will be subject to required FICA, social security tax and income tax withholding.'"[150] The employment agreement further allowed Michael to participate in the McNamara Farms medical reimbursement plan and stated that he would be provided medical insurance for himself and his dependents.[151]

Nancy McNamara also entered into a purported employment agreement with McNamara Farms, signed by Michael McNamara as president, on February 1, 1992.[152] The employment agreement provided that Nancy was required to perform certain duties for the farming business, such as: bookkeeping, preparing of meals for employees, helping with field work, assisting in providing security for machinery and inventory, and such other usual and customary duties as may be delegated by the employer from time to time.[153] Nancy's duties under the employment agreement were essentially the same as those she had been performing since she and Michael began farming.[154] Nancy's employment agreement included the same provisions as Michael's concerning compensation subject to taxes and participation in a medical insurance plan.[155]

Michael and Nancy filed their Forms 1040 income tax returns as married individuals filing joint returns.[156] Michael listed his occupation as "farmer," and Nancy listed her occupation as "bookkeeper."[157] Michael and Nancy reported that they received net rental income on their Schedules E (Supplemental Income and Loss) in the amounts of

147. *Id.*
148. *See id.*
149. *See id.*
150. *Id.*
151. *See id.*
152. *See id.*
153. *See id.*
154. *See id.*
155. *See id.*
156. *See id.*
157. *See id.*

$19,180 in 1993, $24,442 in 1994, and $22,671 in 1995.[158] On line 7 of their Forms 1040, Michael and Nancy reported that they received wages in the amounts of $30,603 in 1993, $30,466 in 1994, and $31,252 in 1995.[159] They also reported earnings from McNamara Farms of $30,603 in 1993, $30,466 in 1994, and $31,252 in 1995.[160] However, McNamara Farms failed to withhold federal income taxes and state income taxes from Michael and Nancy's earnings, contrary to the terms of the employment agreements.[161]

The Commissioner noted deficiencies and determined that the "real estate rental payments [Michael and Nancy] received from McNamara Farms during the taxable years at issue were includible in [their] net earnings from self-employment under section 1402(a)(1), and thus[,] subject to self-employment tax income."[162] Michael and Nancy contended that the written lease agreement did not require material participation by them in the farming operations, which would indicate that the rentals from McNamara Farms were not self-employment income.[163] They further argued that the rentals should be excluded in determining net earnings from self-employment because the rental income was cash rent from real estate.[164]

The issue for determination was whether the rental income Michael and Nancy received from McNamara Farms was pursuant to an arrangement between the parties to produce agricultural commodities on the farm within the meaning of section 1402(a)(1)(A) of the Code.[165] The Tax Court had previously recognized that cash rental payments might be includible in self-employment income.[166] The Tax Court held that the arrangement between Michael and Nancy and McNamara Farms provided for or contemplated that Michael and Nancy materially participate in the production of agricultural commodities on the farmland, subjecting the rental income to self-employment tax.[167]

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158. *See id.*

159. *See id.*

160. *See id.* Michael's reported earnings were $28,019 and Nancy's reported earnings were $2,584 in 1993, $27,775 and $2,691 in 1994, and $28,561 and $2,691 in 1995. *See id.*

161. *See id.* McNamara Farms withheld FICA taxes and Medicare tax for all three years from their earnings. *See id.*

162. *Id.* The Commissioner divided the amounts equally between Michael and Nancy with respect to self-employment income and self-employment tax. *See id.* The Commissioner also allowed petitioners a deduction for one-half of the self-employment taxes imposed for the taxable years at issue. *See id.*

163. *See id.* at 532.

164. *See id.*

165. *See id.*

166. *See id.* (citing Hennen v. Commissioner, 78 T.C.M. (CCH) 445, 448 (1999); Bot v. Commissioner, 78 T.C.M. (CCH) 220, 223 (1999); Gill v. Commissioner, 70 T.C.M. (CCH) 120, 126 (1995)).

167. *See id.* at 533.

