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 Publisher/Editor  
 Robert P. Achenbach, Jr.  
 Contributing Editor  
 Dr. Neil E. Harl, Esq.  
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# Agricultural Law Digest

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## The Latest Chapter in the CRP Saga

-by Neil E. Harl\*

On June 18, 2013, the United States Tax Court, with 15 judges agreeing (one was not participating in the decision), held that an investor in farmland which the investor bids into the Conservation Reserve Program<sup>1</sup> is subject to the 15.3 percent self-employment tax on the basis that such an investment is a trade or business.<sup>2</sup> The decision follows a drumbeat of published authority from the Internal Revenue Service beginning in 2003<sup>3</sup> that everyone signing up for the CRP program (and, by implication those signing up for a range of other federal programs) is subject to self-employment tax. The drumbeat continued with Notice 2006-108 which, among other unsupported assertions, stated that the key ruling Rev. Rul. 60-32<sup>4</sup> was being obsoleted by a draft revenue ruling that was never issued.<sup>5</sup> The Tax Court, unfortunately, accepted the IRS position in the matter with little or no attention to conflicting authority with a result that appears bizarre when viewed with other authority in the area.

### The facts of *Morehouse*

The Tax Court decision in *Morehouse v. Commissioner*<sup>6</sup> involved an investor, living in Minnesota, who had acquired tracts of land in South Dakota by inheritance and by purchase, who bid specified tracts into the Conservation Reserve Program.<sup>7</sup> The taxpayer (*Morehouse*) hired a local individual, a retired farmer, to carry out some of the contract obligations required of CRP recipients. The taxpayer himself executed documents, shipped seeding materials to the local manager where the seeding needed to be established and requested authority for emergency haying and grazing, all within the realm of what is required of participants in the CRP program. The taxpayer visited the properties occasionally, allowed hunting on the properties and occasionally sold gravel from a pit on one of the tracts.

### The Tax Court's reasoning

The Tax Court was faced with two theories in deciding the case – (1) that the arrangement of the taxpayer was a “trade or business” under I.R.C. § 1402(a); and (2) that the CRP payments were not “rentals from real estate” under I.R.C. § 1402(a)(1).

*Whether CRP participation was a “trade or business.”* The Court relied on *Announcement 83-43*<sup>8</sup> 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 payments. . . “ asserting that the statement was consistent with *Rev. Rul. 60-32*.<sup>9</sup> It was obvious to almost everyone in 1983 that the *Announcement* was wrong when it was issued in 1983<sup>10</sup> and is just as wrong today. *It is simply, categorically, wrong to state that someone receiving cash or payment in kind is liable for self-*

\* Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.

employment tax as stated in the Announcement and repeated in the *Morehouse* opinion. Moreover, it is simply, categorically wrong to state that the Announcement is “consistent with *Rev. Rul. 60-32*.”<sup>11</sup>

The Court labors at length over whether the taxpayer’s activities, few as they were, elevated the relationship to “trade or business” status. The Court never gained a sense of perspective on just what the term “trade or business” implies. It is clear from any reasonable reading of that term as it is used throughout the Internal Revenue Code that “trade or business” involves three tests<sup>12</sup> (1) bearing the risks of production such as crop yields (receiving CRP rents does not involve bearing the risks of production – the payments are set for the period of the commitment, usually 10-years, and that is indicative of an investment, not a trade or business); (2) bearing the risks of price change (again, price changes do not affect the level of payments under the CRP program and that is indicative of an investment, not a trade or business); and (3) some involvement in management. As for the latter, the meaning of the term “trade or business” in the Internal Revenue Code ranges from “no involvement” needed for income averaging for farm landowners<sup>13</sup> through material participation on a regular, continuous and substantial basis for passive activity losses.<sup>14</sup> This is where the focus should be in cases like *Morehouse* where the first two tests of “trade or business” are clearly not met.

