

Application of the Self-Employment Contributions Act (SECA) Tax to Payments Made by the U.S. Department of Agriculture (USDA) Under the Conservation Reserve Program (CRP)

Notice 2006-108

I. Overview and Purpose

This notice sets forth a proposed revenue ruling concerning the application of the Self-Employment Contributions Act (SECA) tax to payments made by the U.S. Department of Agriculture (USDA) under the Conservation Reserve Program (CRP), 16 U.S.C. 3831. CRP was authorized in 1985. It is one of several programs administered by the USDA that provide payments in exchange for diverting land from agricultural use to other uses.

The Service has previously issued an announcement addressing the SECA tax treatment of payments made by the USDA under land diversion programs. Announcement 83-43, 1983-10 I.R.B. 29, provides guidance in a Question and Answer format related to land diversion programs sponsored by the USDA for purposes of special use valuation under section 2032A of the Code, estate tax deferral under section 6166 of the Code, and the SECA tax. In Q&A 3, the Service stated that a farmer who receives cash or a payment in kind from the USDA for participation in a land diversion program is liable for self-employment tax on the cash or payment in kind received. The Announcement was consistent with guidance provided in Rev. Rul. 60-32, 1960-1 C.B. 23, with respect to two earlier land diversion programs conducted under the Soil Bank Act. Both the announcement and the revenue ruling concluded that participants in the land diversion programs were subject to SECA taxes on their payments if the participants were otherwise operating a farm or materially participating in the production of commodities on a farm operated by others.

However, Rev. Rul. 60-32 also states that participants in land diversion programs are not subject to SECA tax on the payments, if they do not operate a farm or materially participate in farming activities. The material participation factor is relevant for SECA under these circumstances only with respect to the exception from net income from self-employment provided in section 1402(a)(1) for rentals from real property. Some taxpayers may have read the reference to material participation as implying that the rental exception could potentially apply to payments under a land diversion program.

More recently, the treatment of CRP payments for purposes of SECA, and more specifically, the potential application of the rental exception under section 1402(a)(1) was addressed by the Court of Appeals for the Sixth Circuit in Wuebker v. Commissioner, 205 F.3d 897 (6th Cir. 2000). The Court held that CRP payments were net income from self-employment because they were received in exchange for performing tasks “that are intrinsic to the farming trade

or business” such as tilling, seeding, fertilizing and weed control. Moreover, notwithstanding the fact that the CRP statutes labeled the payments as “rent”, the court concluded the payments are not rent for tax purposes because they are not payments for use or occupation of the property. The court stated that “the essence of the program is to prevent participants from farming the property and to require them to perform various activities in connection with the land, both at the start of the program and continuously throughout the life of the contract, with the government’s access limited to compliance inspections.” *Id.* at 904. Thus, under the Court’s reasoning, CRP payments do not fall within the exception that excludes rent from net income from self-employment provided by section 1402(a).

Like the 1983 announcement and the 1960 revenue ruling, Wuebker addresses CRP recipients who are engaged in the business of farming while also receiving CRP payments. The IRS has received questions asking whether CRP payments are subject to SECA if the recipient is retired or not otherwise actively engaged in farming. This proposed revenue ruling is intended to respond to those questions. In addition, in light of the fact that the USDA no longer operates programs under the Soil Bank Act, and to remove any confusion that may arise from its holding, the proposed revenue ruling would obsolete Rev. Rul. 60-32. The IRS and Treasury are soliciting comments regarding the proposed revenue ruling. The Department of the Treasury and the Internal Revenue Service anticipate issuing a final revenue ruling after the comments have been considered.