This decision was based in part on Michael's admission that his role was to operate the farm, make management decisions, and run the farm "from planting to harvest."[168] The Tax Court determined that Nancy's duties constituted sufficient material participation in the farming business, which meant the rental income that she received from McNamara Farms should be included in determining the amount of self-employment income.[169] The Tax Court concluded that Michael and Nancy "played a material role in the production of agricultural commodities under an arrangement with McNamara Farms" and that the rental income was, therefore, includible farm rental income subject to self-employment taxation.[170]

While the McNamaras contended that they were not required by the lease to materially participate in the farming business, the Tax Court found that they played a material role in the production of agricultural commodities under an arrangement with McNamara Farms.[171] It was immaterial that the farm operated as a corporation in determining whether the landowners had materially participated in the production of agricultural commodities.[172]

In both *Bot* and *Hennen*, the Tax Court found that there need not be an explicit agreement to constitute an arrangement requiring material participation by the landowner.[173] Furthermore, neither the blood or legal relationship between the parties nor whether the landowner received wages was considered material.[174] These decisions suggest that any type of work performed by the land owner in connection with the rented land will likely be deemed material participation and result in taxation of rental income as self-employment income.[175] The United States Tax Court recognized an exception to this generalization in *Wuebker v. Commissioner*.[176] However, *Wuebker* was reversed by the United States Court of Appeals for the Sixth Circuit.[177]

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168. *Id.*
169. *See id.*
170. *Id.*
171. *See id.*
172. *See generally id.*
173. *See id.* at 532-33; Hennen v. Commissioner, 78 T.C.M. (CCH) 445, 447 (1999); Bot v. Commissioner, 78 T.C.M. (CCH) 220, 222 (1999).
174. McNamara v. Commissioner, 78 T.C.M. (CCH) 530, 533 (1999); *Hennen*, 78 T.C.M. (CCH) at 447; *Bot*, 78 T.C.M. (CCH) at 223.
175. *See generally* McNamara, 78 T.C.M. (CCH) 530; *Hennen*, 78 T.C.M. (CCH) 445; *Bot*, 78 T.C.M. (CCH) 220.
176. 110 T.C. 431 (1998).
177. *See generally* Wuebker v. Commissioner, 205 F.3d 897 (6th Cir. 2000).

E. *WUEBKER V. COMMISSIONER*

The Tax Court's decision in *Wuebker* allowed farmers an opportunity to avoid self-employment taxation on payments under the Conservation Reserve Program.[178] However, the Tax Court's decision was reversed by the Sixth Circuit Court of Appeals.[179] The vast difference in reasoning used by the two courts warrants analysis of both opinions.

1. *The Tax Court's Decision*

The issue in *Wuebker* was whether payments received under the United States Department of Agriculture's (USDA) Conservation Reserve Program (CRP) were subject to self-employment income taxes.[180] The taxpayers were Fredrick J. Wuebker and his wife Ruth.[181] Fredrick had been farming for approximately twenty years prior to the years in issue.[182] The Wuebkers were joint owners of 258.67 acres of land, of which approximately 214 acres was tillable.[183] The Wuebkers' property contained hilly land that was prone to erosion, on which Fredrick had grown a variety of crops, including corn, soybeans, and wheat.[184] Fredrick also raised laying hens as part of his farming operations.[185]

In 1991, Fredrick and Ruth decided to enroll their tillable land in CRP.[186] The Wuebkers believed that participation in the CRP would increase the productivity of Fredrick's poultry operation by allowing him to devote more time and effort to it.[187] They also felt that participation in the CRP would be beneficial for their land.[188] Only an owner, operator, or tenant of eligible cropland may enter land into a CRP contract.[189] An operator must show that he or she will remain in control of such cropland for the duration of the CRP contract.[190] In November

178. *See* Wuebker v. Commissioner, 110 T.C. 431, 439 (1998), *rev'd*, 205 F.3d 897 (6th Cir. 2000).

179. *See Wuebker*, 205 F.3d at 905.

180. *See Wuebker*, 110 T.C. at 432.

181. *See id.* at 431.

