



# Conservation Reserve Program Payments: Self-Employment Income, Rental Income, or Something Else?

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## Summary

Under the Conservation Reserve Program (CRP), owners and operators of eligible land may enter into a contract with the Secretary of Agriculture to enroll land in the program and convert it to less intensive use under an approved conservation plan. In return, participants receive an annual payment that the statute refers to as “rent.” Legislation establishing and extending the program has been silent as to the appropriate tax treatment of these payments. For many years, the Internal Revenue Service (IRS) generally treated the payments as farming income when received by someone who was engaged in the trade or business of farming, but as rental income when received by others.

The IRS’s position appears to have changed to one that would treat all Conservation Reserve Program payments as farming income and, thus, subject to self-employment tax. Recently, the IRS published a proposed revenue ruling that explains its treatment of CRP payments as income from the trade or business of farming and, thus, subject to self-employment tax.

Currently, case law provides some support for the IRS’s position that the CRP’s annual rental payments are not rent that is excludible from self-employment tax. This case law has not, however, considered CRP payments received by individuals who were not previously engaged in farming and who have purchased property and immediately enrolled it in the CRP (or agreed to continue the enrollment begun by the previous owner/operator). Neither have courts considered CRP payments to those who hire third parties to perform activities required by the CRP contract.

The possibility that the payments may not constitute self-employment income even if they do not qualify as excludible rent has not been considered by either the courts or the IRS. Neither has yet considered the statutory requirement that all payments must be returned if the contract is terminated.

The Heartland, Habitat, Harvest, and Horticulture Act of 2007 (S. 2242), introduced in the 110<sup>th</sup> Congress, contained provisions that would exclude CRP payments from self-employment income for some taxpayers and would allow all recipients to choose to receive a tax credit in lieu of the payments. These provisions were incorporated into the 2007 Farm Bill (H.R. 2419), which is in conference.

This report outlines the history of the program, the changing positions of the IRS, pertinent case law, and other provisions of the Internal Revenue Code (IRC). Several possible approaches to the taxation of CRP payments are discussed.

## Contents

Background and Introduction .....	1
Tax Treatment by the Internal Revenue Service and the Courts .....	2
Treatment by IRS Before 1996 .....	2
1996 Shift in Tax Treatment.....	2
Hasbrouck v. Commissioner .....	3
Ray v. Commissioner .....	4
Post-1995 Guidance from the IRS .....	4
1998 Shift by the Tax Court: <i>Wuebker v. Commissioner</i> .....	5
Court of Appeals Reverses <i>Wuebker</i> .....	6
Recent Guidance from the IRS.....	7
Response to Notice 2006-108.....	8
Congressional Response.....	8
Other Responses.....	9
Other Income and Tax Provisions .....	10
Rentals of Real Estate .....	10
Easement Income .....	10
Other IRS Rulings and Notices .....	11
Revenue Ruling 60-42, 1960-1 C.B. 23.....	11
Revenue Ruling 65-149 .....	11
Notice 87-26 .....	12
Comparison of CRP Payments to Other Types of Income .....	13
Rental Real Estate .....	13
Easements.....	14
Soil Bank Program Payments.....	15
Grain Storage .....	15
Dairy Termination Program Payments .....	16
Examining the Unexamined Factor: The Repayment Requirement .....	17
Conclusion.....	18
Services Required.....	19
Fair Market Rental Values.....	19
Self-Employment Taxes and the Repayment Provision .....	19

## Appendixes

Appendix. The Conservation Reserve Program .....	20
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## Contacts

Author Contact Information .....	23
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## Background and Introduction

The Conservation Reserve Program<sup>1</sup> is a federal program originally intended to remove highly erodible croplands from production for periods of 10 to 15 years. Participants in the program agree to remove the land from production and follow an approved conservation plan. The program was established by the Food Security Act of 1985.<sup>2</sup> Originally enacted to be in effect through 1990, it has been extended repeatedly.<sup>3</sup> The most recent extension was through the end of 2007,<sup>4</sup> but legislation proposed in the 110<sup>th</sup> Congress would extend it through 2012.<sup>5</sup>

Participants in the program receive annual payments based on the acreage they have enrolled in the program. Early termination of the CRP contract requires repayment of all amounts the participant has received.<sup>6</sup>

The applicable statute refers to the annual payments as “rental payments.”<sup>7</sup> Rental real estate income is generally not subject to self-employment tax even when received in connection with a trade or business.<sup>8</sup> However, early in the program, using a revenue ruling<sup>9</sup> written regarding a prior agricultural program,<sup>10</sup> the Internal Revenue Service took the position that CRP annual payments received by farmers were to be included as self-employment income along with other farm income and, therefore, subject to self-employment tax. The payments were treated by the IRS as rental income when received by non-farmers.

Over the years, the IRS has expanded its position regarding CRP payments and self-employment taxes.<sup>11</sup> In December 2006, the IRS issued a notice of a proposed revenue ruling that takes the position that virtually all CRP annual rental payments are subject to self-employment taxes.<sup>12</sup> The notice has been responded to by Congress, as well as by others.<sup>13</sup>

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<sup>1</sup> P.L. 99-198, § 1231, *et seq.*, 99 Stat. at 1509-16 (codified in 16 U.S.C. § 3831, *et seq.*).

<sup>2</sup> P.L. 99-198, 99 Stat. 1354.

<sup>3</sup> The Food, Agriculture, Conservation, and Trade Act of 1990, P.L. 101-624, § 1432(2), 104 Stat. 3359, 3577-78; The Federal Agriculture Improvement and Reform Act of 1996, P.L. 104-127, § 332(a), 110 Stat. 888, 994; The Farm Security and Rural Investment Act of 2002, P.L. 107-171, § 2101(a), 116 Stat. 134, 238. In addition to extending the duration of the program, legislation has expanded the list of land eligible for the program as well as modifying the ways in which land enrolled in the program was to be maintained and could be used. The major bills extending and modifying the program are discussed in the **Appendix**, *infra*.

<sup>4</sup> The Farm Security and Rural Investment Act of 2002, P.L. 107-171, § 2101(a), 116 Stat. at 238.

<sup>5</sup> H.R. 2419 (this and all subsequent references are to the engrossed amendment agreed to by the Senate Dec. 14, 2007).

<sup>6</sup> 16 U.S.C. § 3832(a)(5)-(6). *See also* CRS Report RS21613, *Conservation Reserve Program: Status and Current Issues*, by (name redacted).

<sup>7</sup> 16 U.S.C. § 3833(2).

<sup>8</sup> 26 U.S.C. § 1402(a).

<sup>9</sup> Rev. Rul. 60-32.

<sup>10</sup> The Soil Bank Act, P.L. 84-540, 70 Stat. 188.

<sup>11</sup> *See* “Tax Treatment by the Internal Revenue and the Courts,” *infra*.

<sup>12</sup> *See* I.R.S. Notice 2006-108, 2006-51 I.R.B. 1118.

<sup>13</sup> *Infra* “Response to Notice 2006-108.”

This report outlines the evolution of the IRS's position along with relevant case law and legislative history. It also provides comparisons to treatment of income from other sources where that income has some similarity to CRP payments.

## **Tax Treatment by the Internal Revenue Service and the Courts**

Taxpayers and the Internal Revenue Service have generally agreed that CRP payments must be included in gross income and are subject to income tax. However, there has been conflict regarding whether the payments should be considered income from farming and, therefore, subject to self-employment tax.

The self-employment tax rate is 15.3%. Many participants would prefer that their CRP payments be excluded from self-employment tax treatment. Other individuals may want to increase their eligibility for Social Security benefits by including the payments in self-employment income. The IRS, to varying degrees, has treated the payments as includible self-employment income.

### **Treatment by IRS Before 1996**

Until 1996, the IRS treated CRP payments as self-employment income for those who were otherwise engaged in the trade or business of farming. For all others, the payments were treated as rental payments and were not subject to self-employment tax. This treatment was similar to that in an earlier revenue ruling<sup>14</sup> for payments received under the Soil Bank Act.<sup>15</sup>

In distinguishing between those who were engaged in the trade or business of farming and all others, it appears that the IRS looked at the participant's activities just before enrolling land in the program. A participant who had leased his land to a tenant from March 1, 1984, to March 1, 1985, then farmed it himself for a year, and subsequently leased it again from March 1, 1986, to March 1, 1987, was considered retired from the business of farming when he enrolled his land in the CRP in 1987.<sup>16</sup> At the time the participant was 71 years old. Since he had previously farmed the land personally, it is possible that the IRS's position might have been different had he been younger and, therefore, not of retirement age.

