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The Eighth Circuit Court of Appeals Reverses the Tax Court in Morehouse v. Commissioner

-by Neil E. Harl*

In an opinion released on October 10, 2014, the Eighth Circuit Court of Appeals reversed the Tax Court in Morehouse v. Commissioner in holding that Conservation Reserve Program (CRP) payments are “rentals from real estate” and, therefore, are not subject to self-employment tax. Although the decision may be appealed to the United States Supreme Court, the facts of the case suggest that the Supreme Court is unlikely to take the case.

History of the controversy

The case of Morehouse v. Commissioner caps more than 20 years of effort by the Internal Revenue Service to impose the 15.3 percent self-employment tax on all lease arrangements. A 1960 Revenue Ruling had established the rule, which was heavily relied upon by the court in Morehouse, that “...land conservation payments made to non-farmers constitute rentals from real estate and are excluded from the self-employment tax.” Moreover, a 1988 private letter ruling voiced the long-standing position of IRS that a landlord’s activities under the Conservation Reserve Program did not constitute material participation and so participation in the CRP program did not subject the retired land owner to self-employment tax.

However, in 1992 IRS stated in the income tax return instructions that all rentals of personal property were to be reported on business schedules. After considerable criticism, that position was abandoned as reported in Tax Notes. A Chief Counsel’s ruling in 2003 revealed that, for retired landowners as well as those who were conducting a farming business and those who were not conducting a farming business, merely signing up for the CRP program was enough to constitute material participation and, therefore, to justify imposition of the self-employment tax. An IRS Notice issued in late 2006 confirmed the Chief Counsel’s position taken in 2003 that merely participating in the CRP program constituted a “trade or business” and proposed that Rev. Rul. 60-32 be obsoleted (which was never done).

The Congress, concerned about the battle then raging, provided in the Food, Conservation, and Energy Act of 2008 that individuals receiving retirement benefits under the Social Security Program and those receiving disability benefits under the Social Security Program were not subject to self-employment tax on CRP payments after December 31, 2007. The 2008 legislation did not provide relief for “mere investors.”

Morehouse v. Commissioner

The Tax Court Morehouse case, which involved mostly inherited land that had been

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bid into the CRP program, held that the CRP payments were subject to the 15.3 percent self-employment tax on the payments on the grounds that such an investment was a trade or business, even if owned by “mere investors.” Heavy reliance was placed on IRS Ann. 83-43 which 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 payments . . . .”\(^\text{18}\) As this author has stated, “it was obvious to almost everyone in 1983 that the Announcement was wrong when it was issued in 1983 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-employment tax as stated in the Announcement and repeated in the Morehouse decision. Moreover, it is simply, categorically wrong, to state that the Announcement is ‘consistent with Rev. Rul. 60-32.’”\(^\text{19}\)

What lies ahead?

The Morehouse case may well be appealed to the United States Supreme Court although it seems doubtful that the Supreme Court would grant review in the matter. If the decision stands, those landowners with land bid into the CRP program where the rents would grant review in the matter. If the decision stands, those landowners with land bid into the CRP program where the rents are no longer subject to the 15.3 percent self-employment tax might well discover they are liable for the 3.8 percent Unearned Income Medicare Contribution under the Patient Protection and Affordable Care Act.\(^\text{16}\) However, the 3.8 percent tax is substantially less than the 15.3 percent self-employment tax.

It is hoped that the Internal Revenue Service would once again realize that “taking tax law in new directions” is the province of Congress and not the Department of the Treasury or the Internal Revenue Service. The results from attempting in rulings issued and cases litigated in the area of self-employment tax liability over more than two decades hopefully will result in some caution in attempting to change tax policy in the future.

ENDNOTES

1 140 T.C. No. 16 (2013).
3 I.R.C. § 1402(a)(1).
9 53 Tax Notes 1410 (March 6, 1995).
11 The Chief Counsel’s ruling also indicated that such an interpretation would apply to other federal programs such as the wetland’s program.
13 1960-1 C.B. 23.
14 Rep. Earl Pomeroy of North Dakota organized a session in Bismarck, North Dakota on March 26, 2004 and a session with Commissioner Mark Everson, IRS Commissioner and four senior staff members on June 9, 2004 in Washington, D.C., to discuss the IRS position on the tax treatment of CRP payments. This author was in attendance at the meetings and agreed to provide extensive material about the controversy which was reported “lost” by IRS 18 months later. At the June 8, 2004 meeting after a lengthy debate, the Commissioner agreed that IRS would endeavor to “harmonize” their conflicting authorities, which was never done.
16 Id.

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