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Self-employment tax for spouses receiving farm program payments?*

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Recent audit activity by the Internal Revenue Service suggests that IRS believes that spouses who receive farm program payments under the current farm program legislation are liable for self-employment tax on the amounts received. That position, while justified if the spouse has "net earnings from self-employment" from a "... trade or business carried on by such individual. . . .", does not appear to be justified if the involvement by the spouse falls short of that standard. The question is whether, if the only participation by the spouse is that sufficient to meet the minimum requirements to be eligible to receive government farm program payments, the spouse is subject to self-employment tax.

The test for spousal eligibility for farm program payments

Since 1991, when the Secretary of Agriculture exercised the authority from Congress to allow each spouse

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to be considered a separate "person," in the case of a married couple consisting of spouses who do not hold, directly or indirectly, a substantial beneficial interest in more than one entity (including the spouses themselves) engaged in farming operations that also receives farm program payments as separate persons, the spouses may be considered separate persons if each spouse meets the other requirements necessary to be considered separate persons. That rule did not change the already existing exception allowing a married couple who were engaged in separate farming operations before marriage and continue to operate separately after marriage to be considered separate persons for purposes of the payment limitation provision.

To be eligible for farm program payments, an individual or entity must be "actively engaged in farming." To be actively engaged in farming, three conditions must be met—

- The individual's share of profits or losses from the farming operation must be commensurate with the

individual's or entity's contribution to the operation; *continued on page 2*

Handbook updates
For those of you subscribing to the handbook, the following updates are included.
Group Risk Insurance (GRP) and Group Risk Income Protection (GRIP) – A1-58 (2 pages)
2008 Iowa Farm Custom Rate Survey – A3-10 (2 pages)
Operating Leverage – C1-45 (3 pages)
Please add these files to your handbook and remove the out-of-date material.
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- The individual's or entity's contribution must be "at risk;" and
- An individual must make a significant contribution of (1) capital, equipment or land or a combination of capital, equipment or land and (2) active personal labor or active personal management or a combination of active personal labor and active personal management.

Obviously, the last item listed – active personal labor and active personal management—is the key factor in comparing the "actively engaged" test with the "self-employment income" test. The regulations go on to state that, in determining if the individual or entity is contributing a significant amount of active personal labor or active personal management, several factors are taken into consideration—

- (1) the types of crops produced by the farming operation;
- (2) the normal and customary farming practices of the area; and
- (3) the total amount of labor and management which is necessary for such a farming operation in the area.

The regulations also specify that, for farming operations conducted by persons a majority of whom are family members, "... an adult family member who makes a significant contribution of active personal management, active personal labor, or a combination of active personal labor and active personal management, shall be considered to be actively engaged in farming."

The test for "self-employment income"

The statute states 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. . . less the deductions allowed. . . ." The statute goes on to define "trade or business" as that term is used in determining the deductibility of trade or business expenses under I.R.C. § 162 with specified exceptions.

In general, continuity and regularity of activity are necessary before a venture can be considered a trade or business. Thus, ventures did not rise to the level of a "trade or business" where the taxpayer's efforts were "irregular and sporadic" as an inventor, where the sale of insider information by an investment firm's employee was involved, where the taxpayers were not actively involved in the operation of a night club and restaurant, where securities trading was not conducted with sufficient frequency to constitute a trade or business, and where an attorney was not involved in law practice sufficient to be a trade or business, to mention a few of the numerous cases litigated under I.R.C. § 162. On the other hand, the U.S. Supreme Court held in *Commissioner v. Groetzinger* that "constant

and large-scale effort" by the taxpayer in a gambling activity (60 to 80 hours per week, 48 weeks per year) was considered a trade or business. Basically, what is a "trade or business" is a facts and circumstances question as pointed out in *Commissioner v. Groetzinger*.

It should be noted that "material participation" was added to the statutory authority for self-employment income in the context of landlord-tenant relationships in 1956. That concept could be relevant in the context of a husband and wife farming operation if the relationship is characterized as a landlord-tenant relationship.

Characterization as a partnership

If a husband and wife farming operation is properly characterized as a partnership, as has been asserted in some audits over the issue of self-employment tax liability of spouses, there is authority that all general partners in a general partnership have self-employment tax liability. As stated in *Norwood v. Commissioner*, "It is undisputed that petitioner's interest. . . was a general partnership interest. Accordingly, his distributive share of the partnership's trade or business income is, subject to the imitations of section 1402(b), subject to the taxes imposed by section 1401 on self-employment income."

