# Self Employment Taxation of CRP Rents – Part Three

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## Overview

Today's article is the last in a three-part series on the self-employment taxation of Conservation Reserve Program (CRP) payments. In Part One, 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 failed to formalize that change in policy. Next, the Congress provided partial relief in the 2008 Farm Bill, but the larger issue remained.

In Part Two, I discussed the litigation on the issue including a major federal appellate court decision in 2014 that wiped out the IRS position on the issue.

In today's Part Three, I address the proper income tax reporting of CRP payments based on the taxpayer's facts and circumstances.

Proper tax reporting of CRP payments – it's the topic of today's post.

## The *Morehouse* Decision

As noted in Part Two, in 2014, the U.S. Court of Appeals for the Eighth Circuit reversed the Tax Court and held that CRP payments paid to non-farmers are rents from real estate that are *excluded* from self-employment tax under I.R.C. §1402(a)(1). *Morehouse v. Comr., 769 F.3d 616 (8th Cir. 2014).* In so holding, the court gave no deference to an IRS Notice of Proposed Revenue Ruling IRS Notice 2006-108, IRB 2006-51. Had the IRS formally adopted the Revenue Ruling it would have reversed the longstanding IRS position that land conservation payments paid to non-farmers are not subject to self-employment tax. *See, e.g., Rev. Rul. 60-32, 1960-1 CB 23*.

**IRS non-acquiescence.** In reaction to the Eighth Circuit's *Morehouse* decision, the IRS did not appeal but instead issued a non-acquiescence, sticking to its (unofficial) position on the self-employment taxability of CRP payments. In its non-acquiescence, the IRS announced that audits would continue unabated – even in the Eighth Circuit. *A.O.D. 2015-002, I.R.B. 2015-41 (Oct. 13, 2015).* The IRS asserted that the Eighth Circuit "misinterprets" Rev. Rul. 60-32 and Rev. Rul. 65-149. Of course, Rev. Rul. 60-32 is a major obstacle to the IRS position on the self-employment taxability of CRP payments in the hands of a non-farmer. The IRS, in the A.O.D., claimed that Rev. Rul. 60-32 only applies in the context of landlords who do not materially participate in a farming operation on their land. Since *Morehouse* was not a landlord, IRS claimed that Rev. Rul. 60-32 didn't apply to shield the CRP payments from self-employment tax. Under the IRS rationale, *Morehouse* was an "operator" of his CRP land which doesn't require material participation to trigger self-employment tax. The IRS claimed to base its position on the exception to the rental real estate exception of I.R.C. §1402(a)(1) that is contained in I.R.C. §1402(a)(1)(a). That provision subjects income to self-employment tax that is derived under an arrangement between a farm owner or tenant and another

individual which provides that the other individual will produce agricultural or horticultural commodities on the land and provides that there shall be material participation by the owner or tenant in the production or the management of the production of the commodities, and that there actually is material participation by the owner or tenant in the production of the commodities on the land. The IRS made no mention of the fact that the statute (I.R.C. §1402(a)), the U.S. Supreme Court (*Comr. v. Groetzinger, 480 U.S. 23 (1987)*) and the Eighth Circuit (at least during oral arguments in *Morehouse*), require income to be derived from the taxpayer's trade or business for the income to be subject to self-employment tax.

To put it bluntly, the IRS position in the non-acquiescence is absurd. Rev. Rul. 60-32 states that payments and benefits attributable to the acreage reserve program (a.k.a. the Soil Bank – the precursor to the CRP) are includible in determining the recipient's net earnings from self-employment if the taxpayer operates his farm personally or through agents or employees but if ". . . he does not so operate or materially participate, payments received *are not to be included in determining net earnings from self-employment."* (Emphasis added). Notice that it says "personally" and "he does not so operate." Thus, Rev. Rul. 60-32 is not limited in its application to landlords, it includes "operators" and it is directly applicable to the facts of *Morehouse* (and countless other non-farmers with CRP income), and remains a major obstacle to the changed position of the IRS first announced in 2003.

The IRS, in the A.O.D. also claimed that Rev. Rul. 65-149 merely elaborated the point made in Rev. Rul. 60-32 that the only situation addressed was that non-materially participating landlords would not have self-employment tax on their Soil Bank payments, but that non-landlord investors or non-farmer estate beneficiaries would. Again, that is a mischaracterization of Rev. Rul. 65-149. In that Revenue Ruling, the IRS stated that annual payments under farm programs comparable to the CRP are *not* subject to self-employment tax if the taxpayer was not materially participating in farming operations *(either personally or via a lease)* on land not in the government land diversion program. "Personally" refers to being the "operator."

**Note:** The key to understanding the IRS position is that, with respect to the CRP, a recipient of CRP payments is either a farm landlord or a farmer. There is no room, in the IRS view, for a non-farmer who is not a landlord. A non-farmer is an "operator" for which the material participation requirement doesn't apply. Thus, the CRP income is subject to self-employment tax without any requirement that the income be derived from the taxpayer's conduct of a trade or business.

