ACTION ON DECISION

Subject: Morehouse v. Commissioner, 769 F.3d 616 (8th Cir. 2014), *rev'g* 140 T.C. 350 (2013)

Issue:

Whether Conservation Reserve Program (CRP) payments from the federal government to a non-farmer to implement a conservation plan on CRP properties are excluded from net earnings from self-employment as rentals from real estate under section 1402(a)(1) of the Internal Revenue Code and thus not subject to self-employment tax.

Discussion:

The Food Security Act of 1985 established the CRP, 16 U.S.C. §§ 3831 to 3835, which is administered by the United States Department of Agriculture (USDA). The purposes of the CRP are to conserve and improve the soil and water resources of highly erodible croplands, to protect the nation's long-term food production capabilities, and to provide some income support to farmers. Under this voluntary program, a landowner who meets the eligibility criteria enters into a contract with USDA pursuant to which the landowner agrees to implement an approved conservation plan for converting lands normally devoted to the production of crops to a less intensive use, establish approved vegetative cover, control weeds, and refrain from using the land for agricultural purposes for the contract period. In return the landowner receives an annual payment from the USDA.

Morehouse, a non-farmer, acquired farm land through inheritance from his father and by purchasing undivided interests from relatives. He enrolled this land in CRP which obligated him to perform significant activities pertaining to the land including: (1) maintaining already established grass and legume cover for the life of the contract, (2) seeding to establish and maintain additional vegetative cover, (3) engaging in pest control and pesticide management for the life of the contract, (4) controlling weeds, (5) visiting the land to ensure the land maintains status as CRP properties, (6) filing annual certifications that he is implementing conservation plans in accordance with the CRP contracts, and (7) making decisions regarding the profitability of keeping the properties enrolled in CRP. During the years 2006 and 2007, Morehouse engaged in these activities either directly or through a third party whom he hired to perform all of the physical duties.

Morehouse received CRP payments of $37,872 in both 2006 and 2007. Morehouse and his wife filed joint income tax returns for those years in which he reported the CRP payments as income from "rents received" but not as self-employment income subject

to self-employment tax.

Section 1401 imposes a tax for each taxable year on the self-employment income of every individual. Section 1402(b) defines the term "self-employment income" to mean "the net earnings from self-employment derived by an individual…during any taxable year" with certain exceptions not relevant here. Section 1402(a) defines "net earnings from self-employment," in relevant part, to mean "the gross income derived by an individual from any trade or business carried on by such individual" less allowable deductions. Certain categories of income are excluded from the definition of "net earnings from self-employment," including most "rentals from real estate" under section 1402(a)(1). In 2008, Congress amended section 1402(a)(1) to provide that CRP payments made to Social Security benefit recipients should be treated as rental income effective for tax years beginning after December 31, 2007.[1] Thus, the amendment is effective after the years at issue in this case.

The Service determined that the CRP payments received by Morehouse in 2006 and 2007 were self-employment income and the Tax Court in an opinion reviewed by the full court sustained the Commissioner's determination. Morehouse v. Commissioner, 140 T.C. 350 (2013). The Tax Court concluded that Morehouse "was engaged in the business of participating in the CRP…with the primary intent of making a profit" and that there was a sufficient nexus between this business and the CRP. The Tax Court also rejected the assertion that the CRP payments were rentals from real estate, adopting the analysis used by the Court of Appeals for the Sixth Circuit in Weubker v. Commissioner, 205 F.3d 897 (2000). The Sixth Circuit, in determining whether the CRP payments in Wuebker were rentals from real estate within the meaning of section 1402(a)(1), considered whether the CRP payments constitute consideration for the "use" of the land, under the "ordinary or natural meaning" of the phrase "rentals from real estate." Wuebker at 903-904. The Sixth Circuit found that the "Wuebkers continue to maintain control over and free access to their premises" and that the restrictions imposed by the Department of Agriculture on a farmer's use of his own land did not "translate into 'use' by the Department itself." Id. at 904. The Sixth Circuit held the rental exception did not apply and the CRP payments were subject to self-employment tax.

