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Private Letter Ruling 8742007

Issues

1. Whether payments made to W by H in the operation of a farm represent the distribution of self-employment income.

2. Whether H is allowed a deduction under section 162 of the Code for salary payments made to W.

Facts

Taxpayers, H and W, are farmers engaged in hog and cattle feeding and grain production. Together they own Y acres of tillable land, Z acres of which are owned solely in H's name and X acres of which are owned solely in W's name.

H began farming a portion of his land when he was employed by his father; he eventually purchased the farm in 1963. H and W were married in 1961.

In 1984 W purchased here X acres of land on contract at the recommendation of H and W's attorney, who suggested ownership in her name for estate planning purposes. However, the crops grown on W's land were commingled with the crops grown on the land of H.

H's activities in the farm operation included the following:

1) All planting and crop rotation decisions, including selection of seed;

2) All decisions regarding chemicals, insecticide, fertilizer and herbicide applications, including product selection, purchase discount decisions, and decisions regarding timing and method of application and mixing;

3) Management of machinery maintenance schedule, repair decisions, and machinery replacement decisions and purchase sale negotiation on all equipment and machinery;

4) All decisions regarding harvesting of crops, including both timing and method of harvesting, storage of crops, and trucking for market delivery;

5) All decisions regarding marketing and pricing of crops and negotiation of sales terms;

6) All decisions regarding hog and cattle purchases, including selection of animals and negotiation with selling agents;

7) All decisions regarding animal feeding, including rations and nutrient mixes;

8) All vaccination and animal health care decisions, including consultations with outside veterinarians;

9) All marketing and sales decisions with respect to hog and cattle disposition, and decisions regarding culling of animals;

10) Planning and projection of farm cash flow, and all control and management of farm disbursements and farm receipts; and

11) All negotiations and discussions with lenders regarding working capital debt and farm cash management.

The records of W indicate that during 1984 and 1985 she worked more than 30 hours per week, 52 weeks a year. Her duties included bookkeeping, attending agricultural functions, purchasing supplies, harvesting crops, checking and operating farm machinery, assisting in the sale of pigs, and various other errands and chores.

The farm income and expenses (including the interest and real estate taxes on W's land) were reported on Schedule F with H & W's joint tax return for 1984 and 1985. The Schedule F was in both names in 1984 but only in H's name in 1985. For both years the monies paid to W were deducted on the appropriate line for "labor hired" on the Schedule F. The receipt of income by W was reported in 1984 on line 22 of the 1984 Form 1040 and described as "wife's farm wages". For 1985, H issued W a Form W-2 and income was reported on line 1 of the Form 1040. The difference in reporting is attributable to the fact that taxpayers changed income tax preparers, and the latter tax return preparer recommended the filing of the Form W-2 for all wages paid by H to family members. The Schedule F was in both names in 1984 but only in H's name in 1985. Also included with each return was a completed Schedule SE, Computation of Social Security Self-Employment Tax, in the name of H only.

H and W owned a joint bank account, over which both had signature authority, in which was deposited income from the farm and income from other sources. All expenses, including both farm and personal expenses of H and W, were paid from this joint account.

W paid no rent to H for use of H's land. However, as compensation for work performed, H made a lump sum payment to W at the end of each year. The amount was determined on the basis of actual hours of work performed multiplied by a rate of $6.50 per hour. The salary checks were drawn by H from the joint account and redeposited in the account by W shortly thereafter. W reported the salary payment in gross income but no self-employment taxes or Federal Insurance Contributions Act (FICA) taxes were paid by H or W on this amount.

Applicable Law and Rationale

Initially, a determination must be made whether a partnership existed between H and W. If there was a partnership the distributions to both H and W from farm income were distributions of self-employment income. This is so because section 1401 of the Internal Revenue Code imposes taxes under the Self-Employment Contributions Act (SECA) on the "self-employment income" of every individual.

Section 1402(b) of the Code defines "self-employment income" as an individual's "net earnings from self-employment", subject to certain limitations and conditions.

Section 1402(a) of the Code defines "net earnings from self-employment" to mean, subject to certain conditions and limitations, the gross income derived by an individual from a "trade or business" less the deductions allowed by law attributable to such trade or business, plus the individual's distributive share of income or loss from a trade or business carried on as a member of a partnership.

In addition, Rev. Rul. 82-39, 1982-1 C.B. 119, in applying the rules of section 1402(a) of the Code to both community and non-community property states, concludes that in the absence of a partnership, only the spouse carrying on the trade or business will be subject to the self-employment taxes imposed under section 1401.

Section 7701(a)(2) of the Code provides that the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not for federal tax purposes, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

Whether parties have formed a joint venture is a question of fact to be determined by reference to the same principles that govern the question of whether persons have formed a partnership which is to be accorded recognition for tax purposes. Therefore, while all circumstances are to be considered, the essential question is whether the parties intended to, and did in fact, join together for the present conduct of an undertaking or enterprise. The following factors, none of which is conclusive, are evidence of this intent: (1) the agreement of the parties and their conduct in executing its terms; (2) the contributions, if any, that each party makes to the venture, (3) control over the income and capital of the venture and the right to make withdrawals; (4) whether the parties are co-proprietors who share in net profits and who have an obligation to share losses; and (5) whether the business was conducted in the joint names of the parties and was represented to be a partnership. See COMMISSIONER V. TOWER, 327 U.S. 280 (1946), 1946-1 C.B. 11; COMMISSIONER V. CULBERTSON, 337 U.S. 733 (1949), 1949-2 C.B. 5; LUNA V. COMMISSIONER, 42 T.C. 1067 (1964); and Rev. Rul. 82-61, 1982-1 C.B. 13.

