SELF EMPLOYMENT TAX TREATMENT OF CRP PAYMENTS

By Gary J. Hoff, E.A.*

Synopsis: The Internal Revenue Service has taken the position that all conservation reserve program (CRP) payments are subject to self employment (SE) tax. This is a reversal of prior opinions. This proposed rule may affect the reporting of CRP income received in 2007.

There has been some confusion regarding whether CRP payments are subject to SE (Self Employment) tax. The IRS attempted to clarify the situation when it released a proposed revenue ruling on December 15, 2006.1 Unfortunately, this ruling is unfavorable to many CRP recipients. For some taxpayers, this proposed revenue rule may affect the way their tax preparers report CRP income in 2007.

Income from farm rent is generally not subject to SE tax. In the past, it was thought that CRP payments were a form of cash rent paid because the landowner removed the land from production.

The proposed ruling makes all CRP rental payments subject to SE tax regardless of whether the recipient is engaged in a farming business on non-CRP land. Prior to the ruling it was thought that only those recipients who were materially participating in a farming operation qualified for the SE tax.

The IRS has taken the position that the CRP meets the criteria of a trade or business based on the activities required directly under the program. These activities include seeding a cover crop and maintaining weed control. Therefore, it does not matter that a recipient may be elderly and confined to a nursing home, the payment is still subject to SE tax.

The IRS first took this position in a 2003 letter ruling.2 This ruling from the Chief Counsel’s office stated all USDA land diversion and conservation program payments are subject to SE tax, regardless of whether the recipient is actively conducting a farming operation on non-CRP land. The proposed ruling came as a surprise because of prior court decisions and IRS rulings. In these situations, whether the taxpayer was engaged in a trade or business was determined by the facts of each particular situation presented.

The IRS used a 1983 announcement3 as the prime authority for this new position. This announcement pre-dates the existence of CRP. It was based on the position that participation in the payment-in-kind (PIK) program (and any other land diversion program) does not cause the enrolled land to cease to be treated as land used in the active

2 LTR 200325002, (May 29, 2003).
3 Announcement 83-43.
conduct of the farming business for purposes of IRC §2032A (Special Use Valuation) and IRC §6166 (Installment Payment of Federal Estate Tax). In a later letter ruling, IRS determined a 71-year old CRP recipient, who had been farming the land personally, prior to enrolling the land in the CRP, was retired from farming. Therefore, the payments were not subject to SE tax. [See Ltr. Rul. 8822064 (March 7, 1988).]

The courts consistently uphold the IRS’s position in ruling that rental payments are subject to SE tax if the taxpayer is engaged in a trade or business when the rental payments relate to that business. However, the courts have ruled that if the taxpayer is not engaged in a trade or business, then rental payments, by themselves, are insufficient to constitute a trade or business that would result in the payments being subject to the SE tax.

Unfortunately, the proposed revenue rule increases the possibility that the IRS may assess a penalty on both the taxpayer and the tax preparer if the tax return fails to treat the CRP as SE income.

The IRS opened the proposed ruling for public comment. Numerous comments were received, none of which favored the IRS position. In addition, legislation has been introduced in Congress to exempt CRP payments from SE tax if the recipient is not actively farming non-CRP land. [See HR 2659 and S 1155.] However, no further action has been taken on these bills.

**Conclusion**

In December of 2006, the IRS clarified its position that CRP rental payments are subject to SE tax regardless of whether the recipient is engaged in a farming business on non-CRP land. About six months later, on June 7, 2007, the IRS issued Notice 2007-54 which increases preparer penalties from $250 to the greater of $1,000 or 50% of the income derived from preparing a tax return (unless the return contains a disclosure stating the return takes a position which is different from the IRS position). The increased penalty is effective for tax years beginning after December 31, 2007, but it also signals greater tax preparer accountability for the tax return.

Therefore, even beginning with 2007 tax returns, tax preparers are more likely to follow the IRS position that CRP is SE income unless legislation is passed to eliminate the SE tax problem.

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*Gary J. Hoff is an extension specialist in the Department of Agricultural and Consumer Economics. AGRICULTURAL LAW AND TAXATION BRIEFS are available at www.farmdoc.uiuc.edu/legal.*