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Self-employment tax on contract production
“rents” *

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The gradual increase in contract production in agriculture has focused attention on the nature of payments made by integrators to the growers and, specifically, whether part or all of such payments could be treated as rents for self-employment tax purposes.

The statutory framework
The statute specifies that--
“The term ‘net earnings from self-employment’ means the gross income derived by an individual from any trade or business carried on by such individual. . . .”

The statute then proceeds to exclude rentals from real estate but then includes amounts paid “under an arrangement” involving the production of agricultural or horticultural commodities where there is material participation under the lease.

The term “trade or business,” an important aspect of the definition, has the same meaning as when used in I.R.C. § 162 with stated exceptions. As interpreted by the cases, the term “trade or business” has come to mean that continuity and regularity of activity are necessary before a venture can be considered to be a trade or business. Note that the statute does not define “trade or business carried on by such individual.” Moreover, the statute does not address the self-employment tax liability of a taxpayer who is carrying on a trade or business and is also carrying on a rental activity.

Handbook updates
For those of you subscribing to the handbook, the following updates are included.

Corn and Soybean County Yields – A1-14 (4 pages)
Estimated Costs of Pasture and Hay Production – A1-15 (8 pages)
Iowa Farm Custom Rate Survey – A3-10 (2 pages)

Please add these files to your handbook and remove the out-of-date material.

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Thus, the key questions with contract production involving payments for production and for use of the grower's facilities are –

1. whether the grower was carrying on a trade or business and
2. whether the rents received are a part of that trade or business.

Guidance from the cases
In a 1965 Ninth Circuit Court of Appeals case, the court acknowledged that Congress realized that the income of self-employed persons is, in most instances, a combination of income from both labor and invested capital, and deliberately chose not to attempt the difficult, if not impossible, task of separating one from the other. The court then proceeded to explain the exclusion of rentals from self-employment income as follows –

“The Committee reports accompanying the bill which included section 211(a)(1) [42 U.S.C. § 411(a)(1)] make it clear that not all payments which might be considered “rent” in ordinary parlance are to be excluded from self-employment net income . . . . “The apparent intent of Congress was that section 211(a)(1)

[42 U.S.C. § 411(a)(1)] should be applied to exclude only payments for use of space, and, by implication, such services as are required to maintain the space in condition for occupancy. If the owner performs additional services of such substantial nature that compensation for them can be said to constitute a material part of the payment made by the tenant [in this context means the one obtaining the services of the space], the “rent” received then consists in part of income attributable to the performance of labor which is not incidental to the realization of the return from passive investment. In such circumstances, the entire payment is to be included in computing the recipient’s “net earnings from self-employment.” [Emphasis added]
The proper characterization of payments is the responsibility of the grower.

In conclusion
Therefore, a taxpayer who is sufficiently active to be carrying on a trade or business in a contract venture is not permitted to carve out a portion of the payment as rent regardless of how the integrator may be reporting the payment. While the trend is toward a reduced role in management for growers under contract, and ultimately courts may view the grower’s role as that of an employee or agent, falling short of trade or business status, that is not the case at present.


Higher fuel prices push up farm custom rates
by William Edwards, extension economist, (515) 294-6161, wedwards@iastate.edu

With prices for diesel fuel up nearly 50 percent over a year ago, farm custom rates have increased, as well. Our recently completed survey of custom rates paid or charged by Iowa farmers showed consistent increases in nearly every operation. Most operations showed increases of five percent or more over the 2005 average rate. Heavy tillage operations showed the highest percentage increases, since fuel is a large portion of the total cost for tillage.

The most commonly reported custom rate was for combining corn or soybeans. The average rates reported this year were $25.70 per acre for corn and $25.00 per acre for soybeans, compared to $24.60 and $23.90, respectively, in 2005.

While the price of diesel fuel has the most immediate impact on a custom operator’s costs, prices for both new and used machinery have jumped significantly, as well. This is due in part to higher prices for steel, but also to a strong demand for machinery purchases.

The Iowa Farm Custom Rate Survey sampled 165 farmers, custom operators, farm managers and lenders. Respondents were asked what they expected to pay or charge for various operations in 2006. Rates may vary from the average based on timeliness, size and shape of the fields, condition of the crop, quality of the machine and skill of the operator. A summary of the survey, including average values and ranges reported, is available as information file A3-10.