**Office of Chief Counsel**
**Internal Revenue Service**
# Memorandum

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from: Christopher F. Kane
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subject: Sale of Conservation Reserve Program Payments

<u>LEGEND</u>

| | |
|---|---|
| Taxpayer | = |
| Factor | = |
| r | = |
| s | = |
| t | = |
| u | = |
| v | = |
| w | = |
| x | = |
| y | = |
| Year 1 | = |
| Year 2 | = |
| Year 3 | = |
| Year 4 | = |
| Year 5 | = |
| Year 6 | = |
| Year 7 | = |
| Year 8 | = |
| Year 9 | = |
| Year 10 | = |

Year 11 =
Year 12 =

This Chief Counsel Advice responds to your request for advice regarding whether Taxpayer must include in gross income in the year of receipt a lump-sum payment received from Factor for the sale to Factor of Taxpayer's right to receive payments under Conservation Reserve Program (CRP) contracts.

We note that the field has not raised the question of whether the payments received by Taxpayer under the CRP contracts or from Factor are subject to Self Employment Contributions Act (SECA) taxes. Thus, this response does not discuss the SECA tax treatment of the payments.

## I. FACTS

Taxpayer entered into three CRP contracts with the U.S. Department of Agriculture (USDA). The CRP, 16 U.S.C. §§ 3801, 3831-3836, is a USDA voluntary conservation reserve program under which land is enrolled through the use of contracts. The program generally assists owners and operators of land to conserve and improve the soil, water, and wildlife resources of such land. The CRP offers, among other things, annual payments, called "rental payments," to owners and operators for converting highly erodible cropland normally devoted to the production of an agricultural commodity to less intensive use.

The first CRP contract (CRP 1), dated September 20, Year 1, entitled Taxpayer to annual CRP payments of $r and had a contract period of October 1, Year 1, to September 30, Year 11. The second CRP contract (CRP 2), dated January 30, Year 2, entitled Taxpayer to annual CRP payments of $s and had a contract period of February 1, Year 2, to September 30, Year 12. The third CRP contract (CRP 3), dated September 30, Year 2, entitled Taxpayer to annual CRP payments of $t and had a contract period of October 1, Year 2, to September 30, Year 12.

Pursuant to the CRP contracts, Taxpayer agreed not to harvest, sell, or otherwise make commercial use of trees or forage or other cover on the farmland subject to the CRP contracts. Taxpayer also agreed to certify crop and land use annually, and to control all weeds, insects, pests, and other undesirable species to the extent necessary to ensure the establishment and maintenance of the approved cover. The USDA agreed, subject to availability of funds, to make the annual CRP payments after October 1 of each year of the contract period.

The CRP contracts provide that if Taxpayer breaches the terms of the CRP contracts or makes an erroneous or fraudulent representation with respect to the CRP contracts, he would not be entitled to further payment and would be required to refund payments received plus interest and liquidated damages.

Taxpayer entered into a Purchase and Assignment Agreement with Factor, dated November 1, Year 3, pursuant to which Taxpayer sold to Factor for $u his right to 90 percent of nine annual CPR payments. Taxpayer sold to Factor his rights to 90 percent of the eight $v CRP payments due annually from October Year 4 to October Year 11 and 90 percent of the $w payment due in October Year 12. The following chart summarizes the amounts Taxpayer was to receive under each of the three CRP contracts.

| Contract | Year 4 | Year 5 | Year 6 | Year 7 | Year 8 | Year 9 | Year 10 | Year 11 | Year 12 |
|---|---|---|---|---|---|---|---|---|---|
| CRP 1 | $r | $r | $r | $r | $r | $r | $r | $r | |
| CRP 2 | $s | $s | $s | $s | $s | $s | $s | $s | $s |
| CRP 3 | $t | $t | $t | $t | $t | $t | $t | $t | $t |
| Sum | $v | $v | $v | $v | $v | $v | $v | $v | $w |

Pursuant to the Purchase and Assignment Agreement, Factor is entitled to receive all CRP payments due under the CRP contracts and is required, within 30 days of receipt, to remit to Taxpayer the portion of each CRP payment, if any, that exceeded the amount of such payment sold to Factor.

Pursuant to the Purchase and Assignment Agreement, Taxpayer relinquished to Factor all rights to the CRP payments. Taxpayer agreed to comply with the terms of the CRP contracts, any applicable lease, and applicable statutes, rules, and regulations related to the CRP payments. Taxpayer also agreed not to sell or encumber his ownership interest in the farm, without the prior consent of Factor. If any portion of the CRP payments is offset on account of any action or omission of Taxpayer, Taxpayer promised to pay to Factor, within 10 days of demand, the entire amount of any payment, plus an additional 16 percent of the amount offset. The Purchase and Assignment Agreement states that the assignment of the CRP payments by Taxpayer to Factor is not a loan and does not constitute a joint arrangement between Taxpayer and Factor.

