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AVOIDING SELF-EMPLOYMENT TAX

— by Neil E. Harl

Two recent private letter rulings issued about a month apart in late 1991 have provided additional guidance on the IRS national office position on two of the strategies used to avoid self-employment tax. In both rulings, the IRS position was adverse to the taxpayers.

Rent to spouse

In the first ruling, a farmer paid rent to his wife for her tenant in common interest in farmland. The land had been purchased in 1981 with the husband reporting the income and expenses from the farming operation on Schedule F. Starting in 1984, the husband paid the wife an annual lump sum rental. Until 1988, the husband also made wage payments to his wife. No lump sum payment was made in 1988. In 1989, the husband made both periodic payments and a lump sum rental payment. All of the payments were drawn on a joint checking account, which was the farm account, and deposited in an account in the wife's name only. No written rental agreement existed.

For the year in question, the husband deducted the rental payments on Schedule F, which reduced the husband's self-employment tax. The wife reported the amounts as rental income on Schedule E. The wage amounts were deducted on Schedule F and reported by the wife in gross income on Form 1040.

The farmland had been encumbered by a mortgage since purchase. The husband, however, had deducted the full amount of the interest paid on the mortgage on Schedule F. In two of the years in question, the wife deducted one-half of the property taxes paid on the farmland on Schedule E and the husband deducted the other one-half on Schedule F. In the other year, the husband deducted the full amount of the property taxes on Schedule F.

The couple agreed that the wife made no management decisions although she performed a variety of tasks on the farm. The couple was not operating as a partnership.

The IRS pointed out that the couple did not consistently treat the wife's interest in the farmland as separate rental property. The Service noted that inconsistently on both the property tax and mortgage interest payments. The IRS stated that "in order for the rental arrangement to be recognized for federal tax purposes, the actions of [the husband and wife] with respect to the sharing of the economic burden of, and claiming deductions for, expenses related to the property must be consistent with the assertion that [the wife] is conducting a separate rental activity." IRS found that no bona fide landlord-tenant relationship existed so what purported to be rental payments were not income tax deductible. That increased the husband's self-employment tax.

Gift of crop to spouse

The other ruling involved a husband and wife who owned farmland jointly. The operation was a sole proprietorship of the husband with the wife providing bookkeeping services to the operation.

In 1988, the husband delivered soybeans to the local elevator for storage. The husband's name was listed as "patron" but the wife's name appeared at the bottom of the form.

The husband then executed a notarized statement that the stored soybeans were a gift to the wife and that the soybeans were to be sold before September 1, 1988. In a statement to IRS, the husband took the position that the gift was to materially reward the wife "for companionship and patience with the stressful lifestyle of farming."

When the soybeans were sold, the husband picked up the check (which was made out to the wife) and deposited the check in their joint checking account. The wife later wrote a check on the joint account transferring the amount to her personal savings account.

The couple did not report the income from sale of the soybeans on Schedule F. Rather, the soybeans were reported as capital gain on Schedule D with no self-employment tax paid.

IRS agreed that gifts of agricultural products could be excluded from self-employment income. However, the letter ruling states that the rule applies only to valid gifts.

The Service held that there was no valid gift in this instance because — (1) the husband did not intend to make a gift; (2) the husband did not release control over the soybeans as evidenced by the notarized statement that the soybeans be sold before a specified date; (3) the gift was made in the form of a warehouse receipt (at the time of the gift the soybeans had already been stored in the elevator); and (4) the gift lacked economic substance, given the close family relationship and joint ownership of the farm. The
only purpose of the transaction was to avoid self-employment tax.\textsuperscript{11}

The outcome was that the gain on the sale of the soybeans was included in the husband's regular farm income and subjected to social security tax.

\textbf{Conclusion}

In both rulings, the message is relatively clear: transactions involving closely related family members, especially husband and wife, will be subjected to close scrutiny. In neither case did the ruling state that the basic planning strategy was improper or impossible. But in both instances the taxpayers failed to meet the standard of adherence to detail and the careful establishment of bona fides necessary in a family transaction.

\textbf{FOOTNOTES}

\begin{footnotes}
\footnote{1}{Ltr. Rul. 9206008, Oct. 31, 1991; Ltr. Rul. 9210004, Nov. 29, 1991.}
\footnote{2}{See generally 4 Harl, \textit{Agricultural Law} Ch. 37 (1992).}
\footnote{3}{Id.}
\footnote{4}{Id.}
\footnote{5}{Id.}
\footnote{6}{Ltr. Rul. 9210004, Nov. 29, 1991.}
\footnote{7}{Id.}
\footnote{8}{Id.}
\footnote{10}{Ltr. Rul. 9210004, Nov. 29, 1991.}
\footnote{11}{Id.}
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