182. *See id.* at 432. The years in issue were 1992 and 1993. *See id.*

183. *See id.* The non-tillable acres were made up of woods, waterways, and land containing improvements. *See id.*

184. *See id.* at 432.

185. *See id.* at 433.

186. *See id.* The United States Secretary of Agriculture is required to formulate and carry out the enrollment of certain lands in a conservation reserve program through the use of contracts to conserve and improve the soil and water resources of the lands. *See* 16 U.S.C. § 3831(a) (1994).

187. *See* Wuebker v. Commissioner, 110 T.C. 431, 433 (1998), *rev'd*, 205 F.3d 897 (6th Cir. 2000).

188. *See id.*

189. *See id.*

190. *See id.*

of 1991, a CRP contract was executed on behalf of the Commodity Credit Corporation (CCC),[191] which covered the Wuebkers 214 tillable acres (the CRP land).[192] Fredrick was listed on the CRP contract as the operator of the land and Ruth was listed as the owner of the land.[193] The contract provided that Fredrick was to receive 100 percent of the CRP payments.[194]

As required by the contract, Fredrick agreed to place the CRP land into the program for ten crop years.[195] Fredrick also consented "to implement the conservation plan which [wa]s part of the contract; to establish and maintain [a] vegetative cover; not to engage in or allow grazing, harvesting, or other commercial use of the crop from CRP land; and to control weeds, insects, and pests on the CRP land."[196] Under the contract, the CCC agreed to make annual rental payments to Fredrick at the rate of $85 per acre enrolled in the CRP and share the cost of establishing the conservation plan.[197] Representatives of the CCC had the right to access the CRP land and to examine Fredrick's records or other lands for the purpose of determining whether Fredrick was complying with the contract.[198]

The first year of the CRP contract term was 1992.[199] That year, Fredrick disced the CRP land and planted seed to establish ground cover.[200] Fredrick used the same equipment he had used previously in farming the CRP land.[201] In the years to follow, Fredrick performed minimal, if any, maintenance of the CRP land.[202]

In 1992, Fredrick received CRP payments in the amount of $18,190 and cost-share payments for establishing ground cover on the CRP land.[203] His CRP payments totaled $18,267 in 1993.[204] On Schedules E

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191. *See id.* The CRP contract is a form contract. *See id.* The Commodity Credit Corporation, which is an agency within the United States Department of Agriculture, was created for the purpose of stabilizing and supporting farm income prices. *See* 15 U.S.C. § 714 (1994).

192. *See Wuebker*, 110 T.C. at 433. To qualify for the CRP, the land was required to "[h]ave been annually planted or considered planted to an agricultural commodity in 2 of the 5 crop years, from 1986 to 1990," be highly erodible, and currently planted to an agricultural commodity. *Id.*

193. *See id.*

194. *See id.*

195. *See id.*

196. *Id.* The conservation plan included seeding recommendations for the CRP land and provided an estimated cost-share for the plan. *See id.* Once the conservation practices had been established, Fredrick was required to maintain such practices at no cost to the government. *See id.*

197. *See id.* at 433-34.

198. *See id.* at 434.

199. *See id.*

200. *See id.*

201. *See id.*

202. *See id.*

203. *See id.* The Secretary of Agriculture is required to share the cost of carrying out the conservation measures. *See* 16 U.S.C. § 3833(1) (1994).

204. *See* Wuebker v. Commissioner, 110 T.C. 431, 434 (1998), *rev'd*, 205 F.3d 897 (6th Cir.

of their tax returns for 1992 and 1993, the Wuebkers reported rents received on the CRP land as farm rental income not subject to self-employment taxes.[205] "For 1992, [the Wuebkers] included the cost-share payments received with respect to the CRP land on Schedule F, Profit or Loss from Farming."[206] The Wuebkers paid self-employment taxes with respect to their reported net profit from farming.[207]

The Commissioner argued that the amount received by Fredrick under the CRP contract was self-employment income subject to self-employment tax.[208] The Commissioner did not contend that the payments were includible farm rental income.[209] The Tax Court stated that the CRP payments likely did not fit into the exception to the exclusion under section 1402(a)(1)(A) and (B) of the Code.[210] The Tax Court determined that the CRP contract neither constituted an agreement to produce agricultural or horticultural commodities on the CRP land, nor was there in fact any actual production of such commodities on the CRP land.[211]

