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SE Tax on CRP Payments

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The Tax Court, in a decision handed down on June 23, 1998,\(^1\) distinguished a 1996 Tax Court case with similar facts\(^2\) and held that conservation reserve payments (CRP)\(^3\) are not subject to self-employment tax.\(^4\) The question is whether the \textit{Wuebker} decision\(^5\) will stand and whether the holding will be extended to all income properly classified as “rents” whether the rents are from real or personal property.\(^6\)

**The \textit{Wuebker} decision**

In \textit{Wuebker v. Commissioner},\(^7\) the taxpayer bid 214 acres of farmland into the 10-year CRP program.\(^8\) While the land accepted into the CRP program represented all of the taxpayer’s owned tillable land, the taxpayer continued to farm rented land on a crop-share basis and continued to raise laying hens on their own land which was contiguous to the CRP land.\(^9\) The taxpayer established ground cover on the CRP land using the same equipment used previously on the CRP land when farmed and presumably the same equipment used in the crop-share operations on rented land. The taxpayer reported the CRP payments as “rent” on Schedule E and did not pay self-employment tax on the income.\(^10\)

The Tax Court, in reaching its conclusion that CRP payments are not subject to self-employment tax, began by noting that, in order to be subject to self-employment tax, income must be derived from a trade or business carried on by the individual.\(^11\) Echoing \textit{Ray v. Commissioner},\(^12\) the case distinguished by the \textit{Wuebker} court, the court proceeded to point out that there must be a nexus between the income received and the trade or business carried on for the income to become subject to self-employment tax.\(^13\) The court then made the point that the self-employment income statute\(^14\) is to be “construed broadly” to “favor coverage for Social Security purposes.”\(^15\)

Having said all of that, the court in \textit{Wuebker} aligned itself with the taxpayer’s argument that the CRP contract used the word “rental” and Congress must have intended for the payments to be excluded from self-employment income because they presumably knew, “that rental income is excluded from self-employment income.”\(^16\) More precisely, “rentals from real estate and from personal property leased with the real estate” are excluded from self-employment income.\(^17\)

The court addressed the nature of the rental payment in stating that the CRP payments “represented compensation for the use restrictions imposed on the land, rather than remuneration for petitioner’s labor.”\(^18\) The primary purpose of the CRP contract was “to effectuate the statutory intention of converting highly erodible

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croplands to soil conserving uses.”

The court concluded by stating that, because the payments are characterized as rents, “even if such payments were derived from petitioner’s farming operations, the payments would not be includable in petitioner’s earnings from self-employment.”

The earlier CRP case

In the 1996 Tax Court decision, Ray v. Commissioner, the court examined a factual situation similar to Wuebker. In Ray, the farmer owned a substantial amount of land which was used in the taxpayer’s farming and cattle raising operation. The taxpayer purchased an additional tract of land which had been bid into the CRP program by the prior owner. The Tax Court stated that the payments received under the CRP program had a “direct nexus” to the taxpayer’s business of farming. Accordingly, the payments were included in self-employment income and subject to self-employment tax.

Distinguishing Ray

So how did the Tax Court in Wuebker v. Commissioner distinguish Ray v. Commissioner? The Wuebker court said simply that “the Court [in Ray] did not address whether the payments qualified under the rental exclusion provisions of section 1402(a)(1).”

Lessons from Wuebker

If Wuebker v. Commissioner is not appealed or is upheld on appeal, what lessons can be learned from the decision?

- The narrowest construction of Wuebker is that government program payments characterized as rents by the federal government will be considered as rents for self-employment tax purposes regardless of the relationship to an on-going farm business (the “direct nexus”). In this regard, it is important to note that the court in Wuebker pointed out that the key revenue ruling in this area, Rev. Rul. 60-32, did not address in that ruling whether the payments constituted rentals.

- Presumably, the treatment of rentals from personal property leased with real estate would be treated the same.

- For rentals involving personal property not leased with the real estate, the situation is less clear. In a 1989 case, a taxpayer conducting a business involving the sale of portable advertising signs and a separate rental operation could not exclude the rental payments from self-employment income. The court was not impressed with the taxpayer’s argument that the statutory language, “...rentals from real estate and from personal property leased with the real estate,” should be read to permit exclusion of rentals from personal property not rented with real estate. Indeed, that case apparently touched off the IRS audit position in the early 1990s based on the assertion that all rentals on personal property were subject to self-employment tax.

- The key question in light of Wuebker is whether rentals clearly classified as such but not part of a government program referring specifically to payments as “rentals” will be excluded from self-employment income. The answer to that question is not clear. A convincing argument can be made that substance, not form, should prevail and payments properly classifiable as rent should be treated the same as the payments in Wuebker v. Commissioner.

