

Tax Court Finds CRP Payments Subject to Self Employment for Non-Farmers.

By Bryan P. Robertson

In an important decision¹ that represents a significant departure from what appears to be common practice, the Tax Court determined that non-farmer recipients of Conservation Reserve Program (CRP) payments may be in a trade or business merely as a result of participation in the program. As a result of the existence of a trade or business, CRP payments are subject to self employment tax even for landowners that are not themselves in the trade or business of farming.

Background

Minnesota resident Rollin J. Morehouse owned approximately 1,200 acres of mostly-tillable real property in South Dakota. Beginning in 1997, Mr. Morehouse enrolled certain of the tillable acres in the CRP and, as a result of that enrollment, effectuated certain conservation plan contracts.

Mr. Morehouse hired a retired farmer and CRP program participant, Wallace Redlin, to carry out certain of the conservation plan commitments made by Mr. Morehouse as a result of the contracts. Mr. Morehouse himself performed some of the required tasks by making annual certifications, requesting certain emergency haying provisions, applying for cost-sharing reimbursements, purchasing seed materials, visiting the properties periodically to assess compliance, and meeting with Farm Service Agency personnel.

On his 2006 and 2007² income tax returns, Mr. Morehouse reported the income and expense activities related to the properties on his income tax form schedule E as supplemental income not subject to self employment tax. The IRS, believing that Morehouse should have reported the CRP payments as subject to self employment tax on his income tax form schedule F, determined

¹ Morehouse v. Comr., 140 T.C. No. 16 (June 18, 2013). The opinion is a reviewed opinion. Fifteen of the Tax Court judges signed on and one did not participate.

² The tax years at issue in the case are significant to the extent that they pre-date a congressional amendment to the Internal Revenue Code. In 2008, the Code was amended to expand the definitional exception to self employment income so as to include in the exception CRP payments received by social security beneficiaries who are either retired or disabled. For years after 2007, then, CRP payments received by retired or disabled social security beneficiaries are not subject to self employment tax. The Morehouse decision does not affect those beneficiaries.

The 2007 version of I.R.C. § 1402(a) provided that “there shall be excluded rentals from real estate and from personal property leased with the real estate (including such rentals paid in crop shares).” The 2008 amended I.R.C. § 1402(a) provides that

there shall be excluded rentals from real estate and from personal property leased with the real estate (including such rentals paid in crop shares, and including payments under section 1233(2) of the Food Security Act of 1985 (16 U.S.C. 3833(2)) to individuals receiving benefits under section 202 or 223 of the Social Security Act).

that Morehouse under-reported self employment income of approximately \$25,600 and \$28,400 for 2006 and 2007, respectively, and asserted tax deficiencies of approximately \$3,300 and \$3,600 for 2006 and 2007, respectively.

Opinion

The court first noted that the net earnings from self employment of a taxpayer include the gross income derived from any trade or business carried on by the taxpayer. Focusing on the “trade or business” and “derived from” elements of the analysis, the court noted that

we must decide: (1) whether petitioner carried on a trade or business during the years in issue, whether personally or through an agent; and (2) if so, whether there was a nexus between the trade or business conducted and the income petitioner received.

Reviewing the activities performed by Messrs. Morehouse and Redlin, and apparently finding it unimportant which of the two parties performed those activities, the court concluded that Mr. Morehouse was engaged in the business of participating in the CRP and managing his CRP properties with the primary intent of making a profit. Having found a “participating and managing” trade or business, it was unnecessary for the court to determine whether Mr. Morehouse was likewise engaged in the business of farming.

As a participant in the CRP, petitioner, either directly or through Mr. Redlin as his agent, regularly and continuously: (1) satisfied seeding and weed control obligations with respect to the ... properties as required under the CRP contracts; (2) visited the ... properties to ensure that the properties maintained their status as CRP properties; (3) filed annual certifications; (4) participated in emergency haying programs; (5) requested cost-sharing payments; and (6) made decisions regarding the profitability of keeping the ... properties enrolled in the CRP. Regardless of whether some or all of these activities qualify as farming, we find that petitioner was engaged in the business of participating in the CRP and that he enrolled, maintained, and managed multiple properties subject to CRP contracts with the primary intent of making a profit.

The court then turned to the alternative argument that CRP payments qualified for exception to the self employment tax as rentals from real property. The court dismissed that argument pointing, among other things, to the limited scope of a congressional amendment to the self employment statute, to the control over the underlying real property retained by the landowner, and to the significant scope of activities required of the landowner with respect to enrolled property.

Scope of Required Activities

The Tax Court repeatedly highlighted the activities performed by or on behalf of Mr. Morehouse relying upon those activities as a basis both to find a trade or business and to differentiate the CRP program from a cash or crop share lease. The CRP activities required of both the landowner and the government are substantial and are enumerated in the CRP regulations³ and the appendix⁴ to the conservation reserve program contract. The current⁵ version of the appendix identifies a series of activities that each of the parties agrees to undertake. The following table demonstrates selected obligations of the landowner participant and the government according to that appendix.⁶

The Participant Agrees	The Government Agrees
<ul style="list-style-type: none"> ● To comply with the terms and conditions of the conservation plan ● To establish, maintain, and replace, as specified in the CRP contract, the practices agreed to in the conservation plan ● Not to harvest or sell, nor otherwise make commercial use of, trees or forage or other cover on the CRP land ● Not to undertake any action on land under the participant's control which tends to defeat the purposes of this contract ● To annually certify crop and land use ● To control on land subject to a CRP contract all weeds, insects, pests and other undesirable species ● To provide such maintenance as necessary to avoid an adverse impact on surrounding land ● Not to disturb the acreage under contract during the primary nesting and brood rearing season for wildlife ● To annually file required forms ● To perform certain periodic management activities described in the conservation plan to maintain the approved cover such as light discing, burning, etc. 	<ul style="list-style-type: none"> ● To share the cost with owners and operators of establishing an eligible practice, or an identified unit thereof, agreed to in the conservation plan

³ See 7 C.F.R. §§ 1410.20 and 1410.21.

⁴ U.S. Department of Agriculture Commodity Credit Corporation Form CRP-1(Appendix).

⁵ The sample appendix form from which the elements were excerpted was acquired from the Lancaster County, Nebraska Extension Office and is dated May 7, 2013.

⁶ The scope of the CRP contractually mandated obligations, especially those placing an affirmative duty on the participant to act, appears to go substantially beyond the scope of obligations traditionally associated with a cash or crop share lease.

Scope of any Shift in Treatment

Generally, a shift in the treatment of CRP payments from “not subject to” to “subject to” self employment tax will absorb approximately⁷ twelve percent of the CRP payment. For a taxpayer with \$180,000 of wages and \$20,000 of CRP payments in 2013, for example, the increase in total federal tax, due to the shift in treatment, would be \$2,430 or approximately 12% of the CRP payment balance.

Impact of the Decision

For non-farmer landowners that participate in the CRP program and that are neither retired nor disabled, the Morehouse decision is likely to require a thoughtful review of the consequences of participating in the CRP. Based upon the analysis of the Tax Court, the economic return on that participation is likely to have just decreased substantially. Given the sizable incentive to do so and emboldened by the near-unanimous decision of the Tax Court, the IRS is likely to use its new “participating and managing trade or business rule” as a tool to be increasingly aggressive as it relates to characterization of CRP payments.

⁷ The provision of the 2010 health care reform legislation increasing the hospital insurance tax portion of the tax on self-employment income for years beginning after 2012 may operate to further increase the cost of such a shift for certain higher income taxpayers.