DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF THE CHIEF COUNSEL

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The Honorable Mark Kirk
United States Senator
230 South Dearborn St.
Suite 3900
Chicago, Illinois 60604

Attention:

Dear Senator Kirk:

This letter is in response to your inquiry dated April 3, 2012, on behalf of your constituent, . She asked about the self-employment tax treatment of rental payments farmers receive for farmland.

The Internal Revenue Code taxes self-employment income to fund Social Security benefits for the self-employed. Section 1402(b) provides that self-employment income means the net earnings from self-employment derived by an individual. Section 1402(a)(1) generally excludes rentals from real estate from net earnings from self-employment. However, rentals are not excluded if the income is derived under an arrangement between an owner or tenant and another individual which provides that the individual shall produce agricultural or horticultural commodities on the land, and that there shall be material participation by the owner or tenant in the production or management of the production, and the owner or tenant materially participates.

The United States Tax Court has held in several cases that rental payments are subject to self-employment tax based on the fact that the employment agreements and other informal understandings required that the lessors materially participate in farm production and that they did in fact materially participate. In *McNamara v. Commissioner*, 236 F.3d 410 (8th Cir. 2000), the United States Court of Appeal for the

Eighth Circuit consolidated three of these cases. The appellate court did not disagree with the Tax Court's finding regarding the total relationship between the parties, but questioned whether the rental amounts were in fact derived under the same arrangement that required the lessor's material participation. The appellate court held that, to the extent that the rent paid was consistent with the fair rental value of the leased property, the rental agreements should be treated as separate and distinct from the employment agreements in determining whether an arrangement existed calling for material participation in farm production for purposes of determining whether self-employment tax applied to the rental payments.

On October 22, 2003, we announced our nonacquiescence to the Eighth Circuit's decision in AOD-2003-03 (copy enclosed) and our intent to continue to litigate the issue in cases outside the Eighth Circuit. We indicated that we disagree with the Eighth Circuit decision because the decision did not reflect the Congress' intent. We believe that our interpretation of the exception in section 1402(a)(1) best promotes Congress' intent that farmers who must work for a living have their incomes replaced through coverage under the social security system.

questions our choice not to acquiesce to the decision by the United States Court of Appeal for the Eighth Circuit. She wants us to apply this decision to her case. Under our judicial system, however, the decisions of one appellate court are not binding on another circuit court of appeals (or lower federal courts whose decisions are appealable to those other circuits), even when considering the same issue.

We issue an action on decision or AOD to enhance consistency in dispute resolution or future litigation. An AOD that recommends nonacquiescence to an appellate court decision apprises taxpayers that, although we sought no further review of that case, we do not agree with the court's holding. It provides early notice to taxpayers that we intend to seek additional judicial review of the issue in courts that are not bound by the decision, allowing taxpayers residing in different circuits to take our position into consideration in meeting their tax obligations.

If you would like to discuss this matter further, please contact me at or at .

Sincerely,

Victoria A. Judson
Division Counsel/Associate Chief Counsel
(Tax Exempt & Government Entities)

Enclosure