Self Employment Taxation of CRP Rents – Part Two

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Overview

As noted in Part 1, the IRS continues to hold to its incorrect position on the self-employment tax treatment of Conservation Reserve Program (CRP) payments. In its 2021 version of Publication 225, the "Farmer's Tax Guide," the IRS states incorrectly 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.

In Part One of this three-part series, I set forth the background of the CRP and the history of the self-employment tax treatment of government payments that farmers receive. I then covered the significant IRS private rulings on the tax treatment of CRP payments, a Tax Court case in 1996 and another Tax Court decision a couple of years later that was subsequently reversed by the U.S. Court of Appeals for the Sixth Circuit. The IRS then announced that its historic position on the self-employment tax treatment of CRP payments was going to change (for the worse), but then failed to formalize that change in policy. Next, the Congress provided partial relief in the 2008 Farm Bill, but the larger issue remained.

This leads up to today's discussion – further litigation leading up to a major federal appellate court decision in 2014. Part Two of the self-employment tax treatment of CRP payments – it's the topic of today's post.

The Intervening Years – The Storm Brews

Based on the court rulings, IRS Revenue Rulings and Private Letter Rulings, the IRS has always had significant support for its position that an *active farmer* is subject to self-employment tax on CRP income. As a result, many practitioners took the conservative approach of reporting CRP income as Schedule F income subject to self-employment tax on the tax returns of active farmers. The *Ray* case *(Ray v. Comr., T.C. Memo. 1996-436)* and Sixth Circuit's *Wuebker* opinion *(Wuebker v. Comr., 205 F.3d 897 (6th Cir. 2000))* represent strong authority for treating CRP income in the hands of an *active* farmer as business-related income subject to self-employment tax.

However, some practitioners, particularly those representing clients not within the Sixth Circuit (the Sixth Circuit is comprised of Kentucky, Michigan, Ohio and Tennessee) took a more aggressive approach, on a case-by-case basis, by advising active farmers of the controversy and continuing to report CRP income as non-SE income based on the Tax Court's *Wuebker* opinion. *(Wuebker v. Comr., 110 T.C. 431 (1998)).*

For taxpayers who are *not* actively involved in farming (and not receiving Social Security benefits) the IRS position that CRP rents in the hands of these taxpayers are self-employment taxable is not correct. As noted in Part One, the IRS had always held that Soil Bank and CRP payments are not subject to self-employment tax in the hands of a non-farmer, and the courts had confirmed that view.

The Key Case - *Morehouse*

In 2013, the U.S. Tax Court released its opinion in *Morehouse v. Comr*. *140 T.C 350 (2013).* In *Morehouse*, the taxpayer was a non-farmer that lived in Texas and worked for the University of Texas. In 1994, he

inherited farmland in South Dakota and bought other farmland from his family members. He never personally farmed the land, but rented it out. In 1997, he put the bulk of the property in the CRP while continuing to rent-out the non-CRP land. He hired a local farmer to maintain the CRP land consistent with the CRP contract (e.g., plant a cover crop and maintain weed control). In 2003, the petitioner moved to Minnesota, but still never personally engaged in farming activities. Consequently, the petitioner reported his CRP income on Schedule E where it was not subject to self-employment tax.

The IRS took the position that the CRP rents were subject to self-employment tax, based on its administrative change of position that it first asserted in 2003. The Tax Court, in a full Tax Court opinion (Judge Paris not participating), agreed. *140 T.C. 350 (2013).* The Tax Court found the existence of a trade or business based on either the petitioner's personal involvement with the CRP contract or through the local farmer that he hired to maintain the land. The Tax Court noted that the CRP contract required seeding of a cover crop and maintenance of weed control. The Tax Court also found important that the taxpayer visited the properties on occasion to ensure that the CRP contract requirements were being satisfied, and participated in emergency haying programs, requested cost-sharing payments, and made the decision as to whether to re-enroll the properties in the CRP upon contract expiration.

The Tax Court cited the Sixth Circuit's decision in *Wuebker* as controlling even though the taxpayer in that case was an active farmer and Morehouse had never been engaged in farming. Thus, *Wuebker* was factually distinguishable. However, the court stated that the petitioner was in the business of maintaining "an environmentally friendly farming operation."

Note: While, as the Tax Court ruled in *Morehouse*, CRP payments may not constitute "rents from real estate" that are thereby exempt from self-employment tax under the exception of I.R.C. §1402(a)(1), that determination has no bearing on the issue of whether the taxpayer is engaged in a trade or business as required by I.R.C. §1402(a). That question can only be answered by examining the facts pertinent to a particular taxpayer. Mere signing of a CRP contract and satisfying the contract terms via an agent is insufficient to answer that question.