The key question, of course, is whether a husband and wife carrying on a farming operation with the wife involved only to the extent of being "actively engaged in the farming operation" for purposes of eligibility for farm program payments, are a partnership. Although courts in a few states have held that husband-wife partnerships are recognized even if the formalities of partnership organization are not in evidence, the Uniform Partnership Act defines a partnership as an association of two or more persons to carry on as co-owners a business for profit. The sharing of gross returns does not, in itself, establish a partnership. However, receipt of a share of the profits is prima facie evidence of partnership existence.

If the spouse receiving farm program payments under the "actively engaged in farming" test receives only a portion of the government payments, that does not indicate a sharing of net income and, therefore, is not indicative of a partnership.

Electing out of partnership status

A provision has been available for several years to allow the members of an unincorporated organization to elect not to be treated as a partnership. However, that election only applies to organizations "... availed of for investment purposes only and not for the active conduct of a business. Therefore, that provision is of little help to a

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husband and wife facing an assertion that the spouse has self-employment income as a general partner in a general partnership for receiving farm program payments.

Another provision, enacted in 2007, perhaps with an objective of addressing the problems now faced on audit, affords another opportunity for husbands and wives to elect out of partnership status. That enactment, involving "qualified joint ventures," specifies that, in the case of a qualified joint venture conducted by a husband and wife who file a joint return for the taxable year, an election may be made to elect not to be treated as a partnership. The husband and wife can be the only members of the electing joint venture and both must be materially participating within the meaning of section 469(f). That meaning of "material participation" requires material participation on a regular, continuous and substantial basis. That provision is unlikely to be helpful in husband-wife situations inasmuch as the spouse qualifying for farm program payments under the "actively engaged" test would generally not be sufficiently involved to meet the higher standard of material participation on a regular, continuous and substantial basis. If that test were met, the spouse would be subject to self-employment tax under the lesser rule of material participation. If the statute providing for the election out of partnership status had specified that the election could be made if one of the spouses is materially participating under that higher standard, the election out would provide a good defensive opportunity for the couple.

In conclusion

Until litigated, it will likely not be known with certainty whether the "actively engaged" test requires less (or more) than the "trade or business" test. Based on the way the

two tests have been administered, it appears that the "actively engaged" test requires significantly less involvement than the trade or business test. The one exception to that is the recent controversy over taxation of Conservation Reserve Program (CRP) payments where the Internal Revenue Service has taken the position, which has been roundly criticized, that merely signing up for the program is sufficient for the imposition of self-employment tax on annual CRP payments.

If that is the case, and if the facts support lesser involvement than is required for the trade or business test, the only remaining argument for self-employment tax liability is the argument that the husband-wife arrangement is a partnership. That assertion should be effectively countered with a showing that no partnership exists under state law and that the requirements for a partnership under the Uniform Partnership Act have not been met. However, in a different setting, eligibility of co-owned property for like-kind exchange treatment, IRS has persisted in its belief that use of a partnership tax return as a convenient way to report income and deductions makes the property ineligible for like-kind exchange treatment as an interest in a partnership even though no partnership was intended and no partnership existed under state law. That position by IRS has not been litigated nor has the position that all CRP payments are subject to self-employment tax regardless of the relationship to a trade or business.

IRS seems to be attempting to redraw the line between what is a trade or business and what is an investment asset. Unless Congress steps in, which appears unlikely, litigation is the only way to resolve the issue.



Global warming – impact of greenhouse gases

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(Second in series)

Global warming will have a profound impact on global agriculture, with yet unknown influences on Midwest agriculture. As with most changes, this will provide both opportunities and threats for Midwest agricultural producers. This article discusses the role greenhouse gases play in global warming.

Solar energy heats the earth's surface. But the energy does not stay bound up in the earth's environment forever. Instead, as the earth warms, it emits thermal radiation.

This thermal radiation, which is largely in the form of long-wave infrared rays, eventually finds its way out into space, leaving the earth and allowing it to cool. However, not all of the infrared rays pass into space. Some of the infrared rays are absorbed by greenhouse gases and warm the atmosphere. So the amount of greenhouse gases in the atmosphere is directly related to the temperature of the atmosphere. Increased concentrations of greenhouse gases increase the temperature of the atmosphere leading to the warming of the earth's surface.

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The natural carbon cycle

Carbon dioxide and other greenhouse gases go through a natural cycle. Large amounts of carbon pass back and forth between the atmosphere and the earth's surface. For example, growing crops and trees take in carbon dioxide (CO₂) during photosynthesis. The carbon is the feedstock for making the plant and the oxygen (O₂) is released into the atmosphere. When the plant dies and deteriorates or is processed, the carbon is combined with oxygen by microbial processes to become CO₂ and is returned to the atmosphere. So these processes tend to keep the amount of carbon dioxide relatively constant over time.

