

Comments

On

Notice 2006-108, I.R.B. 2006-51

By

Neil E. Harl

Application of the Self-Employment Contributions Act (SECA) Tax to Payments Made by the U.S. Department of Agriculture (USDA) Under the Conservation Reserve Program (CRP)

I. This Commentator's Conclusions

It is the belief of this commentator that Notice 2006-108, I.R.B. 2006-51, which would impose the 15.3 percent self-employment tax on *all* participants in the federal conservation reserve program is not consistent with statutory law and case law applicable to the issue in question and is also inconsistent with the Internal Revenue Service position on this matter over at least the past four decades. The key issue is whether, as the Notice maintains, that “. . . participation in a CRP contract is a trade or business” for a landowner who rents out part of the land to a farmer and enrolls the remainder in the conservation reserve program (CRP). It is submitted that there is no authority in existence at any level (other than Announcement 83-43, I.R.B. 1983-10, 28, which was thoroughly discredited when it was issued and stands no higher today) that supports that conclusion in the Notice in question. While this commentator agrees that the term “trade or business” has never been defined statutorily, administratively or through litigation, it is abundantly clear that it is improper to take the position that all arrangements entered into for profit, regardless of the level of involvement of the taxpayer, should automatically be deemed to be a trade or business. That would reduce the language in I.R.C. § 1402(a) to a meaningless passage, including all activities or ventures of taxpayers entered into for profit, including activities which are merely investment in nature and all retired and disabled taxpayers regardless of the level of involvement of the activity.

II. What is CRP?

The Conservation Reserve Program (CRP) is an agricultural program administered by the United States Department of Agriculture. Food Security Act of 1985, Pub. L. No. 99-198, 99 Stat. 1508 (1985). Under the CRP, the Secretary of Agriculture is authorized to enter into long-term contracts (typically 10 years) to assist owners and operators of highly erodible cropland in conserving and improving the soil and water resources of farms and ranches. By entering into a contract, the owner or operator agrees to implement a conservation plan approved by the local

conservation district for converting the highly erodible cropland normally devoted to the production of agricultural commodities to a less intensive use. Typically, the land is seeded down with the landowner agreeing to establish and maintain a suitable vegetative cover for the land. Once the seeding is established, the landowner's involvement under the contract is usually limited to clipping the seeding once or twice each year and to patch areas where the cover crop kills out or is otherwise inadequate.

III. Meaning of "trade or business"

It is agreed that the issue is governed by I.R.C. § 1402(a) which states "[t]he term 'net earnings from self-employment' means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle. . . ." The regulations issued under Section 1402, Treas. Reg. § 1.1402(c)-1, state that, for the purpose of the tax on self-employment income, the term "trade or business" has the same meaning as when used in section 162.

Commissioner v. Groetzinger

The reference to I.R.C. § 162, brings in all of the cases and interpretative authority on deductibility of trade or business expenses. Of the many cases and rulings which have addressed the issue of 'trade or business' in the context of deductibility of expenses, the Notice singles out one of those cases, Commissioner v. Groetzinger, 480 U.S. 23 (1987), in support of the Service position that merely participating in the CRP constitutes a trade or business. The Supreme Court in Groetzinger stated that the ". . . resolution of this issue [meaning of 'trade or business'] 'requires an examination of the facts in each case.'" The Supreme Court goes on to point out, in further elucidation of its position, that ". . . the difficulty rests in the Code's wide utilization in various contexts of the term 'trade or business,' in the absence of an all-purpose definition by statute or regulation, and in our concern that an attempt judicially to formulate and impose a test for all situations would be counterproductive, unhelpful, and even somewhat precarious for the overall integrity of the Code. We leave repair or revision, if any be needed, which we doubt, to the Congress where we feel, at this late date, the ultimate responsibility rests."

The author of Notice 2006-108 (and the proposed revenue ruling) disregarded the high court's cautionary approach to the problem of defining the term "trade or business" and proceeded to craft a definition that is not consistent with the court's guidance to look at "the facts in each case" and that proceeds to attempt to impose a highly simplistic definition that is consistent with no precedent other than Ann. 83-43 which has no standing whatsoever as pointed out below.