Pursuant to the Purchase and Assignment Agreement, the failure of Taxpayer to comply with the terms of the Purchase and Assignment Agreement, any lease, the CRP contracts, or applicable statutes, rules, and regulations constitutes a default under the Purchase and Assignment Agreement. In the event of default, either party shall be entitled to any and all remedies, including the right to recover damages, available under any applicable law. In addition, Factor is entitled to an injunction restraining a breach by Taxpayer and to specific performance of any such provision of the Purchase and Assignment Agreement. In the event that the total amount of any annual CRP payment is less than the amount purchased by Factor (other than due to a breach by Taxpayer), Factor shall have a right to recover the shortage by offsetting against future CRP payments. In addition, in the event of any breach, default, or failure to perform by Taxpayer, Factor is entitled to liquidated damages equal to the amount of CRP payments not received by Factor, plus 16 percent of such payments.

As required by the Purchase and Assignment Agreement, Taxpayer executed a USDA Form CCC-36, Assignment of Payment, notifying the USDA that he had assigned a portion of his CRP payments to Factor. The Form CCC-36 was executed by Taxpayer on October 26, Year 3.

Taxpayer uses the cash receipts and disbursements method of accounting.

Year 3 Income Tax Return: On his original Year 3 income tax return, Taxpayer included the $u received from Factor for the sale of his CRP payments in income on Form 4835, Farm Rental Income and Expenses.

In November Year 5, Taxpayer filed a Year 3 Form 1040X, Amended U.S. Individual Income Tax Return, claiming a refund for Year 3. On the amended return, Taxpayer reduced his income by $u, the amount received from Factor, and explained that "$u which was not income to the taxpayer was incorrectly reported as other income on Form 4835 of the original return. This amendment is to correct this incorrect reporting."

Year 4 Income Tax Return: On his original Year 4 income tax return, Taxpayer included the annual $v CRP payment, $x of which was sold to Factor in Year 3, in income on Form 4835. Taxpayer deducted as an expense on Form 4835 the $x that had been sold to Factor.

In November Year 5, Taxpayer filed a Year 4 Form 1040X. On the amended return, Taxpayer stated that on his original Form 4835 for Year 4, "$x was claimed in error and has been removed."

Year 5 Income Tax Return: On his Year 5 income tax return, Taxpayer included the $v annual CRP payment in income on Form 4835.

Taxpayer contends that the $u was not income to him in Year 3 because he did not have an unrestricted claim of right to the funds and held them as a conduit. As outlined above, Taxpayer amended his Year 3 and Year 4 tax returns and filed his Year 5 tax return to exclude from income the $u lump sum received in Year 3 and include in income the entire annual CRP payments for Year 4 and Year 5.

The field proposes to deny the claim for refund on the Year 3 amended return and to decline to accept the Year 4 amended return. The revenue agent questions whether Taxpayer may exclude from gross income the $u lump sum received from Factor in Year 3 as the proceeds from the sale of his CRP payments. The revenue agent questions whether Taxpayer should include in gross income the entire annual CRP payments for Year 4 and Year 5.

II. ISSUES

(1) Is the $u lump-sum payment that Taxpayer received from the sale of 90 percent of his annual CRP payments includible in his gross income in Year 3, the year of receipt?

(2) Are the annual CRP payments for Year 4 and Year 5 includible in Taxpayer's gross income?

III. HOLDINGS

(1) The $u lump-sum payment that Taxpayer received from the sale of 90 percent of his annual CRP payments is includible in his gross income in Year 3, the year of receipt, as ordinary income.

(2) Only the portion of the CRP payments for Year 4 and Year 5 not sold to Factor are includible in Taxpayer's gross income.

IV. ANALYSIS

Generally, a lump-sum payment received in a bona fide sales transaction in adequate and full consideration for the right to receive a future ordinary income stream results in ordinary income to the seller in the year of receipt. Accordingly, we conclude below that Taxpayer must include the $u lump-sum payment received from Factor in gross income in Year 3, the year of receipt, as ordinary income.

<u>(1) Inclusion in gross income of $u lump-sum payment</u>

Section 451(a) provides that the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period. Section 1.451-1(a) of the Income Tax Regulations states that under the cash receipts and disbursements method of accounting, an item is included in gross income when actually or constructively received. <u>See also</u> § 1.446-1(c)(1)(i) of the Income Tax Regulations.

<u>Claim of right</u>

Amounts received under a claim of right, without restriction on disposition, are included in income when received even though the taxpayer may have to repay part or all of the amounts at a later date. <u>North American Oil Consolidated v. Burnet</u>, 286 U.S. 417, 424 (1932).