### **1996 Shift in Tax Treatment**

In 1996, the IRS changed its position regarding CRP payments received by those not otherwise engaged in the trade or business of farming. Initially, this shift was signaled by the IRS's concession, in *Hasbrouck v. Commissioner*,<sup>17</sup> to taxpayers who had no traditional farming activity either before or after acquiring the CRP land. The taxpayers had reported the CRP payments on Schedule F and, after deducting expenses, claimed a loss from farming. The IRS attributed its

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<sup>14</sup> Rev. Rul. 60-32, 1960-1 C.B. 23.

<sup>15</sup> P.L. 84-540, 70 Stat. 188.

<sup>16</sup> I.R.S. Priv. Ltr. Rul. 88-22-064 (Mar. 7, 1988).

<sup>17</sup> 76 T.C.M. 48 (1998).

concession to the Tax Court's ruling in another case, *Ray v. Commissioner*;<sup>18</sup> however, since *Ray* involved a taxpayer who was involved in farming and ranching outside of his CRP involvement, it is unclear why the results in *Ray* led to the concession in *Hasbrouck*.

### Hasbrouck v. Commissioner

Generally, participants pay less in total taxes if their CRP payments are treated as rental income rather than as farm income because they do not have to pay self-employment tax on rental income. However, when taxpayers have expenses connected to the land that exceed their CRP income, their tax burden may be lower if they treat the CRP payments as farm income; this was the case in *Hasbrouck*.

In *Hasbrouck*, a couple purchased land in 1987 that had been enrolled in the CRP by the previous owner.<sup>19</sup> The taxpayers chose to continue that enrollment. They incurred significant expenses, which they maintained were related to the conservation plan for the CRP land. They then reported their annual CRP payments on Schedule F, even though they were not otherwise engaged in the trade or business of farming. On Schedule F, they deducted expenses they incurred, which exceeded the income from the CRP.<sup>20</sup> In 1995, the couple's tax returns were examined by the IRS.<sup>21</sup> The examination report denied the losses claimed on Schedule F. The report explained, "Because the amount of income you receive each year is fixed by the federal government, no amount of effort or management skill on your part can increase it. Therefore it has been determined that, at this point in your operation, you are not yet in business."<sup>22</sup> The report went on to say that because the taxpayers were not in the business of farming, use of the Schedule F was inappropriate.

The couple appealed the IRS determination, providing copies of letters received each year from the Agricultural Stabilization and Conservation Service office for their county. These letters stated that their farm operating plan for each year had been reviewed and it had been determined that they were actively engaged in a farming operation.<sup>23</sup>

After receiving a notice of deficiency, the Hasbroucks petitioned the U.S. Tax Court. Just before filing their petition, the couple received a letter from an IRS Problems Resolution Officer who advised them that "Title 16 of the U.S. Code specifically designates [CRP] payments as rental payments."<sup>24</sup>

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<sup>18</sup> 72 T.C.M. 780 (1996).

<sup>19</sup> 76 T.C.M. 48.

<sup>20</sup> The nature of these expenses is unclear. Upon examination, the IRS allocated only some of the expenses to the CRP income saying that these were the only expenses "directly connected with the maintenance of the [CRP land]." *Hasbrouck*, 76 T.C.M. 48.

<sup>21</sup> It is unclear which tax returns were examined. The case refers to 1990, 1992, and 1994 as the years for which deficiencies were determined, but states that the couple's 1992, 1993, and 1994 tax years were examined. *Hasbrouck v. Comm'r*, 76 T.C.M. 48 (1998).

<sup>22</sup> *Hasbrouck*, 76 T.C.M. 48 (quoting June 9, 1995 examination report).

<sup>23</sup> The Tax Court noted that determining that a participant was actively engaged in a farming operation involved different criteria from those involved in determining whether one was in the trade or business of farming. *Hasbrouck*, 76 T.C.M. 48.

<sup>24</sup> *Hasbrouck*, 76 T.C.M. 48.

Before the case was heard by the Tax Court, the IRS conceded the case, allowing the losses the couple had claimed on their tax returns. It proceeded as a claim for attorney's fees and costs, thus providing a public record of the underlying facts in the tax controversy.<sup>25</sup>

## Ray v. Commissioner

In *Ray*, as in *Hasbrouck*, the taxpayers purchased land that had been enrolled in the CRP by the previous owner, and they chose to continue in the program. However, unlike the Hasbroucks, who arguably had no current farming activity, Mr. Ray was a farmer and a rancher who already owned and operated other farmland. The Tax Court found that “the CRP acreage was added to his existing farmland and since [he] was already in the business of farming and ranching, this was a payment to him in connection with his ongoing trade or business.”<sup>26</sup>

## Post-1995 Guidance from the IRS

Since neither tax returns nor IRS examination reports are generally available to the public, there is no way to know for certain whether the IRS began, after *Ray* and *Hasbrouck*, to treat CRP payments as self-employment income for those who were not otherwise engaged in the trade or business of farming. However, a 1997 Market Segment Specialization Audit Technique Guide for Farming indicated that proper treatment of CRP payments could only be determined on a case-by-case basis.<sup>27</sup> An example was provided for a situation in which the payments would not be subject to self-employment tax: a retired farmer who would have rented the land out had it not been enrolled in the Conservation Reserve Program.

Nothing about proposed alternative uses for the land was mentioned, however, in the Farmer's Tax Guide for 1996. That IRS publication indicated that “[t]he annual CRP payment is farm income, ... [reported on] Schedule F. However, if you do not materially participate in *farming operations* on the land, the annual payment is rental income, which you report on Form 4835.”<sup>28</sup> In contrast, the same guide for tax year 1995 stated,

The annual CRP payment is a receipt from farm operations, ... [reported on] Schedule F. However, if you do not materially participate in *production or management of production of the farm products* on your land, the annual payment is rental income, which you report on Form 4835.<sup>29</sup>

The change in the IRS publication for taxpayers seems to indicate that the IRS adopted the view that simply having land enrolled in the CRP was itself a farming operation, which would be self-

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<sup>25</sup> Fees and costs were denied because the court found that the IRS's position that the taxpayers had not established that they were actively engaged in the trade or business of farming was substantially justified. *Hasbrouck*, 76 T.C.M. 48.

<sup>26</sup> *Ray v. Comm'r*, 72 T.C.M. 780 (1996).

<sup>27</sup> *Farming—Specific Issues and Farm Cooperatives*, TPDS No. 84403T, at 5-7. Available at <http://www.irs.gov/pub/irs-mssp/farm.pdf>.

<sup>28</sup> *Farmer's Tax Guide*, I.R.S. Pub. No. 225, at 18 (1996) (emphasis added). Available at <http://www.irs.gov/pub/irs-prior/p225—1996.pdf>. The same guide for 1997 said the same thing. *Farmer's Tax Guide*, I.R.S. Pub. No. 225, at 17 (1997). Available at <http://www.irs.gov/pub/irs-prior/p225—1997.pdf>.

<sup>29</sup> *Farmer's Tax Guide*, I.R.S. Pub. No. 225, at 18 (1995) (emphasis added). Available at <http://www.irs.gov/pub/irs-prior/p225—1995.pdf>. The same guide for 1994 said the same thing. *Farmer's Tax Guide*, I.R.S. Pub. No. 225, at 17 (1994). Available at <http://www.irs.gov/pub/irs-prior/p225—1994.pdf>.

employment income so long as the taxpayer materially participated in that operation—essentially the taxpayers' view in *Hasbrouck*.

## 1998 Shift by the Tax Court: *Wuebker v. Commissioner*

In 1998, in *Wuebker v. Commissioner*,<sup>30</sup> the U.S. Tax Court held that CRP payments were rental income and, therefore, excluded from self-employment income. The case was heard by a Special Trial Judge, but the opinion was agreed to and adopted by the Tax Court.

