Self Employment Taxation of CRP Rents – Part One

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Overview

In its 2021 version of Publication 225, the "Farmer's Tax Guide," the IRS states with respect to Conservation Reserve Program (CRP) payments that, "You must include the annual rental payments…on the appropriate lines of Schedule F." Of course, by reporting CRP rents on Schedule F the payments are subjected to self-employment tax. However, the IRS statement in Pub. 225 is an incorrect statement of the applicable law. Not all CRP rental payments are subject to self-employment tax.

In Part One of this three-part series, I lay out the background of the CRP and the history of the self-employment tax treatment of government payments that farmers receive. In Part Two, I get into the tax reporting of CRP payments before a significant federal court decision on the issue in 2014. In Part Three, I discuss the current rules for the proper reporting of CRP payments. By explaining the historical context of the CRP program, past IRS rulings and court cases, the proper tax reporting of the payments can be clearly understood and the IRS statement concerning the reporting of CRP rents in Pub. 225 will be thoroughly disembowled.

The background of the CRP and the history of the self-employment tax treatment of CRP payments – it's the topic of today's post. Part One of the three-part series.

Background

The CRP, originally enacted in 1985, is an agricultural program administered by the U.S. Department of Agriculture (USDA). Under the program, the program participant agrees to remove the land from active farming, implement a conservation plan, and seed the tract to permanent grass or other vegetative cover to prevent erosion and improve soil and water resources. The USDA, in exchange, generally shares the initial cost of the conservation measures and makes an annual rental payment (reported on a Form 1099) to the owner of the land.

History of SE Tax Treatment of Government Payments

1960s IRS rulings. In 1965, the IRS ruled that grain storage fees paid under a price support loan program of the Commodity Credit Corporation (CCC) were self-employment (SE) income if they were paid to an active farm operator, but excludable from SE income if they were paid to a taxpayer who did not materially participate in the farming operation. *Rev. Rul. 65-149, 1965-1 C.B. 434.* That ruling followed-up on and is consistent with another ruling that IRS had released in 1960 in which the IRS took the position that payments received for acres idled under the Soil Bank program were SE income "if he operates his farm personally … or … if his farm is operated by others and he participates materially in the production of commodities." *Rev. Rul. 60-32, 1960-1 C.B. 23.*

When the CRP was created with the 1985 Farm Bill (the CRP has been termed the "son of Soil Bank"), the IRS maintained that its rulings from the 1960s applied and that CRP rents were not SE taxable in the hands of a non-farmer. CRP rents, according to the IRS, would only be SE taxable if the recipient was a farmer. For example, in *Ray v. Comr., T.C. Memo. 1996-436*, an active farmer who received income from

CRP was required to pay SE tax on the CRP rents, because the farmer was found to already be in the business of farming and the CRP had a direct relationship (nexus) to the farming business. While the farmer was required to care for and conserve the acreage, he was required not to farm or graze the land.

Note. The Tax Court's *Ray* decision reinforced the conclusion that a farmer actively involved in the business of farming who receives CRP income for not farming the acreage is still subject to SE tax on the CRP rents.

The *Wuebker* Case

In 1998, the Tax Court held that CRP payments in the hands of an active farmer were *not* subject to SE tax. Under the facts of the case, an active farmer received about $18,000 of CRP program payments in 1992 and 1993. The payments were reported on Schedule E as land rents. At the same time, the taxpayer was reporting other farming activity on Schedule F subject to SE tax. The IRS assessed SE tax on the CRP income. However, the Tax Court concluded that the CRP payments were rental income, and accordingly exempt from SE tax under I.R.C. §1402(a)(1). *Wuebker v. Comr., 110 T.C. No. 31 (1998).* The Tax Court noted that both the federal legislation authorizing the CRP program and the CRP contractual terms described the payments as "rental income." Further, the court noted that the farmer's service requirements with respect to the land (implementing a conservation plan and establishing ground cover) were incidental, particularly after the first year. Thus, the court concluded that the CRP payments represented rental for the use of land rather than payment for services, and excluded the payments from SE income as rentals from real estate. Having determined that CRP income qualifies as rental from real estate under I.R.C. §1402(a)(1), the Tax Court pointed out that, based on Treas. Reg. §1.1402(a)-4(d), the CRP income is exempt from SE tax even if the payments are associated with a taxpayer's active farming operation. That regulations states that where an individual or partnership is engaged in a business and the income is classifiable in part as rental from real estate, only that portion of the income that is *not* classifiable as rental from real estate is subject to SE tax.

Note: The Tax Court, in *Wuebker*, distinguished its findings from its earlier opinion in *Ray*, noting that the issue of equating the CRP program payments with rental income had not been raised by the taxpayer in that case. The *Ray* case had focused exclusively on the nexus between the CRP payments and the taxpayer's farming business, but the Tax Court stated that its determination of CRP income as rental income made that issue moot.

