

## **Farmland Rental to a Related-Party Entity**

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Until the mid-1990's, cash rent from farmland was always considered passive income, even if rented to an entity owned or controlled by the landlord/taxpayer. As long as there was not material participation by the landlord – the rental income was not subject to self-employment tax.

Since the mid-1990's the IRS has been challenging the “passive characteristic” of farmland rental when the land is rented to a related entity or an entity in which the landowner materially participates in the operation of the farm. The IRS argues that an “arrangement” exists between the landowner and the related entity. Given an “arrangement” between the related entities, the IRS is attempting to impose self-employment tax on the rental income.

In 2000, the Eighth Circuit Court (Missouri is in this Circuit) stated its position that lessor-lessee arrangements should stand on their own, apart from any employment relationship or “arrangement”. It further indicated that if the rentals were consistent with going rental rates for agricultural land - the rents were not derived under an “arrangement” and, therefore, self-employment tax was not due. The Eighth Circuit remanded the McNamara case, the case in question, back to the Tax Court and gave the IRS the opportunity to show a connection between rents and the “arrangement”.

The IRS did not make a connection and on July 15, 2002, the Tax Court rendered its remand opinion holding the rental arrangements reflected fair market rental and that no self-employment tax would be imposed.