

**SUGGESTED OUTLINE OF POINTS TO BE MADE WHEN  
SUBMITTING COMMENTS TO TREASURY CONCERNING  
*I.R.S. NOTICE 2006-108, I.R.B. 2006-51***

**Overview of the Issue**

On December 5, 2006, the Internal Revenue Service (IRS) issued a Notice of proposed revenue ruling concerning the self-employment tax treatment of Conservation Reserve Program (CRP) payments. The primary purpose of the *Notice* is to address the question of whether CRP payments are subject to self-employment tax if the taxpayer is retired or not otherwise actively engaged in agriculture. The *Notice* concludes that participation in the CRP, absent the taxpayer's participation in a farming operation, constitutes a trade or business because the CRP itself meets the criteria to be a trade or business based on the activities required directly under the program – including seeding a cover crop and maintaining weed control. Thus, CRP rental payments are subject to self-employment tax regardless of whether the recipient is engaged in a farming business on non-CRP land. However, the *Notice* states that any amounts received as a cost-share payment for participation in the CRP that are excludible from income under I.R.C. §126 are not subject to self-employment tax.

**Primary Basis for the IRS' Position**

The primary authority for the IRS' position is *Announcement 83-43, 1983-10, I.R.B. 29*, an *Announcement* that pre-dates the existence of the CRP. In the *Announcement*, IRS took the position that participation in the payment-in-kind (PIK) program (or any other land diversion program) does not cause the enrolled land to cease to be treated as land used in the active conduct of a farming business for purposes of I.R.C. §2032A (special-use valuation) and I.R.C. §6166 (installment payment of federal estate tax). IRS stated that this would also be the result if a taxpayer's entire farm were devoted to conservation use under the program. The impact of the ruling is that a decedent's estate containing PIK-enrolled land remained eligible for special use valuation (because the decedent still met the qualified use test with respect to the enrolled land) as well as the ability to pay any resulting estate tax in installments (for the same reason). Likewise, if an heir were to enroll land in the PIK, that would also not trigger recapture or acceleration of federal estate tax. On the other hand, the *Announcement* states that the cash rental amount received by a *farmer* for participation in the PIK is subject to self-employment tax. The *Announcement*, however, is silent on the question of whether PIK payments received by a non-farmer (investor) or retired farmer would be subject to self-employment tax.

**Subsequent IRS Rulings**

The IRS has applied the principles of *Announcement 83-43* in several rulings.

In *Priv. Ltr. Rul. 8729037 (Apr. 21, 1987)*, the first IRS ruling issued after the creation of the CRP in the 1985 Farm Bill, IRS ruled that the CRP is similar to the PIK

program and that a qualified heir's participation in the CRP would not trigger recapture of estate tax under I.R.C. §2032A for failure to use the elected land as a farm for farming purposes. Of course, to elect special-use valuation in a decedent's estate the decedent must have been using the land for farming purposes for a specified period of time before death and the qualified heir(s) must continue the farm use for 10 years after the decedent's death. The ruling provides no guidance on the question of whether a taxpayer that is either retired from farming or has never been a farmer is converted into the status of a farmer by virtue of enrollment of land into the CRP.

Again, in *Priv. Ltr. Rul. 8745016 (Aug. 7, 1987)*, IRS ruled (based on Announcement 83-43) that a qualified heir's participation in the CRP does not trigger recapture of federal estate tax under I.R.C. §2032A for failure to use the land as a farm for farming purposes.

In *Priv. Ltr. Rul. 8802026 (Oct. 14, 1987)*, IRS again ruled that a qualified heir's participation in the CRP does not trigger recapture of federal estate tax under I.R.C. §2032A for failure to use the land as a farm for farming purposes.

More squarely on point, in *Priv. Ltr. Rul. 8822064 (Mar. 7, 1988)*, IRS ruled that CRP payments are to be considered receipts from farming operations rather than rents from real estate (which would be excluded from self-employment tax by virtue of I.R.C. §1402(a)(1)). However, IRS noted in the ruling that the taxpayer (who was 71 years old and had been farming the land personally during the year immediately prior to enrolling the land in the CRP) was retired from farming. As such, IRS ruled that the CRP payments were not subject to self-employment tax. The IRS referenced *Rev. Rul. 68-44, 1968-1 C.B. 191*, *Rev. Rul. 65-149, 1965-1 C.B. 434*, and *Rev. Rul. 60-32, 1960-1 C.B. 23* to bolster its position. In those rulings, IRS stated that annual payments under farm programs comparable to the CRP are in the nature of farm receipts from farm operations and are not rental payments. But, IRS stated in the rulings that such payments are *not* subject to self-employment tax if the taxpayer was not materially participating in farming operations (either personally or via a lease) on land not in the government land diversion program.

*Tech. Adv. Memo. 9212001 (Jun. 20, 1991)*, involved facts where a taxpayer, who was engaged in the active trade or business of farming, purchased land previously enrolled in the CRP. The taxpayer subsequently died while still engaged in the trade or business of farming on the non-CRP land. The question was whether the CRP land constituted a closely-held business interest for purposes of an I.R.C. §6166 election (installment payment of federal estate tax) in the taxpayer's estate. The IRS ruled that the CRP land did constitute an interest in a closely-held business for purposes of I.R.C. §6166 because it was part of the taxpayer's trade or business of farming along with the other property used by the taxpayer (before death) in the trade or business of farming. The ruling is silent as to whether such CRP land would constitute an interest in the trade or business of farming if the taxpayer was not engaged in the trade or business of farming by virtue of being retired or a passive investor in farmland.