In *Wuebker*, the taxpayer had been farming for about 20 years before enrolling all of his tillable land in the Conservation Reserve Program. The contract provided for rent at \$85 per acre. The taxpayer had previously grown crops on the hilly, erosion-prone land and thought that the land would benefit from participation in the CRP. He had an additional 44.67 acres not enrolled in the program. This land consisted of “woods, waterways, and land containing improvements.” He had been raising laying hens on this additional land and continued to do so after enrolling the previous cropland in the program. He also farmed separate land under a sharecrop agreement.<sup>31</sup>

The first year of the CRP contract, the taxpayer established a ground cover as required by the contract. This involved first disking the 214 acres and then planting seed. According to the court, little or no upkeep was performed in later years.<sup>32</sup>

In finding that the CRP payments received by the taxpayer were rent and not subject to self-employment tax, the court recognized that Congress intended the exclusion of rent from self-employment income to apply only “for use of space, and, by implication, such services as are required to maintain the space in condition for occupancy.”<sup>33</sup> In cases where additional services are provided that are so substantial that the payments received include compensation for those services, the entire amount is included as self-employment income rather than being excluded as rent.<sup>34</sup>

The court pointed out that “[t]he statute, the regulations, and the CRP contract identify the payments as rental payments or rent. The CRP statute and regulations repeatedly and consistently refer to the annual payments as rent or rentals.”<sup>35</sup> The court noted that “rent” generally referred to compensation for either the occupancy or use of land.<sup>36</sup> The CRP contract placed restrictions on the taxpayer’s use of the land, which the court apparently viewed as another sort of use.<sup>37</sup> The

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<sup>30</sup> 110 T.C. 431 (1998).

<sup>31</sup> It is unclear whether this sharecropping began before or after enrolling his cropland in the CRP.

<sup>32</sup> Only two tax years were in question—1992 and 1993—but the case was decided in 1998 and the court, in discussing later upkeep, referred to multiple years subsequent to the initial year of the contract.

<sup>33</sup> *Wuebker*, 110 T.C. at 436 (quoting *Delno v. Celebrezze*, 347 F.2d 159, 163 (9<sup>th</sup> Cir. 1965) (internal quotation marks omitted)).

<sup>34</sup> *Id.*

<sup>35</sup> *Wuebker*, 110 T.C. at 437 (citing 16 U.S.C. §§ 3833(2), 3834(a), (c); 7 C.F.R. §§ 1401.3, 1410.101 (1997)).

<sup>36</sup> *Wuebker*, 110 T.C. at 436.

<sup>37</sup> Property rights are frequently referred to as a bundle of rights—“use” may comprise several rights such that if one does not have full use of one’s land, another entity is deemed to have some use of it. See Keith Wiebe, et al., *Partial Interests in Land: Policy Tools for Resource Use and Conservation*, AER-744 at 2 (Econ. Research. Serv./USDA 1996). Available at <http://www.ers.usda.gov/publications/AER744/aer744b.pdf>.



court found that the primary purpose of the CRP contract was to achieve environmental benefits<sup>38</sup> by restricting usage and that the services required from the taxpayer “were not substantial and were incidental to the primary purpose of the contract.”<sup>39</sup> Therefore, the payments qualified as rent that was excludible from self-employment income.

## Court of Appeals Reverses *Wuebker*

The court of appeals did not agree.<sup>40</sup> The majority opinion acknowledged that there was some basis for a position that the government was using the land by restricting the taxpayer’s use of that land, but “believe[d] that such an argument impermissibly stretches the plain meaning of the term ‘use,’ especially in light of the narrow construction required of the rentals-from-real-estate exclusion.”<sup>41</sup> It stated that it was not compelled to conclude that the CRP payments were rentals even though references in the CRP statute, regulations, and contract might favor such a conclusion.<sup>42</sup> The IRS had argued that the nature of the payments rather than the label placed on them should lead to a conclusion that they were not excludible rent and the court agreed.<sup>43</sup> It supported its conclusion that the payments had the form, but not the substance, of rental payments, with the language of the CRP statute:

[I]n setting forth the CRP payment rules, Congress expressly qualified its use of the term “rental” by providing that “[t]he amounts payable ... *in the form of* rental payments under contracts entered into ... may be determined through ... the submission of bids ... or ... [through] other means....”<sup>44</sup>

The dissent, however, “believe[d] that the substantial and wide-ranging limitations”<sup>45</sup> the CRP imposed on the taxpayer’s use of the land resulted in the sort of use by the government that would be compatible with the ordinary meaning of “rent.”

The appeals court also disagreed with the Tax Court’s finding that the maintenance services provided by the taxpayer were legally insignificant. The appeals court’s finding does not address the actual extent of the taxpayer’s maintenance services. The finding appears to be based only on what the court deemed to be the program’s essence—“to prevent participants from farming the property and to require them to perform various activities in connection with the land, both at the start of the program and continuously throughout the life of the contract....”<sup>46</sup> Although the Tax Court had cited both a Senate and a House report<sup>47</sup> to support its conclusion that “[t]he primary

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<sup>38</sup> *Wuebker*, 110 T.C. at 437.

<sup>39</sup> *Wuebker*, 110 T.C. at 438.

<sup>40</sup> *Wuebker v. Comm’r*, 205 F.3d 897 (6<sup>th</sup> Cir. 2000).

<sup>41</sup> *Wuebker*, 205 F.3d at 904.

<sup>42</sup> *Wuebker*, 205 F.3d at 904.

<sup>43</sup> *Wuebker*, 205 F.3d at 903.

<sup>44</sup> *Wuebker*, 205 F.3d at 905-05 (quoting 16 U.S.C. § 3834(c)(2)) (deletions and emphasis as supplied by the court).

<sup>45</sup> *Wuebker*, 205 F.3d at 905 (Jones, J. dissenting).

<sup>46</sup> *Wuebker*, 205, F.3d at 904.

<sup>47</sup> “S.Rept. 101-357, at 199-200 (1990); H.Rept. 99-271(I), at 81 (1985).” *Wuebker*, 110 T.C. at 437.

purpose of the CRP is to achieve specified environmental benefits,”<sup>48</sup> the appeals court cited no support for its conclusion as to the “essence of the program.”<sup>49</sup>

## Recent Guidance from the IRS

In contrast to the 1997 Market Segment Specialization Audit Technique Guide for Farming<sup>50</sup> indicating that proper treatment of CRP payments could only be determined on a case by case basis, a 2006 guide indicates that the payments “are reportable on Schedule F and subject to self-employment tax.”<sup>51</sup> The guide provides no exceptions to that treatment.

It appears that the IRS has shifted its position regarding CRP payments again. Although in 1997, the taxpayer’s material participation in the farm operations was cited in IRS publications as determining whether the CRP payments were subject to self-employment tax, the IRS seems to now take the position that material participation in providing required services under the CRP is irrelevant in determining whether the payments are subject to self-employment tax. In 2006, the IRS proposed a revenue ruling that indicates an intent to treat CRP payments as self-employment income even if the participant’s only “farming activity” was being a participant in the Conservation Reserve Program, even if the participant hired a third party to perform all required activities.<sup>52</sup>

A 2003 Chief Counsel Advice (CCA) came to conclusions about CRP payments and self-employment tax that are similar to those in the proposed revenue ruling,<sup>53</sup> though they do not extend to include payments received by those who do not materially participate. The CCA relied on two revenue rulings<sup>54</sup> and an announcement<sup>55</sup> to support its position that CRP payments are includible in self-employment income *whether or not* the recipient was otherwise engaged in the trade or business of farming. Each of the cited sources was released before the inception of the Conservation Reserve Program. They each addressed payments received under a different government program. The two revenue rulings are discussed later in this report.<sup>56</sup> The CCA appears to be the first time the announcement was used to support a position regarding CRP payments.<sup>57</sup>

IRS Announcement 83-43 consists of answers to a set of three questions regarding the “PIK Program”<sup>58</sup> and other land diversion programs that are sponsored by the Department of

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<sup>48</sup> *Wuebker*, 110 T.C. at 437.

<sup>49</sup> *Wuebker*, 205 F.3d at 904.

<sup>50</sup> *Farming—Specific Issues and Farm Cooperatives*, TPDS No. 84403T, at 5-7. Available at <http://www.irs.gov/pub/irs-mssp/farm.pdf>.

<sup>51</sup> *Farmers: Audit Technique Guide* at 2-6 (July 2006). Available at [http://www.irs.gov/pub/irs-mssp/farmers\\_072006.pdf](http://www.irs.gov/pub/irs-mssp/farmers_072006.pdf).

<sup>52</sup> I.R.S. Notice 2006-108, 2006-51 I.R.B. 1118.

<sup>53</sup> See C.C.A. 2003-25-002 (May 29, 2003). Available at <http://tax.cchgroup.com>.

<sup>54</sup> Rev. Rul. 60-32, 1960-1 C.B. 23; Rev. Rul. 65-149, 1965-1 C.B. 434.

