OFFICE OF
CHIEF COUNSEL
CC:EBEO:Br2

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
December 10, 1998

UILC: 1402.01-01

Number: **199917006**
Release Date: 4/30/1999

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
DISTRICT COUNSEL
Attention: , Senior Attorney

FROM: Jerry E. Holmes
Branch Chief CC:EBEO:BR2

SUBJECT:
Docket No.
Prebrief Review

This Prebrief Review Memorandum responds to your memorandum dated . The above case was tried on . Simultaneous opening briefs are due on . This document is not to be cited as precedent.

LEGEND:

A =

B =

ISSUE(S):

Whether rental payments received by B from A are includible in net earnings from self-employment under section 1402(a)(1) of the Code.

CONCLUSION:

The payments received by B from A are includible in net earnings from self-employment under section 1402(a)(1) of the Code.

FACTS:

The petitioners, A and B, are husband and wife. During the years in issue, A conducted farming operations. A rented farmland from B for $ per year. The rental agreement did not require that B perform any services in connection with farm production. A used the land rented from B in farming operations to produce agricultural commodities such as livestock and crops. B participated in farming operations approximately hours per year. B performed duties such as buying, loading, and vaccinating cattle; driving the tractor; cleaning the shop; spraying weeds; picking up parts; keeping the farm books; and unloading grain. B performed these services pursuant to an employment contract entered into with A each year. These same services were performed in prior years in the absence of an employment contract.

LAW AND ANALYSIS:

Section 1401 of the Code imposes a self-employment tax on an individual's self-employment income. Section 1402(b) provides that the term "self-employment income" means the net earnings from self-employment derived by an individual, subject to certain limitations not relevant here.

Section 1402(a)(1) provides that there shall be excluded from net earnings from self-employment rentals from real estate and from personal property leased with the real estate (including such rentals paid in crop shares) together with the deductions attributable thereto.

However, this section provides an exception to the rentals exclusion for 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 on such land, and that there shall be material participation by the 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 with respect to any such agricultural or horticultural commodity (hereinafter, referred to as "includible farm rental income").

The facts clearly demonstrate that there was actual material participation by B in farming operations. B participated in farming operations approximately hours per year. Therefore, the balance of this discussion will address whether there existed an "arrangement" obligating B to materially participate in the production or the management of the production of agricultural commodities within the meaning of section 1402(a)(1).

Section 1.1402(a)-4(b)(2) of the regulations provides that in order for rental income received by an owner or tenant of land to be treated as includible farm rental income, such income must be derived pursuant to a sharefarming or other rental arrangement which contemplates material participation by the owner or tenant in the production or management of production of agricultural or horticultural commodities.

Section 1.1402(a)-4(b)(3)(i) of the regulations provides that the arrangement referred to above may be either oral or written. The arrangement must impose upon such other person the obligation to produce one or more agricultural or horticultural commodities on the land of the owner or tenant. In addition, it must be within the contemplation of the parties that the owner or tenant will participate in the production or the management of the production of the agricultural or horticultural commodities required to be produced by the other person under such arrangement to an extent which is material with respect either to the production or to the management of production of such commodities or is material with respect to the production and management of production when the total required participation in connection with both is considered.

Section 1.1402(a)-4(b)(3)(ii) of the regulations provides that the term "production" refers to the physical work performed and the expenses incurred in producing a commodity, and includes such activities as the actual work of planting, cultivating, and harvesting crops, and the furnishing of machinery, implements, seed, and livestock. An arrangement will be treated as contemplating that the owner or tenant will materially participate in the "production" of commodities if under the arrangement it is understood that the owner or tenant is to engage to a material degree in the physical work related to the production of such commodities.

Section 1.1402(a)-4(b)(3)(iii) provides that the term "management of the production" refers to services performed in making managerial decisions relating to the production, such as when to plant, cultivate, dust, spray, or harvest the crop, and includes advising and consulting, making inspections, and making decisions as to matters such as rotation of crops, the types of crops and livestock, and the types of machinery and implements to be furnished. An arrangement will be treated as contemplating that the owner or tenant is to participate materially in the "management of the production" of commodities if the owner or tenant is to engage to a material degree in the management decisions related to the production of such commodities.

In Mizell v. Commissioner, T.C.M. 1995-571, the Tax Court concluded that the term "arrangement" in section 1402(a)(1) and the corresponding regulations is not limited to contractual relationships, nor to terms and conditions included in a single agreement, contractual or otherwise. Instead, the court recognized that the term "arrangement" often refers to some general relationship or overall

understanding between or among parties in connection with a specific activity or situation. Accordingly, in examining the arrangement with respect to the production of products on the taxpayer's property, the court looked to the overall scheme of the farming operations, which included the relevant leases, the partnership agreement requiring the taxpayer to devote his full time and attention to the partnership farming business, and the general understanding between the taxpayer and the other partners.

The petitioners contend that the rentals were not self-employment income because the lease did not require that B perform any services in connection with farm production. Implicit in the petitioners argument is that the term "arrangement" for purposes of section 1402(a)(1) means only the contractual lease agreement, and therefore it is not correct to look outside the four corners of the lease to determine whether an "arrangement" existed obligating the owner to materially participate in farm production. Therefore, petitioners contend, because the services were performed pursuant to an employment contract, and not pursuant to the lease, the payments were not made under an "arrangement" for purposes of section 1402(a)(1).

The general relationship and overall understanding which existed between A and B indicates that B was obligated to materially participate in agricultural production. The employment contracts, which required that B provide material services, and the fact that the same services were performed prior to the periods in issue in the absence of an employment contract, indicate the existence of an arrangement whereby B was obligated to materially participate in the production of agricultural commodities.

The fact that B was paid amounts under the employment contracts does not prevent the rental payments from being characterized as net earnings from self-employment. Under Mizell, all agreements, including employment contracts, must be considered when examining the general relationship or overall understanding between the parties.

The petitioners also contend that the farm rentals exception only applies to crop-share arrangements, and not to cash rental arrangements. The petitioners state that "[o]ur research has disclosed that there has never been, in the history of social security law, or the tax law, a material participation cash rent lease." Petitioners cite Wuebker v. Commissioner, 110 T.C. No. 31 (1998) (notice of appeal filed in the 6th Circuit on November 18, 1998) as authority for the proposition that cash rent leases are not subject to self-employment tax.

The regulations do not limit the exception to crop-share arrangements. The regulations provides that "in order for rental income received by an owner or tenant of land to be treated as includible farm rental income, such income must be derived

pursuant to a sharefarming or other rental arrangement which contemplates material participation by the owner." Treas. Reg. § 1.1402(a)-4(b)(2). In Gill v. Commissioner, T.C.M. 1995-328, the Tax Court concluded that cash rental payments were includible in self-employment income. Thus, payments under a cash rental arrangement may be includible farm rental income.

The issues decided in Wuebker are entirely inapposite from those in the present case. In Wuebker, the court addressed whether government payments made to a farmer in consideration for removing certain land from agricultural production were rentals from real estate. Thus, the Wuebker court was not called upon to determine whether an arrangement existed requiring the material participation in the production of farm products. Accordingly, the Wuebker decision is not helpful in determining whether the rental payments in the present case are includible farm rental income.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

The attorney assigned to this case is John Richards. If you have any further questions, Mr. Richards can be reached at (202) 622-6040.

Jerry E. Holmes
Branch Chief

By: _____
JERRY E. HOLMES
Branch Chief
Associate Chief Counsel (Employee Benefits & Exempt Organizations)