Morehouse v. Commissioner, 140 T. C. 350 (2013)

In Morehouse v. Commissioner, the U. S. Tax Court ruled that payments received under the Conservation Reserve Program (CRP) are subject to self-employment tax. The court found that the taxpayer's participation in the CRP constituted a trade or business, and thus, the payments were includable in self-employment income. This decision reversed prior rulings and clarified that CRP payments are not considered 'rentals from real estate' exempt from such taxes, impacting how landowners participating in environmental conservation programs must report their income.

Parties

Rollin J. Morehouse and Maureen B. Morehouse, petitioners, filed a petition against the Commissioner of Internal Revenue, respondent, in the United States Tax Court. The Morehouses were the taxpayers challenging the determination of self-employment tax liabilities, while the Commissioner represented the IRS's position on the tax treatment of CRP payments.

Facts

Rollin J. Morehouse inherited and purchased various properties in South Dakota, which he enrolled in the U. S. Department of Agriculture's Conservation Reserve Program (CRP). Under the CRP, Morehouse agreed to implement conservation plans on the enrolled lands, which included planting specific crops and controlling weeds and pests. He received annual payments from the USDA for his participation. Morehouse did not personally perform the required maintenance activities but instead hired Wallace Redlin to carry out these obligations. Morehouse also engaged in other activities related to the properties, such as leasing them for hunting and managing a gravel pit. The Morehouses reported the CRP payments as rental income on their tax returns for 2006 and 2007, but the IRS determined that these payments were subject to self-employment tax.

Procedural History

The IRS issued a notice of deficiency to the Morehouses on October 14, 2010, determining self-employment tax deficiencies for 2006 and 2007. The Morehouses timely filed a petition in the U. S. Tax Court, challenging the IRS's determination. The Tax Court heard the case, and after reviewing the relevant facts and law, it issued its opinion on June 18, 2013. The court applied a de novo standard of review to the legal issues presented.

Issue(s)

Whether the payments received by the Morehouses under the Conservation Reserve Program are includable in self-employment income under I. R. C. § 1401?
Whether the CRP payments constitute 'rentals from real estate' and are thus excluded from the calculation of net earnings from self-employment under I. R. C. §

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1402(a)(1)?

Rule(s) of Law

I. R. C. § 1401 imposes a self-employment tax on the net earnings from self-employment, which are defined under I. R. C. § 1402(b) as the gross income derived from any trade or business. I. R. C. § 1402(a) provides that 'net earnings from self-employment' include gross income derived from a trade or business carried on by the individual, less allowable deductions. I. R. C. § 1402(a)(1) excludes 'rentals from real estate' from the calculation of net earnings from self-employment unless such rentals are received in the course of a trade or business as a real estate dealer or under certain agricultural arrangements involving material participation by the owner.

Holding

The Tax Court held that the CRP payments received by Morehouse were includable in his self-employment income under I. R. C. § 1401 because he was engaged in a trade or business related to the CRP. The court also held that the CRP payments did not constitute 'rentals from real estate' under I. R. C. § 1402(a)(1) and thus were not excluded from the calculation of net earnings from self-employment.

Reasoning

The court's reasoning was based on the following points: Morehouse's regular and continuous participation in the CRP, including the hiring of an agent to fulfill CRP obligations, constituted a trade or business under I. R. C. § 162. The court relied on the Supreme Court's definition of a trade or business in Commissioner v. Groetzinger, which requires continuity and regularity and a profit motive. The court also considered the IRS's position in Notice 2006-108, which stated that participation in the CRP constitutes a trade or business. The court rejected Morehouse's argument that his activities were de minimis, noting that the use of an agent does not negate the trade or business status. The court further reasoned that the CRP payments had a direct nexus to Morehouse's trade or business, satisfying the 'derived from' requirement under I. R. C. § 1402. Regarding the 'rentals from real estate' exclusion, the court adopted the Sixth Circuit's analysis in Wuebker v. Commissioner, holding that CRP payments are not payments for the use or occupancy of property but compensation for the taxpayer's activities under the CRP contract. The court overruled its prior decision in Wuebker v. Commissioner, 110 T. C. 431 (1998), and aligned its position with the Sixth Circuit's interpretation.

Disposition

The Tax Court sustained the IRS's determination that the CRP payments were subject to self-employment tax and were not excluded under I. R. C. § 1402(a)(1). The court directed that a decision be entered under Rule 155, allowing the parties to

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compute the exact amount of the deficiency.

Significance/Impact

The Morehouse decision has significant implications for landowners participating in the CRP and similar conservation programs. It clarifies that such payments are subject to self-employment tax, impacting how participants must report their income. The decision also reflects a shift in the Tax Court's interpretation of the 'rentals from real estate' exclusion, aligning with the Sixth Circuit's view and overruling prior precedent. This ruling may influence future cases involving the tax treatment of income from conservation programs and underscores the importance of the 'trade or business' concept in tax law. The decision also highlights the court's deference to IRS guidance, such as Notice 2006-108, in interpreting tax statutes. Subsequent legislative changes, such as the 2008 amendment to I. R. C. § 1402(a)(1), which excluded CRP payments for certain Social Security recipients, further illustrate the ongoing dialogue between the judiciary, the IRS, and Congress regarding the tax treatment of conservation payments.

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