



The Conservation Reserve Program: Legal Analysis of Proposed Legislation to Change the Structure and Taxation of Benefits Received

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Summary

The Internal Revenue Service considers payments received under the Conservation Reserve Program (CRP) self-employment income even though they are called “annual rental payments,” and rental income from real property is generally excluded from self-employment income. Bills have been repeatedly introduced before Congress to statutorily exclude the CRP payments from self-employment tax, but these bills generally have died in committee. In the 110th Congress, the Senate passed H.R. 2419, which contains a provision that would exclude the payments from self-employment income in some, but not all, cases. Unlike most previously introduced legislation, it would also provide a tax credit as an optional alternative to the current annual rental payments. This credit would be subject to neither income tax nor self-employment tax.

Background

The Conservation Reserve Program began in 1985 as a program designed to remove highly erodible croplands from current crop production. It was established by the Food Security Act of 1985¹ and has been expanded and extended by subsequent legislation.² The program provides for “annual rental payments” to land owners or operators who agree to enroll their qualifying land in the program. Enrollment requires them to remove land from production and, generally, refrain from using the land commercially. They must also follow an approved conservation plan. In return, they receive annual payments. These payments are referred to as “rent” in the statute, regulations, and contracts. However, from the beginning, the Internal Revenue Service (IRS) has treated this income as self-employment income for those who continued to farm other land connected to the CRP land. Although the IRS initially treated the payments as rental income for those not otherwise engaged in farming, and, therefore, not subject to self-employment tax, that treatment has changed over the years.³ In 2006, the IRS issued a proposed revenue ruling that would treat virtually all CRP annual payments as self-employment income.⁴

Net self-employment income is subject to a 15.3% self-employment tax. Since CRP annual payments are also subject to income tax, the total tax an individual must pay on CRP payments is generally between about 25%⁵ and 56%⁶ of the total received if the CRP payments are subject to self-employment tax.⁷

Congressional Response

Several bills have been introduced in recent Congresses to completely exclude CRP payments from self-employment income.⁸ Most were simply referred to committee, and no hearings were held.⁹

¹ P.L. 99-198, 99 Stat. 1354.

² For more details on the expansion and extension of the CRP, please see CRS Report RL34457, *Conservation Reserve Program Payments: Self-Employment Income, Rental Income, or Something Else?*, by (name redacted) See CRS Report RS21613, *Conservation Reserve Program: Status and Current Issues*, by (name redacted), for general background of the CRP and procedures for enrolling land in the program.

³ See CRS Report RL34457, *Conservation Reserve Program Payments: Self-Employment Income, Rental Income, or Something Else?*, by (name redacted) for more information about the IRS’s positions regarding including CRP payments as self-employment income.

⁴ I.R.S. Notice 2006-108, 2006-51 I.R.B. 1118.

⁵ This assumes no expenses to offset the CRP income, a federal marginal tax rate of 10% for the entire amount, and no state tax.

⁶ This assumes no expenses to offset the CRP income, a federal marginal tax rate of 35% for the entire amount, and a state marginal tax of 6%.

⁷ Some individuals would have an effective tax rate that was lower; for others it could be higher. Expenses to offset income would lower the taxes paid. Other income would affect the extent to which the income was taxed at the marginal rate. “Phase-outs” of itemized deductions and exemption amounts can result in more tax being paid because more is subject to higher marginal rates.

⁸ See e.g., H.R. 4073, H.R. 5169, S. 665, S. 1316 (108th Congress); H.R. 923, H.R. 2347, S. 312, S. 315 (107th Congress); H.R. 4064, S. 2344, H.R. 4212, S. 2422 (106th Congress). These were introduced after a Sixth Circuit Court case reversed the Tax Court’s holding that CRP payments were rent that was excludible from self-employment income. *Wuebker v. Comm’r*, 205 F.3d 897 (2000), *rev’g* 110 T.C. 431 (1998).

⁹ Hearings were held on S. 312 and S. 315 (both 107th Congress).