II. Proposed Revenue Ruling

Part I

Section 1402.--Definitions

26 CFR 1.1402(a)-1: Definition of net earnings from self-employment.
(Also: Section 1401)

Rev. Rul. XXXX-XX

ISSUE

Whether Conservation Reserve Program (CRP) rental payments (including incentive payments) by the U. S. Department of Agriculture (USDA) to (1) a farmer actively engaged in the trade or business of farming who enrolls land in CRP and fulfills the CRP contractual obligations personally or to (2) an individual not otherwise actively engaged in the trade or business of farming who enrolls land in CRP and fulfills the CRP contractual obligations by arranging for a third party to perform the required activities, are included in net earnings from self-employment for purposes of the Self-Employment Contributions Act (SECA) tax and not excluded from net income from self-employment as rentals from real estate.

FACTS

Situation 1.

A is engaged in the business of farming on land that A owns. A farms a portion of his cropland and has enrolled the remaining portion of his cropland in the CRP program. The CRP, 16 U.S.C. §§ 3801, 3831-3836, is a voluntary program under which the USDA through the Commodities Credit Corporation makes annual payments to participants. Participants include farm owners and operators who agree to place environmentally sensitive cropland in conserving uses for 10 to 15 years. Participants receive an annual “rental” payment (including incentive payments) and cost sharing assistance to establish and maintain approved groundcover, and participants agree to plant grasses, trees, and other conserving cover crops, restore wetlands and establish buffers. Generally, a participant is eligible to enroll land in CRP if the participant has owned or operated the land for at least twelve months prior to the close of the CRP sign up period. Land is eligible for placement in CRP if it is cropland or marginal pasture land.

A meets the eligibility requirements with respect to the portion of his land he is seeking to enroll in CRP. A enters into a 10 year CRP contract with the USDA for the primary purpose of earning a profit from the land. The terms of A’s CRP contract require that A will receive payments if A will (1) implement a conservation plan, (2) establish vegetative cover, (3) not engage in or allow grazing, harvesting, or other commercial use of the CRP land, (4) not use the land for agricultural purposes except as permitted by the USDA, (5) not harvest, sell, nor otherwise make commercial use of trees on the CRP land, (6) control on the CRP land all weeds, insects, pests, and other undesirable species to ensure

the establishment and maintenance of the approved cover, and (7) file annual CRP reports. In order to implement the conservation plan, the terms of the contract require significantly more activities to be performed in the first year of the contract than in the later years. A personally completes the activities required under the CRP contract for tilling, seeding, fertilizing, and weed control using his own farm equipment. A also satisfies the other requirements of the contract. In return, A receives CRP rental payments each year during the contract term. A also receives cost sharing payments based on the costs A incurs in performing A's obligations under the CRP contract.

Situation 2.

The facts are the same as in Situation 1, except that B, who owns the land, ceases all activities related to the business of farming in the year before he enters into the CRP contract. In the next calendar year B rents out a portion of his land to another farmer and enters into a 10-year CRP contract with respect to the remaining portion of his land. B arranges for a third party to perform the tilling, seeding, fertilizing and weed control required under the CRP contract and to fulfill the other contractual requirements. In return, B receives CRP rental payments each year during the contract term. B also receives cost sharing payments based on the costs B incurs in implementing CRP on the land.

LAW

Section 1401 of the Internal Revenue Code (Code) imposes a tax on the self-employment income of every individual (SECA tax). The term "self-employment income" is defined in section 1402(b) as the net earnings from self-employment derived by an individual, with certain limitations.

Section 1402(a) defines an individual's "net earnings from self-employment" as the gross income derived by an individual from any trade or business carried on by such individual, also with certain limitations. 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

(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.

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), less allowable deductions.

Section 1.1402(c)-1 of the Income Tax Regulations generally provides that in order for an individual to have net earnings from self-employment, he must carry on a trade or business, either as an individual or as a member of a partnership. Whether or not he is engaged in carrying on a trade or business will depend upon all of the facts and circumstances in the particular case.

In considering whether an individual is engaged in a trade or business, the United States 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 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 Wuebker v. Commissioner, 205 F.3d 897 (6th Cir. 2000), the Sixth Circuit held that CRP payments received by a farmer actively engaged in the business of farming were includible in self-employment income. The court concluded that 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 Sixth Circuit noted that the taxpayers were required under the CRP contract to perform tasks 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. In addition, under the court's view, the CRP payments were not payments of rent for the use or occupancy of property and therefore were not rentals from real estate excluded from SECA by section 1402(a)(1). The Court observed that the essence of the CRP program is to prevent participants from farming enrolled 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" 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.