The Tax Court determined that rent is ordinarily defined as compensation for the occupancy or use of property.[212] The Wuebkers asserted that the CRP payments were "rent as the term is ordinarily defined," pointing out that both the CRP authorizing statute and the CRP contract used of the word "rental."[213] The Wuebkers argued that the intent of Congress was for the payments to be excluded from self-employment income because Congress is presumed to have known that rental income is excluded from self-employment income.[214] The Tax Court agreed with this argument.[215]

The Tax Court found that the primary purpose of the CRP contract was to convert highly erodible cropland to soil conserving uses.[216] In doing so, Fredrick was required to perform services, including maintaining the vegetative cover, controlling weeds and insects on the land, and fulfilling reporting requirements.[217] The Tax Court held that these

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2000).

205. *See id.*

206. *Id.*

207. *See id.* at 434-35.

208. *See id.* at 435.

209. *See id.* at 436.

210. *See id.* For income to be includible farm rental income, there must be an arrangement between the renter and the landowner to produce agricultural commodities. *See* I.R.C. § 1402(a)(1)(A) (1994).

211. *See* Wuebker v. Commissioner, 110 T.C. 431, 436 (1998), *rev'd*, 205 F.3d 897 (6th Cir. 2000).

212. *See id.* (citing Treas. Reg. § 1.61-8(a); BLACK'S LAW DICTIONARY 1297 (6th ed. 1990)).

213. *Id.* at 437.

214. *See id.*

215. *See id.*

216. *See id.* at 438.

217. *See id.*

service obligations were not substantial, but rather only incidental to the primary purpose of the contract.[218] Therefore, the Tax Court concluded that the CRP payments were not compensation for Fredrick's labor, but only for the use restrictions placed on the land by the CRP contract.[219] Accordingly, the CRP payments were rentals from real estate within the meaning of section 1402(a)(1) of the Code and excluded from Fredrick's earnings from self-employment.[220]

The Commissioner contended that the CRP program was intertwined with Fredrick's farming operation and that the CRP payments were still includible as earnings from self-employment.[221] However, the Tax Court held that because the CRP payments were rentals from real estate under section 1402(a)(1) of the Code, the payments were not includible as earnings from self-employment, regardless of whether they were derived from Fredrick's farming operations.[222] The Tax Court quoted part of Treasury Regulation 1.1402(a)-4(d) to support its rationale:

> Except in the case of a real-estate dealer, where an individual or a partnership is engaged in a trade or business the income of which is classifiable in part as rentals from real estate, only that portion of such income which is not classifiable as rentals from real estate, and the expenses attributable to such portion, are included in determining net earnings from self-employment.[223]

In summary, the Tax Court in *Wuebker* ruled that the CRP payments were not subject to self-employment taxation because they were characterized as rentals from real estate.[224] Moreover, the CRP payments were not includible farm rental income, as the CRP contract was not deemed an agreement to produce agricultural commodities.[225]

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218. *See id.*
219. *See id.*
220. *See id.*
221. *See id.* at 438.
222. *See id.* at 438-39.
223. *Id.* at 438. In making its decision, the Tax Court distinguished *Ray v. Commissioner*, 72 T.C.M. (CCH) 780 (1996), where the Tax Court held that payments received by an active farmer from the CRP were subject to self employment tax, but never addressed whether such payments were rentals from real estate. *See* Wuebker v. Commissioner, 110 T.C. 431, 439 (1998) (citing *Ray*, 72 T.C.M. (CCH) at 781), *rev'd*, 205 F.3d 897 (6th Cir. 2000).
224. *See id.* at 439.
225. *See id.* at 436.

