

PolicyPennings by Daryll E. Ray & Harwood D. Schaffer

Recent developments in the tax treatment of CRP payments

Are Conservation Reserve Program (CRP) payments to be considered earned income or are they considered to be rental income? The answer to that question makes a big difference when it comes to the self-employment tax, which affects most farmers. With the self-employment tax set at 12.4 percent for social security (old age, survivors, and disability) and 2.9 percent for Medicare (hospital insurance) for 2013 and 2014, each \$10,000 in self-employment income under the cap incurs a tax liability of \$1,530.

The Social Security tax caps out at \$113,700 for 2013 incomes and \$117,000 for 2014 incomes. For the Medicare tax, there is no cap; all combined wages, tips, and net earnings are subject to the 2.9 percent Medicare tax.

If the CRP payments are considered to be earned income, the self-employment tax would be owed, but if they are considered to be rental income then there is no self-employment tax. According to the November 2, 2014 Parker Tax Pro Library (<http://tinyurl.com/kzsgclj>), rental income from real estate is not subject to the self-employment tax unless it is “received in the course of a trade or business as a real estate dealer” (for farmers it means that rental income from real estate is subject to the self-employment tax if it is received under an arrangement in which there is material participation in the production of agricultural commodities).

The issue came up for legal review when Rollin Morehouse and his wife, who listed their occupation as self-employed in the 1040 tax form, posted “CRP payments of \$37,872 in both 2006 and 2007...as ‘rents received’ [on their 1040 Schedule E] and thus the CRP payments were not taxed as self-employment income” (Morehouse v. IRS, US Court of Appeals for the Eighth Circuit, <http://tinyurl.com/ozpup8o>).

Morehouse is a non-farmer passive investor in agricultural land. He had never actively engaged in farming, so he believed that he was not subject to the self-employment tax. His position in this matter was bolstered by a 1960 Revenue Ruling in which “the IRS concluded that soil bank [Soil Bank Act of 1956 which is so similar to CRP that it has been called ‘Son of Soil Bank’] payments made to persons who did not operate or materially participate in a farming operation were ‘not to be included in determining net earnings from self-employment.’ Soil bank payments to farmers, however, were to be treated as self-employment income derived from their farming business” (Morehouse v. IRS).

“On October 14, 2010, the Internal Revenue Service Commissioner (Commissioner) mailed to the Morehouses a notice of deficiency for 2006 and 2007. The notice stated the CRP payments should have been reported as income on a [1040] Schedule F, Profit or Loss From Farming, and were thus unreported self-employment income, which should have been taxed.” They petitioned the Tax Court and lost.

They then appealed to the Eighth Circuit Court of Appeals. That court reversed the ruling and returned the case to the Tax Court “with instructions to enter judgment in favor of the Morehouses.” This ruling applies to passive non-farmer landowners in the Eighth Circuit (AR, IA, MN, MO, ND, NE, SD) for the years preceding 2008. In the 2008 Farm bill, Congress provided an “exemption...for individuals receiving Social Security or disability benefits, even though they report the CRP income on Schedule F due to other active farming activities” (Farm Tax Network, December 11, 2014, (<http://tinyurl.com/q46o64w>)).

In his article “Top 10 Agricultural Law and Taxation Developments of 2014,” Roger A. McEowen writes, “Technically, the court’s holding is limited in its application to CRP rents paid before 2008 to a non-farmer that is not receiving Social Security. But, for payments made after 2007 to taxpayers in the Eighth Circuit, the court’s opinion will make it very difficult, if not impossible, for the IRS to argue that CRP rents in the hands of a non-farmer are subject to self-employment tax.... The court’s opinion also bolsters the argument that CRP payments paid to a farmer where there is no nexus between the CRP ground and the farmer’s farming operation are not subject to self-employment tax” (<http://tinyurl.com/m2nur5p>).

As economists and not tax attorneys, our advice is limited to urging affected parties to consult their accountant/tax attorney before deciding how to handle CRP payments in their tax filings.

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