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More On Mizell

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MORE ON *MIZELL*

— by Neil E. Harl[*]

In a decision handed down by the Eighth Circuit Court of Appeals on December 29, 2000,[1] additional light was cast on how to avoid self-employment tax on rents[2] for those renting land to an entity in which the lessor is materially participating, taking into account the activities of the taxpayer as lessor and the involvement as partner or employee or in any other status.[3] The problem, which arose with the 1995 Tax Court case of *Mizell v. Commissioner*,[4] applies only to those producing agricultural or horticultural commodities.[5]

Reasoning in *Mizell* and other authorities

In *Mizell v. Commissioner*,[6] the taxpayer had formed a general partnership with three sons, each with a 25 percent general partnership interest. The father, the taxpayer, had retained 731 acres of land which were rented to the general partnership under a non-material participation crop share lease. The father did not report the rents as self-employment income and did not pay self-employment tax on the rental amounts.

On audit, the Internal Revenue Service asserted that 15.3 percent self-employment tax was due on the rents because the taxpayer was materially participating "under an arrangement"[7] involving the general partnership and the partnership was engaged in the production of "agricultural or horticultural commodities."[8]

The Tax Court agreed with the I.R.S. position and upheld the SE tax levy.[9] The case was not appealed (although, interestingly, it was appealable to the Eighth Circuit Court of Appeals).

The following year, 1996, I.R.S. ruled that the same analysis applied to the cash rental of land and personal property to a corporation.[10] In that ruling, a husband and wife as officers and directors of a ranching corporation had self-employment income from the rental of property to the corporation.

Three Field Service Advice rulings, issued in 1998, were in accord with the position in *Mizell v. Commissioner*.[11]

In three cases decided by the Tax Court in 1999 (which factually resembled the three FSA rulings in 1998), I.R.S. prevailed using basically the same arguments as had been used successfully in *Mizell v. Commissioner*.[12] In the first of the three cases, *Bot v. Commissioner*,[13] the wife was renting land to her husband's sole proprietorship. She was deemed to be materially participating in the husband's farming operation and so the Tax Court held that she was liable for self-employment tax on the rental

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See the back page for details about the

2001 Agricultural Tax and Law Seminars

by Dr. Neil Harl and Prof. Roger McEowen

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payments. The second case, *Hennen v. Commissioner*,[14] was factually similar. In the third case, *McNamara v. Commissioner*,[15] the husband and wife, owners of the land in joint tenancy, cash rented their land to the husband's farm corporation. The Tax Court determined that the husband and wife, as lessors, were liable for self-employment tax on the rents inasmuch as they were materially participating in the farming operation.

The three 1999 Tax Court cases were all appealed to the Eighth Circuit Court of Appeals.[16]

The Eighth Circuit Decision

The Eighth Circuit Court of Appeals, examining the question for the first time, was not impressed by the taxpayers' argument that Section 1402(a)(1) only applies to "rental payments derived from sharecropping or share-farming."[17] The Eighth Circuit, not surprisingly, also gave short shrift to the argument that the instructions to Form 4835 (on which non-material participation share rent income and expenses are reported) contradicted the statute and should override Section 1402(a)(1).[18]

The appellate court also stated that it could not say that the Tax Court erred in holding that the taxpayer in the three cases had materially participated under the respective arrangements. However, the Eighth Circuit was impressed by another argument, that the lessor-lessee arrangements should stand on their own, apart from any employment relationship, and that if the rentals were "consistent with market rates for agricultural land"[19] the rents were not "derived under an arrangement" and, therefore, self-employment tax was not due.[20] The appellate court was looking at the "nexus" between the rents received by the lessor and the "arrangement" that requires material participation for self-employment tax to be due.[21] As the court pointed out, "the mere existence of an arrangement requiring and resulting in material participation in agricultural production does not automatically transform rents received" into self-employment income.[22] The court pointed out that rents 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.[23]

The court proceeded to remand the cases to the Tax Court to provide an opportunity for I.R.S. to show a connection between the rents and the "arrangement."[24]

In conclusion

Until the Tax Court has re-examined the facts, particularly in light of whether the rents were "fair market rental" rents, it is imperative that taxpayers potentially subject to challenge set the rental rates in keeping with rates in the area for comparable land. Moreover, it is important that evidence of rental rates be preserved for use in any later audit.

FOOTNOTES

1 McNamara et al. v. Comm'r, 2001-1 U.S. Tax Cas. (CCH) ¶ _____ (8th Cir. 2000). The decision consolidated the appeals of McNamara v. Comm'r, T.C. Memo. 1999-333; Bot v. Comm'r, T.C. Memo. 1999-256; and Hennen v. Comm'r, 1999-306.

2 I.R.C. § 1402(a)(1).

3 *Id*. See Mizell v. Comm'r, T.C. Memo. 1995-571.

4 T.C. Memo. 1995-571.

5 See generally 5 Harl, *Agricultural Law* § 37.03[3] (2000); Harl, *Agricultural Law Manual* § 4.06[3] (2000). See also Harl, "Renting Land to a Family Partnership, Corporation or LLC", 7 *Agric. L. Dig*. 49 (1996); Harl, "Renting Land to a Family Entity," 7 *Agric. L. Dig.* 157 (1996).

6 T.C. Memo. 1995-571.

7 See I.R.C. § 1402(a)(1).

8 *Id*.

9 T.C. Memo. 1995-571.

10 Ltr. Rul. 9637004, May 1, 1996.

11 FSA Ltr. Rul. 9917005, Dec. 10, 1998 (husband rented farmland from wife who was involved in husband's farming operation; self-employment tax imposed on rents) FSA Ltr. Rul. 9917006, Dec. 10, 1998 (same); FSA Ltr. Rul. 9917007, Dec. 10, 1998 (husband and wife rented land to corporation owned by husband where both were involved in farming operation; self-employment tax imposed).

12 T.C. Memo. 1995-571.

13 T.C. Memo. 1999-256.

14 T.C. Memo. 1999-306.

15 T.C. Memo. 1999-333.

16 McNamara v. Comm'r, No. 99-3876; Hennen v. Comm'r, No. 99-3968; Bot v. Comm'r, No. 99-3891.

17 2001-1 U.S. Tax Cas. (CCH) ¶ _____ (8th Cir. 2000).

18 *Id*.

19 *Id*.

20 *Id*.

21 *Id*.

22 *Id*.

23 *Id*.

24 *Id*.