2. *The Sixth Circuit's Reversal*

The Sixth Circuit Court of Appeals' opinion stated that this case hinged on whether the CRP payments were determined to be farm income or rental income.[226] According to the Sixth Circuit, the Tax Court failed to expressly conclude whether the CRP payments constituted self-employment income.[227] The Sixth Circuit further stated that the Tax Court, by proceeding directly to an analysis of whether the CRP payments fell within the rentals-from-real-estate exclusion, implied that the payments would be taxable as self-employment income if the exclusion did not apply.[228] The Sixth Circuit then agreed with the Commissioner's contention that a sufficient nexus existed between the CRP payments and the Wuebkers' farming operations.[229]

The Sixth Circuit then went on to find that the nature of the CRP payments indicated that they did not fall within the rentals-from-real-estate exclusion for determining self-employment income.[230] Just as the Tax Court had done, the Sixth Circuit found that rent was the "[c]onsideration paid . . . for the use or occupancy of property."[231] The Sixth Circuit determined, however, that the Department of Agriculture did not have the right to "occupy" or "use" the CRP land.[232] Because the government's access was limited to inspecting the property and determining whether the Wuebkers were in compliance with the contract, the Sixth Circuit stated that the Wuebkers continued to maintain control over and enjoy free access to the CRP land.[233] The Sixth Circuit Court thus reversed the decision of the Tax Court.[234]

As the case law illustrates, employees generally will be liable for self-employment taxes on rental income they receive from their employers who rent their land and run farming operations on the land.[235] If the landowner is an active participant in the operation, then the only

226. *See* Wuebker v. Commissioner, 205 F.3d 897, 901 (6th Cir. 2000).

227. *See id.*

228. *See id.* at 901-02.

229. *See id.* at 902 (citing Ray v. Commissioner, 72 T.C.M. (CCH) 780, 781 (1996) (holding that a substantial nexus exists between CRP payments and other farming operations)). Although the Tax Court held that *Ray* was inapplicable because it did not address whether CRP payments were rentals, the Sixth Circuit said that the Tax Court's view of *Ray* was unwarranted. *See id.* at 903.

230. *See id.*

231. *Id.* at 904 (quoting BLACK'S LAW DICTIONARY 1299 (7th ed. 1999)).

232. *See id.*

233. *See id.*

234. *See id.* at 905.

235. *See generally* McNamara v. Commissioner, 78 T.C.M. (CCH) 530 (1999); Hennen v. Commissioner, 78 T.C.M. (CCH) 445 (1999); Bot v. Commissioner, 78 T.C.M. (CCH) 220 (1999); Mizell v. Commissioner, 70 T.C.M. (CCH) 1469 (1995).

question is whether such participation was anticipated under the arrangement.[236] Even if the rental agreement between the farm employer and the farm employee did not require the farm employee to participate in the production of the commodities in any way, the courts may consider all other aspects of the relationship between the employee and the employer in determining whether material participation was anticipated under an arrangement between the parties.[237] Material participation can include such duties as operating farm equipment and caring for livestock.[238] Furthermore, although the landowner may be receiving wages as an employee, the receipt of wages is immaterial to the consideration of whether the rental income is includible as self-employment income.[239] Thus, the receipt of wages does not establish that the farmer is playing two distinctive roles of owner and employee of the farming business.[240]

Under the current law, there appears to be no circumstances where a landowner can escape paying self-employment tax on rental income when conducting some type of activity related to the farmland.[241] However, given the changes in agriculture such as the implementation of farming corporations and farmland owners seeking employment as farm laborers, this author contends that the tax policy should be changed to recognize the distinctive roles that a farmland owner may play in a farming operation.

IV. THE CURRENT POLICY FAILS TO RECOGNIZE THE DISTINCTIVE ROLES OF SHAREHOLDER, EMPLOYEE, AND LANDOWNER

Courts have held that when dealing with a corporation, a person who "wears two hats" within the corporate framework is not to be treated as wearing only one hat for tax purposes.[242] Courts have also recognized

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236. *See generally McNamara*, 78 T.C.M. (CCH) 530; *Hennen*, 78 T.C.M. (CCH) 445 (1999); *Bot*, 78 T.C.M. (CCH) 221; *Mizell*, 70 T.C.M 1469.

