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## *CONSERVATION RESERVE PAYMENTS AND SELF-EMPLOYMENT TAXES*

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**Abstract.** Farmers enrolling their land in the Department of Agriculture's Conservation Reserve Program (CRP) receive payments for refraining from farming their property and for engaging in certain conservation practices mandated by the Department of Agriculture. These payments are described in the contract with the Department of Agriculture as "rental payments." Farmers would like to treat the income as "rental income" because it would not be subject to self-employment taxes, but the Internal Revenue Service (IRS) insists that under certain conditions, the payments are income from the trade or business of farming and thus subject to self-employment taxes. On March 3, 2000, the Sixth Circuit endorsed the IRS' view of the payments in *Wuebker v. Commissioner*, 205 F.3d 897 (6th Cir.2000). The Sixth Circuit reversed the Tax Court's decision in the same case, eliminating the only significant precedent supporting the farmers' view of the payments. Several bills to exclude CRP payments from self-employment earnings have been introduced since the *Wuebker* decision.



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# CRS Report for Congress

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## Conservation Reserve Payments and Self-Employment Taxes

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### Summary

Farmers enrolling their land in the Department of Agriculture's Conservation Reserve Program (CRP) receive payments for refraining from farming their property and for engaging in certain conservation practices mandated by the Department of Agriculture. These payments are described in the contract with the Department of Agriculture as "rental payments." Farmers would like to treat the income as "rental income" because it would not be subject to self-employment taxes, but the Internal Revenue Service (IRS) insists that under certain conditions, the payments are income from the trade or business of farming and thus subject to self-employment taxes. On March 3, 2000, the Sixth Circuit endorsed the IRS' view of the payments in *Wuebker v. Commissioner*, 205 F.3d 897 (6<sup>th</sup> Cir. 2000). The Sixth Circuit reversed the Tax Court's decision in the same case, eliminating the only significant precedent supporting the farmers' view of the payments. Several bills to exclude CRP payments from self-employment earnings have been introduced since the *Wuebker* decision.

### Background

The Conservation Reserve Program became law in the Food Security Act of 1985, P.L. 99-198, § 1231, et seq., (codified in 16 U.S.C. § 3831, et seq.). The current version of the program extends through calendar year 2002. It permits the Secretary of Agriculture to enroll up to 36.4 million acres in a conservation reserve program to assist farmers to conserve and improve the soil and water resources of their lands. The program is implemented by entering into 10 to 15 year contracts with farmers. Under the contract, the farmers agree to follow an approved conservation plan for converting lands normally devoted to agricultural production to a less intensive use. In exchange the Department of Agriculture (USDA) shares the cost of carrying out the conservation plan, provides technical assistance, and pays "an annual rental payment" for converting highly erodible cropland to a less intensive use. The rental payments can be in cash or commodities. According to the facts presented in *Wuebker v. Commissioner*, 205 F.3d 897 (6<sup>th</sup> Cir. 2000), the USDA pays farmers approximately \$1.8 billion each year under the CRP.

The tax treatment of CRP payments has been a bone of contention between the IRS and farmers. There is no disagreement that the payments should be included in income, but the IRS takes the position that if individuals are engaged in the trade or business of farming, the CRP payments are farm income which they must report on Schedule F. If the individuals are simply landlords, they report the CRP payments as farm-related income on Form 4835. This form is designed for land owners who rent their farms and who do not materially participate in the operation of the farm. Since the self-employment tax rate is currently 15.3%, farmers would like to follow the Tax Court opinion in *Wuebker v. Commissioner*, 110 T.C. 31 (1998), *reversed* 205 F.3d 897 (6<sup>th</sup> Cir. 2000), which viewed the CRP payments as rental income, which is excluded from the definition of self-employment income under IRC § 1402(a)(1).

IRC § 1402(a) defines “net earnings from self-employment” as follows:

The term “net earnings from self-employment” means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business . . . except that in computing such gross income and deductions . . .

(1) there shall be excluded rentals from real estate and from personal property leased with the real estate (including such rentals paid in crop shares) together with the deductions attributable thereto, . . . **except** that the preceding provisions shall **not** apply to any income derived by the owner or tenant of land if (A) such income is derived under an arrangement, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities (including livestock, bees, poultry, and fur-bearing animals and wildlife) on such land, and that there shall be material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) in the production of such agricultural or horticultural commodities, and (B) there is material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) with respect to any such agricultural or horticultural commodity. [Emphasis added]

When the exception was originally enacted, it was intended to provide social security self-employment coverage to share-farmers and to landowners participating in the production so that they would have some sort of guaranteed retirement income when they were too old or too disabled to continue farming. Because a large number of farmers would have been excluded from the social security provisions if they could not count their crop-share income as self-employment income, the exception language was added to the Code in 1956. The Senate Report associated with the Social Security Amendments of 1956, S. Rep. No. 2133, 84<sup>th</sup> Cong., 2d Sess, as reprinted in Vol. 3 1956 U.S. Code, Cong. & Admin. News at 3877, 3883-3884, indicates that the bill would remove any doubt as to whether a share-farmer was an employee or a self-employed person and that it would extend coverage to landowner/farmers who had income from working and who were at risk for the types of income loss against which the social security program was designed to protect.

