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ACTION ON DECISION

SUBJECT: Michael and Nancy B. McNamara v. Commissioner
236 F.3d 410 (8th Cir. 2000), rem'g, McNamara v. Commissioner, T.C. Memo 1999-333; Hennen v. Commissioner, T.C. Memo 1999-306; Bot v. Commissioner, T.C. Memo 1999-256.

T.C. Dkt. Nos. 7537-98 (McNamara); 7535-98 (Hennen); 7970-98 (Bot).

Issue: Whether farm rental income is includible in self-employment income if the lessor materially participates in farm production, but the lease agreement itself does not require the lessor to materially participate.

Discussion: Each of the three cases involved a farm couple that structured its agricultural operations so that land owned by one or both spouses was leased to the person that conducted the farm operations. In each case, rental income received by the wife as owner of the leased property was treated as excluded from self-employment income. In each case, the wife also entered into an employment agreement calling for her to perform substantial services. The wives had been performing these services since they began farming with their husbands. In McNamara, both spouses leased their respective farmland to McNamara Farms, Inc., a corporation solely owned by Michael McNamara, and entered into employment contracts with McNamara Farms. The Commissioner issued a notice of deficiency to each taxpayer determining that the rental payments were includible in self-employment income.

Section 1401 of the Code imposes 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) generally excludes rentals from real estate from net earnings from self-employment. However, rentals are not excluded if:

> (A) such income is derived under an arrangement, between the owner or

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> 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.

In all three cases the Tax Court held that the rental payments were subject to self-employment tax. Following its earlier decision in Mizell v. Commissioner, T.C. Memo 1995-571, the Tax Court based its holding in each case on the fact that the employment agreements and other informal understandings required that the lessors materially participate in farm production and that they did in fact materially participate.

Mizell considered whether rental payments received by a farmer who leased farmland to a partnership that he formed with his three sons were self-employment income. The lease did not call for the farmer to materially participate in farm production, but it was undisputed that as a result of the partnership agreement, and the general understanding with his sons, the farmer was obligated and expected to materially participate in farm production.

The farmer asserted that the term Aarrangement@ in ' 1402(a)(1) means solely the lease agreement, and nothing outside of the four corners of the lease. After examining the common usage of the term Aarrangement,@ and how this term is used in other provisions of the Code, the Tax Court concluded that the term "arrangement" in ' 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. Rather, the court recognized that the term "arrangement" often Arefers to some general relationship or overall understanding between or among parties in connection with a specific activity or situation.@ Accordingly, the Tax Court stated, AIn examining the arrangement with respect to the production of agricultural products on petitioner's property, . . . we look not only to the obligations imposed upon petitioner by the leases, but to those obligations that existed within the overall scheme of farming operations which were to take place on petitioner=s property.@ This included 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 his sons.

On Appeal, the Eighth Circuit consolidated the cases and agreed that the lessors= employment agreements and other informal understandings required that they materially participate in farm production, and that they did, in fact, materially participate. However, the court remanded the cases to the Tax Court for determination of whether

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the rental amounts were in fact Aderived under@ the same arrangement that required the lessors= material participation. The court found that, to the extent that the rent paid was consistent with the fair rental value of the leased property, the rental agreements should be treated as separate and distinct from the employment agreements in determining whether an arrangement existed calling for material participation in farm production. The court noted that the transcripts of each trial contained uncontradicted testimony that the rents were at or slightly below fair market value. The court stated, ARents that are consistent with market rates very strongly suggest that the rental arrangement stands on its own as an independent transaction and cannot be said to be part of an >arrangement= for participation in agricultural production.@ On remand, the Tax Court found no deficiencies in petitioners= federal income taxes based on the Eighth Circuit=s view of the law and the Eighth Circuit=s finding of fact that the rents were at or slightly below fair market value.

The Service disagrees with the Eighth Circuit=s narrow construction of the term Aarrangement@ because it is inconsistent with the common meaning of that term and with Congress= intent. The Service agrees with the Tax Court=s analysis regarding the common meaning of the term Aarrangement,@ and how that term is construed for purposes of other Code provisions. If, under the overall scheme of farming operations it was understood that the farmer would materially participate in farm production, and the farmer did in fact materially participate, then the income received from the lessee is subject to self-employment tax. The Service continues to believe that this is the correct result regardless of whether the material participation was explicitly called for under the written or oral lease. This interpretation best promotes Congress= intent that farmers who must work for a living have their income replaced through coverage under the social security system. See the legislative history to the Social Security Amendments of 1956, S. Rep. No. 84-2133 (1956), 1956-2 C.B. at 1255, 1257.

Recommendation:

Nonacquiescence.

The Service does not acquiesce to the Eighth Circuit=s decision and will continue to litigate its position in cases in other circuits. Outside the Eighth Circuit, the Service will continue to assert that it is correct to look to the overall scheme of farming operations in determining whether rentals were derived under an arrangement calling for material participation in farm production.

Although it disagrees with the decision of the court, the Service recognizes the precedential effect of the decision to cases appealable to the Eighth Circuit, and therefore will follow it within that circuit, if the decision cannot be meaningfully distinguished. Thus, the Service may litigate cases in the Eighth Circuit with certain

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facts and circumstances showing a connection between a service agreement and a land lease. In determining whether to litigate a particular case, relevant factors under the Eighth Circuit=s standard include, but are not limited to, (1) whether fair rental value was paid under the leases, (2) whether wages were paid pursuant to an employment agreement, and whether any wages paid were at fair value, (3) whether there would have been rental income absent the farmer=s services, and (4) whether past practices suggest that the services would have been performed absent an employment contract.

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