

# Agricultural Law Digest

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## TAXING AGRICULTURAL PROGRAM PAYMENTS

— Neil E. Harl\*

As a general rule agricultural program payments received in cash or in materials or services are includible in income.<sup>1</sup> The time at which the amounts are received *or made available* under constructive receipt principles<sup>2</sup> is ordinarily the time the payments are to be included in income.<sup>3</sup> Amounts are "made available" in the year in which farm program payment requirements have been met, regardless of whether an application had been signed to receive final payment.<sup>4</sup> Thus, if federal farm program payments are made available in one year with an option to accept payment in the following year, the amount made available is includible in income in the earlier of the year of actual payment or the year made available to the taxpayer.<sup>5</sup>

In general, amounts received other than as cash are includible in income at fair market value although USDA commodity certificates are income on receipt *at face value*.<sup>6</sup> Later disposition of commodity certificates may produce further gain or loss.<sup>7</sup>

**Conservation Reserve Program payments.** As with most other government farm program payments, Conservation Reserve Program (CRP) payments are includible as ordinary income.<sup>8</sup> The major concerns with CRP have been — (1) whether payments are subject to self-employment tax and (2) whether CRP participation causes recapture of special use valuation benefits. Those two issues are discussed below.

**Self-employment tax.** The rule was well established many years ago that

government payments received by farm operators and materially participating farm landlords were includible in net earnings from self-employment and thus subject to self-employment tax.<sup>9</sup> It follows that CRP payments received by a farm operator (owner or tenant) or materially participating landowner are subject to self-employment tax.

The Associate Chief Counsel, Technical, of IRS has stated that where the farm operator or owner is materially participating in the farm operation, CRP payments constitute receipts from farm operations includible in net earnings from self-employment.<sup>10</sup> The Commissioner of Social Security has indicated agreement with that treatment. The more difficult questions are — (1) whether payments received by retired individuals (who are not materially participating) are included in net earnings from self-employment and (2) whether retirement and a shift to nonmaterial participation status on the part of farm operators or materially participating landowners are effective to cause CRP payments to be recharacterized as non-earned income.

In a private letter ruling in 1988,<sup>11</sup> the Internal Revenue Service indicated that, for a taxpayer who was retired when the land was bid into CRP and who was not materially participating in the production of income in retirement, CRP payments were not considered to be net income from self-employment. In that situation, there was no tenant involved in the operation. The prior tenant had received notice of termination a year before the land was bid into CRP. The landowner's activities were not considered as earned income. Once the necessary groundcover is established, merely clipping once or twice each year does not, therefore, appear to rise to the status of materially participation. Even the establishment of seeding in the initial year may not constitute material participation. Some, to remove doubt, hire the seeding operations done by an independent contractor.

For landowners who retire after bidding land into CRP, the question is whether the self-employment tax status of CRP payments changes upon retirement. Thus far, there is no published authority on that point. Some authorities, in other settings, focus on the taxpayer's status at the time the agreement was entered into.<sup>12</sup> With that approach, CRP payments received in retirement would continue to be included in net earnings from self-employment where the land was bid in while an operator or a materially participating landowner. Other authorities, however, suggest that it is the taxpayer's status at the time that payment is received that determines liability for self-employment tax.<sup>13</sup> With that approach, a shift to nonmaterial participation status would be accompanied by a change in self-employment tax liability.

**Special use valuation.** For farmland under a special use valuation election to avoid recapture of benefits, several tests must be met.<sup>14</sup> Among those requirements is the material participation test requiring material participation by each qualified heir or a member of the qualified heir's family.<sup>15</sup> Absence of material participation for more than three years during any eight year period ending after the decedent's death triggers recapture.<sup>16</sup> The other requirement particularly relevant to CRP participation is that each qualified heir must have an "equity interest in the farm operation" under what has come to be known as the "qualified use" test.<sup>17</sup> In general, with two exceptions, land may not be cash rented in the recapture period after death, even to a family member as tenant.<sup>18</sup> Exceptions are provided for a two-year grace period immediately after the decedent's death (a time to terminate pre-death cash rent leases)<sup>19</sup> and cash rent leasing by a surviving spouse who inherits qualified real property and rents the land to a member of the surviving spouse's family.<sup>20</sup>

The question is whether participation in a government acreage diversion program or CRP would constitute a cash rent lease

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that would trigger recapture after the two-year grace period. In four private letter rulings, IRS has ruled that participation in the 10-year Conservation Reserve Program does not result in recapture.<sup>21</sup> In a 1989 ruling, IRS has indicated that participation in a similar state-level program likewise does not result in recapture.<sup>22</sup>

Legislation was enacted in 1983 specifically providing that participation in the 1983 Payment-in-Kind program would not lead to special use valuation recapture.<sup>23</sup> That legislation was not added to the Internal Revenue Code and expired with the 1984 wheat PIK program. IRS also, in early 1983, issued an announce-

ment and a private letter ruling indicating that participation by a qualified heir in the 1983 PIK program or other Department of Agriculture program would not cause the qualified heir to be treated as having ceased to use the property for a qualified use for special use valuation purposes.<sup>24</sup>

