

# AGRICULTURAL FINANCIAL AND TAX PLANNING

## Self Employment Tax on Ranch Related Income

By Thomas J. Bryant, CPA and Ryan Beasley, CPA

In last months article we mentioned a February 27, 2017, Internal Revenue Service (IRS) memorandum that provided guidance for a pilot program for auditing Schedule F expenses. The pilot is only being worked currently in IRS's Brookhaven, NY campus. But this memorandum indicates that the IRS is focusing some of their attention on auditing Schedule F income. One of the items that the IRS has identified in the past as an audit issue is the proper reporting of Self Employment tax (SE tax). SE tax is Social Security and Medicare tax primarily for individuals who work for themselves. There are special rules that apply to ranch related income that must be considered to minimize the impact of the tax. This is a 15.3% tax assessed on net income up to \$127,000 and a 2.8% on amounts above that amount for 2017. This tax needs to be managed. With the IRS's focus on auditing Schedule F income, proper planning and execution should be done to minimize the impact of this tax. However, the analysis must also consider any impact on future Social Security (SS) benefits for each of the individuals being impacted by the reduction or elimination of the tax. This article will identify some audit issues and possible options to minimize the tax with proper planning.

### **Why do we pay the Tax**

Social security benefits are available to self-employed ranchers just as they are to wage earners. Your payments of SE tax contribute to your coverage under the social security system. Social security coverage provides you with retirement benefits, disability benefits, survivor benefits, and hospital insurance (Medicare) benefits. You must be insured under the social security system before you begin receiving social security benefits. You are insured

if you have the required number of earned credits (also called quarters of coverage). You can earn a maximum of four credits per year. Most ranchers have sources of income outside of their ranch and thus will accumulate enough credits to become covered. There is a special rule for farmers that allow them to elect to use a simplified calculation called the “Farm Option Method” to calculate farm Net Earnings for SE purposes even if they are having losses for income tax. If a rancher has losses and has not earned enough credits, then he should consider this rule to increase his benefits.

The impact on an individual’s benefits by increasing the total amount of earnings subject to the tax is very complicated and is beyond the scope of this article. For an explanation of the number of credits you must have to be insured and the benefits available to you and your family under the social security program, consult your nearest Social Security Administration (SSA) office or visit the SSA website at [www.socialsecurity.gov](http://www.socialsecurity.gov). Generally, the SSA will give you credit only for self employment earnings reported on a tax return filed within 3 years, 3 months, and 15 days after the tax year you earned the income. If you file your tax return or report a change in your self-employment earnings after the SSA time limit for posting self-employment earnings, the SSA may change its records, but only to remove or reduce the amount. The SSA will not change its records to increase your self-employment earnings after the SSA time limit listed above. If you are near retirement, an increase in your SE could reap some long term benefits so, reducing the tax may not always be the best answer. Your financial advisor should be able to help with that analysis.

### **What is subject to SE**

Simple put any earnings from self-employment with a few exceptions are subject to SE. It should be noted, include in self-employment earnings any payments you receive from insurance or other sources to replace income (not property) lost because you reduced or stopped farming activities. This is true even if you are not currently farming when you receive the payment. It is still included in self-employment earnings if it relates to your farm business (even though it is temporarily inactive) if it is clear the payment would not have been made but for your conduct of your farm business. Also under the Conservation Reserve Program (CRP), you must include the annual rental payments and any onetime incentive payment you receive under the program. The one exception is if you received social security retirement or disability benefits then the CRP payments are not subject to SE tax

It may be easier to identify what is not subject to the SE tax.

- Land Rent where no participation in the ranching activity is included in rental agreement (this is the planning item that can blow up under audit if not documented correctly- see further discussion below )
- Ranch Equipment rental when included with qualified land rental
- CRP payments that are for the permanent retirement of cropland base and allotment history (they are for the sale of section 1231 property or a capital asset.)
- A gain or loss from the disposition of equipment and other property that is neither stock in trade nor held primarily for sale to customers.

This includes the following

- Investment property.
- Depreciable property or other fixed assets used in your trade or business.
- Livestock held for draft, breeding, sport, or dairy purposes, and not held primarily for sale, regardless of how long the livestock was held, or whether it was raised or purchased.
- Unharvested standing crops sold with land held more than 1 year.
- A gain or loss from the cutting of timber if the cutting is treated as a sale or exchange.