However, burning fossil fuels takes carbon that has been stored deep in the earth and emits the carbon into the atmosphere in amounts that are too large for the earth's plants to absorb. This is "new" carbon dioxide that is being pumped into the atmosphere.

Changing land-use has the effect of slightly increasing carbon dioxide atmospheric concentrations. Human activities such as burning fossil fuels, releasing chlorofluorocarbons, and deforestation have raised levels of greenhouse gases far above natural levels. Nature requires hundreds of years to remove these excessive amounts of greenhouse gases.

Types of greenhouse gases

Water vapor is the most prevalent greenhouse gas in the atmosphere. Water vapor doesn't stay in the atmosphere very long. Although concentrations can change rapidly on a local basis, globally concentrations remain quite constant. The greenhouse gases that impact the gradual warming of the earth's surface are those that stay in the atmosphere for a long period of time and build-up over time. In spite of their relatively low atmospheric concentrations, their long lifetime makes their influence on global warming large.

The warming impact of different types of greenhouse gases varies according to the warming power of the gas and the length of time it stays in the atmosphere. As shown in Table 1, carbon dioxide has an atmospheric life of 50 to 200 years. So once emitted into the atmosphere, it has a warming effect over a long period of time. Methane, for example, has a life of about 12 years, much shorter than carbon dioxide.

The warming power of each gas varies greatly. For example, methane is a much more powerful greenhouse gas than carbon dioxide. Over a 100 year period, a molecule of methane (CH₄) has 21 times the warming effect as a molecule of carbon dioxide (CO₂), even though it stays in the atmosphere for only about 12 years of the 100 year period.

Table 1. Global Warming Potentials and Atmospheric Lifetimes (years).

	Atmospheric Lifetime	GWP*
Carbon Dioxide (CO ₂)	50-200	1
Methane (CH ₄)	12	21
Nitrous Oxide (N ₂ O)	114	289
Other	1-50,000	5-22,800

* Global warming potential over 100 year lifetime
 Source: Intergovernmental Panel on Climate Change, 2007 Report.

To compare the impact of each gas, the warming potential of each gas is computed over a 100 year period as shown in Table 1. The Greenhouse Warming Potential (GWP) is computed for each gas based on its warming power and atmospheric lifetime. As a basis of comparison, carbon dioxide is assigned a GWP of one and the GWP of the other gases are computed in relationship to carbon dioxide. For example, relative to carbon dioxide, nitrous oxide has about 300 times the warming effect. The other gases (halocarbons, perfluorocarbons and sulfur hexafluoride) are also powerful gases. Although the warming potential of the other gases is more powerful than carbon dioxide, carbon dioxide emissions dwarf those of the other gases due to its large volume of emissions.

Atmospheric levels of greenhouse gases

The current rate of increase of greenhouse gas levels in the atmosphere is unprecedented. Focusing specifically on the major greenhouse gas, carbon dioxide, it has traditionally fluctuated from about 180 parts per million (ppm) to about 300 ppm. Carbon dioxide emissions have increased from less than 320 ppm in 1960 to 380 presently. The atmosphere now contains more carbon dioxide than at any time in the last 420,000 years and possibly the last 20 million years.

We can calculate with confidence that, even with severe limits on emissions, carbon dioxide concentrations will be at least 450 ppm by 2050. If we allow for rapid economic growth based on continued use of fossil fuels, carbon dioxide concentrations will reach 600 ppm by 2050 and about 950 ppm by the end of the century (Intergovernmental Panel on Climate Changes, 2007 Report).

Impact on global temperatures

Average global temperature will rise 0.7 to 2.2 degrees Fahrenheit by 2030 and a 2.5 to 10.4 degrees Fahrenheit over the next 100 years (Intergovernmental Panel on Climate Change). Recent scientific reports conclude there is a 40% chance that warming will exceed this range and only a 5% chance that it will be less. There is no scientific

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evidence to suggest that global average temperatures will remain constant or decline in the next 100 years.

Although the earth has warmed and will continue to warm, the temperature increase has not and will not be distributed evenly. The warming tends to be concentrated in certain parts of the world, especially the northern areas. There were also areas that actually cooled slightly.

Projected temperatures increases over the next 100 years are once again not expected to be distributed evenly. The

warming tends to be concentrated in the far north. Also, because land is more responsive to atmospheric temperature changes than the oceans, the temperature increase will be greater over the continents than the oceans

This article has focused on the role of greenhouse gases in global warming. The next article will focus on agriculture's role in greenhouse gas emissions.