Section 704(e) of the Code deals specifically with family partnerships. Section 704(e)(1) provides that a person shall be recognized as a partner for purposes of federal income taxes if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.

Section 1.704-1(e)(1)(iv) of the Income Tax Regulations provides, in part, that for purposes of section 704(e)(1) of the Code, capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business conducted by the partnership. Capital is ordinarily a material income-producing factor if the operation of the business requires substantial inventories or a substantial investment in plant, machinery, or other equipment.

Section 1.704-1(e)(1)(v) of the regulations provides that for purposes of section 704(e) of the Code, a capital interest in a partnership means an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon limitation of the partnership. The mere right to participate in the earnings and profits of a partnership is not a capital interest in the partnership.

Section 1.704-1(e)(2) of the regulations lists a series of factors to be considered in determining whether a partner is, in fact, the real owner of a capital interest in a partnership. The factors to be considered, which are illustrative rather than exhaustive, break down into five categories: retained controls (including retention of control of assets essential to the business), indirect controls, participation in management, income distributions, and conduct of partnership business. The first two factors indicate lack of ownership, while the last three factors indicate ownership.

In UNITED STATES V. RAMOS, 393 F. 2d 618 (9th Cir. 1968), CERT. DENIED, 393 U.S. 983, an alleged family partnership was found to be invalid under section 704(e) of the Code

where the taxpayer-parents retained the complete interests in the operating assets of a ranch, and the children contributed neither property nor services except bookkeeping services, for which compensation was paid for such services. The failure of the parents to transfer title to farmland to the partnership was one of the most important factors in the court's decision not to recognize the partnership.

The following factors, none of which by itself is controlling, weigh against the finding of a partnership under sections 7701(a)(1) or 704(e) of the Code. First, neither H or W transferred title to his or her farmland into the name of the farm business or into a joint tenancy; thus, each retained dominion and control over his or her own property. Second, W kept records of the hours she worked on the farm, and all amounts paid to W were based on those records rather than on a percentage of the farm income corresponding to W's share of the land farmed. Third, the X acres of farmland were purchased in W's name for estate planning purposes, not for the purpose of contributing the land to a partnership. Fourth, the farming business had been conducted by H for more than 20 years prior to the time that W's land was used in the business; the economic relationship of the parties remained the same afterwards as before. Other factors which tend to indicate that no partnership existed for federal tax purposes are that there was no formal partnership agreement under which the two were to share profits and expenses; there is no evidence that the couple have held themselves out to third parties as partners; and it appears that H retained the management powers in the business. The fact that W performed services in H's farming business and that she allowed her own land to be used in that business does not necessarily establish a partnership for federal tax purposes. The Service recognizes that there may be a mere uncompensated loan of property, particularly between spouses. The Service also recognizes that one spouse can provide services in the business of the other spouse in a capacity other than as a partner. Finally, it is not unusual in a family business operation for both spouses to have signature authority over a bank account which is used for both personal and business matters.

Therefore, we conclude that no partnership existed between H and W.

The issue also arises as to whether W was an employee of H in the performance of farm activities. This determination is necessary because, for SECA purposes, section 1402(c)(2) of the Code provides that the performance of services as an employee does not constitute a "trade or business" within the meaning of section 1402(a).

Sections 31.3121(d)-1, 31.3306(i)-1, and 31.3401(c)-1 of the Employment Tax Regulations provide that generally the relationship of employer and employee exists when the person for whom the services are performed has the right to control and direct the individual not only as to the result to be accomplished by the work but also as to the details and means by which the result is accomplished.

Based on the information furnished, it appears that W merely assisted H with farm activities and H had the right to exercise direction and control over W while she performed her duties. Thus, we conclude that W was an employee of H in the performance of services in H's farm business and those services did not constitute a "trade or business" under section 1402(a) of the Code.

Lastly, we will address the issue of the deductibility under section 162 of the Code of the payments made by H to W.

Section 162(a)(1) of the Code provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the tax year on carrying on any trade or

business, including a reasonable allowance for salaries or other compensation for personal services actually rendered. See also section 1.162-7 of the regulations.

The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. Thus, in Rev. Rul. 73-393, 1973-2 C.B. 33, the Service held that reasonable wages paid by a father to his child for services actually rendered as a bona fide employee are deductible an ordinary and necessary expenses under secction 162 of the Code. As the revenue ruling indicates, the criteria to be used in making a determination as to the deductibility of a salary payment between related parties is whether actual services have been rendered, whether the amount paid is reasonable, whether there was an actual or constructive payment made, and whether there was an employee-employer relationship in existence for which an ordinary and necessary business expense had been incurred.

In STRADLEY V. COMMISSIONER, T.C. Memo 1986-424, no amount was deductible as a business expense for salary paid to taxpayer's wife for secretarial services because there was no evidence of an employment relationship or an actual payment of salary. See also TINKOFF V. COMMISSIONER, 120 F. 2d 564 (1941), in which an amount allegedly paid to the taxpayer's wife was not deductible because the wife performed no services and the checks drawn in her favor were cancelled and never paid. In the instant case, there is no dispute as to the fact that W performed valuable services on a regular basis for H, that payment was made and that an employer-employee relationship existed.

Conclusion

1. The payments made to W by H in 1984 and 1985 do not constitute self-employment income distributed to W for SECA purposes.

2. H is allowed a deduction under section 162 of the Code for salary payments made to W.