<sup>55</sup> Announcement 83-43, 1983-10 I.R.B. 29.

<sup>56</sup> *Infra* “Other IRS Rulings and Notices.”

<sup>57</sup> A search on CCH for “Announcement 83-43” shows that the announcement has been cited in another IRS document three times. One of these is this CCA. Another is the 2006 notice with the proposed revenue ruling. The only citation that predates this CCA is a 1983 letter ruling, 83-30-016 (Apr. 2, 1983), which also predates the CRP.

<sup>58</sup> “PIK” stands for “payment in kind.” A participant received payments in the form of commodities rather than cash.

Agriculture. The first two questions address estate tax issues, and in doing so, the answer to the first states that participation in the “program will be treated as material participation in the operation of a farm with respect to the diverted acres.” The third question addresses self-employment tax. The answer states, “A farmer who receives cash or payment in kind from the Department of Agriculture for participation in a land diversion program is liable for self-employment tax on the cash or payment in kind received.”<sup>59</sup>

Generally, IRS Announcements carry very little authority. They are not published in the Cumulative Bulletin (CB), but appear only in the weekly Internal Revenue Bulletin (IRB). Some might question using such weak authority as the basis for a position regarding CRP payments that appears to have no support in either statutory or case law. The announcement predates the CRP statute, but was not used as a basis for the IRS’s position on CRP payments until the 2003 CCA. Additionally, although the announcement is compatible with the IRS’s early treatment of CRP payments, it does not clearly support the position that all who receive CRP payments are subject to self-employment tax on the payments. Instead, it refers to “[a] *farmer* who receives [payments].”<sup>60</sup>

The CCA admitted that there are hazards of litigation in asserting that receipt of CRP payments denotes operation of a trade or business. The facts of an individual case could lead a court to determine that the taxpayer was not engaged in a trade or business. Hazards exist both when the required activities under the CRP contract are minimal as well as when the participants were not farmers before enrolling land in the CRP. The IRS acknowledged that “[t]here is no case law or guidance that has held that an individual is considered to have entered into the trade or business of farming by merely entering into a CRP contract...”<sup>61</sup> There is case law that holds that a factual determination is required in every case to determine whether a taxpayer is engaged in a trade or business.<sup>62</sup> Despite this, in issuing Notice 2006-108, the IRS has publicly indicated its intention to adopt the position that entering into the CRP contract means that one is in the trade or business of farming and that the payments are self-employment income.

## Response to Notice 2006-108

### Congressional Response

Several bills have been introduced in 110<sup>th</sup> Congress to address the tax treatment of the CRP payments. Two were introduced soon after the IRS notice.<sup>63</sup> Each proposed excluding CRP payments from self-employment income. They were referred to committee. A bill was later introduced in the Senate that would change both the structure of the payments and their taxation.<sup>64</sup> It would clearly exclude the income from self-employment income for certain

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<sup>59</sup> Announcement 83-43, 1983 I.R.B. 29.

<sup>60</sup> *Id.* (emphasis added).

<sup>61</sup> *Id.*

<sup>62</sup> *Groetzing v. Comm’r*, 480 U.S. 23, 36 (1987). Note that Notice 2006-108 cites this case as well (“The question of whether a taxpayer is engaged in a trade or business requires an examination of the relevant facts in each case”). It then, however, reaches the conclusion that CRP payments are self-employment income from a trade or business.

<sup>63</sup> H.R. 2659; S. 1155.

<sup>64</sup> The Heartland, Habitat, Harvest, and Horticulture Act of 2007, S. 2242.

participants and would allow all participants the option of receiving non-taxable tax credits rather than annual rental payments, thus shielding CRP payments from both income and self-employment taxes.<sup>65</sup> These provisions are now contained in the 2007 Farm Bill, now in conference.<sup>66</sup>

## Other Responses

State universities and departments of agriculture often provide newsletters that address current issues of interest to farmers. They may also produce yearly tax guides. The proposed revenue ruling garnered attention from many of these publications. However, they varied in their interpretation of the impact of the IRS notice.

One 2007 tax guide for farmers acknowledged the IRS's announced position regarding self-employment taxes and CRP payments, but stated that there is "substantial authority to exclude CRP payments from earnings from self-employment on current tax returns."<sup>67</sup> Another stated that the proposed revenue ruling is effective for the 2007 tax year and that preparer penalties will be asserted against preparers who do not include CRP payments in self-employment income for all recipients if they fail to disclose this treatment with the tax return.<sup>68</sup> Others advise those receiving CRP payments to remain attentive to announcements that may come before April 15, 2008.<sup>69</sup>

Unlike Treasury Regulations, revenue rulings do not have the force of law—they express the position of the IRS, but are not binding on the courts.<sup>70</sup> If a tax return is examined by the IRS, the IRS may use the revenue ruling to support recommendations in the revenue agent's report (RAR). However, proposed revenue rulings express a proposed position of the IRS. The revenue agent may still assert the position in the RAR, but it seems unlikely that penalties would be asserted against either the preparer or the taxpayer for failure to adhere to that proposed position on the tax return.

A taxpayer wishing to challenge the IRS's position on CRP payments and self-employment tax would need to support such a challenge with relevant case law as well as statutory authority, including legislative history where relevant. Similar information may be helpful to Congress as it considers whether to enact legislation addressing the tax status of CRP payments.

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<sup>65</sup> For the details of this proposed legislation and discussion, see CRS Report RS22851, *The Conservation Reserve Program: Legal Analysis of Proposed Legislation to Change the Structure and Taxation of Benefits Received*, by (name redacted).

<sup>66</sup> H.R. 2419.

<sup>67</sup> George F. Patrick, *Income Tax Management for Farmers in 2007*, CES Paper No. 364-W at 24-25 (Purdue Extension Serv. Dec. 2007). Available at <http://www.agecon.purdue.edu/extension/pubs/TAXPLAN2007final.pdf>. The statement appears to apply only to CRP payments received by those traditionally considered "non-farmers."

<sup>68</sup> Posting of Stu Ellis to The Farm Gate, [http://www.farmgate.uiuc.edu/archive/2007/11/beware\\_of\\_a\\_new.html](http://www.farmgate.uiuc.edu/archive/2007/11/beware_of_a_new.html) (Nov. 29, 2007, 12:36 a.m.).

<sup>69</sup> See e.g., *Farmers See New Tax 'Stimulus,' Uncertainties*, FARM WEEK, Ill. (Farm Bureau Feb. 15, 2008). Available at <http://farmweek.ilfb.org/viewdocument.asp?did=11254&drvid=106&r=0.488888&r=0.6045496>.

<sup>70</sup> *Weubker v. Comm'r*, 205 F.3d 897, 903 (6<sup>th</sup> Cir. 2000).

## Other Income and Tax Provisions

### Rentals of Real Estate

As noted by the Tax Court in *Wuebker*,<sup>71</sup> real estate rentals do not always generate income that is exempt from self-employment tax. Services provided<sup>72</sup> and average rental period<sup>73</sup> are factors that distinguish rental income that is from a business from rental that is not from a business and, thus, not subject to self-employment tax.

Hotels or motels generally involve, at a minimum, such personal services as daily housekeeping and maintenance. They also generally involve rental periods of less than thirty days. Similarly, beach houses and other vacation getaways are often rented for less than thirty days at a time and generally include cooking utensils and linens as well as furnishings. They often include books, games, and magazines and may include cleaning during the occupancy period. Some may include even more substantial services, and all generally include cleaning between occupants—in other words, they include more extensive furnishings and more substantial services than standard residential real estate that is rented on a monthly or yearly basis. Both hotel/motels and recreational rental lodgings are considered businesses<sup>74</sup> and, to the extent owned by individuals rather than corporations, the income is subject to self-employment tax.

On the other hand, long-term rentals of both commercial and residential properties where the average rental period is at least 30 days do not generate self-employment tax. In these rentals, there may be some aspect of personal service—repairs and basic maintenance, for example—but it is not considered a material part of the rental. Instead these services are considered to be necessary to maintain the property in a condition for occupancy. The income is, by definition, passive,<sup>75</sup> rather than from an active trade or business even when the owner materially participates.

### Easement Income

Easements are a real estate concept.<sup>76</sup> Most easements are positive easements, but there can be negative ones as well. A positive easement allows a person or entity that does not own the land to use the land in certain ways. Frequently, the owner of one piece of property (the dominant property) may be granted an easement by the owner of another piece of property (the servient property) to use the servient property for access to the dominant property. Another sort of positive easement is a public utility easement that allows the utility company to use the land to install lines or pipes to deliver utilities to a series of properties.

