Office of Chief Counsel
Internal Revenue Service

memorandum

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subject: CONSERVATION RESERVE PROGRAM & SECA

This Chief Counsel Advice responds to your request for advice regarding the Conservation Reserve Program (CRP) of the United States Department of Agriculture (USDA) and Self-Employment Contributions Act (SECA) tax. In accordance with section 6110(k)(3) of the Internal Revenue Code, this Chief Counsel Advice should not be cited as precedent.

ISSUES

1. Whether annual "rental" payments received by Taxpayer A, who is an individual, for land enrolled in the CRP constitute self-employment income to Taxpayer A that is subject to SECA tax where Taxpayer A was engaged in the trade or business of farming prior to enrolling the land in the CRP and Taxpayer A personally fulfilled her CRP contractual obligations.

2. Whether annual "rental" payments received by Taxpayer B, who is an individual, for newly acquired land, that had been enrolled in the CRP by the land's previous owner and the enrollment is continued by the Taxpayer B, constitute self-employment income to Taxpayer B subject to SECA tax where Taxpayer B was not engaged in the trade or

business of farming prior to acquiring the land but Taxpayer B personally fulfilled his CRP contractual obligations.

3. Whether the annual "rental" payments respectively received by Taxpayer A and Taxpayer B under the CRP should be reported (i) on Schedule F (Form 1040), Profit or Loss From Farming, as farming income from a trade or business, (ii) on a Schedule E (Form 1040), Supplemental Income and Loss, as rental income from real estate, or (iii) on a Form 4835, Farm Rental Income and Expenses, as rental income from crop or livestock production.

CONCLUSIONS

1. The annual "rental" payments received by Taxpayer A for land enrolled in the CRP constitute self-employment income to Taxpayer A that is subject to SECA tax where Taxpayer A was engaged in the trade or business of farming prior to enrolling the land in the CRP and Taxpayer A personally fulfilled her CRP contractual obligations.

2. The annual "rental" payments received by Taxpayer B for newly acquired land, that had been enrolled in the CRP by the land's previous owner and the enrollment is continued by Taxpayer B, constitute self-employment income to Taxpayer B subject to SECA tax where Taxpayer B was not engaged in the trade or business of farming prior to acquiring the land but Taxpayer B personally fulfilled his CRP contractual obligations.

3. The annual "rental" payments respectively received by Taxpayer A and Taxpayer B under the CRP constitute self-employment income to the recipient taxpayer that is subject to SECA tax and is not rental income that is excludible under the rentals-for-real-estate exclusion. The respective payments received by each recipient taxpayer must be reported on a Schedule F and Schedule SE (Form 1040), Self-Employment Tax, filed by that taxpayer with that taxpayer's Form 1040, U.S. Individual Income Tax Return. The use of Schedule E or Form 4835 is not allowed.

FACTS

The CRP, 16 U.S.C. §§ 3801, 3831-36, is a USDA voluntary conservation reserve program under which land is enrolled through the use of contracts. The program generally assists owners and operators of land to conserve and improve the soil, water, and wildlife resources of such land. The CRP offers, among other things, annual "rental" payments to owners and operators for converting highly erodible cropland normally devoted to the production of an agricultural commodity to less intensive use. In general, the durations of contracts are from 10 to 15 years. The Farm Security and Rural Investment Act of 2002, Pub. L. No. 107-171, provides that up to 39.2 million acres can be enrolled in CRP at any one time during the 2002 through 2007 calendar years.

No specific taxpayer or detailed factual situation was provided in regards to the requested advice. Accordingly, we address two hypothetical situations.

Taxpayer A was a farmer who owned highly erodible cropland. After planting crops on the land for six years, Taxpayer A decided to enroll Taxpayer A's cropland into the CRP and entered into a CRP contract with the USDA.

Under the CRP contract, Taxpayer A agreed to certain terms and conditions as to the cropland under contract. Among the terms and conditions, Taxpayer A agreed to: (1) implement a conservation plan for converting the land normally devoted to the production of an agricultural commodity on the farm to a less intensive use, such as pasture, permanent grass, legumes, shrubs, or trees; (2) not to use the land for agricultural purposes except as permitted by the USDA, (3) establish approved vegetative cover or maintain existing cover on the land; and (4) not engage in or allow grazing, harvesting, or other commercial use of the land, except with USDA's permission (e.g., harvesting and grazing in response to a drought or other emergency).