During the first session of the 110th Congress, two similar bills were introduced.¹⁰ Again, they were referred to committee. However, in S. 2242, the Heartland, Habitat, Harvest, and Horticulture Act of 2007, the issue was approached in a different manner. This approach has been adopted in H.R. 2419—the “Farm Bill.”¹¹

Rather than exempting all CRP payments from self-employment tax, while still including them for income tax, the Farm Bill provides two alternatives that would provide some relief to taxpayers. The first offers an optional tax credit in lieu of CRP payments. The second explicitly exempts CRP payments from self-employment tax for certain taxpayers. CRP annual payments would remain subject to income tax for all recipients. The credit would be subject to neither income nor self-employment taxes.

Tax Credit

As proposed in the Farm Bill, participants in the CRP could elect to receive an annual tax credit¹² rather than receiving the annual rental payments.¹³ This credit would be subject to neither income nor self-employment tax.¹⁴ Those who did not elect to receive the credit would continue to receive the annual rental payments.

The amount of the credit would be the same as the amount of the annual rental payment each electing participant would otherwise have received.¹⁵ The credit could be used to offset current year’s taxes, but would not be refundable.¹⁶ However, any excess could be carried forward and used against tax in future years.¹⁷ The credit would not be allowed as either an original credit or as a carryforward in any fiscal year after FY2012.¹⁸

Early termination of a CRP contract generally involves repayment of all payments received from the program since the beginning of the contract.¹⁹ The proposed credit would be treated differently—it would be recaptured only on a prorated basis for the fiscal year in which the contract was terminated and the credit allowed.²⁰

¹⁰ H.R. 2659, S. 1155.

¹¹ H.R. 2419 (Engrossed Amendment Agreed to by Senate). All references to “the Farm Bill,” H.R. 2419,” or “the current proposal” are to the Senate-passed version of H.R. 2419.

¹² H.R. 2419 § 12201(a) (adding 26 U.S.C. § 30D(a)).

¹³ H.R. 2419 § 12201(b)(1) (adding 16 U.S.C. § 3834(c)(6)).

¹⁴ H.R. 2419 § 12201(a) (adding 26 U.S.C. § 30D(e)(4)).

¹⁵ H.R. 2419 § 12201(a) (adding 26 U.S.C. § 30D(a)).

¹⁶ H.R. 2419 § 12201(a) (adding 26 U.S.C. § 30D(b)(1)).

¹⁷ H.R. 2419 § 12201(a) (adding 26 U.S.C. § 30D(d)).

¹⁸ H.R. 2419 § 12201(a) (adding 6 U.S.C. § 30D(c)(1), (3)).

¹⁹ 16 U.S.C. § 3832(a)(5)-(6). See CRS Report RS21613, *Conservation Reserve Program: Status and Current Issues*, by (name redacted); CRS Report RL34457, *Conservation Reserve Program Payments: Self-Employment Income, Rental Income, or Something Else?*, by (name redacted).

²⁰ H.R. 2419 § 12201(a) (adding 26 U.S.C. § 30D(e)(3)).

Exclusion from Self-Employment Income for Certain Taxpayers

The Farm Bill would exclude CRP payments from self-employment income for those receiving regular retirement benefits from Social Security as well as those receiving Social Security disability benefits.²¹ It is silent as to the treatment of CRP payments received by all others. Given the current position of the IRS, it seems likely that this silence would result in these payments being considered self-employment income for all others.²² The committee report for the Heartland, Habitat, Harvest, and Horticulture Act of 2007, in addressing that act's identical provision, stated, "The treatment of conservation reserve program payments received by other entities is not changed."²³

Analysis of the Tax-Related CRP Proposals in the Farm Bill

Tax Credit

A tax credit reduces taxes dollar-for-dollar. Most tax credits are not refundable and no current tax credit is subject to federal income tax or self-employment tax.²⁴ In this regard, the proposed credit is no different. It is different than most credits, however, because it can be carried forward to a subsequent tax year if not used in full in the current one.²⁵