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<sup>71</sup> 110 T.C. at 436.

<sup>72</sup> See *Delno v. Celebrezze*, 347 F.2d 159, 163 n. 9 (1965) (citing S.Rept. 81-1669 (1950), *reprinted in* 1950 U.S.C.C.A.N. 3454).

<sup>73</sup> See C.F.R. 1.48-1(h)(2)(ii) (allowing business credits for property used predominantly to house “transients” and defining “used on a transient basis” to mean rental period normally lasting less than thirty days).

<sup>74</sup> *Id.* See also, S.Rept. 81-1669; C.F.R. 1.1402(a)-4(c); Rev. Rul. 57-108 1957-1 C.B. 273.

<sup>75</sup> 26 U.S.C. § 469.

<sup>76</sup> For a more detailed discussion of easements, both positive and negative, see *Wiebe*, *supra* note 37, at 4-5.

Negative easements, on the other hand, do not allow an outside party to use the owner's land. Instead, they restrain owners from using their own land in certain ways specified in the easement. In this case, the easement holder may be an adjacent land owner or may be some other third party.

In the case of both positive and negative easements, the owners generally remain responsible for maintaining their property. In many jurisdictions, required maintenance would include mowing and pest control.

Easements, though they often involve transfers of money to the property owners, do not result in self-employment income and frequently do not result in income at all for income tax purposes.<sup>77</sup> Instead, money paid for permanent easements reduces the effective amount the owner has invested in the property. This is referred to as "tax basis." It becomes important when the property is sold because a decrease in tax basis will result in an increase in gain from the sale. Compensation for temporary easements, on the other hand, is treated as a lease,<sup>78</sup> taxable as ordinary rental income in the year of payment.

## **Other IRS Rulings and Notices**

### **Revenue Ruling 60-42, 1960-1 C.B. 23**

This revenue ruling addressed payments received under the Soil Bank Act.<sup>79</sup> It concluded that the payments received were "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."<sup>80</sup> As such they were includible in gross income under IRC § 61. The revenue ruling concluded by stating that the payments were also included as self-employment income by those who operate a "farm personally or through agents or employees," but were not included by others. The ruling did not explain the rationale for this difference.

### **Revenue Ruling 65-149**

This ruling uses Revenue Ruling 60-32 to reach the conclusion that payments for grain storage are self-employment income when received for storing grain produced by the storage owner, but are rent when that grain was produced by a third party, even if the grain is a crop share, so long as the storage owner did not materially participate in the crop-sharing arrangement.

The situation addressed was one in which a farmer grew grain and received a price support loan on it through the Commodity Stabilization Service (CSS). Under the loan agreement, he was to store the grain for a fixed period of time. When that period was up, he was asked to continue storing it, and his loan period was extended. The CSS agreed to a set fee per bushel of grain for the storage.

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<sup>77</sup> See *Sales and Other Dispositions of Assets*, I.R.S. Pub. No. 544, at 2 (2007). Available at <http://www.irs.gov/pub/irs-pdf/p544.pdf>.

<sup>78</sup> *Gilbert v. U.S.*, 808 F.2d 1374, 1381.

<sup>79</sup> P.L. 84-540, 70 Stat. 188.

<sup>80</sup> Rev. Rul. 60-32, 1960-1 C.B. 23.

The ruling points out that the agreement extending the loan period had “no language ... to indicate that the [CSS] was leasing storage space” for which it was paying rent in a landlord tenant relationship. Further, the farmer “had full dominion and control over the stored grain and could dispose of it at any time and in any manner he chose, subject to the discharge of the loan obligation.”

## **Notice 87-26**

This notice was issued regarding the Dairy Termination Program (DTP),<sup>81</sup> which was established in the same legislation as the CRP: the Food Security Act of 1985. Under this program, participating dairy farmers agreed to sell all of their dairy cows for either slaughter or export.<sup>82</sup> They agreed to refrain from acquiring any interest in either dairy cows or milk production for the contract period.<sup>83</sup> They were also prohibited from either acquiring a milk production facility or making one available to anyone for the contract period.

The statute is silent regarding the nature of the compensation; it is referred to only as “a payment to be made by the Secretary.”<sup>84</sup> The IRS notice asserted that the payments were “intended to compensate the milk producer for lost receipts from two sources.” These sources were (1) the difference between the actual sale price of the cows for slaughter or export and the higher price the cows would have commanded if sold for dairy purposes and (2) the dairy production revenue lost when dairy operations were terminated. To the extent that revenue was lost on the sale of the cows, the payments were to be treated as sales of business assets, which are not subject to self-employment tax. The remainder of the payments received were to be treated as replacement for milk production income and reported on Schedule F. These amounts would be self-employment income and, thus, subject to self-employment tax.

The notice provides no explanation for how the IRS arrived at its explanation of the purpose of the compensation or why it determined that the payments were to be attributed first to sales of business assets. The statute required participating producers to furnish information about marketing history, size and composition of the dairy herd during that marketing history, and the size and composition of the dairy herd at the time the bid to participate was submitted.<sup>85</sup> It seems likely that it would have been easier to accurately calculate lost dairy sales revenue than lost revenue from the sale of the dairy cows. However, the provision may not have shielded much of the payments from self-employment tax. The notice put the burden on the taxpayer to show that a portion of the payments received was compensation for selling the cows as non-dairy cows and, therefore, for less than if they had been sold as dairy cows at the same time and place.

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<sup>81</sup> P.L. 99-198 § 101 *et seq.*, 99 Stat. at 1362-66.

<sup>82</sup> P.L. 99-198 § 101(b)(1), 99 Stat. at 1364.

<sup>83</sup> The notice specifies five years, but the statute refers to “a period of 3, 4, or 5 years, as specified by the Secretary in each producer contract.” P.L. 99-198 § 101(b)(1), 99 Stat. at 1364.

<sup>84</sup> P.L. 99-198 § 101(b)(1), 99 Stat. at 1363.

<sup>85</sup> P.L. 99-198 § 101(b)(1), 99 Stat. at 1364.

## Comparison of CRP Payments to Other Types of Income

### Rental Real Estate

In a 1960 revenue ruling, the IRS found that payments made by a steel company to owners of farms were rent from real estate that could be excluded from self-employment income even though the owners' right to use the land was not restricted and the owners were obligated to maintain the land.<sup>86</sup> In comparison, CRP participants are also required to maintain their enrolled land, but their use of that land is very restricted.

The situation that was presented in the revenue ruling was one in which the company's plant discharged various gases and fumes and the company wanted to insulate itself from liability for damage to livestock, crops, and other farm property. To do so, it entered into leases for rights to the farm land; however, these leases did not restrict the farmers' use of those lands, but provided that the company would not be liable for any damages unless due to negligence. The farmers were allowed full use of their lands, but they were not required to continue using them. They were, however, required to maintain the land such that it did not "grow up in weeds or sprouts."

The only way in which the steel company "used" the land was through the gases, etc., that emanated from the plant. The IRS found that limited use was sufficient to "carve out of the owner's interest a certain estate in the land." The maintenance services required under the contract were apparently irrelevant to the IRS, since they were not mentioned at all in the discussion of why the amounts paid constituted "rentals from real estate" that were not included in self-employment income.

Though it did not find the argument persuasive, the Sixth Circuit Court acknowledged in *Wuebker* that it is arguable that the government, by placing restrictions on the use of property enrolled in the CRP, is "using" the property and payments made could be considered rent. It could be argued that just as the steel company in the revenue ruling carved out an estate in the land from the owner's interest, the government carves out an estate in the land from the owner's interest when it restricts the owner's use of the land under the CRP.

If one accepts that argument, the question becomes whether the services required under the contract are of such magnitude that "compensation for them can be said to constitute a material part of the payments"<sup>87</sup> made under the contract. If so, the entire payment should be considered income from self-employment,<sup>88</sup> but if not, none of the payment should be subject to self-employment tax.

In the case of the steel company, the IRS apparently did not consider maintaining the land free of weeds and sprouts to be services that required consideration in its analysis of the nature of the payments made to the land owners. In *Wuebker*, the Tax Court recounted the services provided by the taxpayer under the CRP contract and found them minimal. The Sixth Circuit Court, however,

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<sup>86</sup> Rev. Rul. 60-170, 1960-1 C.B. 357.