Taxpayer B purchased highly erodible cropland that had been enrolled in the CRP by its previous owner. As the new owner, Taxpayer B executed an agreement to continue and assume all obligations of the CRP contract under the same terms and conditions as the original owner. These terms and conditions were identical to those in Taxpayer A's CRP contract. Taxpayer B was not engaged in the trade or business of farming prior to acquiring the cropland that was and continues to be subject to a CRP contract.

Taxpayer A and Taxpayer B each personally fulfilled their duties under their respective CRP contracts and received annual "rental" payments. Neither Taxpayer A nor Taxpayer B disputed the taxability of the CRP payments as includible in gross income under section 61. However, both taxpayers reported the payments as rental income not subject to SECA tax. Taxpayer A reported the amounts received as rental income from real estate on Schedule E. Taxpayer B reported the amounts as rental income from farm production and crop shares on Form 4835.

LAW AND ANALYSIS

Section 1401 imposes SECA tax on the self-employment income of every individual. SECA tax consists of the Old-Age, Survivors, and Disability Insurance tax (OASDI tax which is commonly referred to as social security tax) and the Hospital Insurance tax (HI tax which is commonly referred to as Medicare tax).

Section 1402(b), in pertinent part, defines "self-employment income" as the net earnings from self-employment derived by an individual (other than a nonresident alien individual, except as provided by an agreement under section 233 of the Social Security Act) during any taxable year; except that such term shall not include--

> (1) in the case of the OASDI tax imposed by section 1401(a), that part of the net earnings from self-employment which is in excess of (i) an amount equal to the contribution and benefit base (as determined under section 230 of the Social Security Act) which is effective for the calendar year in which such taxable year begins, minus (ii) the amount of the wages paid to such individual during such taxable years; or
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> (2) the net earnings from self-employment, if such net earnings for the taxable year are less than $400.

Section 1402(a) defines the term "net earnings from self-employment" as the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by subtitle A which are attributable to such trade or business, plus the individual's distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which the individual is a member, with certain enumerated exceptions.

Section 1402(a)(1) generally excludes from the computation of "net earnings from self-employment" rentals from real estate and from personal property leased with the real estate (including such rentals paid in crop shares) together with the deductions attributable thereto, unless such rentals are received in the course of a trade or business as a real estate dealer, with an exception. Under this exception, any income derived by the owner or tenant of land must be included in the computation of "net earnings from self-employment" if–

> (A) such income is derived under an arrangement, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities (including livestock, bees, poultry, and fur-bearing animals and wildlife) on such land, and that there shall be material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) in the production or the management of the production of such agricultural or horticultural commodities, and
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> (B) there is material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) with respect to any such agricultural or horticultural commodity.

See also, Income Tax Reg. § 1.1402(a)-4.

Section 1402(c) provides that the term "trade or business" when used with reference to self-employment income or net earnings from self-employment shall have the same meaning as when used in section 162 (relating to trade or business expenses), with

certain enumerated exceptions. In order for an individual to have net earnings from self-employment, the individual must carry on a trade or business, either as an individual or as a member of a partnership. Whether or not the individual is engaged in carrying on a trade or business will be dependent upon all of the facts and circumstances in the particular case. See also, Income Tax Reg. § 1.1402(c)-1.

In considering whether an individual is engaged in a trade or business, the U.S. Supreme Court has stated that "to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity . . . does not qualify." Commissioner v. Groetzinger, 480 U.S. 23, 35 (1987). The question of whether a taxpayer is engaged in a trade or business requires an examination of the relevant facts in each case. Id. at 36.

In order for income received by an individual to be taxable as self-employment income, not only must the income in question derive from a trade or business carried on by the individual, but there must be a nexus between the income and the trade or business. Newberry v. Commissioner, 76 T.C. 441, 444 (1981). The income "must arise from some actual (whether present, past, or future) income-producing activity of the taxpayer." Id. at 446.