According to Rev. Rul. 60-32, 1960-1 C.B. 23, which discussed payments made to farmers under an earlier acreage reserve program,

Acreage reserve and the cost-sharing and annual conservation reserve payments, whether in cash or, at the option of the producer, in grain, are in the nature of receipts from farm operations in that they replace income which producers could have expected to realize from the normal use of the land devoted to the program. As such, they are includible in gross income.

Without analysis, Rev. Rul. 60-32 concludes,

Payments and benefits attributable to the acreage reserve program are includible in determining the recipient's net earnings from self-employment if he operates his farm personally or through agents or employees. This is also true if his farm is operated by others and he participates materially in the production of commodities, or management of such production, within the meaning of section 1402(a)(1) of the Self-Employment Contributions Act of 1954, as amended.... If he does not so operate or materially participate, payments received are not to be included in determining net earnings from self-employment.

Rev. Rul. 60-32 did not address whether CRP payments should be considered rental income. According to the IRS, farm income (and farm income substitutes, such as CRP payments) are treated as farm self employment income if the recipient of the payments is a farmer, i.e., the recipient is in the trade or business of farming and "materially participates." If the recipient is a retired farmer, or if the recipient is strictly a landlord, the payments are not "self-employment income." The IRS analysis is that since the CRP payments are received in the trade or business of farming they are automatically farm/self-employment income. Use of the "materially participates" language is somewhat confusing since it derives from the arrangement exception to the rental income rule.

### ***Wuebker v. Commissioner***

*Wuebker v. Commissioner*, 110 T.C. 31 (1998), was the first case to explicitly find that CRP payments were rental income, and, thus, not subject to self-employment tax. In *Wuebker*, the Special Trial Judge rejected the existing precedents and determined that CRP payments were rental income which did not come within the "arrangement" exception and, therefore, the farmer did not have to pay self-employment taxes on CRP payments. The Special Trial Judge rejected Rev. Rul. 60-32 as unpersuasive and rejected *Ray v. Commissioner*, T.C. Memo. 1996-436, as precedent because the *Ray* court did not address whether the CRP payments qualified under the rental exclusion provisions of section 1402(a)(1).

The other cases dealing with this issue have not directly addressed the rental income exclusion from self-employment taxes applies to CRP payments. While *Ray* did not explicitly address the issue of whether the CRP payments were rental income, the *Ray* court did note that the taxpayers had reported the payments as rental income. The court said that taxability of the payments was not in question, the only question was whether they were self-employment income. In *Ray* the court followed Revenue Ruling 60-32 and found that the CRP payments were self-employment income because of the "nexus" of the payments and the trade or business from which they are derived. *Dugan v. Commissioner*, T.C. Memo 1994-578, set forth the IRC § 1402(a)(1) analysis when the income was derived from a sharecropping rental arrangement, but the court did not apply the analysis to the CRP payments since there was a net loss on the CRP payment land, meaning no self-employment taxes would be due. In *Hasbrouck v. Commissioner*, T.C. Memo 1998-

249, which was a suit for attorneys' fees and costs and did not involve self-employment taxes, the facts showed the IRS and the taxpayers switched their usual sides. The IRS maintained that the CRP payments were not properly reported on Schedule F, but should have been treated as farm rental income, because the IRS did not believe the taxpayers were in the trade or business of farming. The taxpayers claimed the CRP payments were farm income because they wanted to deduct certain business expenses. Before the case went to trial, the IRS conceded the issue based on *Ray*.

The Tax Court decision in *Wuebker* is the only case in a line of precedent dating back to 1960 to have found the payments excludible from self-employment income taxes. The Tax Court was reversed in a 2-1 decision by the Sixth Circuit Court of Appeals on March 3, 2000. *Wuebker v. Commissioner*, 205 F.3d 897. The Sixth Circuit's analysis was that the Wuebkers were in the trade or business of farming and that the CRP payments should be viewed as "derived" from the farming business. The Sixth Circuit did not attach as much significance to the fact that the CRP payments were termed rental payments by the statute as the Tax Court opinion did. Using the argument that substance should prevail over form, the Sixth Circuit rejected the idea that the payments were "rent" because the Department of Agriculture was not paying to use or occupy the property. The court acknowledged that the USDA was restricting the uses that the farmer could make of the land, but the court did not believe that such restrictions constituted "use" by the USDA. This analysis, along with prior precedents, convinced the majority that the Tax Court's decision should be reversed. The dissenting judge believed that the wide-ranging limitations on the use of the land did constitute "use" by the USDA.

## Legislative Reaction

Since the Sixth Circuit reversed the Tax Court in *Wuebker*, several bills have been introduced in the 106<sup>th</sup> Congress to overturn the *Wuebker* decision: H.R. 4064, S. 2344, H.R. 4212, and S.2422, §4. The House bills are identical. All the bills would amend the definition of net earnings from self-employment in IRC § 1402(a) to exclude amounts received as payments under the CRP program from such earnings. The House bills would add a new paragraph to the list of exclusions; the Senate bills would amend the existing paragraph dealing with rentals from real estate. The House bills would also amend a similar definition in section 211(a) of the Social Security Act. All the bills would apply to CRP payments received before, on, or after the date of enactment. The bills do not indicate whether the IRS would be required to refund self-employment taxes paid by farmers on CRP payments prior to the date of enactment, but presumably IRC § 6511 would authorize the IRS to pay refunds claimed within three years of the time a return was filed.