<sup>87</sup> *Delno*, 347 F.2d at 163.

<sup>88</sup> *Delno*, 347 F.2d at 163.



found the services “legally significant,” without explaining why. Those services were, however, addressed in explaining why there was a nexus between the CRP payments and the taxpayer’s farming activity on other land. The new revenue ruling proposed by the IRS refers to these services saying that the circuit court “noted that the taxpayers were required under the CRP contract to perform tasks intrinsic to the farming trade or business (e.g. tilling, seeding, fertilizing, and weed control) that required the use of their farming equipment.” If it is pertinent that the tasks involved are intrinsic to the farming trade and pertinent that the equipment used is also used in the farming trade, could it also follow that an owner of residential property that is rented out might have to include the rent as part of income from self-employment if that owner were a plumber, electrician, or carpenter and provided routine maintenance that involved tasks intrinsic to the owner’s trade, particularly if using the same equipment used in that trade? If not, why are the tasks or equipment pertinent in determining that CRP payments are income from self-employment?

A further consideration is the extent to which the annual rental payments actually include payment for services. The Farm Service Agency (FSA), which is part of the U.S. Department of Agriculture (USDA), establishes a maximum rental rate for each offer. Participants may offer their land for enrollment at that rate or at a lower rate.<sup>89</sup> The FSA website states that it “bases rental rates on the relative productivity of the soils within each county and the average dry land cash rent or cash-rent equivalent.”<sup>90</sup> The average annual rental for all CRP land in February 2008 was \$50.63 per acre; however, allowed rental rates ranged from \$44.16 per acre to \$125.44 per acre.<sup>91</sup> CRP annual payments vary depending upon the type of land and the location of that land, not on services provided. The payments do not exceed the fair market rental for the land. This leaves the question open as to how and why the IRS has determined that the payments are for services and subject to self-employment tax.

## Easements

The CRP does not acquire a legal easement when it enrolls land in the program. However, the limitations placed on the use of the enrolled land are similar to limitations on land use when a negative easement is in place.<sup>92</sup> CRP payments amount to \$1.8 billion annually. If the CRP acquired a permanent easement, these payments would, in most cases, reduce the owner’s basis in the land, resulting in no immediate tax revenue to offset the payments. However, reasonable unrestricted use of the enrolled land reverts to the owner/operator at the end of the enrollment period. Therefore, even if the CRP held a legal easement, it is likely that the payments would be treated as currently taxable rental payments rather than being nontaxable to the extent that they did not exceed the basis of the land.

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<sup>89</sup> Land might be offered at a lower rate to increase the possibility of the land being accepted for enrollment.

<sup>90</sup> Available at <http://www.fsa.usda.gov/FSA/webapp?area=home&subject=copr&topic=crp>.

<sup>91</sup> Conservation Reserve Program Monthly Summary (Feb. 2008). Available at [http://www.fsa.usda.gov/Internet/FSA\\_File/feb2008.pdf](http://www.fsa.usda.gov/Internet/FSA_File/feb2008.pdf).

<sup>92</sup> See *Wiebe*, *supra* note 37 at 7 (“The Conservation Reserve Program does not strictly acquire easements, at least in the legal sense, although the interests acquired are closely analogous in economic terms”).

## Soil Bank Program Payments

Revenue Ruling 60-32 addressed payments received under the Soil Bank Act and concluded that they were to be included in self-employment income when received by those who were otherwise engaged in the trade or business of farming because they replaced income the recipients would have generated from farming the land.<sup>93</sup> Similar reasoning has been used by the IRS to support its position regarding CRP payments.

In discussing CRP payments, the IRS has said that the annual rental payments have “the substantive effect of providing owners and operators with compensation for the potential income from their land had they devoted such land to the production of an agricultural commodity.”<sup>94</sup> However, nothing in the statutory language for the Conservation Reserve Program either states or implies that the payments are being made to compensate for the participant’s loss of commodity income. On the other hand, the Soil Bank Act explicitly states that

[c]ompensation ... shall ... provide producers with a fair and reasonable return for reducing their acreage of the commodity, taking into consideration the loss of production of the commodity on the reserve acreage, any savings in cost which result from not planting the commodity on the reserve acreage, and the incentive necessary to achieve the reserve acreage goal.<sup>95</sup>

In contrast, virtually all references to CRP payments use the term “rent” to describe them. Although the Sixth Circuit Court inferred significance from the phrase “in the form of rental payments,” the legislative history gives no indication that the payments were rent in form only. Both the House Report and the Conference Report refer to the payments as rent.<sup>96</sup>

Use of the “substance over form” doctrine to invalidate, for tax purposes, the form given to a transaction by Congress is an unusual application of the doctrine. The doctrine is one that is generally used when the taxpayer was able to influence the form of a transaction, choosing one with favorable tax consequences rather than another with less favorable ones even though that form might better reflect the real substance of the transaction.<sup>97</sup> In the case of CRP payments, participants have no influence over the form of the transaction. Instead it is the government that chose the form of the transaction. It is arguable that participants may have relied on Congress’s description of the transaction—and its accompanying tax consequences—when choosing to enroll their land in the CRP.

## Grain Storage

Revenue Ruling 65-149 found that grain storage fees were includible as self-employment income when there was no language in the agreement to indicate that the Commodity Stabilization

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<sup>93</sup> See supra “Other IRS Rulings and Notices.”

<sup>94</sup> I.R.S. Priv. Ltr. Rul. 88-22-064.

<sup>95</sup> P.L. 84-540, 70 Stat. at 191.

<sup>96</sup> H.Rept. 99-271 at 81 (“annual rental payments”), 285 (“land rental payments”), 413 (“land rental fee”) (1985); H.Rept. 99-447 at 465 (“annual rental fees” and “rental payments”) (1985) (Conf. Rep.).

<sup>97</sup> BORIS I. BITTKER ET AL., *FEDERAL INCOME TAXATION OF INDIVIDUALS* ¶ 1.03[3], at 1-31 to -32 (3d ed. 2002).

Service was leasing space and paying rent.<sup>98</sup> In the provided facts, the farmer had “full dominion and control” of the grain.

In contrast, the CRP contracts state that the payments are rent and set out the limitations placed on the participant’s use of the enrolled land. The participant does not have full dominion and control over the land. Even the right to freely transfer the land is limited since if the land is transferred to anyone who chooses not to continue the enrollment, repayment of all payments will generally be required.

## **Dairy Termination Program Payments**

IRS Notice 87-26 found that payments received under the Dairy Termination Program were not includible in self-employment income to the extent that they represented compensation for the lower prices received when dairy cows were sold for slaughter or export. The statute establishing the payments was silent regarding the nature of the payments and the IRS provided no explanation of its determination of the purpose for the payments.

Both the Dairy Termination Program (DTP) and the Conservation Reserve Program were established in the same legislation. However, in the former, the IRS chose to infer purpose and form to the DTP payments, despite the statute’s silence on those matters. In the latter, the IRS has chosen to ignore the statute’s description of the payments as rent. Instead, over the years, it has used different interpretations to support inclusion of the CRP payments in self-employment income.

Initially, the IRS treated the payments as for lost income from crop production when received by farmers. For those who were not engaged in farming, the payments were treated as rent, but even that treatment may have been as compensation for lost income in that a non-farmer might otherwise have rented the land out.<sup>99</sup> Unlike the DTP, the CRP has never required participants to provide information regarding either the income they had derived from the land before enrolling it in the CRP or other income they might receive if the land were not enrolled.

More recently, the IRS’s position seems to have shifted to one that considers the CRP payments to be compensation for services performed under the terms of the contract. This leaves at least two questions unanswered:

- Why do the payments for services remain the same even though the extent of those services may vary greatly from year to year?
- Why must the entire amount be repaid if the contract is terminated early?

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<sup>98</sup> See *supra* “Other IRS Rulings and Notices.”

<sup>99</sup> See *Farming—Specific Issues and Farm Cooperatives*, *supra* note 57 (providing as an example a retired farmer who would otherwise rent out the land).