In determining what income is includible in self-employment income, sections 1401 and 1402 are to be broadly construed to favor coverage for Social Security purposes. Braddock v. Commissioner, 95 T.C. 639, 644 (1990). In order to achieve this end, the rental exclusion under section 1402(a)(1) is "narrowly construed." Johnson v. Commissioner, 60 T.C. 829, 833 (1973); see also Delno v. Celebrezze, 347 F.2d 159, 165 (9th Cir. 1965) (noting that a parallel provision of the Social Security Act relates Congress' specific intent for the "rental exclusion to be narrowly restricted to payments for occupancy only").

In Wuebker v. Commissioner, 205 F.3d 897 (6th Cir. 2000), the Sixth Circuit reversed a Tax Court decision that CRP payments received by Frederick and Ruth Wuebker (taxpayers) were excludible from their self-employment income as rentals from real estate. The Sixth Circuit held that CRP payments received by a farmer in exchange for the farmer's implementation of a conservation plan were includible in self-employment income from the trade or business of farming that were subject to SECA tax pursuant to section 1401.

In Wuebker, the taxpayers had been farming for approximately twenty years when they enrolled a portion of their farmland into the CRP. The Sixth Circuit held that because the taxpayers were "engaged in the business of farming prior to and during the term of their CRP contract" and their "agreement . . . required them to perform several ongoing tasks with respect to the land enrolled in the CRP, the very land they already owned and had previously farmed," the CRP payments "were 'in connection with' and had a

'direct nexus to' their ongoing trade or business." Id. at 902. The Sixth Circuit noted that the taxpayers were required under the CRP contract to perform tasks that are intrinsic to the farming trade or business (e.g., tilling, seeding, fertilizing, and weed control) that required the use of their farming equipment. Id. at 903.

The Sixth Circuit found that the taxpayers' contention that their involvement with the CRP land was insufficient to constitute "material participation" within the meaning of section 1402(a)(1) had no bearing on whether the CRP payments constituted rentals from real estate. The issue of material participation arises only when there is an arrangement between an owner or tenant and another individual whereby the other individual is to produce agricultural or horticultural commodities on the land. No such arrangement was present in Wuebker.

In addition, because of the narrow construction required of the exclusion for rentals from real estate, the Sixth Circuit held that the CRP payments were not true rental payments for the use or occupancy of property. The essence of the CRP program is to prevent participants from farming of the property and to require the participants to perform various activities in connection with the land continuously throughout the life of the contract with the government's access limited to inspections. Id. at 904. Furthermore, the Sixth Circuit looked to the "substance, rather than the form, of the transaction"[1] in determining that the income derived from the CRP contract is includible in self-employment income earned in lieu of farm income, for which SECA tax was due.

The CRP payments are not excludible per se as rentals from real estate. Rent is defined as "consideration paid . . . for the use or occupancy of property (esp. real property)." Id. at 904 citing Black's Law Dictionary 1299 (7th ed. 1999). Under a CRP contract, the USDA does not obtain the right to "occupy" the land enrolled in the CRP. The government's access is limited to inspecting the property and determining whether the recipients of the CRP payments are in compliance with the CRP contract. See id. at 904.

In Hasbrouck v. Commissioner, T.C. Memo. 1998-249, taxpayers purchased land that had already been enrolled in the CRP. The taxpayers, who fulfilled their obligations under the terms and conditions of the CRP contract, considered themselves engaged in the trade or business of farming and reported their CRP income and expenses on Schedule F. Prior to the purchase, the taxpayers were not engaged in the trade or business of farming. The Service initially reclassified the income and expenses as rentals from real estate on the basis that the taxpayers were not engaged in the trade or business of farming when they acquired the land. The Service, however, following

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[1] Although the CRP contract referred to the payments as annual "rental" payments, such reference does not compel the conclusion that they should fall within the rentals-from-real-estate exclusion. Wuebker at 904; citing Cline v. Commissioner, 617 F.2d 192, 195 (6th Cir. 1980) ("Courts must look to the substance, rather than the form, of the transactions ...)."

the decision in Ray v. Commissioner, T.C. Memo 1996-436, reconsidered its position, and conceded the case.