The IRS appealed the Tax Court's decision, and the Sixth Circuit reversed in a split decision. *Wuebker v. Comr., 205 F.3d 897 (6th Cir. 2000).* In reaching its decision, the Sixth Circuit noted that the taxpayer was actively engaged in farming prior to and during the term of the CRP contract, and that the CRP payments were "in connection with" and had a "direct nexus to" the taxpayer's ongoing farming business. The Sixth Circuit concluded that the key to the SE tax analysis was the substance, rather than the form, of the transaction. Even though the USDA program labeled the CRP payments as "rent," the court reasoned that this fact alone was not determinative of the tax issue, given the connection of the CRP income to the active farm business. However, the Sixth Circuit did not clearly analyze where the line is between activity that constitutes a trade or business for purposes of self-employment tax and activity that does not rise to that level.

The Sixth Circuit also differed with the Tax Court on the basic issue of whether CRP income was rent. Noting that rent is defined as payment "for the use or occupancy of property," the Sixth Circuit observed that the U.S. Department of Agriculture (the payor of the CRP revenue) was not using or occupying the farmland. The Wuebkers, the court noted, continued to have control over and access to their property, despite the CRP restrictions on the agricultural use of the land.

Observation. This split between the Tax Court and the Sixth Circuit appears to be a classic judicial difference in approach. The Tax Court took the more literal interpretation, considering CRP income to be exempt from SE tax because of its plain equivalence to cash rental income. On the other hand, the Sixth Circuit disregarded the rental terminology of the CRP program, and considered the revenue to be a USDA subsidy in lieu of active farming income.

IRS Announcement

In 2003, the IRS signaled that it was changing its position on the self-employment taxability of CRP payments. In a Chief Counsel Memo., the IRS took the position that a taxpayer's mere *signature* on a CRP contract was sufficient to constitute a trade or business which would then make the CRP payments subject to self-employment tax. *C.C.M. 200325002 (Jun. 20, 2003).*

Note: There is absolutely zero authority for the position that a taxpayer's signature on a document, by itself, is sufficient to constitute a trade or business triggering SE tax. The determination of SE tax is based on the totality of the facts and circumstances of each particular situation. *See Comr. v. Groetzinger, 480 U.S. 23 (1987).*

In late 2006, the IRS announced a proposed Revenue Ruling in which it would officially take the position of the 2003 Chief Counsel Memo, revoke the prior Revenue Rulings to the contrary, and thereby make official the government's position that CRP payments are always subject to SE tax, whether received by an active farmer or an inactive landlord/investor. *IRS Notice 2006-108.* Thus, the IRS was announcing that it planned to change its official, long-held position that such payments were not subject to self-employment tax.

The proposed Revenue Ruling (which was never made final) contained two situations to illustrate its potential holdings:

- In the first situation, an individual actively engaged in the business of farming enrolled a portion of his land in the CRP program. The proposed ruling held that the individual would be subject to SE tax on the CRP income.

- In the second situation, individual B, a landowner, ceased all activities related to the business of farming in the year before entering into a CRP contract. In that subsequent year, B rented out a portion of his land to another farmer and entered into a 10-year CRP contract with respect to the remaining portion of his land. A third party performed the seeding and weed control required under the CRP contract. The proposed ruling held that the individual must treat the CRP rental income as subject to SE tax. This second situation relied on the Sixth Circuit's *Wuebker* decision, and focused on the activities required under the CRP contract (tilling, seeding, fertilizing and weed control).

2008 Farm Bill Provision

As a result of a provision included in the 2008 Farm Bill effective for CRP payments made after tax years after 2007, individuals receiving benefits under Section 202 (i.e., retirement) or Section 223 (i.e., disability) of the Social Security Act are exempt from the payment of self-employment tax on CRP income. The provision amended I.R.C. §1402(a)(1). For other taxpayers, no change was made in the SE tax treatment of CRP payments. Indeed, the Committee Report to the 2008 Farm Bill states that "the treatment of conservation reserve payments received by other taxpayers is not changed." The 2008 amendment applies even though the taxpayer begins receiving Social Security benefits before reaching full retirement age.

This statutory change clearly exempts individuals from SE tax imposition on CRP income, for those who are collecting retirement or disability benefits from the Social Security Administration, even though they might be reporting the CRP income on Schedule F due to other active farming activities.

Note: Railroad Retirement benefits Tier III is not a retirement benefit from the Social Security Administration. A person that receives Railroad Retirement and no Social Security benefit is not protected from self-employment tax on CRP payments.

For taxpayers covered by the 2008 amendment, the Schedule SE instructions note that CRP payments are included on Schedule F, line 4b or listed on Schedule K-1 (Form 1065), box 20, Code AH. If the taxpayer is receiving Social Security benefits at the time of receipt of CRP payments, the CRP payment amount is then to be subtracted on line 1(b) of Schedule SE. *Instructions, 2021 Schedule SE.*

Note: In its 2021 Pub. 225, the IRS correctly states that, "Individuals who are receiving social security retirement or disability benefits may exclude CRP payments when calculating self-employment tax."

Conclusion

In Part Two, I will continue the discussion by diving deeper into the tax reporting of CRP payments leading up to a major federal appellate court opinion in 2014.