## Examining the Unexamined Factor: The Repayment Requirement

Both the Internal Revenue Service and the Tax Court have repeatedly looked at CRP payments to determine whether they should be included in self-employment income or excluded under the rental income exclusion. In so doing, neither has looked at the requirement that *all* payments received by participants, whether as annual rental payments or as cost-share payments for the conservation plan, generally must be repaid if the contract is terminated before it expires.<sup>100</sup> Termination may occur if the participant violates a term or condition of the contract.<sup>101</sup> Termination also occurs if owner/operators transfer their rights and interests in the contracted land unless the transferee agrees to assume the contract.<sup>102</sup> However, repayment is not required in two situations: (1) “the land is purchased by or for the United States Fish and Wildlife Service”<sup>103</sup> or (2) the Secretary of Agriculture and the new owner/operator agree to modifications that are in line with the program’s objectives.<sup>104</sup> Assuming that their tax returns were filed in compliance with the IRS’s position on CRP annual payments, participants paid both income and self-employment tax on the annual payments that must be repaid if the contract is terminated.

The Internal Revenue Code (IRC) provides a possible income tax solution for those who have included amounts in taxable income and, after the close of that tax year, repaid all or part of the amount previously received.<sup>105</sup> In this situation, a taxpayer may be allowed to deduct the amount repaid in the year it is repaid. If the amount is over \$3,000, the IRC allows taxpayers to compare the income tax savings from the deduction to the income tax savings that would have occurred had the amount not been included in income in the year it was received, and recoup the larger tax savings.<sup>106</sup> There does not, however, appear to be a similar provision for recapturing the self-employment tax paid on those previously taxed but repaid amounts.

Participants who are actively engaged in farming outside of their CRP land may be able to recoup both the income tax and self-employment tax paid on the CRP annual payments that must be repaid after termination. If the participant’s net income from farming is equal to or greater than the amount repaid, it appears that the self-employment tax might be reduced in the repayment year to the same degree that it was increased in the years in which the CRP payments were included in income. If, however, the participant had no self-employment income other than the CRP payments, the self-employment tax for the year of repayment would be zero, but this would not recapture self-employment tax paid in earlier years.<sup>107</sup> Thus, though some participants who

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<sup>100</sup> 16 U.S.C. § 3832(a)(5)-(6). See also CRS Report RS21613, *Conservation Reserve Program: Status and Current Issues*, by (name redacted).

<sup>101</sup> 16 U.S.C. § 3832(a)(5).

<sup>102</sup> 16 U.S.C. § 3832(a)(6). However, for some land early termination without repayment is allowed for contracts entered into prior to 1995 that have been in force for at least five years. 16 U.S.C. § 3835(c).

<sup>103</sup> *Id.*

<sup>104</sup> *Id.*

<sup>105</sup> 26 U.S.C. § 1341.

<sup>106</sup> See Treas. Reg. § 1.1341-1 for further discussion and examples of calculations.

<sup>107</sup> If the repayment were large enough to result in a net operating loss in the year of repayment, some of the self-employment tax previously paid might be recouped through a net operating loss carryback.

must repay CRP annual payments may be able to recoup some or all of the self-employment taxes paid in previous years, such recoupment is not certain for all participants.

Amending prior years' tax returns to remove the CRP payments does not provide a way to recoup either income or self-employment tax. CRP payments are received under a "claim of right."<sup>108</sup> At the time the payments were received, the taxpayer had an unqualified right to the payment. As such, the payments cannot be removed from income for the tax year in which they were received, even if they are later repaid.

The requirement to repay all CRP payments that were received raises at least two issues. First is the equitable issue regarding imposing self-employment tax on the annual payments but providing no sure means for that self-employment tax to be recouped if the money must be returned. Second is the issue of whether money that must be repaid if the land does not remain out of production for the duration of the contract can reasonably be considered money paid for services rather than money paid for agreeing to refrain from using the land commercially.

## Conclusion

It is easy to understand the IRS's move to treat all CRP payments as self-employment income subject to self-employment tax. Doing so establishes a bright-line rule that does not require interpretation of facts and circumstances on a case-by-case basis. Such a rule is easier for the IRS to enforce and easier for taxpayers to follow.

This is similar to the bright-line rule that treats income from hotels and motels as self-employment income, but treats longer-term real estate rentals as rental income. A bright-line rule for CRP payments might be based on a determination by Congress that the services required under the CRP contracts are significant and payment for them is included in the CRP "rent." This would eliminate the need to examine the services provided on a case-by-case basis. Further, it would eliminate any arguable need to examine whether the participant was engaged in the trade or business of farming. The CRP payments would be considered income from self-employment because they included compensation for significant services. With this bright-line rule, there would be no need to consider the extent of the services provided by the recipient on a case-by-case basis.

A different bright-line rule could be established if Congress were to choose to do so: a bright-line rule that CRP payments are to be treated as rent that is not subject to self-employment tax. As evidenced by bills repeatedly introduced in Congress, some Members of Congress have been aware that the IRS was treating some CRP payments as self-employment income, but, thus far, Congress has not chosen to act to change that. If Congress now chooses to examine the possibility of explicitly excluding some or all CRP payments from self-employment income, it may want to look at the services required under the CRP contracts and conservation plans. It may also want to determine actual fair market rental values for lands similar to those enrolled in the CRP to determine whether CRP payments exceed those values.

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<sup>108</sup> For discussion of "claim of right," see BITTKER ET AL., *supra* note 94, ¶ 4.03[1], at 4-8 to -9.

## **Services Required**

The Tax Court and the Sixth Circuit Court disagreed regarding the significance of the services provided by the taxpayer in fulfilling the obligations under the CRP contract. A survey of the activities of participants might provide information as to the extent and significance of services provided by participants. It is possible that these may be greater in the first year than in subsequent years and that services may be more significant for some types of enrolled lands and conservation plans than for others. Congress might choose to determine to what extent participants must provide significant services on an ongoing basis over the life of the contract.

If it were to determine that there were significant services in the first year of a contract, but negligible ones in subsequent years, it might choose to treat CRP payments differently in the first year than in subsequent ones. Modifying the way in which the payments are reported to the participant and the IRS<sup>109</sup> would allow the nature of the payments to be clear and aid the IRS's enforcement efforts. Of course, Congress could decide to exclude the CRP payments from self-employment income in all years even if the services required in the first year were disproportionate to the services required in later years. Similarly, if Congress determined that some types of land or conservation plans required more ongoing services, it could designate that all CRP payments for those lands or plans would be includible in self-employment income. In either case, the statute could be modified to explicitly define the nature of the payments received and their tax treatment.

## **Fair Market Rental Values**

The correlation between the annual CRP rental payments and the fair market rental rates for similar land might be another consideration. The average rental payments for all CRP property is \$51 per acre, but payments vary depending upon the type of land, its location, and the particular type of enrollment. Even if Congress finds that the CRP payments are no more than the rental income that might be received from a third party who would use the land, it could still determine that the services provided were sufficient that the payments must be considered self-employment income. However, it might conclude that payments that were at or below fair market rental values could not be considered to include compensation for services, thus shielding the payments from self-employment tax. Conversely, if it should find that the payments made by the CRP were greater than the fair market rental rate, it could consider that a clear indication that the CRP payments included compensation for services and thus clearly subject to self-employment tax.

## **Self-Employment Taxes and the Repayment Provision**

Congress may choose to enact legislation that explicitly excludes some or all CRP payments from self-employment income. Taking no legislative action would leave the issue up to the IRS and the courts. If Congress chooses not to act to exclude any or all CRP payments from self-employment income, it may want to consider whether some provision should be made to allow recoupment of self-employment taxes paid whenever a contract is terminated and the participant is required to return all payments received.

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<sup>109</sup> The first year's payments might be reported as "non-employee compensation" on Form 1099- MISC. Subsequent years' payments could be reported as "rents" on the same form. Alternatively, Form 1099—G could be modified to distinguish between first year and subsequent years' payments.

## Appendix. The Conservation Reserve Program

### The Food Security Act of 1985

Under the Food Security Act of 1985, the Secretary of Agriculture was to “enter into contracts with owners and operators of farms and ranches containing highly erodible cropland.”<sup>110</sup> Other lands could be included in the program if they “pose[d] an off-farm environmental threat or ... a threat of continued degradation of productivity due to soil salinity.”<sup>111</sup> The contracts could not be for more than 15 years nor less than 10. No more than 45 million acres could be enrolled in the program. In the first year—crop year 1986—the act required enrollment of at least 5 million acres. Each year, through 1989, the minimum was increased by 10 million acres. For the final year, the minimum was increased to 40 million acres. One-eighth of the land under contract was to be devoted to trees.

