
The action taken by the Internal Revenue Service is in direct opposition to what was well-settled law dating back to 1988 [Ltr. Rul. 8822064, March 7, 1988.] will mean a significant tax increase for retired and disabled taxpayers and for investors whose CRP land does not bear a “direct nexus” to a trade or business of farming. [See Ray v. Comm’r, T.C. Memo. 1996-436.]

IRS Guidance being relied on by taxpayers

In 1988, the Internal Revenue Service issued a private letter ruling [Ltr. Rul. 8822064, March 7, 1988.] indicating that a retired landowner who bid land into the conservation reserve program was not materially participating under the arrangement and the payments were not subject to self-employment tax. [Id.] Various statements from both IRS and the Social Security Administration indicated that where the farm operator or owner was materially participating in the farm operation, CRP payments were properly includible in net earnings from self-employment, subject to self-employment tax. [E.g., Letter from Peter K. Scott, Associate Chief Counsel, Technical, March 10, 1987.]

Additional guidance came from a 1996 Tax Court case [Ray v. Comm’r, T.C. Memo. 1886-436.] involving a Texas farmer who bought land already under a CRP contract. The Tax Court held that the CRP payments were subject to self-employment tax because of the “direct nexus” or connection with the farming operation. [Id.] The farmer used the equipment and employees from the farming operation to maintain the seeding on the CRP acreage and to clip the weeds and admitted that, at the end of the 10-year CRP contract, the land would be part of the regular farming operation. That case affirmed that a retired landowner who had land enrolled in the CRP and was not materially participating and neither would a mere investor who had land in the CRP. [Id.]

A 1998 Tax Court case held that CRP payments were “rent” and not subject to self-employment tax [Wuebker v. Comm’r, 110 T.C. 431 (1998).] but that decision was overturned on appeal. [Commissioner v. Wuebker, 205 F.3d 897 (6th Cir. 2000).] The appellate court, in dictum, specifically rejected the application of “material participation” to CRP contracts.
pointing out that material participation was applicable only to landlord-tenant relationships). It is important to note that the Sixth Circuit Court of Appeals reversed the Tax Court decision without articulating a clear test as to the line between what is and what is not a trade or business as required by the statute. [I.R.C. § 1402(a).] The appellate court did not acknowledge that the statute provides such a guide – whether the taxpayer is carrying on a trade or business. [Id.]

The 2003 “bombshell”

On June 23, 2003, IRS issued a Chief Counsel’s Office letter ruling, stating that a landowner’s activities under a CRP contract amount to material participation and taking the position that all CRP payments should be reported on a business schedule, not a Form 4835 (for non-material participation landlords) or Schedule E (rents). [CCA Ltr. Rul. 200325002, May 29, 2003.] That meant that all CRP payments would be subject to the 15.3 percent self-employment tax, including payments to retired or disabled landowners as well as to mere investors with land under CRP contracts. [Id.] Moreover, the language also appeared to apply to other federal conservation-oriented programs such as the conservation security program, the wetlands reserve program and the grasslands reserve program.

The CCA letter ruling triggered several responses. Legislative bills that had been introduced earlier [S. 2422, S. 2344, H.R. 4212, 106th Cong., 2d Sess. (2000).] were dusted off and reintroduced. [S. 665, S. 1316, 108th Cong., 1st Sess. (2003).] And Rep. Earl Pomeroy of North Dakota commenced a crusade to convince IRS that their position was not in accord with established tax law. A meeting in Bismarck, North Dakota, on March 26, 2004, produce little in the way of results so Pomeroy arranged a meeting on June 8, 2004 in Washington, D.C. with IRS Commissioner Mark Everson and several senior IRS staff members. At both meetings, this author laid out a history of the controversy and urged IRS to harmonize the 1988 and 2003 rulings.

At the request of Commissioner Everson, a file of materials was submitted in late June of 2004. In October of 2005, IRS admitted to losing the file so a replacement file was submitted. The IRS response came on December 5, 2006. [Notice 2006-108, I.R.B. 2006-___.]

Notice 2006-108

The IRS response, Notice 2006-108, [Id.] indicated that a revenue ruling was anticipated with an opportunity for comments through March 19, 2007.

The Notice examined two fact situations – a farmer carrying on a farming operation who bids part of the land into the CRP; the other fact situation involved a situation where the landowner rented out part of the land and bid the rest into CRP, with the work on the CRP land done by a third party. In both instances, the payments were subject to self-employment tax.

In its reasoning, IRS tossed out material participation, citing Wuebker v. Commissioner, [205 F.3d 897 (6th Cir. 2000).] as applicable only to landlord-tenant relationships, disregarded the “direct nexus” concept of Ray v. Commissioner,[T.C. Memo. 1996-436.] and interpreted the statutory language of “trade or business” as interpreted by the U.S. Supreme Court as requiring that a taxpayer 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.” [Commissioner v. Groetzinger, 480 U.S. 23, 35 (1987).] The Notice baldly asserts, without
support, that “[p]articipation in a CRP contract is a trade or business” and that the 10-year term during which a CRP participant has duties to perform in “tilling, seeding, fertilizing, and weed control” assures the “continuity and regularity” necessary to be a trade or business. [Notice 2006-108, I.R.B. 2006-____.] The Notice obsoletes Rev. Rul. 60-32 [1960-1 C.B. 23.] which posed an embarrassing obstacle to the reasoning in Notice 2006-108. [I.R.B. 2006-____.]

The Notice does not mention other federal conservation programs but at least some of those programs are also likely to fall within the scope of the Notice with the expansive interpretation employed of “trade or business.”