Demise of “nexus”? 

Finally, Wuebker poses the question whether the “direct nexus” requirement articulated in earlier cases is dead where the payment is of “rent.” A reading of Wuebker would support that conclusion, at least where the rentals are paid pursuant to a government program specifically referring to “rents.”

Keep in mind, however, that if there is sufficient involvement under a lease to amount to “material participation,” even “rents” become subject to self-employment tax.

FOOTNOTES


# *Agricultural Law Manual* (ALM). For information about ordering the *Manual*, see the last page of this issue.
ADVERSE POSSESSION

FENCE. The property dispute arose from the placement, more than 40 years ago, of a fence too far on to the defendant’s property. The plaintiff had maintained the fence for over 30 years and the parties or their predecessors had recognized the fence as the boundary between the two properties. The defendant argued that the doctrine of acquiescence of a fence did not apply because the fence did not fully enclose the disputed property. The evidence demonstrated that a gap existed at the end of the fence when a creek receded during dry months but that the fence reached the water in wet months. The court held that the natural boundary of the creek would be included to determine whether the fence completely enclosed the disputed property and upheld the trial court award of title to the disputed property to the plaintiff. Lindgren v. Martin, 949 P.2d 1061 (Idaho 1997).

ANIMALS

DOGS. The defendant county had ordered the plaintiff’s dog to be destroyed under Or. Stat. § 609.155(3)(a) because the dog had chased a horse owned by a third party in the third party’s pasture. There was no evidence that the horse was injured or that the dog had attempted to harm the horse. The plaintiff argued that the statute required proof of injury or intent to injure. The court held that the statute was clear that merely chasing livestock was an action that required that the dog be put to death. Roach v. Jackson County, 949 P.2d 1227 (Or. Ct. App. 1997).

BANKRUPTCY

GENERAL-ALM § 13.03.*

EXEMPTIONS

EARNED INCOME TAX CREDIT. The debtors filed for Chapter 7 in December 1995 and claimed their 1995 earned income tax credit as exempt under Okla. Stat. tit. 31, § 1(A)(19) which allowed an exemption for “alimony, support, separate maintenance or child support payments to the extent reasonably necessary for the support of such person and any dependent of such person.” The court noted that such payments usually result from a divorce decree but that the statute did not restrict the exemption to divorce decree payments. The court held that the purpose of the earned income tax credit was the support of families with children and allowed the exemption. In re George, 98-2 U.S. Tax Cas. (CCH) ¶ 50,588 (Bankr. N.D. Okla. 1998).

HOMESTEAD. The debtor was of advanced age and poor health. Three years before filing for bankruptcy, the debtor moved to a nursing home but had since moved in with a daughter who provided medical care. The debtor’s other two daughters lived in the debtor’s residence. The debtor argued that the residence still was eligible for the homestead exemption because the debtor’s absence from the residence was involuntary, due to poor health and need of care. The court held that the evidence did not demonstrate any necessity that the debtor move out of the residence but only that it was more convenient for the daughter who cared for the debtor. The court also noted that the eligibility for the exemption relied on physical presence rather than personal intent and held that the residence was not eligible for the exemption. Matter of Burns, 218 B.R. 897 (Bankr. N.D. Ind. 1998).

The debtor owned a 42 acre property on which the debtor’s residence was located. The property was located within city limits and city sewer and water hookups were available to the property but not used. The city provided fire and police protection for the property. The property was surrounded by residential subdivisions and the property was zoned for residential use. The court held that the property was an urban homestead, limited to an exemption of one acre. Matter of Crowell, 138 F.3d 1031 (5th Cir. 1998).

Chapter 12-ALM § 13.03[8].*

PLAN INTEREST. This ruling involved two unrelated Chapter 12 cases in which the Bankruptcy Court had set an interest rate on payments on secured claims as equal to the rate for U.S. Treasury instruments of similar duration. The cases were appealed but sent back to the Bankruptcy Court in light of new decisions. During the appeals in these cases, the Second Circuit Court of Appeals decided In re Valenti, 105 F.3d 55 (2d Cir. 1997), which held that the basic interest rate should not have any factor for a “coerced loan” aspect of the plan payments. However, Valenti, held that the interest rate should be adjusted for a risk of default factor. The issue was further affected by the holding in Associates Commercial Corp. v. Rash, 117 S. Ct. 1879 (1997), which held that any risk factor was to be included in the value of the claim before the interest rate was determined. The Bankruptcy Court held that the U.S.