237. *See Mizell*, 70 T.C.M. (CCH) at 1471-72. Lee Mizell's rental agreement with Mizell Farm did not require that he participate in the farming operations. *See id.* at 1471. However, as a partner in Mizell farm, such an arrangement was inferred. *See id.* at 1472.

238. *See Bot*, 78 T.C.M. (CCH) at 221. Judy Bot provided general farming services, such as; raising pigs, mowing, moving snow, and dragging crops. *See id.*

239. *See id.* at 223.

240. *See id.* Judy Bot received wages for her services, but the Tax Court ruled that the receipt of wages was immaterial. *See id.*

241. *See generally McNamara*, 78 T.C.M. (CCH) 530; *Hennen*, 78 T.C.M. (CCH) 445; *Bot*, 78 T.C.M. (CCH) 221; *Mizell*, 70 T.C.M 1469.

242. *See* Burruss Land & Lumber Co., Inc. v. United States, 349 F. Supp. 188, 189 (W.D. Va. 1972).

that a majority of corporations are not large multi-million dollar operations, but rather family or partnership arrangements using a corporate form.[243] This policy was enacted in *Burruss Land & Lumber Co. v. United States*,[244] which held that small corporations sometimes must have their agents employed in distinctive roles.[245] Courts have recognized the independence of a corporation as a separate entity[246] and determined that an individual may simultaneously wear the distinctive hats of shareholder-investor and employee-officer.[247]

It is the contention of this author that the current tax policy be changed to recognize the distinctive roles an individual farmer may play. For example, a farmer may individually own farmland and also be an

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243. *See id.* at 190.

244. 349 F. Supp. 188 (W.D. Va. 1972).

245. *See* Burruss Land & Lumber Co. v. United States, 349 F. Supp. 188, 189 (W.D. Va. 1972). *Burruss Land & Lumber* involved a corporation's failure to file tax returns, and the issue was whether or not penalties should be imposed under the Code. *See id.; see also* I.R.C. §§ 6651(a); 6656(a) (1994) (imposing penalties for failure to pay taxes). Penalties were required to be imposed unless the failure to file was for reasonable cause. *See Burruss Land & Lumber Co.*, 349 F. Supp. at 189. The taxpayer contended that its failure to file tax returns was due to its reliance on house counsel, which would constitute reasonable cause. *See id.* The government took the position that while reliance upon the advice of counsel generally constitutes reasonable cause, such is not the case where counsel is also the person charged with the responsibilities of filing the taxpayer's tax returns and is also an agent of the corporation. *See id.* The government argued that in-house counsel in this case acted as an agent of the corporation when he determined the legal aspects of the corporation's tax liability because he was a director of the corporation, and a corporation can only act through its agents. *See id.* The government further argued that the decision of counsel thus constituted a unilateral act by the taxpayer corporation through its agent that tax was not due, and that a unilateral decision by a taxpayer regarding his tax liability is not reasonable cause. *See id.* The issue before the Tax Court was whether or not reliance upon in-house counsel's advice constitutes reasonable cause where house counsel also performed non-legal duties. *See id.* If outside counsel had provided the same advice, there would have been no question that reasonable cause was present. *See id.* The government argued "that although a person may wear two hats within the corporate framework, he can wear only one for tax purposes" and that the counsel's determination could not be considered to be independent of the corporation. *Id.* The Tax Court rejected this argument, recognizing the independence of the corporation as an entity and the distinction between house counsel's roles as an agent and as a legal advisor. *See id.* The Tax Court reasoned that small corporations sometimes must have its agents employed in distinctive roles. *See id.* at 190. Therefore, the Tax Court held that house counsel in smaller companies are to be treated as a separate legal department when performing legal functions and declined to enforce penalties. *See id.* at 190-91.

