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Are CRP Payments Subject to SE Tax?

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August 7, 2013

***farmdoc daily* (3):150**

Recommended citation format: Lovell, M. "Are CRP Payments Subject to SE Tax?." *farmdoc daily* (3):150 , Department of Agricultural and Consumer Economics, University of Illinois at Urbana-Champaign, August 7, 2013.

Permalink: http://farmdocdaily.illinois.edu/2013/08/crp-payments-subject-se-tax.html

Farmers receiving payments from the **Conservation Reserve Program** (CRP) have frequently been unsure how to categorize these payments for self-employment (SE) tax purposes. Generally, income that the farmer receives from a farming trade or business constitutes SE income which is subject to SE tax (currently 15.3%). In order for an activity to be considered a trade or business, the farmer must be actively involved in the operation on a regular, continuous basis with a view to earning income or profit. However, one form of income specifically exempt from SE tax is rental income. Rental income represents income that comes from a passive investment instead of an active business. Passive investment income isn't considered income from a trade or business in which the farmer is actively involved. Passive income therefore does not trigger SE tax. The fact that the CRP rules refer to CRP payments as "rent" has caused considerable confusion on how self-employment (SE) tax applies to those CRP payments, especially since the CRP contracts place substantial obligations on the farmer that require active participation. Along with farmers, courts have also struggled with the issue of how to classify CRP payments for SE tax purposes.

The Tax Court Decides

Frederick and Ruth Wuebker owned farmland that was considered highly erodible. After farming that land for about 20 years, they enrolled their land in the CRP and focused on their poultry operation. During the first year of the CRP contract, they were required to seed their CRP land and used their farming equipment to do so. Under the CRP contract, the Wuebkers had several obligations, including the implementation of a conservation plan, establishment of vegetative cover, and to control weeds and pests on the land. The Wuebkers received a notice from the IRS regarding their CRP payments for 1992 and 1993. While the Wuebkers reported their CRP payments as rental income, the IRS took the position that the rent payments were, in fact, SE income, subject to SE tax. The Wuebkers challenged the IRS position in Tax Court. The Tax Court heard the case in June, 1998[1] and agreed with the Wuebkers, indicating that the CRP contract did not require the Wuebkers to produce any agricultural or horticultural commodities on the CRP land. Therefore, the Tax Court reasoned, the CRP rental payments were not connected to any active farming trade or business. The Wuebkers also noted that the CRP contract called the payments "rent" and the Tax Court agreed that the CRP payments fell under the rental income exemption from SE tax.

The IRS Appeals

However, the IRS appealed the Tax Court decision and the appeal was heard by the U.S. Court of Appeals for the Sixth Circuit in March, 2000.[2]

In deciding whether the CRP payments received by the Wuebkers constituted rent, the Sixth Circuit court noted that rent was defined as payment made for use or occupancy of property. Under the CRP program, the government does not obtain use or occupancy in exchange for the CRP "rent" payments. The government only obtains the right to inspect the property to ensure the Wuebkers are fulfilling their obligations under the contract. The court noted that throughout the duration of the CRP contract, the Wuebkers continued to maintain control and free access to their land. While the Wuebkers argued that the CRP payments were not connected to any farming activity and that their obligations under the CRP contract were minimal enough that they did not constitute engaging in a farming trade or business. However, the court noted that the Wuebkers were engaged in a farming business before and during the duration of the CRP contract and their CRP contractual obligations were significant obligations that were farming activities (including weed control, seeding and tilling) that required use of their farming equipment. The court also noted that the SE tax exemption for rental income should be narrowly interpreted and concluded that the Wuebker's CRP payments constituted SE income and were therefore subject to SE tax because the payments were received in connection with their farming business activity.

The IRS Position

After Wuebker and other cases[3] on this point, the IRS took the position that the conservation and land maintenance obligations that are part of a CRP contract will constitute a farming trade or business that will make the CRP payments SE income.[4] In addition, the IRS issued a notice taking the position that CRP rental payments are not payments for the right to use or occupy land. Therefore, the payments, even though referred to as "rent" under the CRP rules, are not rent for SE tax purposes. Instead, the IRS indicated that CRP payments are to compensate the farmer for conducting activities to meet the CRP contract's obligations. This compensation is considered SE income subject to SE tax.[5]

Recent Case Revisits the Question…Again

In June 2013, the Tax Court once again addressed this issue in *Rollin J. and Maureen B. Morehouse v. Comm'r*.[6] Mr. Morehouse had acreage in South Dakota enrolled in the CRP. He was not an active farmer, but rented out the tillable land and hired a retired farmer to assist with fulfilling the land conservation and maintenance obligations under his CRP contracts. He gradually expanded the amount of acreage under the CRP program. Mr. Morehouse argued that his activities under the CRP contracts were minimal and did not rise to the level of having a farming trade or business. He contended that the CRP payments had no connection to a farming trade or business and did not constitute SE income. However, the Tax Court, aware of being overruled by the Sixth Circuit in the earlier *Wuebker* case, noted that Mr. Morehouse was actively engaged as a CRP participant. He completed the annual certifications under the contracts, personally purchased materials and delivered them to the retired farmer that he hired to assist with the contract obligations, paid the retired farmer, rented out the tillable portions of the property, visited the property several times each year and expanded the amount of property enrolled in the CRP because this was more profitable than leasing the property for farming. The Tax Court noted that by signing the CRP contracts, Mr. Morehouse made himself obligated to fulfill substantial contractual obligations. In fulfilling those obligations, Mr. Morehouse's activity was regular and continuous enough to constitute a trade or business. These significant activities were not reflective of the property being held as a passive investment. Mr. Morehouse's CRP payments are therefore classified as SE income and are subject to SE tax.

Conclusion

Once a farmer becomes obligated to conserve and maintain land under a CRP contract, the farmer's activities necessary to fulfill those obligations will likely be considered legally significant enough to constitute a trade or business. The CRP payments will therefore be classified as SE income and the farmer must report those payments as such and pay SE tax on those payments. The fact that the CRP contract refers to the payments as "rent" is immaterial. Farmers that receive CRP payments should consult their tax advisor on the proper reporting of these payments.

***Note**: The Tax Code provides a specific exception, however, for farmers with CRP payments who also receive social security retirement or disability payments. For these farmers, CRP payments are exempt*

from SE tax.[1]

References

[1] Frederick J. and Ruth Wuebker v. Comm'r, 110 TC No. 31 (June 23, 1998).

[2] Frederick J. and Ruth Wuebker v. Comm'r, 205 F.3d 897 (6th Cir, 2000).

[3] See Ray v. Comm'r, TC Memo. 1996-436 (Sep. 25, 1996), Hasbrouck v. Comm'r, TC Memo. 1998-249 (Jul. 7, 1998). For the treatment of analogous payments (value-added payments from a cooperative) for SE purposes, see Bot v. Comm'r, 140 TC No. 16, aff'd, 353 F.3d 595 (8th Cir. 2003).

[4] Chief Counsel Advice Memorandum 200325002 (May 29, 2003).

[5] IRS Notice 2006-108, 2006-51 IRB 1118 (Dec. 18, 2006).

[6] 140 TC No. 16.