The Tax Court's opinion was appealed to the U.S. Court of Appeals for the Eighth Circuit. The majority opinion, issued by Judge Beam, noted that the CRP is the current federal program in a long line of conservation programs and is similar to the old Soil Bank program – even noting that the CRP program has been referred to as the "Son of Soil Bank." Based on that close tie, the court noted that the IRS, in *Rev. Rul. 60-32, 1960-1 C.B. 23.* said that Soil Bank payments paid to *non-farmers* were not subject to self-employment tax, but they were subject to self-employment tax if they were paid to materially participating farmers. The IRS again restated that position in *Rev. Rul. 65-149, 1965-1 C.B. 434.* The appellate court found those rulings to be persuasive and binding on the IRS given the similarities between the CRP and the Soil Bank program. Thus, the court held that "CRP payments made to non-farmers constitute rentals from real estate for purposes of I.R.C. §1402(a)(1) and are excluded from the self-employment tax."

The court also pointed out that IRS issued *Notice 2006*-108*, I.R.B. 2006-51 (Dec. 18, 2006),* and "with little analysis, the proposed revenue ruling concluded CRP payments to non-farmers were not rentals from real estate and should be treated as income from self-employment." IRS said in that *Notice* that the proposed Revenue Ruling would make obsolete *Rev. Rul. 60-32*, but the IRS never formally adopted the proposed revenue ruling, and the court refused to give it any deference.

The appellate court distinguished the Sixth Circuit's opinion in *Wuebker* on the basis that the taxpayer in *Morehouse* was not a farmer and that the taxpayer in *Wuebker* was an active farmer. On that point, the appellate court noted that the Sixth Circuit "neither recognized nor rejected the IRS's position in *Rev. Rul. 60-32* that similar payments [i.e., Soil Bank payments] to non-farmers were not self-employment income."

The appellate court also viewed the CRP payments that the taxpayer received as being for the use and occupancy of his land, noting that the CRP contract reserves the government's right of entry on the land. The court also found it important that the IRS had represented that if the taxpayer had not fulfilled the contractual requirements, "the USDA could arrange for any needed work to complete 'on his behalf.' " Similarly, the appellate court noted that, via a CRP contract, the government is using the taxpayer's land for the government's own purpose of removing sensitive cropland from production and other environmental purposes for the benefit of the public. Accordingly, the appellate court held that "the 2006 and 2007 CRP payments were "consideration paid [by the government] for use [and occupancy] of [Morehouse's property]" and thus constituted rentals from real estate fully within the meaning of I.R.C. §1402(a)(1).

Because the appellate court determined that CRP payments paid to non-farmers are rentals from real estate that are not subject to self-employment tax under the statutory exclusion of I.R.C. §1402(a)(1), the appellate court did not analyze the trade or business issue. However, during oral argument, both justices Beam and Loken noted that if the CRP payments were not "rents" the CRP payments must still be derived from the taxpayer's trade or business to be subject to self-employment tax. The appellate court clearly did not agree with the IRS argument that all arrangements entered into for profit, regardless of the level of the taxpayer's involvement, are automatically deemed to constitute a trade or business. There is absolutely no support for that position.

The bottom line is that the Eighth Circuit reversed the Tax Court and distinguished the Sixth Circuit's *Wuebker* opinion by holding that CRP payments in the hands of a *non-farmer* are not subject to self-employment tax. The court also held that CRP payments at issue (paid before 2008) qualify as "rentals from real estate" because they were payments for the government's use and occupancy of the taxpayer's land.

Note: However, because of the statutory change to I.R.C. §1402(a)(1) by virtue of the 2008 Farm Bill, CRP payments paid after 2007 are "rentals from real estate" for taxpayers receiving Social Security or disability payments. The dissent made this point clear when it stated, "whether CRP payments that the government made after December 31, 2007 or currently makes to a non-farmer qualify as rentals from real estate under amended §1402(a)(1) is a question that the court's decision does not resolve." This seems to indicate that this judge views CRP payments to be "rentals from real estate" in every situation when they are paid after 2007. If this is true, the differing holdings of the Eighth Circuit and the Sixth Circuit on this particular point were rendered meaningless by the 2008 amendment to I.R.C. §1402(a)(1), and CRP payments paid after 2007 are "rentals from real estate."

Conclusion

The appellate court's decision in Morehouse smashed the IRS position that all CRP payments must be reported on Schedule F. In Part Three, I will discuss the tax reporting implications of the *Morehouse* decision.