Those opposing the proposed credit may argue that it is regressive in nature in that it will provide the most benefit to those whose income is highest. This benefit could occur in two different ways. Since the credit would not be subject to either income or self-employment taxes, those in the higher tax brackets would receive a greater tax benefit from nontaxability than would those in lower tax brackets.²⁶ Additionally, those with higher income would be more likely to have tax liabilities that equal or exceed the credit amount.²⁷ Because of the time value of money, those who are able to fully use the credit will receive a greater value from the credit than those who must carry part of the credit forward to a subsequent year.

Those in favor of the credit may point out that no one is forced to take the credit and no one is prevented from doing so. This allows all parties to examine their own situations and determine whether the credit is more beneficial to them than is the direct annual payment. Arguably, even

²¹ H.R. 2419 § 12202(a) (amending 26 U.S.C. § 1402(a)(1); § 12202(b) (amending § 211(a)(1) of the Social Security Act).

²² Some, however, argue that CRP payments can be excluded from self-employment tax on current tax returns. George F. Patrick, *Income Tax Management for Farmers in 2007* at 24-25, CES-364-W, PURDUE EXTENSION PURDUE U. (2007). Available at <http://www.agecon.purdue.edu/extension/pubs/TAXPLAN2007final.pdf>.

²³ S.Rept. 110-206, at 9(2007).

²⁴ Credits may be indirectly subject to some states' income taxes. In some states, federal tax liability (after credits) has been allowed as a deduction on the state income tax return and, thus, lowering net federal income tax would increase state taxable income.

²⁵ At least one other credit, the foreign tax credit, can also be carried forward if not allowed in full in the current year.

²⁶ If the CRP payments are subject to income tax, someone whose marginal tax rate is 35% would only net 65% of the CRP payments (after federal income tax but before either self-employment or state income taxes). On the other hand, an individual whose marginal rate is 10% would net 90% of the CRP payments after federal income tax. The first person's benefit from non-taxability would be 35% of the CRP payments, whereas the second's benefit would be only 10%.

²⁷ A taxpayer's CRP tax credit could be as high as \$50,000. H.R. 2419 § 12201 (adding 26 U.S.C. § 30D(c)(2)(B)).

those who cannot use the credit in full in the first year may still derive more net benefit from the credit than they would from the direct payment since they would have to pay income tax on that direct payment and in many cases would also have to pay self-employment tax. Thus, even those in the 10% marginal tax bracket could realize greater benefit from the credit than direct payment if they were able to use at least 75% of the credit in the initial year.²⁸

Other arguments in favor of the credit may come from those who believe that the IRS's treatment of CRP payments as self-employment income is wrong or has been expanded too far. They may also argue that the credit provides an incentive needed to encourage enrollment in the CRP. The committee report indicates that the reason for the change in the law is to provide additional incentives "to encourage eligible producers to establish long-term, resource conserving covers on eligible farmland."²⁹ On the other hand, the effect on the credit if a contract is terminated early is rather mild when compared to the total repayment requirement for regular CRP payments; so it is arguable that the credit might encourage people to enroll, but might not encourage them to remain enrolled long term.

Some may argue that there is no need for further incentives since there has been a competitive bidding process under which applicants have tried to assure acceptance of their bids by offering their land in return for annual payments below the allowed rental values.³⁰ However, rising commodity prices may reduce interest in participating in the CRP.³¹

Exclusion from Self-Employment Tax for Certain Individuals

Unlike earlier proposed legislation that would have excluded all CRP payments from self-employment income, the Farm Bill would exclude only those payments received by retirees and the disabled. Even these would be limited to those individuals who were receiving benefits from either regular retirement³² or disability³³ under the Social Security Act.³⁴ Both regular retirement benefits and disability benefits received from Social Security have links to other "earned income"³⁵ received. In the case of regular retirement benefits received prior to reaching "full retirement" age, the benefits are reduced by \$1 for every \$2 by which the recipient's earned income exceeds a statutory annual limit.³⁶ Receipt of disability benefits from Social Security is

²⁸ This assumes that the CRP annual payment would be subject to both federal income and self-employment taxes, but not state taxes.