Under the program, owner/operators were required to follow a plan, approved by their local conservation district, to convert the enrolled land to a less intensive use according to a planned schedule and to establish an approved vegetative cover on the land. They were generally prohibited from using the land for agricultural purposes, and could not use the forage from the land commercially, whether for harvesting, grazing, or any other commercial purpose.<sup>112</sup>

In return, the owner/operators were to be reimbursed for half of the cost of the conservation measures when such cost-sharing was “appropriate and in the public interest.”<sup>113</sup> Additionally, they were to be paid an “annual rental payment” in cash or commodities.<sup>114</sup> However, full refunds of both the rental payments and the cost-share payments could be required in two situations: (1) violation of the contract sufficient to warrant termination of the contract, or (2) transfer of the owner/operator’s rights and interests in the land to another who chose not to assume all the obligations of the contract.<sup>115</sup> In case of termination, the act specified that the repayment was to be with interest. Partial repayment might be required if the contract had been violated but the Secretary of Agriculture did not find termination appropriate.<sup>116</sup>

### The Food, Agriculture, Conservation, and Trade Act of 1990

This act extended the Conservation Reserve Program through 1995 and expanded the types of land eligible for the program.<sup>117</sup> In addition to highly erodible croplands, eligible land included some marginal pasture lands as well as otherwise ineligible croplands if their continued use for agricultural production created certain threats to water or the environment. Otherwise ineligible croplands could also be enrolled if they were “newly-created, permanent grass sod waterways, or ... contour grass sod strips established and maintained as part of an approved conservation

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<sup>110</sup> P.L. 99-198, § 1231 (b), 99 Stat. at 1509.

<sup>111</sup> *Id.*

<sup>112</sup> P.L. 99-198, § 1232, 99 Stat. at 1509-11.

<sup>113</sup> P.L. 99-198, § 1234(a)-(b), 99 Stat. at 1511.

<sup>114</sup> P.L. 99-198, § 1234(a), 99 Stat. at 1511.

<sup>115</sup> P.L. 99-198, § 1232(a)(5)-(6), 99 Stat. at 1510.

<sup>116</sup> P.L. 99-198, § 1232(a)(5), 99 Stat. at 1510.

<sup>117</sup> P.L. 101-624, § 1432, 104 Stat. 3359, 3577-78.

plan.”<sup>118</sup> Croplands that would “be devoted to ... newly established living snow fences, permanent wildlife habitat, windbreaks, shelterbelts, or filterstrips devoted to trees or shrubs”<sup>119</sup> could also be enrolled in the program.

The 1990 act also modified the duties of contract holders. Rather than requiring vegetative cover to be established on all enrolled lands, the 1990 act allowed owner/operators to establish “water cover for the enhancement of wildlife”<sup>120</sup> so long as it did not include commercial fish ponds or ponds used to water livestock or irrigate crops. Water cover was allowed in addition to vegetative cover. For some contracts entered into after the date of enactment, the act prohibited owner/operators from producing agricultural commodities on their unenrolled highly erodible land if that land was purchased after the date of enactment and had not previously been used to produce nonforage agricultural commodities.<sup>121</sup> However, “alley cropping” of agricultural commodities could be allowed in conjunction with enrolled land that was planted in hardwood trees.<sup>122</sup>

One-eighth of the land enrolled between 1991 and 1995 was to be devoted to either trees or “shrubs or other noncrop vegetation or water that may provide a permanent habitat for wildlife including migratory waterfowl.”<sup>123</sup> Owner/operators holding contracts predating the 1990 act were allowed to convert highly erodible lands from vegetative cover to “hardwood trees, windbreaks, shelterbelts, or wildlife corridors,”<sup>124</sup> but were required to participate in the Forest Stewardship Program.<sup>125</sup> In some cases, owner/operators could choose to convert the land to wetlands rather than trees.<sup>126</sup>

## **The Federal Agriculture Improvement and Reform Act of 1996**

The 1996 act extended the Conservation Reserve Program through 2002.<sup>127</sup> It also reduced the maximum enrollment to 36.4 million acres at any one time. It did not expand the list of land eligible for enrollment nor modify the duties of the owner/operators. It did, however, allow for early termination of some contracts predating January 1, 1995.<sup>128</sup>

## **The Farm Security and Rural Investment Act of 2002**

The 2002 act extended the Conservation Reserve Program through 2007.<sup>129</sup> The purpose of the program was revised to include conservation of the eligible land’s wildlife resources as well as

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<sup>118</sup> P.L. 101-624, § 1432, 104 Stat. at 3578 (amending P.L. 98-198, § 1231(b)(4)(B)).

<sup>119</sup> P.L. 101-624, § 1432, 104 Stat. at 3578 (amending P.L. 98-198, § 1231(b)(4)(C)).

<sup>120</sup> P.L. 101-624, § 1433, 104 Stat. at 3579 (amending P.L. 98-198, § 1232(a)(4)).

<sup>121</sup> P.L. 101-624, § 1433, 104 Stat. at 3580 (amending P.L. 98-198 to add § 1232(a)(11)).

<sup>122</sup> P.L. 101-624, § 1433, 104 Stat. at 3580 (amending P.L. 98-198 to add § 1232(d)).

<sup>123</sup> P.L. 101-624, § 1433, 104 Stat. at 3580 (amending P.L. 98-198, § 1232(c)).

<sup>124</sup> P.L. 101-624, § 1435, 104 Stat. at 3582 (amending P.L. 98-198 to add § 1235A).

<sup>125</sup> P.L. 101-624, § 1435, 104 Stat. at 3583 (amending P.L. 98-198 to add § 1235A(d)).

<sup>126</sup> P.L. 101-624, § 1435, 104 Stat. at 3583 (amending P.L. 98-198 to add § 1235A(b)).

<sup>127</sup> P.L. 104-127, § 332, 110 Stat. 888, 994 (amending P.L. 98-198, § 1231).

<sup>128</sup> P.L. 104-127, § 332, 110 Stat. at 994 (amending P.L. 98-198 to add § 1235(e)).

<sup>129</sup> P.L. 107-171 § 2101(a), 116 Stat. at 238.



soil and water resources.<sup>130</sup> Maximum enrollment was increased to 39.2 million acres. The act expanded the definition of eligible lands to include otherwise ineligible cropland that was part of a field where more than half of the field was enrolled as a buffer and the remainder could not feasibly be farmed.

The act also established a pilot program for wetlands and buffers. Wetlands were eligible only if they had been cropped in 3 out of the last 10 years. To be eligible for enrollment, buffers had to be contiguous to the wetlands and used to protect the wetlands. So long as the total acreage of the wetland and its buffers was no more than 40 acres, buffers could be up to three times the area of the wetland or 150 feet on each side, whichever was larger. Owners and operators of the enrolled wetlands were required to fulfill the same duties as those with other eligible lands, but were also required to restore the hydrology as much as possible and establish a vegetative cover, which could include water-based vegetation.

### **The 2007 “Farm Bill”**

H.R. 2419 is commonly referred to as the “Farm Bill.” The Senate passed the bill with amendments late in 2007, and the bill is now in conference. The amendments include provisions for the Conservation Reserve Program that were found in an earlier Senate bill.<sup>131</sup>

This act, if passed, would extend the Conservation Reserve Program through 2012. It would expand the purpose of the program to include conservation and improvement of pollinator habitat resources.<sup>132</sup> It authorizes enrollment of several types of previously ineligible lands. Marginal pasture land and hay land would be eligible if devoted to appropriate native vegetation, so long as the land would “contribute to the restoration of a long-leaf pine forest or other declining forest ecosystem.”<sup>133</sup>

The pilot program for wetlands and buffers would continue, but would add two additional types of land: (1) shallow water areas previously used as a “commercial pond-raised aqua-culture operation”<sup>134</sup> and (2) agricultural drainage water treatment designed to remove nitrogen, so long as the flow comes from a row crop agricultural drainage system. Eligible buffers would include those around a shallow water area as well as those around a wetland. The duties of owner/operators of land in the pilot program would remain the same; however, acceptable vegetative cover would include “bottomland hardwoods, cypress, and other appropriate tree species in shallow water areas.”<sup>135</sup>

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<sup>130</sup> *Id.*

<sup>131</sup> The Heartland, Habitat, Harvest, and Horticulture Act of 2007, S. 2242, 110<sup>th</sup> Congress.

<sup>132</sup> H.R. 2419 § 2311(a)(2) (engrossed amendment agreed to by the Senate).

<sup>133</sup> H.R. 2419 § 2311 (b)(4).

<sup>134</sup> H.R. 2419 § 2311(e).

<sup>135</sup> *Id.*

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