



Ag Decision Maker

A Business Newsletter for Agriculture

Vol. 10, No. 6 www.extension.iastate.edu/agdm April 2006



Self-employment tax on contract production “rents” *

by Neil E. Harl, Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University, Ames, Iowa. Member of the Iowa Bar, harl@iastate.edu

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 agricul-

tural 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.

continued on page 2

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Please add these files to your handbook and remove the out-of-date material.

continued on page 6

Inside . . .

Higher fuel prices push up farm custom rates Page 3

Designing a viable rural economy Page 4

Self-employment tax on contract production "rents", continued from page 1

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 1989 Tax Court case of *Stevenson v. Commissioner*, involved a taxpayer who was engaged in the business of purchasing portable advertising signs for rental or for resale. The taxpayer assembled and stored at a rental warehouse all new portable advertising signs. The taxpayer also stored all used portable advertising signs, repaired them and held them for sale or rental. The taxpayer argued that income from the rental of portable advertising signs was properly excluded from self-employment income. The taxpayer’s position was that the statutory language excluding rentals from real estate (and from personal property leased with the real estate) from self-employment income was only illustrative as to what was to be excluded.

The Tax Court held that the rental and sale of advertising signs was, overall, a trade or business and the rental income could not be excluded. The court acknowledged that payments for the use of space where the labor involved was incidental to the realization of the return on an investment was not subject to SE tax but held that no part of the taxpayer’s income from the sign business fell within that exception.

In the case of *Gill v. Commissioner*, a grower who had a contract with Jack Frost, Inc. to produce broilers from baby chicks in a period of about six weeks per cycle had self-employment income for the entire payment from the integrator. The taxpayer had sufficient involvement to be considered to be carrying on a trade or business and was considered to be “materially participating” in the production of income. The taxpayer not only maintained the grow-out facility but also performed, with other family members, the tasks necessary to raise the broilers.

In another Tax Court case, *Schmidt v. Commissioner*, this one involving the production of beets for a canning company, the production of the beet crop under contract resulted in self-employment income, not rent for the use of the land.

Self-employment tax on contract production "rents", continued from page 2

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.

** Reprinted with permission from the February 17, 2006 issue of Agricultural Law Digest, Agricultural Law Press Publications, Eugene, Oregon. Footnotes not included.*



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.



Designing a viable rural economy

by Don Hofstrand, Co-Director, Ag Marketing Resource Center,
Iowa State University Extension, dhof@iastate.edu

When I was a farm boy growing up in rural America in the 1950s, the most important event of the week was Saturday night. That was when the farmers went to town. The main street was crammed with parked cars. The stores were full of farmers doing their weekly shopping and visiting with friends and neighbors. Even though our hometown was less than 1,000 people, it had grocery stores, clothing stores, a drug store with its own pharmacist and soda fountain, restaurants, a hardware store, a movie theater, a couple of machinery dealerships and various other businesses.

Government price support programs for farmers were in place at that time and were not very different from today's programs. It was believed that, in addition to supporting farm income, these programs also supported rural America because farmers spent this money in local towns and communities.

Fifty years later we still have government price support programs, and we still believe these programs are supporting rural communities. However, in my hometown the streets are deserted on Saturday night. The stores are gone and the farmers - the few that are left - drive through town to the big town down the road to shop at Wal-Mart. Obviously, government farm payments are a poor rural development program.

Debate on the new farm bill will start soon. It is time to reassess how we create a viable and sustainable rural America. Although we cannot save my home town, we may be able to improve economic activity in rural areas, county seat towns and regional trade area cities.

However, we cannot do this by government order. Nor will it be accomplished by pushing

large sums of government money into the rural sector with vaguely defined objectives. Sustainable rural development requires that we create modern private sector business ventures that can effectively compete with the non-farm sector. To accomplish this, rural residents must garner the entrepreneurial and business development skills and resources needed to drive the economic engine of rural America. This will require targeted government programs like the following:

1. Facilitate the creation of "business development organizations" where rural entrepreneurs can work together and share resources and knowledge in creating rural business ventures. Successful business development involves mastering business development "process" skills. These organizations provide the business environment needed to develop and hone these process skills. It also provides an environment for networking with a wide range of people involved in business development.
2. Foster programs designed to increase the information and communications infrastructure for the rural sector. The Internet has created a vehicle for eliminating the disadvantage of vast distances that has plagued rural areas. However, if the rural sector does not take advantages of this new technology, it will find itself even further behind.
3. Business development skills are best created with "on the job training" of actually creating business ventures. However, this process can be embellished with government supported programs that

Designing a viable rural economy, continued from page 4

provide business development information, processes and analysis.

4. In addition to building the capacity of rural residents to create viable business ventures, programs need to be designed to build the capacity of rural business consultants. Qualified consultants play a major role in building successful businesses.

5. Provide seed capital funding for new business ventures. The value-added producer grant program provided by USDA Rural Development has been very effective in providing seed capital funds for start-up business ventures. These programs need to be maintained.

6. Programs need to be developed to assist in the creation of various types of private sector "rural business funds" that can be used to provide capital to rural business ventures. These can range from high-risk, high-return venture capital funds for start-ups to moderate-risk, moderate-return funds for the expansion of existing businesses. Rural funds would be designed specifically for participation by rural residents.

7. Implement a federal tax credit program focused specifically on business creation and development in low income, economically distressed rural areas. These credits can provide an incentive to locate business ventures in low income areas while providing the credit to local residents for investment.

8. Design programs that encourage the private and public sectors to work together. Many university research programs need to be closely linked to private sector business development organizations for potential commercialization.

The responsibility for revitalizing rural America lies in the hands of the residents that live in these areas. However, the federal government can play an important role in assisting these efforts. The points discussed above provide an outline for designing this assistance.

Updates, continued from page 1

Internet updates

The following updates have been added to www.extension.iastate.edu/agdm.

Understanding and Using Milk Price Basis – B2-44 (2 pages)

Conducting Focus Groups – C5-31 (2 pages)

Writing Materials for Promotion – C5-131 (2 pages)

... and justice for all

The U.S. Department of Agriculture (USDA) prohibits discrimination in all its programs and activities on the basis of race, color, national origin, gender, religion, age, disability, political beliefs, sexual orientation, and marital or family status. (Not all prohibited bases apply to all programs.) Many materials can be made available in alternative formats for ADA clients. To file a complaint of discrimination, write

USDA, Office of Civil Rights, Room 326-W, Whitten Building, 14th and Independence Avenue, SW, Washington, DC 20250-9410 or call 202-720-5964. Issued in furtherance of Cooperative Extension work, Acts of May 8 and June 30, 1914, in cooperation with the U.S. Department of Agriculture. Jack M. Payne, director, Cooperative Extension Service, Iowa State University of Science and Technology, Ames, Iowa.

Permission to copy

Permission is given to reprint ISU Extension materials contained in this publication via copy machine or other copy technology, so long as the source (Ag Decision Maker Iowa State University Extension) is clearly identifiable and the appropriate author is properly credited.