### **Planning and analysis**

Over the years the leasing of land and equipment used in a ranching activity has been used to reduce SE income. The rancher simply forms an entity such as a partnership, LLC or Corporation. The rancher will use the entity he selected to run the ranch operations. He will become an employee of that entity and leases the land and equipment to that entity for use in the ranch operations. The rancher receives the rent and the balance of any earnings as compensation from the entity.

Generally rents from real estate paid in cash or crop share are excluded from SE income definition. However under IRS code Sec. 1402(a)(1) there is an exception to the exclusion if three criteria are met:

1. Rental income is derived under an arrangement, between the owner and another individual, which provides that such other individual shall produce agricultural or horticultural commodities on such land

2. The arrangement calls for material participation by the owner in the production or the management of the production of such agricultural or horticultural
3. There is material participation by the owner with respect to any such agricultural or horticultural commodity;

The IRS won a few tax cases in late 1999 in the U S Tax Court. The opinions were issued as Tax Court Memorandums. Two of the cases had oral lease agreements but had written employment agreements. In Those cases the Judge ignored the lease agreements and said the rent was subject to SE tax. Another case Michael McNamara, TC Memo 1999-333 10/4/99 was a case where a husband and wife leased 480 acres to their C Corporation farm under a written cash lease for \$50,000 per year. Both were employed by the corporation under separate agreements. Again the rental lease and the employment agreement were treated as one agreement by the Judge and the rent was subject to SE tax. In all three cases the Judge looked at the operations and noted that nothing had changed but for the reduction of SE by the amount of the new lease arrangements.

Fortunately, in 2000 these cases were reversed by the Eight Circuit. The court instructed the IRS that there must be a connection between the lease and the employment arrangement in order for the rental income to fall into the farm commodity exception of taxability. Good win for us ranchers. However, the IRS issued a non acquiescence on the issue for locations outside of the Eight Circuit. The IRS has had some success in 2004 when taxpayers failed to support the reasonableness of rents paid when compared to third party leases. Therefore, proper planning and documentation can save some money when it comes to SE tax.

You or your tax advisor should review any lease arrangement clarifying the language in the lease that “the lessor shall have no responsibility or personal participation, as landlord, in the raising or production of commodities under the lease”. And that the agreement confirms that “the lessee shall have all responsibility for, management and control of commodity production and of use and control of the real estate during the term of the lease without the consulting or participation of the lessor”. Review rental rates and document that they were at or below local market at the time of the execution of the lease. If the lessor is also providing services, there should be a separate written employment agreement that defines the duties to be performed and documentation that the compensation is at a reasonable rate for those duties.

## **Summary**

The IRS has tipped their hand of their interest in auditing Schedule F income by initiating their pilot project in the Brookhaven, NY. Over the years the IRS has identified that the lease of land and equipment used in a ranching activity has been used to reduce SE income. Therefore Care must be exercised in the structuring and documentation of any lease arrangement to ensure there is:

- proper language clarifying that the lessor has no participation in the operations under the rental agreement,
- the rent is reasonable at the time of execution
- and any services that might be provided by the lessor be under a separate written employment agreement with reasonable compensation.

It should be noted that the impact on the individual future social security benefits should be considered when SE tax is being reduced especially in the later years just before retirement. Also a quick review to see if the “Farm Option Method” to calculate Farm Net Earnings for SE purposes might help ranchers obtain the required number of earned credits quicker for their coverage under Social Security system should be considered.

For more information on this topic and other tax planning for agricultural operations, please contact me at my cell (863) 640-2008 or [Tom@beasleybryantcpa.com](mailto:Tom@beasleybryantcpa.com) and/or Ryan Beasley at (863) 646-1373 or [Ryan@beasleybryantcpa.com](mailto:Ryan@beasleybryantcpa.com) . Please visit our website at [www.beasleybryantcpa.com](http://www.beasleybryantcpa.com) for information on other relevant topics.

We at Beasley, Bryant & Company, CPA’s, P. A. are experienced in agricultural business problems, tax issues or concerns, and are here to help you.

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