In Ray, the Tax Court found that payments received under a CRP contract were includible in self-employment income. In this case, the taxpayers were engaged in the business of farming and cattle grazing and had acquired additional land that had been previously enrolled in the CRP. The Tax Court held that there was a sufficient nexus between the CRP payments received and the taxpayer's trade or business of farming to support the finding that the payments were includible in self-employment income subject to SECA tax.

In Rev. Rul. 60-32, 1960-1 C.B. 23, the Service held that annual payments received under the Soil Bank Act[2], an earlier acreage reserve program of the USDA, were includible in determining the recipient's net earnings from self-employment, if the recipient operated his farm personally or through agents or employees. The Service reasoned that the payments were in the nature of receipts from farm operations in that they replaced income which producers could have expected to realize from the normal use of the land devoted to the program. This was also true if the recipient's farm was operated by others and he participated materially in the production of commodities, or management of such production, within the meaning of section 1402(a)(1). However, if the recipient did not so operate or materially participate, payments received were not to be included in determining net earnings from self-employment.

In Rev. Rul. 65-149, 1965-1 C.B. 434, the Service addressed whether grain storage fees paid to a farm operator under the price support loan program of the Commodity Credit Corporation are to be regarded as attributable to the operator's trade or business of farming and considered in computing the operator's self-employment income. The Service argued that income derived from the operation of a farm, regardless of the form of the income (cash sales, Commodity Credit Corporation loans, Government subsidies, including soil bank payments, conservation reserve payments, etc.), should be treated in a manner consistent with the position set forth in Rev. Rul. 60-32. That is to say, if this income is received by a farm operator, or a landlord who materially participates, it should be treated as self-employment income. If it is received by a landlord who does not materially participate, it should be treated as rental income and excluded from net earnings from self-employment.

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[2] Soil Bank Act, Title I of the Agricultural Act of 1956, 7 U.S.C. 1801-37 (repealed 1965). Under § 103(a) of the Act, the Secretary of Agriculture is authorized and directed to carry out an acreage reserve program from the crops of specified commodities. Producers participating in the program are compensated for reducing their acreage of a commodity below their farm acreage allotments or their farm base acreage, whichever may be applicable. Producers must enter into a contract where they agree to perform various activities in connection with the land.

More recently, in Announcement 83-43, 1983-10 I.R.B. 29, the Service concluded that if a farmer participates in the Payment-in-Kind (PIK), or any other land diversion program sponsored by the USDA, and receives cash or a payment in kind from the USDA with respect to the diverted acres, the farmer is liable for SECA tax on the cash or payment in kind received. The announcement further provided that, for estate tax purposes (sections 2032A and 6166), land diverted from the production of an agricultural commodity under a USDA land diversion program will be treated as being used as a farm for farming purposes and in the active conduct of a farming business. Furthermore, participation in a USDA land diversion program and in the devotion of such land to conservation purposes under such programs will be treated as material participation in the operation of a farm with respect to the diverted acres.

As to reporting requirements, section 6017 provides that every individual (other than a nonresident alien) having net earnings from self-employment of $ 400 or more for the taxable year shall make a return with respect to SECA tax. Income Tax Reg. § 1.6017-1(a)(2) provides that the return required by section 6017 for SECA tax shall be Form 1040.

Schedule SE is the form used to report net earning from self-employment and SECA tax. See 2002 Instructions for Schedule SE, Self-Employment Tax.

Schedule F is the form used to report farm income and expenses. See 2002 Instructions for Schedule F, Profit or Loss From Farming.

Schedule E is the form used to report income and expenses for rentals of real estate (including personal property leased with real estate) and royalty income and expenses. See 2002 Instructions for Schedule E , Supplemental Income and Loss.

Form 4835 is the form used by landlords or sub-lessors to report farm rental income and expenses based on the crops or livestock produced by the tenant where the landlord or sub-lessor did not materially participate (for SECA tax purposes) in the operation or management of the farm. The use of Form 4835 only applies to those circumstances where there is an arrangement between an owner or tenant and another individual whereby the other individual is to produce agricultural or horticultural commodities on the land. See General Instructions for Form 4835.