Under section 126(a), gross income does not include the excludable portion of payments received under certain conservation programs. Revenue Ruling 2003-59, 2003-1 C.B. 1014, holds that all or a portion of cost sharing payments received under the CRP are eligible for the exclusion from gross income permitted by section 126. The ruling also holds that rental payments and incentive payments received under the CRP are not cost sharing payments and therefore are not excludable from gross income.

ANALYSIS

Under Groetzinger an activity will be a trade or business if the taxpayer “is involved in the activity with continuity and regularity and . . . the taxpayer’s primary purpose for engaging in the activity must be for income or profit.” Participation in a CRP contract is a trade or business for both A and B. The participant is obligated to perform a number of activities, including but not limited to tilling, seeding, fertilizing, and weed control. Although more extensive activities are required at the beginning of the contract term than later, the obligation to perform activities extends throughout the ten-year period, giving participation in CRP the continuity and regularity necessary to be considered a trade or business. Also, both A and B enrolled land in the CRP program to earn a profit. Participation in a CRP contract meets the criteria to be a trade or business irrespective of whether the participant performs the required activities personally or arranges for his obligations to be satisfied by a third party. Thus, the trade or business treatment is the same for A and B even though A meets the CRP requirements for maintenance of the land himself whereas B arranges for someone else to do it. Furthermore, the CRP meets the criteria to be a trade or business based on the activities required directly under the program and without being affected by whether the participant is otherwise engaged in farming or any other trade or business. Finally, although 16 U.S.C. section 3801(a)(13) refers to some of these payments as “rent”, the treatment of these payments under the Code depends upon their substance. CRP rental payments are not payments for the right to use or occupy real property. CRP rental payments are made in exchange for conducting activities that meet the commitments of a CRP contract. Therefore, CRP rental payments are not excluded from net income from self-employment under section 1402(a)(1) as rentals from real estate. See Wuebker. Thus, for both A and B, the CRP rental payments are includible in their net income from self-employment.

To the extent that a cost sharing payment is excluded from gross income under section 126, that portion of the payment would also be excluded from the gross income derived by an individual from the trade or business carried on by the individual. Consequently, to the extent such payment is excluded from gross income under section 126, the payment is also excluded from net earnings from self-employment.

HOLDING

CRP rental payments (including incentive payments) from USDA to a (1) farmer actively engaged in the trade or business of farming who enrolls land in CRP and fulfills the CRP contractual obligations personally and to (2) an individual not otherwise actively engaged in the trade or business of farming who enrolls land in CRP and fulfills the CRP contractual obligations by arranging for a third party to perform the required activities are both includible in net income from self-employment for purposes of the SECA tax and not excluded from net income from self-employment as rentals from real estate.

EFFECT ON OTHER REVENUE RULINGS

Revenue Ruling 60-32 is obsolete.

III. Request for Comments

Comments are requested regarding the interaction of the proposed revenue ruling with the treatment of CRP payments under other Code provisions, such as sections 2032A and 6166. The comments will be available for public inspection and copying. Comments must be submitted by March 19, 2007. Comments should reference Notice 2006-108, and be addressed to:

Internal Revenue Service
Office of the Associate Chief Counsel
(Tax Exempt and Government Entities) CC:TEGE
1111 Constitution Ave., N.W., Rm. 4000
Washington, DC 20224
Attn: Elliot Rogers

In addition, comments may be submitted electronically via the Internet by sending them in an e-mail to notice.comments@irs.counsel.treas.gov and specifying the comments concern Notice 2006-108.

Drafting Information

The principal authors of this notice are Marie Cashman and Elliot Rogers of the Office of the Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from Treasury and the Service participated in its development. For further information regarding this notice, contact Mr. Rogers at (202) 622- 6040 (not a toll-free call).