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Methvin v. Commissioner:
A Decision Worth Watching

by Neil E. Harl*

A very brief decision by the Tenth Circuit Court of Appeals on June 24, 2016, Methvin v. Commissioner¹ bears watching, not because it affects, directly, the agricultural sector, but because of what it likely portends. The case involved liability for self-employment tax for investors who are not partners in a partnership but were swept up by the language of the Internal Revenue Code defining a “partnership and partner” as including “. . . a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term ‘partner’ includes a member in such a syndicate, group, pool, joint venture, or organization.”²

That language effectively disregards the meaning of those terms under state law, as proved to be the case in the Methvin case.

What the case involved

The Methvin case involved a taxpayer with a two to three percent interest in various oil and gas ventures.³ In the year in question, the taxpayer reported $6,760 in net income reported as “other income” on Form 1040. In Article 14 of the agreement between the taxpayer and the operating entities, the parties to that document elected “to exclude from the application of sub-chapter K” of the Internal Revenue Code.⁴ On audit, the taxpayer argued that he was not engaged in a trade or business and was not a partner or a partnership. Both sides of the controversy apparently agreed that the management involvement was “minimal.” One case, Cokes v. Commissioner,⁵ which was heavily relied upon by both the Tax Court and the Tenth Circuit,⁶ involved a 42.9 percent working interest.

In the face of that leap downward in terms of involvement, the courts agreed that the incomes from the “working interests” were from a “pool or joint venture for operation of the wells.”

So how does that affect farmers and ranchers (or those who invest in agricultural properties)?

The role of material participation. The impact on agricultural investments, at the moment at least, is likely to be slight. First of all, after providing for an exclusion from self-employment tax,⁷ the statute states “. . . the preceding provisions of this paragraph

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shall not apply to any income derived by the owner or tenant of land if (A) such income is derived under an arrangement between the owner or tenant and another individual which provides 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 . . . “ That language does not apply to other kinds of entities engaged in something other than the production of agricultural or horticultural commodities. Although Congress might not have realized the importance of that limitation, it is there and creates a barrier to assessing self-employment tax where the involvement is less than “material participation.”

It is entirely possible that the Department of the Treasury could possibly take the position that the quoted language does not prevent imposing self-employment tax on those not meeting the material participation test but that seems unlikely.

The recent history of trying to expand self-employment tax liability. The checkered history of trying to expand self-employment tax liability with specific targeting of farm and ranch taxpayers has been something less than successful. In the Mizell controversy the Eighth Circuit Court of Appeals rebuffed attempts to impose self-employment tax on rental income of farmland, adding involvement as lessor to involvement in the farming or ranching entity. Although Congress might not have realized the importance of that limitation, it is there and creates a barrier to assessing self-employment tax where the involvement is less than “material participation.”

In the battle over the imposition of self-employment tax on government payments such as the Conservation Reserve Program, the Eighth Circuit Court of Appeals reversed the Tax Court’s holding in favor of the Government’s point of view.

In conclusion

The problem is not so much with Congressional enactments; the problems have been with attempts to expand beyond what was anticipated by the Congress. The disagreements over whether moves by the tax administering bodies in the Administration go beyond Congressional intent will likely go on . . . and on . . . and will be refereed by the judicial system. For relatively small taxpayers, in particular, that imposes an unfair financial burden on the targeted taxpayers to resist the shift in tax administration.

ENDNOTES

1 2016-1 U.S. Tax Cas. (CCH) ¶ 50,328 (10th Cir. 2016).
3 T.C. Memo. 2015-81, aff’d, 2016-1 U.S. Tax Cas. (CCH) ¶ 50,328 (10th Cir. 2016).
4 As is widely known, Subchapter K includes Sections 701 through 777 of the bulk of partnership tax law.
5 91 T.C. 222 (1988).
6 T.C. Memo. 2015-81, aff’d, 2016-1 U.S. Tax Cas. (CCH) ¶ 50,328 (10th Cir. 2016).
7 I.R.C. § 1402(a)(1).