It is helpful to note the facts in Commissioner v. Groetzinger. Groetzinger was a gambler who devoted *60 to 80 hours per week* to pari-mutuel wagering on dog races with a view to earning a living from such activity. The taxpayer went to the track six days per week for 48 weeks in the year in question. His betting activity was *more than a full-time job*. The taxpayer had no other employment and gambled solely for his own account. The Tax Court held that Groetzinger was in the trade or business of gambling so that no part of his gambling losses were an item of tax preference subjecting him to the minimum tax in effect in 1978. The Court of Appeals for the Seventh Circuit affirmed and the U.S. Supreme Court affirmed the Court of Appeals decision. The language relied upon by the drafter of the Notice (and the proposed revenue ruling) is dictum and does not reflect the holding in the case.

It is an incredible reach to believe that a case involving a taxpayer putting up to twice the number of hours in a normal work week into a venture, gambling or otherwise, in which it was judicially determined that the activity was a ‘trade or business,’ should stand as authority for the position that a retired or disabled taxpayer (or a mere investor who plays a passive role in the investment activity) should have income from self-employment. The holding of Commissioner v. Groetzinger was that a fulltime gambler who makes wagers solely for the taxpayer’s own account is engaged in a trade or business within the meaning of I.R.C. §§ 162(a) and 62(l).

The drafter of Notice 2006-108, I.R.B. 2006-51, singled out dictum from the court opinion that “. . . to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer’s primary purpose for engaging in the activity must be for income or profit.” Conveniently, for the Service position, the drafter of the Notice ignored the sentence at the beginning of that paragraph of the opinion where the court stated, “[o]f course, not every income-producing and profit-making endeavor constitutes a trade or business.” The court followed that sentence by stating “[t]he income tax law, almost from the beginning, has distinguished between a trade or business, on the one hand, and ‘transactions entered into for profit but not connected with . . . business or trade.’ ” This is what is missing from the Notice – any recognition that a transaction entered into for profit could fall short, indeed, fall far short, of being a trade or business.

A review of the many other cases litigated under I.R.C. § 162 provides no support for the position taken in Notice 2006-108.

Announcement 83-43

Notice 2006-108 makes the statement that Announcement 83-43, I.R.B. 1983-10, 29, “. . . was consistent with guidance provided in Rev. Rul. 60-32, 1960-1 C.B. 23. That is certainly not the case. Ann. 83-43 states, incorrectly, that “[a] farmer who receives cash or a payment in kind from the Department of Agriculture for participation in a land diversion program is liable for self-employment tax on the cash or payment in kind received.” Rev. Rul. 60-32 states that payments and benefits attributable to the acreage reserve program (Soil Bank Act, Title I of the Agricultural Act of 1956, 7 U.S.C. 1801) are includible in determining the recipient’s net earnings from self-employment if he operates his farm personally or through agents or employees but if “. . . he does not so operate or materially participate, payments received *are not to be included in determining net earnings from self-employment.*” (Emphasis added)

Thus, on its face, Ann. 83-43 is at odds with Rev. Rul. 60-32. That was obvious to everyone in 1983 when Ann. 83-43 was issued (I was deeply involved in the controversy that resulted in the issuance of Ann. 83-43 and in drafting Pub. L. No. 98-4, 97 Stat. 7 (1983), which thoroughly eclipsed Ann. 83-43 and relegated the Announcement to the ash heap because of the incorrect statement in Q&A 3). Q&A 3 was wrong when it was issued in 1983; it is just as wrong today. If the drafter of Notice 2006-108 knew that, it was kept well hidden. The crowning indignity is that Notice 2006-108 obsoleted Rev. Rul. 60-32 which has served as guidance for 46 years and remains as the most correct and accurate statement of liability for self-employment tax in the agricultural context.