## FOOTNOTES

- <sup>1</sup> Treas. Reg. § 1.61-4. See *Baboquinari Cattle Co.*, 47 B.T.A. 129 (1942), *aff'd*, 135 F.2d 114 (9th Cir. 1943); *Clara Driscoll*, 3 T.C.M. 73 (1944), *aff'd and rev'd*, 147 F.2d 493 (5th Cir. 1945); *Charles Graves*, 88 T.C. 28 (1986), *aff'd on reconsideration*, 89 T.C. 49 (1987) (payment received under Water Bank Program in exchange for set-aside of 770 acres includible in gross income as rent).
- <sup>2</sup> Treas. Reg. § 1.451-2(a).
- <sup>3</sup> See Rev. Rul. 65-95, 1965-1 C.B. 208. See also Rev. Rul. 67-404, 1967-2 C.B. 159 (farmer required to include in gross income from taxable year 1966 payments received in that year for both 1965 and 1966 crops; no basis for requesting permission to change accounting treatment for those items).
- <sup>4</sup> Rev. Rul. 65-98, 1965-1 C.B. 213 (advance and final diversion payments under 1963 Feed Grain Program includible in gross income when received or made available to taxpayer whichever was earlier; fact operator did not sign application for final payment not effective to defer income to later year).
- <sup>5</sup> Rev. Rul. 68-44, 1968-1 C.B. 191.
- <sup>6</sup> I.R. 86-175, Dec. 31, 1986.
- <sup>7</sup> See Rev. Rul. 87-103, 1987-2 C.B. 41 (handling commodity redemption with certificates under "Pik and Roll" program).
- <sup>8</sup> See Treas. Reg. § 1.61-4.
- <sup>9</sup> Rev. Rul. 60-32, 1960-1 C.B. 23 (payments received under soil bank program subject to self-employment tax for owner-operator). See *Maxwell v. Gardner*, Unempl. Ins. Rep. (CCH) ¶ 14,533 (N.D. Ala. 1966) (materially participating crop share landlord).
- <sup>10</sup> Letter from Peter K. Scott, Associate Chief Counsel, Technical, Mar. 10, 1987.
- <sup>11</sup> Ltr. Rul. 8822064, Mar. 7, 1988.
- <sup>12</sup> See Notice 87-26, 1987-1 C.B. 470 (dairy termination program payments); Rev. Rul. 60-32, 1960-1 C.B. 23 (soil bank payments).
- <sup>13</sup> Soc. Sec. Rul. 67-42 (cropland adjustment income; dictum).
- <sup>14</sup> See generally 5 Harl, *Agricultural Law* § 43.03[2][g] (1990).
- <sup>15</sup> See I.R.C. § 2032A(c)(6)(B).
- <sup>16</sup> *Id.*
- <sup>17</sup> See I.R.C. § 2032A(c)(6)(A).
- <sup>18</sup> See, e.g., *Heffley v. Commr*, 89-2 U.S.T.C. ¶ 13,812 (7th Cir. 1989) (cash rental to non-family member; qualified use test not met).
- <sup>19</sup> I.R.C. § 2032A(c)(7)(A).
- <sup>20</sup> See I.R.C. § 2032A(b)(5)(A).
- <sup>21</sup> Ltr. Rul. 8729037, Apr. 21, 1987; Ltr. Rul. 8743004, July 16, 1987; Ltr. Rul. 8745016, Aug. 7, 1987; Ltr. Rul. 8802026, Oct. 15, 1987.
- <sup>22</sup> Ltr. Rul. 8946023, August 18, 1989 (qualified heir's enrollment of 9 acres of special use valued farmland in the Reinvest in Minnesota land conservation program did not cause recapture of special use valuation benefits).
- <sup>23</sup> Pub.L. 98-4, 97 Stat. 7 (1983).
- <sup>24</sup> Ann. 83-43, I.R.B. 1983-10, 29; Ltr. Rul. 8330016, Apr. 26, 1983.

# DEVELOPMENTS IN PERSPECTIVE

## THE ABSOLUTE PRIORITY RULE

A Chapter 11 plan may be confirmed over the objections of creditors, the so-called "cram down," if the plan does not discriminate unfairly and is fair and equitable to all objecting impaired classes of creditors.<sup>1</sup> The absolute priority rule states that a plan is not fair and equitable if the debtor, or any junior creditor, retains an interest in estate business property and unsecured creditors receive less than full payment on their claims.<sup>2</sup>

The U.S. Supreme Court has provided an exception to the absolute priority rule where the debtor contributes money or money's worth to the business in an amount at least equal to the debtor's interest in the business.<sup>3</sup>

The absolute priority rule provides a major obstacle to the farm debtor in Chapter 11 who wants to keep the farm business but who has little property not essential to the business with

which to pay unsecured creditors. Generally, farm debtors have attempted to use the exception to the absolute priority rule by claiming a value in money's worth for some of the intangible aspects of the farm as a continuing business.

In an Eighth Circuit Court of Appeals case, the farm debtor claimed the contribution of the debtor's skill and labor as a contribution in money or money's worth.<sup>4</sup> Although the Appeals Court agreed with the debtor, with some conditions, the U.S. Supreme Court reversed, holding that a contribution of skill and labor was not a contribution of money's worth to the business.<sup>5</sup>

A farm debtor's contribution of future farm profits was held insufficient to invoke the absolute priority rule.<sup>6</sup> Farm debtors' contribution of farm machinery worth \$20,000 over five years of Chapter 11 plan and contribution of \$30,000 cash to farm operations were not substantial contribution of fresh capital to overcome the absolute priority rule where \$1.1 million was owed to unsecured creditors.<sup>7</sup>

A recent Kansas bankruptcy case illustrates several other aspects of the absolute priority rule.<sup>8</sup> The debtors owned a farm