246. *See* Ross v. Commissioner, 129 F.2d 310, 313 (5th Cir. 1942) (stating that a corporation's separate identity is to be respected, even if the activity coexists with other private business activities of the sole stockholder); *see also* Zamzam v. United States, 79 A.F.T.R.2d 97-2067, 2071-72 (D.C.W.D. Va. 1997) ("[P]ersonal service corporations traditionally pay out income to the service provider to the extent of their net profits, [which] is treated as compensation taxable to the individual service provider but deductible to the corporation."); Yates Holding Corp. v. Commissioner, 39 T.C.M. (CCH) 303, 307 (1979) ("[C]ase law traditionally recognizes the separateness of a business enterprise where there is a substantial business or economic purpose behind its formation and operation.").

247. *See* Peterson v. Commissioner, 74 T.C.M. (CCH) 335, 338 (1997) (stating that employment and corporate profits are distinct concepts).

employee and a shareholder in a farm corporation.[248] A farmer could rent land to another farming business and have no self-employment tax imposed on his or her rental income.[249] Conversely, that same farmer would have self-employment tax imposed on his or her rental income if he or she rented it to the same operation he or she was employed by.[250] Thus, for tax purposes, the government ignores the distinctive roles an individual may play as an employee, a shareholder, and a landowner.[251]

In analyzing the legislative history of the exception of certain farm rentals from the exclusion of rentals from self-employment income, it appears that Congress never contemplated the formation of farming corporations or farms operating in a formal businesslike manner, complete with employees.[252] Based on statutory construction, it appears that when Congress created the concept of includible farm income, it was concerned with joint ventures between the lessor and the lessee acting as partners where the lessor was providing the land and other resources, and the crop was a joint production.[253] Accordingly, while courts have ruled that a person may wear two hats (i.e. play distinctive roles) for tax purposes,[254] it has failed to apply this rule to farmers in the context of Code section 1402(a)(1).[255]

At the time of this writing a bill has been introduced to Congress which would amend the Code to exclude CRP payments from self-employment taxation, as well as replace the words "an arrangement" in Section 1402(a)(1)(A) with the words "a lease agreement."[256] Whether this bill will be enacted, and what effect it may have, remains to be seen.

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248. *See, e.g.*, N.D. CENT. CODE § 10-06.1-12 (Supp. 1999). The North Dakota statute specifically requires that members of a farm corporation must be "actively engaged in operating the farm or ranch." *Id.* This requirement likely triggers the requirement of the Code section 1402(a)(1) that the owner materially participate in the production of agricultural commodities. Thus, any shareholder of a North Dakota farming corporation who rents land to the farming corporation is likely liable for self-employment tax on the rental income. *See* I.R.C. § 1402(a)(1) (1994).

249. *See id.* For example, A rents his land to B. B raises wheat on the land and pays cash rent to A prior to spring planting. A does not get involved in B's farming operations, and offers B no assistance. Barring any other facts, A's rental paid by B will not likely be subject to self-employment tax. *See id.*

250. *See id.* If A from note 249 also drove a combine for B (thereby materially participating in the production of agricultural commodities), the rental income may be subject to self-employment taxation. *See id.*

251. *See id.*

252. *See* Social Security Amendments of 1956 S. REP. NO. 84-2133 (1956), *reprinted in* 1956 U.S.C.C.A.N. 3877, 3930-31.

253. *See id.*

254. *See* Burruss Land & Lumber Co. v. United States, 349 F. Supp. 188, 190 (W.D. Va. 1972).

255. *See generally* McNamara v. Commissioner, 78 T.C.M. (CCH) 530 (1999).

256. H.R. 4260, 106th Cong. (2000).

An owner of farmland must be aware of the potential self-employment tax liability on rental income if the owner is participating in the renter's farming operations.[257] As the decisions demonstrate, the courts see no distinction between voluntarily participating in a renter's operation or being employed by the renter.[258] Thus, simply establishing a farming corporation and working as an employee of the entity will not enable a farmer to escape self-employment taxation.[259]

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257. *See* I.R.C. § 1402(a)(1) (1994).

258. *See, e.g.*, Bot v. Commissioner, 78 T.C.M. (CCH) 220, 223 (1999) (stating that receipt of wages are immaterial in determining an arrangement requiring material participation).

259. *See generally McNamara*, 78 T.C.M. (CCH) 530.

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