Morehouse and his wife appealed to the Eighth Circuit. The Eighth Circuit reversed the

[1] Section 1402(a)(1) now provides that the term "net earnings from self-employment" means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed…there shall be excluded rentals from real estate…(...*and including payments under section 1233(2) of the Food Security Act of 1985 (16 U.S.C. 3833(2)) to individuals receiving benefits under section 202 or 223 of the Social Security Act*)…. The amended language is italicized.

Tax Court and held that CRP payments made to Morehouse as a non-farmer constituted rentals from real estate for purposes of section 1402(a)(1) and thus are not subject to self-employment tax. As support for its decision, the Eighth Circuit cited to Rev Rul. 60-32, 1960-1 C.B. 23, and Rev. Rul. 65-149, 1965-1 C.B. 434, and distinguished the decision of the Sixth Circuit in Wuebker.

In Rev. Rul. 60-32, the Service characterized payments attributable to the acreage reserve program and the conservation reserve program of the old Soil Bank Act (a predecessor program to the CRP) as payments "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" and held that they were includible in income under section 61. The Revenue Ruling also discusses the requirements under the Soil Bank Act that ensure the payments are equitably shared amongst landlords, operators, tenants and sharecroppers. The Revenue Ruling concluded that Soil Bank Act payments were included in determining net earnings from self-employment if the recipient operated his farm personally or through agents or employees, or if his farm is operated by others and he materially participates in the production of commodities or management of such production. The Revenue Ruling also summarily concluded that if the recipient does not operate the farm or does not materially participate in the production or management of production of commodities (i.e., in the case of a landlord/tenant relationship), "payments received are not to be included in determining net earnings from self-employment."

In Rev. Rul. 65-149, the IRS elaborated upon Rev. Rul. 60-32 by providing, "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 of the Internal Revenue Service as set forth in Revenue Ruling 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."

The Eighth Circuit in Morehouse characterized Rev. Rul. 60-32 and Rev. Rul. 65-149 as providing for different self-employment tax treatment for farmers and to non-farmers and establishing a "position that land conservation payments made to non-farmers constitute rentals from real estate and are excluded from the self-employment tax." Morehouse, 769 F.3d at 621. In contrast to the Sixth Circuit's conclusion in Wuebker, the Eighth Circuit held that the CRP payments were "consideration paid [by the government] for use [and occupancy] of [Morehouse's] property" and thus constituted rentals from real estate. Morehouse, 769 F.3d at 622. For support of this holding, the Eighth Circuit found that the government "physically inspected the properties nearly as often as

Morehouse did" and the "government likely had more physical possession for its own land conservation 'uses' than Morehouse did." Id. at 621-622. The Eighth Circuit distinguished the decision of the Sixth Circuit in Wuebker on the basis that the CRP payments in that case were made to an active farmer. More specifically, the Eighth Circuit suggested the Sixth Circuit's nonrent characterization in Wuebker rested on its conclusion that the CRP activities were similar to the farming activities and thus rested on the recipient's status as an active farmer.

We disagree with the Eighth Circuit's characterization of the revenue rulings as establishing a line of demarcation on the self-employment tax treatment of conservation reserve payments paid to farmers and nonfarmers. We also disagree with the Eighth Circuit's holding that the CRP payments were "consideration paid by the government for use and occupancy of Morehouse's property" and thus constituted rentals from real estate excluded from self-employment tax under section 1402(a)(1).

The Eighth Circuit misinterprets Rev. Rul. 60-32 and Rev. Rul. 65-149 when it states that the rulings establish the position that CRP "payments made to non-farmers constitute rentals from real estate and are excluded from the self-employment tax." Morehouse, 769 F.3d at 621. Rev. Rul. 60-32 concludes that similar payments under the Soil Bank Act are "in the nature of receipts from farm operations" and are generally included in self-employment income. It does not state that payments made to non-farmers constitute rentals from real estate. Although the revenue ruling does reference "material participation" in the production of commodities, which is a carve-out from the rental exclusion under section 1402(a)(1), the material participation standard only applies in the context of arrangements between a landlord who may or may not materially participate in the commodity production on his or her land and the tenant or sharecropper leasing the land. It does not apply in the context of a non-landlord receiving CRP payments. Consistent with this understanding, in elaborating upon Rev. Rul. 60-32, Rev. Rul. 65-149 states only that payments "received by a landlord who does not materially participate" in the production of commodities (or management of such production) should be treated as rental income that is excluded from self-employment income. Mr. Morehouse was not acting as a landlord, and therefore, contrary to the Eighth Circuit's opinion, neither Rev. Rul. 60-32 nor Rev. Rul. 65-149 supports the conclusion that the CRP payments in his case constituted rentals from real estate.[2]