Also, the Eighth Circuit did not, as the IRS claims in the A.O.D., assert that either Rev. Rul. 60-32 or Rev. Rul. 65-149 support the conclusion that the CRP payments in *Morehouse* constituted rents from real estate. Instead, the Eighth Circuit opinion was two-pronged: (1) the CRP, as the modern-day version of the Soil Bank, resulted in payments that should be treated the same for self-employment tax purposes as Soil Bank Payments were under the Revenue Ruling that IRS had not obsoleted – not subject to self-employment tax in the hands of a non-farmer; and (2) the CRP payments in the hands of a non-farmer are real estate rentals that are statutorily excluded from self-employment tax under I.R.C. §1402(a)(1).

The IRS also claimed in the A.O.D. that the 2008 Farm Bill amendment to I.R.C. §1402(a)(1), by implication, meant that CRP payments paid before 2008 were not covered by the rental real estate exception of I.R.C. §1402(a)(1), and that for those payments made after 2007 are subject to self-employment tax unless the recipient is also receiving social security retirement or disability payments. However, as pointed out above, the dissent's point in *Morehouse* that the court's rent analysis was inapplicable to post-2007 payments seems to indicate that the dissenting judge believes that the statutory change to I.R.C. §1402(a)(1) means that CRP payments paid post-2007 are "rents" that are statutorily exempt from self-employment tax. That conclusion is precisely the opposite of the IRS statement in the A.O.D.

**Proper Tax Reporting of CRP Payments**

**Inside the Eighth Circuit (AR, IA, MN, MO, NE, ND and SD).** The effect of the Morehouse decision is that non-farmers do *not* have to pay self-employment tax on CRP payments. That is certainly the result within the Eighth Circuit. Active farmers still have self-employment tax to pay on CRP payments unless the 2008 Farm Bill provision applies to them.

**Note.** The 2008 Farm Bill provision excludes CRP payments from self-employment tax in the hands of an individual that is collecting retirement or disability benefits from the Social Security Administration, even though they would otherwise report CPR income on Schedule F due to other active farming activities. The exclusion is tied to receipt of benefits, not mere eligibility. If a taxpayer that is engaged in the trade or business of farming chooses to delay receipt of Social Security payments until age 70, any CRP payments received must be reported on Schedule F.

Even though the *Morehouse* opinion technically applies only to CRP rents paid before 2008, the opinion stands for the proposition that a non-farmer does not materially participate with respect to land in the CRP. In addition, for taxpayers in the Eighth Circuit, the court's expansive view of the term "rent" provides authority for asserting that any taxpayer's receipt of CRP is not self-employment taxable, since it is a receipt from real estate rental. Also, the dissent's point that the court's rent analysis was inapplicable to post-2007 payments seems to indicate that the dissenting judge believes that the statutory change to I.R.C. §1402(a)(1) means that CRP payments paid post-2007 are "rents" that are statutorily exempt from self-employment tax.

**Inside the Sixth Circuit (KY, MI, OH and TN).** For practitioners representing taxpayers in the Sixth Circuit (where the *Wuebker* matter arose), CRP payments are considered farm income rather than rents from real estate if there is a "nexus" with the taxpayer's farming operation. The facts of Wuebker involved taxpayer's that were engaged in the trade or business of farming and the CRP payments were from ground that had a nexus with their farming business. Thus, a taxpayer receiving CRP payments but who is not engaged in the trade or business of farming could reasonably take the position on the return that CRP payments are *not* subject to self-employment tax due to a lack of nexus with a farming operation. Likewise, a farmer with, for example, a hunting property or other farmland in the CRP with no nexus to the trade or business of farming would produce CRP rental income *not* be subject to self-employment tax.

**Outside the Sixth and Eighth Circuits.** For taxpayers in neither the Sixth nor Eighth Circuits, CRP payments could be treated as real estate rents that are excludible from self-employment tax under I.R.C. §1402(a)(1). This position is based on the full Tax Court opinion in *Wuebker* that CRP payments are "rents." Also, all taxpayers (regardless of location) receiving Social Security retirement or disability payments can exclude CRP payments from self-employment income.

**What To Do Now**

Given the IRS non-acquiescence to *Morehouse,* what is a practitioner to do? In the A.O.D., the IRS said it will continue to audit returns where CRP income is not reported as subject to self-employment tax, and will maintain its position that all CRP income is subject to self-employment tax unless the 2008 Farm Bill provision applies. That position is certainly on display in the 2021 IRS Pub. 225. However, I don't have any personal evidence that the IRS has the courage to follow through with its threats to enforce its flawed CRP self-employment tax theories. It appears that IRS is simply relying on misinformation in Pub. 225 to generate more revenue than it is legally entitled to.

Given that the IRS position is wholly without support, and substantial authority exists for excluding CRP rental income from self-employment tax in the hands of a non-farmer, or even in the hands of a farmer where the CRP land has no nexus with the farming operation, the guidance mentioned earlier still

applies. The IRS still has no substantial authority for its position that CRP payments are subject to self-employment tax except for the application of the 2008 Farm Bill provision.

Given all of this, it's important to point out that the IRS computers are programmed to look for CRP rental income on Schedule F in all situations. Thus, to avoid receiving a CP2000 Notice, CRP rents should be reported on Schedule F and then, in appropriate situations consistent with the analysis above, backed out via Schedule SE so that self-employment tax doesn't apply.

**Conclusion**

It's frustrating when a government agency continues to stick to its judicially-rejected position against citizens and taxpayers. It's similarly frustrating when a government agency issues publications to provide education and guidance that deliberately misstates applicable law.

The three-part series is over. I rest…