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# Trusts and Self-Employment Tax

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### Issue Contents

#### Federal Agricultural Programs

Animal Welfare Act **58**

Farm loans **59**

#### Federal Estate and Gift Tax

Family-owned business  
deduction **59**

Gross estate **59**

IRA **59**

Interest **59**

#### Federal Income Taxation

Audit **59**

Accounting method **59**

Bad debts **60**

Bonuses **60**

Cooperatives **60**

Corporations

Mergers **60**

Section 1244 stock **60**

Court awards and settlements **60**

Disaster losses **60**

Legal fees **61**

Margin accounts **61**

Pension plans **61**

Returns **61**

Tax shelters **62**

Travel expenses **62**

#### Labor

Overtime wages **62**

#### Product Liability

Combine **63**

#### Water

Drainage **63**

#### In the News **63**

# Agricultural Law Digest

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## TRUSTS AND SELF-EMPLOYMENT TAX

— by Neil E. Harl\*

With the increase in the use of trusts, both inter vivos and testamentary,<sup>1</sup> in recent years, the question of self-employment tax liability has arisen frequently.<sup>2</sup> Recently, the Internal Revenue Service issued two Technical Advice Memoranda (TAMs) casting light on the self-employment tax liability for trust distributions.<sup>3</sup>

### Liability of trustee for SE tax

Earlier authority had addressed the question of liability of a fiduciary (including trustees) for self-employment tax.<sup>4</sup> Professional fiduciaries are treated as being in the trade or business of being fiduciaries and are treated as receiving self-employment income.<sup>5</sup> In a 1990 private letter ruling an attorney who was trustee for 12 trusts and coexecutor of an estate was considered to be a professional fiduciary for this purpose.<sup>6</sup>

Those serving as executor or administrator of an estate in isolated instances as a nonprofessional fiduciary are treated as receiving income from a trade or business only if there is a trade or business among the assets of the estate unless the estate requires extensive management involvement.<sup>7</sup>

### Distributions from irrevocable QTIP and bypass trusts

In a 2002 Technical Advice Memorandum, IRS addressed a situation where farm income was paid from an irrevocable QTIP trust and a unified credit bypass trust to an individual who was both the trust's beneficiary and trustee.<sup>8</sup> In the facts of that ruling, a couple owned a farm and created a revocable inter vivos trust and named themselves as trustees, which has become a common planning strategy.<sup>9</sup> The trust was funded with farmland. At the husband's death, three trusts were created—(1) a survivor's trust; (2) a qualified terminable interest property (QTIP) trust; and (3) a unified credit bypass trust.<sup>10</sup> The wife, as the surviving spouse, was the sole fiduciary and the sole beneficiary of the survivor's trust. The QTIP and unified credit trusts were irrevocable. Distributions from those two trusts were reported on the surviving spouse's Schedule E and self-employment tax was not paid. The wife, as surviving spouse, reported the distributions from the survivor's trust as self-employment income and paid self-employment tax.

The IRS, in the TAM, pointed out that trust income derived from farming activity and distributed to the surviving spouse as beneficiary is not necessarily considered to be self-employment income subject to SE tax.<sup>11</sup> The IRS noted, however, that in the event the distributions were payments for services the surviving spouse provided to the trust as part of a trade or business, those amounts generally would be considered net earnings from self-employment and subject to SE tax.<sup>12</sup> The Internal Revenue Service noted that a question could arise over whether the surviving spouse received adequate compensation

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for the services performed for the trusts.<sup>13</sup>

In keeping with the Technical Advice Memorandum,<sup>14</sup> the outcome in terms of self-employment tax liability would seem to depend upon—(1) the nature of the lease or other arrangement between the trust and the tenant or operator, (2) the adequacy of the rental amount or other payment and (3) the identity of the tenant or operator. For a cash rent lease to a third party tenant who is not a trustee or beneficiary, the distributions should not be subject to self-employment tax. For a cash rent lease to a tenant who is also a beneficiary or the beneficiary of the trust, there should be no SE tax liability provided the rental is a fair market rental.<sup>15</sup> If it is not, a portion of the distribution could be subject to SE tax. If the trust property is rented under a non-material participation crop share lease to an unrelated tenant, there should be no SE tax on trust distributions. In the event the trust property is rented under a non-material participation crop share lease to a beneficiary or the beneficiary of the trust, again the question would seem to be whether the rental reflects a fair market rental.<sup>16</sup>