[2] As the dissent points out, the majority opinion of the Eighth Circuit in Morehouse rests solely on the conclusion that CRP payments are excluded from self-employment income as rentals from real estate. Morehouse, 769 F.3d at 622-23. The Eighth Circuit does not base its opinion on a conclusion that the CRP payments received by Morehouse did not constitute self-employment income because Morehouse's CRP activities did not constitute the carrying on of a trade or business. In ruling on this question, the Tax Court in Morehouse concluded that "[r]egardless of whether some or all of these [CRP] activities qualify

Neither section 1402 nor any other self-employment tax provision of the Code defines the term "rentals from real estate." In Wuebker, the Sixth Circuit stated that "[r]entals from real estate is not defined by the statute and, therefore, the phrase must be interpreted in accordance with its ordinary or natural meeting." Wuebker, 205 F.3d at 903. "Rent is defined as 'consideration paid … for the use or occupancy of property….'" Id. at 904. In Morehouse, the Tax Court stated, "[u]nder the CRP, a participating owner who enrolls land in the program does not relinquish control of the land to the USDA, and the USDA does not engage in any activities with respect to the land that constitute 'use' of the land by the USDA, applying a commonsense definition of the term." Morehouse, 140 T.C. at 374. We conclude, following the views of the Tax Court and consistent with the Sixth Circuit in Wuebker, that the USDA does not engage in any activities with respect to the land that constitute "use" of the land by the USDA, regardless of whether the CRP payments are made to farmers or non-farmers. The CRP activities are the same in both cases. Accordingly, CRP payments made by the USDA do not constitute rentals from real estate.

In addition, the 2008 amendment to section 1402(a)(1) to treat CRP payments made to Social Security recipients as rentals from real estate effective for tax years beginning after December 31, 2007, served to clarify that other CRP payments are not excluded as rentals from real estate. Congress neither enacted a blanket exclusion with respect to CRP payments (or CRP payments made to non-farmers) nor evidenced any disagreement with the analysis of the Sixth Circuit in Wuebker. Although the statutory amendment does not apply to the years at issue in Morehouse, the implication is that prior to the amendment, CRP payments to farmers and non-farmers alike are not excludible from self-employment income as rentals from real estate. If these payments were already excluded as rental payments then the amendment would have been unnecessary. After the amendment, the implication is that CRP payments to farmers and non-farmers alike are not excludible from self-employment income unless made to Social Security recipients. The dissent specifically points out in footnote 11 that "whether CRP payments that the government made after December 31, 2007 or currently makes to a non-farmer qualify as rentals from real estate under amended § 1402(a)(1) is a question that the court's decision does not resolve." Morehouse, 769 F.3d at 626.

We recognize the precedential effect of the decision in Morehouse to cases appealable to the Eighth Circuit. Accordingly, we will follow Morehouse within the Eighth Circuit

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as farming, we find that petitioner was engaged in the business of participating in the CRP and that he enrolled, maintained, and managed multiple properties subject to CRP contracts with the primary intent of making a profit." Morehouse, 140 T.C. at 364. The Eight Circuit did not contest this conclusion.

only with respect to cases in which the CRP payments at issue were both (1) paid to an individual who was not engaged in farming prior to or during the period of enrollment of his or her land in CRP and (2) paid prior to January 1, 2008 (i.e., the effective date of the 2008 amendment to section 1402(a)(1)). We will continue to litigate the IRS position in the Eighth Circuit in cases not having these specific facts. We will also continue to litigate the IRS position in all cases in other circuits.

Recommendation: Nonacquiescence

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