



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
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OFFICE OF
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The Honorable James A. Leach

Member, U.S. House of Representatives

1756 1st Avenue NE

Cedar Rapids, IA 52402

Attention: Gary Grant

Dear Congressman Leach:

This letter is in response to an inquiry from your Staff Assistant, Mr. Gary Grant, dated April 3, 2000, asking for information on self-employment tax owed by farmers on rental income. Mr. Grant explains that a number of your constituents believe that an inequity exists between the tax treatment farmers receive compared to other businesses with rental income. As explained in the following general information, if a farmer materially participates in farming pursuant to an arrangement between the farmer and a tenant, his rental income is subject to self-employment tax.

Section 1401 of the Internal Revenue Code (the Code) imposes a self-employment tax on an individual's self-employment income. Section 1402(b) of the Code provides generally that the term "self-employment income" means the net earnings from self-employment derived by an individual. Section 1402(a)(1) of the Code excludes from the definition of "net earning from self-employment" rentals from real estate and from personal property leased with the real estate (including such rentals paid in crop shares) together with the deductions attributable thereto.

Section 1402(a)(1) was amended by the Social Security Amendments of 1956 (SSA of 1956), Public Law 880 (84th Cong.), to limit the exclusion of rentals from real estate from net earnings from self-employment. As amended, this section provides that the exclusion of rentals from real estate

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 that 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 by the owner or tenant with respect to any such agricultural or horticultural commodity.

The purpose of the SSA of 1956 was to extend the coverage of the old-age, survivors and disability insurance program to individuals who were not otherwise covered. S. Rep. 2133, 84th Cong., 2d Sess., 1956-2 C.B. 1255 (Senate Report). Therefore, farmers will benefit by receiving social security coverage that they would not enjoy but for the statutory expansion of coverage.

In *Mizell v. Commissioner*, T.C. Memo 1995-571, the Tax Court concluded that the term "arrangement" in section 1402(a)(1) and the corresponding regulations is not limited to contractual relationships, nor to terms and conditions included in a single agreement, contractual or otherwise. Instead, the court recognized that the term "arrangement" may refer to a relationship or overall understanding between or among parties in connection with a specific activity or situation. *Mizell* was followed by three recent Tax Court opinions. *McNamara v. Commissioner*, T.C. Memo 1999-333, *appeal pending*, No. 99-3876 (8th Cir.); *Hennen v. Commissioner*, T.C. Memo 1999-306, *appeal pending*, No. 99-3968 (8th Cir.); *Bot v. Commissioner*, T.C. Memo 1999-256, *appeal pending*, No. 99-3891 (8th Cir.).

This letter will be available for public inspection after names, addresses, and other identifying information have been deleted under the Freedom of Information Act.

I hope the above information responds to your concerns. If I can be of further assistance in this matter, please contact me or John Richards (Identification number 50-08837) at (202) 622-6040.

Sincerely,

Jerry E. Holmes
Chief, Branch 2
Tax Exempt and Government Entities