Livestock Confinement Buildings and S.E. Tax

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Overview

In addition to income tax, a tax of 15.3 percent is imposed on the self-employment income of every individual. Clearly, if a farmer constructs a confinement building, places their own livestock in the building, provides all management and labor, and pays all expenses, the net profit from the activity will be subject to self-employment tax. But, what if the livestock production activity conducted in the confinement building is done so under a contract with a third party? Is the farmer's net income from the activity subject to self-employment tax in that situation?

Livestock confinement buildings and self-employment tax – it's the topic of today's post.

Background

Self-employment income is defined as "net earnings from self-employment." The term "net earnings from self-employment" is defined as gross income derived by an individual from a trade or business that the individual conducts. *I.R.C. §1402*. In general, income derived from real estate rents (and personal property leased with real estate) is *not* subject to self-employment tax unless the arrangement involves an agreement between a landowner or tenant and another party providing for the production of an agricultural commodity and the landowner or tenant materially participates. *I.R.C. §§1402(a)(1)* and *1402(a)(1)(A)*. For rental situations not involving the production of agricultural commodities where the taxpayer materially participates, rental income is subject to self-employment tax if the operation constitutes a trade or business "carried on by such individual." *See, e.g., Rudman v. Comr., 118 T.C. 354 (2002).* Similarly, an individual rendering services is subject to self-employment tax if the activity rises to the level of a trade or business. In general, to be subject to self-employment tax, an activity must be engaged in on a substantial basis with continuity and regularity.

Livestock Confinement Buildings and Contract Production

Does self-employment tax apply to the net income derived from livestock production activities conducted in a farmer's confinement building pursuant to a contract with a third party? As with many tax answers, "it depends."

The U.S. Tax Court provided guidance on the issue in 1995. In *Gill v. Comr., T.C. Memo. 1995-328*, a corporation that produced, processed and marketed chicken products bought breeder stock from primary breeders and placed them in farmer-owned buildings for 20 weeks. The placement of the chicks with individual farmers was done in accordance with production contracts. The petitioners (two different farmers) constructed broiler barns with the corporation's assistance in obtaining financing and established that the petitioners had the ability to maintain their facilities. Each contract was for 10 years and the corporation paid the petitioners a fixed monthly amount tied to the space inside each building ($.045 per month/per square foot) that was supplemented over time to reflect inflation. The petitioners were required to perform certain maintenance items, inspections and general flock management responsibilities.

The petitioners did not report the income received under the contracts as subject to self-employment tax. They claimed that they did not materially participate in the production or the management of the production of the poultry in the barns that they leased to the corporation. As such, they claimed that the payments they received were excluded from the definition of "net earnings from self-employment" as "rents from real estate."

The Tax Court disagreed. The Tax Court noted that the apparent intent of the Congress was to exclude from self-employment tax only those payments for use of space and, by implication, such services as are required to maintain the space in condition for occupancy. Thus, when a taxpayer performs additional services of a substantial nature that compensation for the additional services can be said to constitute a material part of the payment the made to the owner, the payment is income that is attributable to the performance of labor. It's not incidental to the realization of return from a passive investment, and the payment is included in the computation of the taxpayer's "net earnings from self-employment." Applying the analysis to the facts, the Tax Court determined that the petitioners (and their children) performed each and every task necessary to raise the flocks of birds that the corporation delivered. This constituted material participation subjecting the contract payments to self-employment tax. The payments were not excluded from net earning from self-employment as "real estate rents." *See also Schmidt v. Comr., T.C. Memo. 1997-41.*

Planning Considerations

Many ag production contracts like the ones at issue in *Gill* require the farmer/producer to perform substantial services in connection with the production of the livestock or poultry. Therein lies the problem. To avoid having the income subjected to self-employment tax, the farmer/building owner must not participate to a significant degree in the production activities or bear a substantial risk of loss.

So, are there any planning avenues to address the self-employment tax issue? One option may be to split the contractual arrangement into two separate agreements. One agreement would be strictly for the "rental" of the building with IRS Form 1099 issued for the rental income. Given the typical high capital costs for livestock confinement buildings, a return on capital shown as "rent" should not be unreasonable. A second agreement would be entered into providing for herd/flock management with the issuance of a separate Form 1099 for non-employee compensation or a Form W-2 for wages. These payments would be subject to self-employment tax or FICA tax.

Another approach was established by the Tax Court in 2017. In *Martin v. Comr., 149 T.C. 293 (2017),* the petitioners, a married couple, operated a farm in Texas. In late 1999, they built the first of eight poultry houses to raise broilers under a production contract with a large poultry integrator. The petitioners formed an S corporation in 2004, and set up oral employment agreements with the S corporation based on an appraisal for the farm which guided them as to the cost of their labor and management services. They also pegged their salaries at levels consistent with other growers. The wife provided bookkeeping services and the husband provided labor and management. In 2005, they assigned the balance of their contract to the S corporation. Thus, the corporation became the "grower" under the contract. In 2005, the petitioners entered into a lease agreement with the S corporation. Under the agreement, the petitioners rented their farm to the S corporation, under which the S corporation would pay rent of $1.3 million to the petitioners over a five-year period. The court noted that the rent amount was consistent with other growers under contract with the integrator. The petitioners reported rental income of $259,000 and $271,000 for 2008 and 2009 respectively, and the IRS determined that the amounts were subject to self-employment tax because the petitioners were engaged in an "arrangement" that required their material participation in the production of agricultural commodities on their farm.

The Tax Court determined that the "derived under an arrangement" language in I.R.C. §1402(a)(1) meant that a nexus had to be present between the rents the petitioners received and the "arrangement" that

required their material participation. In other words, there must be a tie between the real property lease agreement and the employment agreement. The court noted the petitioners received rent payments that were consistent with the integrator's other growers for the use of similar premises. That fact was sufficient to establish that the rental agreement stood on its own as an appropriate measure of return on the petitioners' investment in their facilities. Similarly, the employment agreement was appropriately structured as a part of the petitioners' conduct of a legitimate business. Importantly, the Tax Court noted that the IRS failed to brief the nexus issue and simply relied on the Tax Court to broadly interpret "arrangement" to include all contracts related to the S corporation. Accordingly, the Tax Court held that the petitioners' rental income was not subject to self-employment tax.

Conclusion

Aside from the "two-check" approach, leases should be drafted to carefully specify that the landlord is not providing any services or participating as part of the rental arrangement. Services and labor participation should remain solely within the domain of the employment agreement. In addition, leases where the landlord is also participating in the lessee entity must be tied to market value for comparable land leases. *See e.g., Johnson v. Comm'r, T.C. Memo. 2004-56*. If the rental amount is set too high, the IRS could argue that the lease is part of "an arrangement" that involves the landlord's services. *See, e.g., Solvie v. Comm'r, T.C. Memo. 2004-55*. If the lessor does provide services, a separate employment agreement should put in writing the duties and compensation for those services.

Whether self-employment tax is incurred or not will likely be determined by the extent of involvement the owner retains with regard to the confinement building. But, a word of caution. With the ability to claim substantial depreciation and large interest expense payments (associated with financing the confinement building), a loss could be created. Thus, classification of the arrangement as a rental activity with no self-employment tax may not be the best tax strategy. Instead, the preference might be to offset the loss against self-employment income. This last point raises a question. Can a taxpayer "change horses" mid-stream when the confinement building is sufficiently paid for such that interest expense is lower and, also, depreciation deductions have dropped significantly? Can the contract then be modified at that point so that self-employment tax is avoided?

Interesting tax planning questions.