Value-added business success factors -- strategic planning and implementation

by Don Senechal, Founding Principal, The Windmill Group, F. Larry Leistriz, Professor, Department of Agribusiness and Applied Economics, North Dakota State University, Nancy Hodur, Research Scientist, Department of Agribusiness and Applied Economics, North Dakota State University

(Third in a series of six)

There has been a surge of interest in farmer-owned business ventures that seek to capture additional value from commodities past the farm gate. Some of these ventures have been very successful, some marginally successful, and some have failed. Supported by funding from the Ag Marketing Resource Center at Iowa State University, we conducted in-depth interviews with farmer-owned businesses to determine the key factors that influenced the relative success or failure of these ventures. A better understanding of why some ventures succeeded while others failed provides valuable insight for the success of future farmer-owned businesses. This article focuses on the role of strategic planning and implementation on business success.

Research method

To identify factors having the greatest impact on the success or failure of farmer-owned business ventures, a cross-section of seven farmer-owned commodity processing businesses formed since 1990 in North Dakota, South Dakota, and Minnesota were selected. Extensive interviews were conducted with individuals who played, or continue to play, an important role in the formation and operation of the business. This included leaders in the formation of the business, key members of the management team, selected board members, lenders, local leaders and others.

Research results

Early in the development of a farmer-owned enterprise, the board of directors and management need to work together to define business goals, objectives, and standards. In a previous article the importance of a shared vision by

management and the board was discussed. The strategic planning process is where the shared vision is identified and articulated. Typically, management with its industry knowledge and expertise would prepare a strategic plan and present it to the board for approval. The implications of the plan need to be understood by both groups.

Business Assessment

The plan should incorporate articulate a tight, well-defined business focus. Launching a multi-million dollar commodity processing business is challenging enough on its own. But without a well-defined vision and plan for implementing of that vision, the odds of success decline. Management and the board need to realistically assess their business's relative strengths and weaknesses and implement plans that capitalize on the venture's strengths. For example, one business found that it had an advantage over competitors in shipping product to points north and west of its facility. It then focused its marketing program to capitalize on this advantage.

It is important that a new business venture not try to do too much. A new business should focus on being very good at one thing rather than try to do several things. Penetrating a commodity market with thin margins, often the case with a processing business, is difficult enough on its own. Trying to penetrate multiple markets is even more difficult. One business venture attempted to process and market five different products. This posed problems for both marketing and plant operations because of the need to retool each time it began processing a different products. The venture failed within a year of beginning operations.

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Business Launch

The launch phase of a new business venture is critical. The strategic plan must provide for significant and appropriate investment in sales and marketing. This is relevant for all new ventures, but particularly for non-commodity or differentiated product ventures.

The use of proven technology is also critical to a new enterprise. A new enterprise should use the best available technology, but also stick to proven technologies. An embryonic organization should not attempt to pioneer new technologies. There are simply too many unidentifiable risks for a new venture to attempt to overcome.

If a technology problem emerges or a production delay emerges that hinders start-up or causes a shutdown in production, starting legal action against the technology provider or builder should not be postponed. A substantial lag can occur between the time of initiating legal action and financial remedy. In one situation the builder was given additional time to reach guaranteed plant production capacity. So, legal action was not initiated until after several attempts by the builder to reach production capacity. By the time legal action was started and subsequent financial remedy received from the builder, the business venture ceased operations and went out of business.

(Next article – Organizational issues)

Major funding for this research provided by the Agricultural Marketing Resource Center. Additional funding provided by Farmers Union Marketing and Processing Association Foundation, Co-Bank and Ag Ventures Alliance.

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Internet Updates

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

Assessing Entrepreneurial Skills – C6-60

Assessing Strategic Management Skills – C6-61

Assessing Personnel Management Skills – C6-62

Assessing Inter-Personal Skills – C6-63

Assessing Organizational and Planning Skills – C6-64

Assessing Financial and Risk Management Skills – C6-65

Decision Tools

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

Crop Insurance Comparison – Use this decision tool to compare different crop insurance strategies for corn and soybeans.

Group Risk Crop Insurance Comparison – Use this decision tool to compare GRIP and GRP crop insurance for corn and soybeans.

Voice Media Presentations

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

Iowa Farm Custom Rate Survey

Managing Risk with Crop Insurance - Choices for 2008

Tools

The following profitability tools have been updated on www.extension.iastate.edu/agdm to reflect current price data.

Corn Profitability – A1-85

Soybean Profitability – A1-85

Ethanol Profitability – D1-10

... and justice for all

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