Leasing Arrangements and Self-employment (Social Security) Tax

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Self-employment tax is imposed on net earnings derived from self-employment. That phrase is defined as gross income derived by an individual from a trade or business that the taxpayer conducts. However, rents from real estate and from personal property leased with real estate are excluded from the definition of net earnings from self-employment. Likewise, income from crop-share and/or livestock-share rental arrangements for landlords who are not materially participating in the farming operation are not classified as self-employment income subject to Social Security tax (and, thus, do not count toward eligibility for Social Security benefits in retirement).

Only if the rental income is produced under a crop or livestock-share lease where the individual is materially participating under the lease does the taxpayer generate self-employment income. Income received under a cash rental arrangement is not subject to self-employment tax, nor does such income count toward eligibility for Social Security benefits in retirement.

An exception to this rule exists if the lessor leases land to an entity in which the lessor is materially participating. IRS has won several cases in which they have successfully attributed the lessor’s material participation in the entity to the leasing arrangement with the result that passive cash rent income is transformed into material participation income subject to self-employment tax. But, in the U.S. Circuit Court of Appeals for the Eighth Circuit (which includes Iowa), if the rental income represents a fair market rate of rent, the rental income is not subject to self-employment tax.

**Observation:** Managing earned income in retirement years is important, and can influence the leasing arrangement. Persons that have reached full retirement age can receive an unlimited amount of income without loss of Social Security benefits. For persons under full retirement age, the earnings limit in 2014 is $15,480. For excess amounts, benefits are reduced $1 for every $2 over the limit. Thus, for retired farm landlords under full retirement age, they may not be able to receive full Social Security benefits if they are materially participating under a lease.

**Note:** For persons born in 1943 through 1954, the full retirement age is 66. The full retirement age increases every year until it reaches 67 for people born in year 1960 or later.

**Material Participation under a Lease**

The key concept for farm landlords attempting to qualify (or not qualify) rental income as self-employment subject to Social Security tax is material participation. Rental income is self-employment income if it results from a material participation lease. If the lease is a material participation lease, the income is subject to self-employment tax. If it is not such a lease, the income is not subject to the tax.

A lease is a material participation lease if (1) it provides for material participation in the production or in the management of the production of agricultural or horticultural products, and (2) there is material participation by the landlord. Both requirements must be satisfied. While a written lease is not required, a written lease does make a material participation arrangement easier to establish.
Tests for Material Participation
The IRS has offered four tests for determining whether the material participation test has been satisfied. A landlord is materially participating if he/she meets one of the following tests.

1. The first test requires the landlord to satisfy any three of the following:
   - advance, pay, or stand good for at least half of the direct costs of producing the crop;
   - furnish half of the tools, equipment and livestock used in producing the crop;
   - advise and consult with the tenant periodically; or
   - inspect production activities periodically.

2. The second test requires the landlord to regularly make, or take an important part in making, management decisions substantially contributing to the success of the enterprise. Under this test, it appears that decisions should be made throughout the year, such as when to plant, cultivate, dust, spray, or harvest; what items to buy, sell or rent; what records to keep; what reports to make; and what bills to pay and when. Establishing a lease arrangement at the beginning of the season probably will not be regarded as making management decisions.

3. The third test requires the landlord to work 100 hours or more over a period of five weeks or more in activities connected with producing the crop.

4. The fourth test requires the landlord to do things which, in total effect, show that the landlord is materially and significantly involved in the production of farm commodities. This test is the catchall that a landlord can attempt to utilize if the landlord wants to show material participation but is not able to satisfy any of the first three tests. The litigated cases on the material participation issue have arisen primarily from this catchall provision.

One additional note-agricultural program payments that are received under a crop-share or livestock-share lease are considered to be self-employment income for Social Security purposes if the landlord materially participates under the lease.