The TAM does not address the consequences of a custom farming operation or material participation crop share lease, both of which ordinarily would not produce self-employment tax liability for the beneficiaries of the trust.<sup>17</sup> However, the TAM cautioned that a trust resembling a business entity could be treated as a business entity with respect to SE tax liability.

#### Distributions from a testamentary trust

The other Technical Advice Memorandum,<sup>18</sup> involved farm income paid from an irrevocable testamentary trust to individuals who were both trust beneficiaries and trustees. In the facts of that TAM, on the decedent's death the decedent's wife and son became co-trustees and were also the trust's beneficiaries. The son was paid a fee by the trust for managing the farm operations and the decedent's surviving spouse was paid a fee for maintaining the farm records. The spouse and son reported these fees as subject to SE tax but the distributions by the trust were not reported as self-employment income.

IRS, in the TAM, agreed that the distributions were not considered net earnings from self-employment. IRS noted, however, that if the distributions from the trust were payments for any services the surviving spouse and son provided to the trust as part of their trade or business, those amounts would be considered net earnings from self-employment. As IRS stated, a focus on the adequacy of payments for services rendered is appropriate.

Thus, for example, if the payments to the son in the TAM represented inadequate compensation for services rendered, at least a portion of the distribution to the son is likely to be treated as net earnings from self-employment for the son.<sup>19</sup>

In conclusion

IRS warned in both TAMs, that arrangements that are denominated as trusts, but resemble business entities, would be treated as business entities for purposes of self-employment tax liability.

#### FOOTNOTES

<sup>1</sup> See generally 8 Harl, *Agricultural Law* Ch. 62 (2003); Harl, *Agricultural Law Manual* § 8.02 (2003).

<sup>2</sup> See I.R.C. § 1402(a).

<sup>3</sup> See TAM 200305001, July 24, 2002; TAM 200305002, July 24, 2002.

<sup>4</sup> See Rev. Rul. 58-5, 1958-1 C.B. 322; Ltr. Rul. 9107009, Nov. 14, 1990.

<sup>5</sup> Rev. Rul. 58-5, 1958-1 C.B. 322.

<sup>6</sup> Ltr. Rul. 9107009, Nov. 14, 1990.

<sup>7</sup> Rev. Rul. 58-5, 1958-1 C.B. 322.

<sup>8</sup> TAM 200305001, July 24, 2002.

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*

<sup>12</sup> I.R.C. §33 1402(a).

<sup>13</sup> TAM 200305001, July 24, 2002.

<sup>14</sup> *Id.*

<sup>15</sup> Cf. *McNamara v. Comm'r*, 236 F.3d 410 (8th Cir. 2000). See Harl, "The Latest on *Mizell*," 13 *Agric. L. Dig.* 137 (2002).

<sup>16</sup> *Id.*

<sup>17</sup> See Treas. Reg. § 1.1402(a)-2(b) (trade or business must be carried on by the individual; income derived from a trade or business carried on by an estate or trust is not included in determining net income from self-employment of the individual beneficiaries).

<sup>18</sup> TAM 200305002, July 24, 2002.

<sup>19</sup> See I.R.C. § 1402(a).

## CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

### FEDERAL AGRICULTURAL PROGRAMS

**ANIMAL WELFARE ACT.** The APHIS has issued proposed regulation under the Animal Welfare Act to require that research

facilities, dealers, and exhibitors maintain medical records as part of their program of adequate veterinary care. **68 Fed. Reg. 17752 (April 11, 2003).**

**CROP INSURANCE.** The CCC has adopted as final regulations implementing section 2501 of the Farm Security and Rural Investment Act of 2002, which amended section 524 of the Federal Crop Insurance Act, which permits CCC to fund the Agricultural Management Assistance program administered by the NRCS in