*Whether the arrangement involved “rentals from real estate.”* The best argument that the CRP payments were “rentals from real estate” was the Tax Court’s own opinion in *Wuebker v. Commissioner*.<sup>15</sup> In that case, the Tax Court stated that the CRP payments qualified as “rentals from real estate” under I.R.C. § 1402(a)(1).<sup>16</sup> The reason why that is so important is that Section 1402(a)(1) includes a 12-word parenthetical statement added by the Congress in 1974 that blocks imputation<sup>17</sup> “. . . as determined without regard to any activities of an agent of such owner or tenant. . . .” Without imputation, the taxpayer’s involvement in *Morehouse* would be miniscule. Actually, it is little more than that with imputation.

The enthusiastic embrace by the Tax Court of *Notice 2006-108*<sup>18</sup> and the proposed revenue ruling leads to an almost unbelievable conclusion – that CRP rental payments received by “an individual not otherwise actively engaged in the trade or business of farming who enrolls land in CRP and fulfills the contractual obligations personally . . . is includible in net income from self-employment and . . . not excluded from net income as ‘rentals from real estate’ under section 1402(a)(1).”<sup>19</sup> The Court, in citing the Supreme Court case of *Commissioner v. Groetzinger*,<sup>20</sup> singled out *dicta* from *Groetzinger* 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.” As an aside, that can be said of almost every investment as well. However, the Tax Court (and IRS earlier) conveniently overlooked the statement at the beginning of that paragraph of the opinion, in which the Court stated, “of course, not every income-producing and profit-making endeavor constitutes a trade or business.” The High Court followed that sentence by stating, “The income tax law, almost from the beginning, has distinguished between a trade or business, on the one hand, and ‘transactions entered into for profit but not

connected with . . . business or trade.’ “ That is what is missing in *Morehouse* – any recognition that a transaction entered into for profit could fall short, indeed fall far short – of being a trade or business.

### In conclusion

Hopefully, we have not heard the last of *Morehouse v. Commissioner*.<sup>21</sup>

### ENDNOTES

<sup>1</sup> Food Security Act of 1985, Pub. L. No. 99-198, §§ 1231-1236, 99 Stat. 1509-1514 (1985). See generally 4 Harl, *Agricultural Law* § 27.03[4][e] (2013), 5 Harl, *Agricultural Law* § 37.03[3][b][ii] (2013); Harl, *Agricultural Law Manual* § 4.02[1][e] (2013); 2 Harl, *Farm Income Tax Manual* § 8.05[1][d][ii] (2013 ed.); Harl, 608-3<sup>rd</sup> T.M., *Reporting Farm Income*, XVI(B) (2012). See also, e.g. Harl, “IRS Notice On SE Tax for CRP Payments,” 18 *Agric. L. Dig.* 1 (2007), Harl, “Developments in CRP Payment Reporting,” 14 *Agric. L. Dig.* 97 (2006).

<sup>2</sup> *Morehouse v. Comm’r*, 140 T.C. No. 16 (2013).

<sup>3</sup> CCA 200325002, May 29, 2003.

<sup>4</sup> 1960-1 C.B. 23.

<sup>5</sup> 2006-2 C.B. 1118.

<sup>6</sup> 140 T.C. No. 16 (2013).

<sup>7</sup> See note 1 *supra*.

<sup>8</sup> I.R.B. 1983-10.

<sup>9</sup> 1960-1 C.B. 23, 26.

<sup>10</sup> This author so advised IRS at the time and requested a withdrawal of *Ann. 83-43*, which did not occur.

<sup>11</sup> 1960-1 C.B. 23.

<sup>12</sup> See 2 Harl, *Farm Income Tax Manual*, § 8.05[1][d][ii][D][II] (2013 ed.).

<sup>13</sup> Treas. Reg. § 1.1301-1(b)(2).

<sup>14</sup> I.R.C. § 469(h)(1).

<sup>15</sup> 110 T.C. 431 (1998). The Tax Court opinion was reversed on appeal. 205 F.3d 897 (6th Cir. 2000).

<sup>16</sup> *Id.*

<sup>17</sup> For a detailed discussion of the three rules of “imputation” as applicable to farm and ranch firms, see 5 Harl, *Agricultural Law* § 41.06[1] (2013).

<sup>18</sup> 2006-2 C.B. 119.

<sup>19</sup> See Notice 2006-108, 2006-2 C.B. 1118.

<sup>20</sup> 480 U.S. 23 (1987).

<sup>21</sup> 140 T.C. No. 16 (2013).