Wuebker v. Commissioner

Notice 2006-108 lavishes a great deal of attention on Wuebker v. Commissioner, 205 F.3d 897 (6th Cir. 2000), and implies that Wuebker supports the position taken in the Notice that all participants in a CRP contract are deemed to be carrying on a trade or business. In fact, the Sixth Circuit Court of Appeals embraced the Tax Court reasoning in Ray v. Commissioner, T.C.Memo. 1996-436, that CRP participation by a taxpayer carrying on the trade or business of farming should be subjected to a “direct nexus” test. Under that test, which was met in Ray and also in Wuebker, if the CRP land bore a direct nexus to the farming operation, self-employment tax is payable on the annual CRP payments. Indeed, the Sixth Circuit stated, “the facts of Ray are almost identical to those in the case before us, and the decision’s reasoning is sound.”

The Wuebker decision affords no support whatsoever for the position taken in Notice 2006-108 that all participants in a CRP contract, including retired and disabled landowners as well as mere investors, had income from self-employment from the annual CRP payments.

Other authority

Notice 2006-108 cites to I.R.C. § 126 (which provides for an exclusion for approved cost-share payments under various federal and state programs) in support of the positions taken in the Notice. The passage in the Notice dealing with Section 126 is confusing at best but the section provides no support for the Notice. Payments under an eligible state or federal program are excludible if for “improvements.” See Temp. Treas. Reg. § 16A.126-1(a). See also Graves v. Commissioner, 89 T.C. 49 (1987), which referred to “capital improvements subject to depreciation.” Participation in CRP usually does not involve improvements and to reference Section 126 is a “red herring” in the context of liability for self-employment tax.

The Notice does not mention Ltr. Rul. 8822064, March 7, 1988, which has been relied upon for nearly 20 years and which involved a fact situation similar to Taxpayer B in Notice 2006-108. In the Notice, Taxpayer B had ceased “. . . all activities related to the business of farming in the year before he enters into the CRP contract. In the next calendar year, B rents out a portion of his land to another farmer and enters into a 10-year contract with respect to the remaining portion of his land . B arranges for a third party to perform the tilling, seeding, fertilizing and weed control required under the CRP contract and to fulfill the other contractual requirements.” The Notice and the proposed revenue ruling state that the CRP payments are subject to the 15.3 percent self-employment tax. The facts are very similar to those in the 1988 letter ruling with the opposite conclusion.

In the 1988 ruling, a retired landowner enrolled 116.9 acres of tillable land out of a 160 acre tract of farmland in CRP after several years of leasing the land to a tenant under a crop share lease. The ruling states that “. . . the payments you receive pursuant to your participation in the CRP are not includible in computing ‘net earnings from self-employment.’ “ Were Notice 2006-108 applied to that set of facts, it would produce the opposite outcome.

Finally, mention is made of Hasbrouck v. Commissioner, T.C. Memo. 1998-249. Although that case dealt with whether the Internal Revenue Service position was substantially justified, the facts involved a situation where the taxpayers purchased land that had already been bid into CRP and attempted to deduct expenses on Schedule F. On audit, IRS objected, alleging that the taxpayers were not engaged in a trade or business on the CRP land and, hence, could not deduct expenses on Schedule F. That is precisely the opposite position taken by IRS in Notice 2006-108. The IRS representative in Hasbrouck eventually conceded the case in full.

IV. In Conclusion

The mischief in Notice 2006-108 actually began with issuance of CCA Ltr. Rul. 200325002, May 29, 2003, which took almost the same position as was taken in Notice 2006-108. After a storm of protest, that the 2003 ruling was inconsistent with prior authority, a session with the Commissioner and staff in Washington, D.C. on June 8, 2004, produced a commitment on the part of the Service to harmonize the 2003 ruling with the earlier authority. Such has not been accomplished with Notice 2006-108.

My recommendation is to withdraw the Notice, go back to the drawing board, and endeavor to craft a ruling that will be consistent with relevant authorities on the meaning of “trade or business.” I would also urge that hearings be held on this matter; it is an important issue for the agricultural sector and influences the economic attractiveness of the conservation reserve program for many landowners. If implemented as is, the Notice and the proposed revenue ruling pose a serious threat to the meaning of “trade or business” in all sectors of the economy.

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Note:

Comments are to be submitted by March 19, 2007 to:

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Comments may be e-mailed to :

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