²⁹ S.Rept. 110-206, at 8.

³⁰ See CRS Report RS21613, *Conservation Reserve Program: Status and Current Issues*, by (name redacted).

³¹ Id. See also Otto Doering, *Overview of the 2007 USDA Farm Bill: A Perspective on the Past & Future of the Conservation Reserve Program*, EC-747-W, PURDUE EXTENSION PURDUE U. Available at http://www.ces.purdue.edu/extmedia/EC/EC_747_W_Conservation_Reserve_Program.pdf.

³² These benefits are received under § 202 of the Social Security Act (42 U.S.C. § 402).

³³ These benefits are received under § 223 of the Social Security Act (42 U.S.C. § 423).

³⁴ The proposed bill would not exclude CRP payments from self-employment income for other retirees—such as military, civil service, and state retirees—or those receiving disability benefits from Veterans Affairs or some other source unless they were concurrently receiving either Social Security retirement benefits or SSI benefits.

³⁵ "Earned income" is income such as wages and net self-employment income. "Unearned income" is other income: interest, dividends, rents, royalties, pensions, etc. Unearned income has no effect on the amount received as regular Social Security retirement benefits, though it can affect the degree to which such benefits are subject to income tax.

³⁶ For 2008, that limit is \$13,560. *How Work Affects Your Benefits*, SSA Pub. No. 05-10069 (Jan. 2008). Available at <http://www.ssa.gov/pubs/10069.html#howmuch>.

predicated on a disability that prevents the recipient from any work that would result in earned income.³⁷

If CRP payments were excluded from the definition of income subject to self-employment tax for those receiving regular Social Security retirement benefits, some might argue that many recipients would receive a double benefit: they would not be required to pay self-employment tax on the income, and the income would not reduce their benefits. A further argument might be made that those receiving Social Security disability benefits would also be receiving a double benefit: they would not be required to pay self-employment tax on the income and the income could not be considered evidence of an ability to engage in substantial gainful activity. In each case, Social Security beneficiaries would be exempt from funding the program under which they receive benefits.

Others may argue that excluding CRP payments from self-employment income for Social Security beneficiaries complies with the rationale behind the IRS's position in an early private letter ruling³⁸—those who are retired are not in the trade or business of farming simply by virtue of having land enrolled in the CRP. The committee report sheds no light on the considerations behind this provision in the Farm Bill. It says only that “[t]he Committee believes that the correct measurement of income for [self-employment tax] purposes in the cases of retired or disabled individuals does not include conservation reserve program payments.”³⁹ The report does not explain why the payments are specifically excluded only for retirees and the disabled, nor does it explain why they are specifically excluded only for those receiving benefits from Social Security.

Conclusion

For FY2008 through FY2012, this provision, if enacted, would assure CRP participants of a choice in the taxation of their CRP benefits. They could choose the nonrefundable credit and shield their benefits from both income and self-employment tax, but potentially postpone or even eliminate⁴⁰ some of the benefit if their tax liability does not equal or exceed their credit. They could choose to receive full payment benefits each year, pay income and self-employment tax on those benefits, and possibly generate future Social Security benefits. The bill does not, however, assure participants a similar choice beyond 2012, nor does it clarify whether CRP annual payments generally should be treated as self-employment income—an issue that has not yet been addressed by Congress.

³⁷ See 42 U.S.C. § 423(d).

³⁸ P.L.R. 88-22-064 (Mar. 7, 1988) (“[Y]ou are retired from farming. Accordingly, the payments you receive pursuant to your participation in the CRP are not includible in computing ‘net earnings from self-employment’”).

³⁹ S.Rept. 110-206, at 9.

⁴⁰ Since credits cannot be carried forward beyond FY2012, some credit amount could be permanently lost.

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