

Commentary: Conflict in Authority on Conservation Reserve Program Payment Reporting

By Neil E. Harl¹ and Roger A. McEowen²

Landowners who have bid land into the highly popular Conservation Reserve Program (CRP) have been confronted for nearly two years with conflicting authority on how to report the annual payments from the federal government. The key question is whether the payments are considered self-employment income³ or whether the payments are considered as investment income like rent and not subject to SE tax. The conflict is covered in detail in the soon-to-be released Portfolio, *Reporting Farm Income*, TM 608-2d by Neil E. Harl and Roger A. McEowen.

The CRP is offered on a bid basis to landowners with highly erodible land. Approximately 35 million acres of land are currently enrolled. The program was enacted as part of the 1985 farm bill with the first round of bidding held in early 1986 for a 10-year term. Landowners agree to idle the land and maintain a cover crop to control erosion. In return, the federal government makes an annual payment to the landowner.

Private letter ruling issued in 1988

The first guidance from the Internal Revenue Service⁴ was issued March 7, 1988, and indicated that, for a retired taxpayer who was not materially participating in the arrangement, payments received under the CRP would not be considered net income from self employment.⁵ In the facts of the ruling, there was no farm tenant involved and the landowner's activities did not rise to the level of material participation in establishing the cover crop and clipping to control weeds.

There had been a tenant on the farm but the landowner had terminated the lease the previous year to avoid sharing payments with the tenant.

The "direct nexus" relationship

In a 1996 Tax Court decision,⁶ the Tax Court was confronted with a fact situation where a Texas farmer, carrying on an active farming operation, had purchased additional land that had already been bid into the CRP program by the predecessor owner. In one of the years under audit, the farmer had not included the CRP payments in self-employment income. The court held that there was a direct nexus between the CRP land and the farming operation and, therefore, the CRP payments were properly included in SE income. The "direct nexus" was found in the fact that the farmer's equipment and employees were used to maintain the seeding on the CRP acreage and the fact that, at the Tax Court hearing, the farmer admitted that the land would be shifted into the farming operation at the end of the 10-year CRP contract.

The decision made it clear that a mere investor (or a farmer who failed the direct nexus test) would not have SE income.

The CCA letter ruling

The Internal Revenue Service, in a Chief Counsel's office private letter ruling⁷ took the position, directly contrary to the 1988 private letter ruling,⁸ that a landowner's activities in entering into a CRP contract amount to material participation with the result that the payments were, subject to SE tax. That is the Chief Counsel's position for retired landowners as well as those conducting a farming business and those who are mere investors. Moreover, the CCA ruling states that the same treatment should be given other federal land idling programs which could well include the Wetlands Reserve Program,⁹ the Emergency Conservation Program,¹⁰ the Emergency Watershed Protection Program,¹¹ the Conservation Security Program¹² and the Grasslands Reserve Program.¹³

In conclusion

The conflicting IRS rulings¹⁴ are both considered "substantial authority" and have created for CRP landowners a dilemma which should be resolved. Inasmuch as IRS issued both rulings, the task of harmonization lies with the Service. At a session in Washington nearly a year ago, the Commissioner agreed that the conflict should be resolved but no further guidance has been issued.

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³ See I.R.C. §1402(a).

⁴ PLR 8822064.

⁵ I.R.C. §1402(a).

⁶ *Ray v. Comr.*, T.C. Memo. 1996-436.

⁷ CCA PLR 200325002, May 29, 2003.

⁸ PLR 8822064.

⁹ 7 C.F.R. Pt. 1467.

¹⁰ 7 C.F.R. §§701.46 – 701.59.

¹¹ 7 C.F.R. Pt. 624.

¹² Farm Security and Rural Investment Act of 2002, P.L. 107-171, Sec. 2001, 116 Stat. 134 (2002).

¹³ *Id.*, §1401.

¹⁴ PLR 8822064 and CCA LR 200325002.