In each case, the annual “rental” payments that Taxpayer A and Taxpayer B individually receive for land enrolled in the CRP are in the nature of receipts from farm operations earned in lieu of income that each taxpayer could have expected to realize from the normal use of their respective cropland, if they had not enrolled the cropland in the CRP. See Rev. Rul. 60-32.

Pursuant to the terms of the CRP contract, each taxpayer is required to engage in soil conservation practices, to establish or maintain approved vegetative cover on the

cropland, to not use the land for agricultural purposes except as permitted by USDA, and to not conduct any harvesting or grazing on the cropland. The income is derived from the income-producing activity of the taxpayers in performing under the CRP contract. The CRP contracts require Taxpayer A and Taxpayer B to perform tasks that are intrinsic to the farming trade or business. The fact that Taxpayer A was previously engaged in the trade or business of farming prior to enrolling Taxpayer A's land in the CRP is an additional fact that helps establish that Taxpayer A's is continuing to be engaged in the trade or business of farming. However, Taxpayer B, who was not engaged in farming prior to the purchase of land subject to a CRP contract, becomes engaged in trade or business of farming in personally fulfilling Taxpayer B's obligations under the terms and conditions of the CRP contract. See Hasbrouck. As long as Taxpayer A and Taxpayer B are actively fulfilling their respective obligations under their respective CRP contracts, they will both individually be considered to be engaged in the trade or business of farming.

The CRP payments are in connection with and have a direct nexus to the taxpayer's ongoing business of farming. See Wuebker; see also Ray.

Although the payments are labeled as "rental" payments for purposes of the CRP, the narrow construction placed on the section 1402(a)(1) exclusion for rentals from real estate eliminates these payments from its provisions. See Wuebker. Further, under our facts, neither Taxpayer A nor Taxpayer B leased the land to a third party, such as another individual, on a rental basis. Thus, the test regarding material participation by the owner of rented land to a third party is irrelevant.[3]

The income derived from the CRP contract is includible in self-employment income subject to SECA tax. Taxpayer A must report the CRP payments as self-employment income from farming subject to SECA tax. Similarly, Taxpayer B must report the CRP payments as self-employment income from farming subject to SECA tax.

After having concluded that CRP payments are includible in self-employment income from farming, such CRP payments should be reported on Schedule F, filed with Form 1040. See Pub 225, Farmer's Tax Guide; and Instructions for Schedule F; Cf. Hasbrouck. Any profit or loss from farming should then be reported on a Schedule SE for SECA tax purposes pursuant to form instructions. See 2002 Instructions for Schedule F, Profit or Loss From Farming.

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[3] Under the rentals-from-real-estate exception, the owner of a farm operated on a rental basis must include the rental income in determining net earnings if (1) such income is derived under an arrangement between the owner and another individual which provides that there be material participation by the owner in the production or the management of the production of such commodities, and (2) there is material participation by the owner with respect to such commodity.

CRP payments are not considered rental income from real estate nor are they rental income from farm production or crop shares.[4] Accordingly, the use of Schedule E or Form 4835, under our facts, is not allowed.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

The determination of whether an individual is engaged in a trade or business is a factual determination that is dependent upon the individual facts of any case. While the requirements of CRP contracts appear to require erodible cropland owners or operators who enter into such contracts to perform tasks that are intrinsic to the farming trade or business, a court may find otherwise. This is a litigation hazard in any case that involves an individual taxpayer who was not engaged in the trade or business of farming prior to the taxpayer's entering into a CRP contract. There 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 under which the individual receives "rental" payments for enrolling erodible cropland in the CRP. Thus, there is some litigation hazard in establishing that such taxpayers are engaged in the trade or business of farming.

Additionally, to the extent that an individual case does not require the taxpayer to engage in any, if this is possible, or few activities under the CRP contract, there will be some weakness in the case in establishing both (i) that the individual is engaged in the trade or business of farming and (ii) a nexus between the CRP payments received by such taxpayer and the taxpayer's trade or business of farming.

This memorandum does not address cost-share assistance.

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Please call if you have any further questions.

[4] An arrangement for the production of agriculture or horticulture commodities is not present under the CRP contract for either Taxpayer A or Taxpayer B.