## Court Rulings

The courts have consistently upheld the IRS position in the rulings that rental payments (either within the context of the CRP or without) are subject to self-employment tax in the hands of a taxpayer *who is engaged in a trade or business and the rental payments relate to that business*. Conversely, the courts have ruled that if the taxpayer is not engaged in a trade or business, rental payments, by themselves, are insufficient to constitute a trade or business resulting in the payments being subject to self-employment tax.

I.R.C. §1402(a)(1) excepts “rents from real estate” from the definition of “net earnings from self-employment.” In *Priv. Ltr. Rul. 8822064 (Mar. 7, 1988)*, IRS ruled that CRP rental payments are receipts from farming operations rather than rents from real estate. Thus, they are not excluded from self-employment tax by virtue of the statutory exception under I.R.C. §1402(a)(1). This position was supported by the United States Court of Appeals for the Sixth Circuit in *Wuebker v. Comm’r, 205 F.3d 897 (6th Cir. 2000)*. The court held that the services required under the CRP contract were substantial enough to classify the payments as “services rendered to the occupant” within the meaning of Treas. Reg. §1.1402(a)-4(c)(2). Thus, the CRP payments were not excluded from self-employment tax by virtue of being “rental payments.” Because the taxpayers in *Wuebker* conducted farming operations on non-CRP land the court, consistent with prior IRS rulings held that the CRP payments were subject to self-employment tax due to the “nexus” with the taxpayer’s existing farming operation. The court’s opinion followed the rationale of *Ray v. Comm’r, T.C. Memo. 1996-436*, in which the court ruled that the self-employment tax treatment of CRP payments was dependent on a “direct nexus” to an existing farming operation the taxpayer conducted. The court in *Wuebker* did *not* state that CRP payments are subject to self-employment tax in the hands of a retired farmer or an investor in CRP land – the court was not faced with that issue.

In the agricultural context, other courts have similarly required a taxpayer to be materially participating in a farming trade or business (either personally, via agent or through a lease) for other income to be subject to self-employment tax. That was the case in *Henderson v. Flemming, 283 F.2d 882 (5th Cir. 1960)*, *McNamara v. Comm’r, 236 F.3d 410 (8th Cir. 2003)*, and *Bot v. Comm’r, 353 F.3d 595 (8th Cir. 2003)*. Conversely, in *Dugan v. Comm’r, T.C. Memo. 1994-578*, a taxpayer was held to not be liable for self-employment tax on income from share-farming operations conducted with a friend where the taxpayer did not materially participate in farming operations and permitted the friend (as tenant) to make all of the decisions concerning the farming activity. Importantly, the contract (lease agreement) between the landlord and the tenant was insufficient, by itself, to subject the lease payments as being subject to self-employment tax in the landlord’s hands. Instead, an examination of the facts was necessary to determine whether the taxpayer was engaged in a trade or business that resulted in the payments being subject to self-employment tax. That approach is consistent with the U.S. Supreme Court’s opinion in *Groetzinger v. Comm’r, 480 U.S. 23 (1987)*, in which the Court noted that whether a taxpayer is engaged in a trade or business requires a factual determination in every case. There is no reported court opinion that supports the notion that the mere signing of a CRP

contract (or any contract or lease for that matter) is sufficient, by itself, to cause the taxpayer to be engaged in a trade or business. That question can only be answered by examining the terms of the contract (or lease) and whether the taxpayer is an active farmer.

Also, *Hasbrouck v. Comm’r, T.C. Memo. 1998-249*, involved a situation where the taxpayers had never been engaged in the trade or business of farming, but purchased CRP land. The taxpayers signed a CRP contract to continue enrollment of the land in the CRP, and USDA determined that the taxpayers were actively engaged in farming. Based on that determination, the taxpayers filed a Schedule F containing net losses after reporting the CRP income and deducting farming expenses. The IRS disallowed the loss on the basis that the taxpayer’s were *not* actively engaged in the trade or business of farming during the tax year in issue. The court held that the IRS’s position was substantially justified. Again, consistent with prior IRS rulings and court opinions, the IRS took the position that the CRP contract, by itself, was insufficient to deem the taxpayer as being in the trade or business of farming. As expected, the court upheld the IRS’s position as being substantially justified.

### **The 2003 IRS Ruling and the 2006 Notice**

In *CCA Ltr. Rul. 200325002 (May 29, 2003)*, the Chief Counsel’s office of IRS took the position for the first time that CRP payments are subject to self-employment tax regardless of whether the taxpayer is actively conducting a farming operation on non-CRP land. The IRS took this position without the support of any court cases. As illustrated above, the courts and the IRS have always determined whether a taxpayer is engaged in a trade or business based on the facts of each particular situation presented. That approach is consistent with long-standing precedence, including the U.S. Supreme Court’s opinion in *Groetzinger*. The *Notice* essentially restates the position of the Chief Counsel’s office as stated in the 2003 ruling.

There remains no support for the proposition that the mere signing of a CRP contract is sufficient to constitute a trade or business such that the payments are subject to self-employment tax. While CRP payments may indeed not constitute “rents from real estate” such that they are exempt from self-employment tax under the exception of I.R.C. §1402(a)(1), that determination has no bearing on the issue of whether the taxpayer is engaged in a trade or business as required by I.R.C. §1402(a). That question can only be answered by examining the facts pertinent to a particular taxpayer. Mere signing of a CRP contract by a taxpayer is insufficient to answer that question.

### **Submission of Comments to IRS**

The IRS is requesting comments regarding the Notice. 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. Room 4000  
Washington, D.C. 20224  
Attn: Elliot Rogers

Comments may also be submitted electronically via e-mail to the following address:

[notice.comments@irscounsel.treas.gov](mailto:notice.comments@irscounsel.treas.gov)

Electronic submissions must note that the comments concern *Notice 2006-108*.