Taxpayer received the $u lump-sum payment in Year 3 under a claim of right, without restriction on disposition. Therefore, the $u lump-sum payment is included in Taxpayer's gross income in Year 3, the year of receipt. Taxpayer didn't hold the lump-sum payment as a conduit for Factor or any other party. The fact that under the terms of the Purchase and Assignment Agreement, in the event of default by Taxpayer, Taxpayer may have to pay liquidated damages to Factor equal to the amount of CRP payments not received by Factor, plus interest, does not preclude income inclusion in the year of receipt. Id.

Sale of right to future income stream

A lump-sum payment received in a bona fide sales transaction in adequate and full consideration for the right to receive a future income stream is includible in gross income in the year of receipt. Later payments of the income stream to the purchaser are not includible in the gross income of the seller. In Cotlow v. Commissioner, 22 T.C. 1019 (1954), the Tax Court held that taxpayer, a life insurance agent who purchased rights to renewal commissions on life insurance policies to be received in the future when earned by other agents, is taxable on the excess of the renewal commissions received over the amounts paid for them. In so holding, the court rejected the taxpayer's argument that the assignors of the renewal commissions should be taxed when the renewal commissions were received by taxpayer, because the assignors earned the renewal commissions. The court explained that the case at issue differed from assignment of income cases, because in the case at issue there was an arm's-length purchase at fair value of property rights. The assignors for full, adequate, and valuable consideration parted with all rights, title, and interest in their right to collect the renewal commissions.

In affirming the Tax Court in Cotlow, the Second Circuit noted that taxpayer, in purchasing future renewal commissions, performs a discounting function and also undertakes the risk that by lapse or termination of a policy, renewal commissions will cease. Cotlow v. Commissioner, 228 F.2d 186 (2d Cir. 1955). The Second Circuit also stated that "[w]here there is an arm's length assignment of income rights for a valuable consideration, it is clear that the assignor realizes only the amount of the consideration received . . . and the assignee is taxable for receipts in excess of this amount." Cotlow, 228 F.2d at 188.

The taxpayer in Estate of Stranahan, 472 F.2d 867 (6th Cir. 1973), sought to accelerate future income to avoid losing the tax benefit of an interest deduction. To accomplish this, he assigned to his son anticipated stock dividends from stock taxpayer owned in exchange for $115,000. Taxpayer then directed that all future dividend checks be issued to his son until the aggregate amount of $122,820 had been paid to the son. Taxpayer reported the $115,000 as ordinary income in the year of sale and his son reported the dividends in excess of basis when later received. The court determined that the transaction was a bona fide sale for adequate consideration, not merely gratuitous, and distinguished the case from the line of assignment of income cases originating with Helvering v. Horst, 311 U.S. 112 (1940). The court also distinguished the case from those in which courts recharacterized a purported sale as a loan because the risk of nonpayment had not shifted to the assignee. E.g., Mapco, Inc. v. United States, 556 F.2d 1107 (Ct. Cl. 1977) (certainty of repayment of "buyer" of future income stream is characteristic of a loan).

In the instant case, Taxpayer and Factor entered into an arm's-length assignment of Taxpayer's income right, 90 percent of the annual CRP payments, for valuable consideration. Through the terms of the Purchase and Assignment Agreement, Taxpayer guaranteed only that he would comply with his obligations under the CRP contracts. The risk that the USDA would not comply with the terms of the CRP contracts shifted to Factor. Accordingly, Taxpayer is taxable on the lump-sum payment received in Year 3 and improperly attempted to exclude the lump-sum payment on an amended Year 3 return. Cf. PLR 8910070. The lump-sum payment is taxable to Taxpayer as ordinary income. Hort v. Commissioner, 313 U.S. 28 (1941) (amount received in lieu of future rents is ordinary income); Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958) (sale of future oil payment rights results in ordinary income).[*]

(2) Inclusion in gross income of Year 4 and Year 5 CRP payments

Based on the discussion in (1) above, Taxpayer improperly included in gross income on his amended Year 4 return and Year 5 return the portion of the annual CRP payments purchased by Factor. However, Taxpayer is taxable on the excess of the CRP payment he received in Year 4 and Year 5 over the portion of those payments that he sold to Factor. Specifically, Taxpayer is taxable on $y in each year Year 4 and Year 5, the excess of $v, the entire annual CFC payment for each year, over $x, the portion of the CRP payment sold to Factor.

If you have any questions, call at .

[*] Taxpayer also contends that his transaction with Factor was an obligation-shifting transaction as defined in § 1.7701(l)-2(h)(1) of the proposed Income Tax Regulations. We assume Taxpayer took interest expense deductions on his amended Year 4 tax return and Year 5 tax return based on that theory.

The Service withdrew proposed regulations § 1.7701(l)-2 by Withdrawal of Notice of Proposed Rulemaking, published in the Federal Register on November 10, 2003 (68 Fed. Reg. 63744). The transaction that Taxpayer entered into with Factor would not be an obligation-shifting transaction within the meaning of the withdrawn proposed regulations. Even if they had been finalized in the format originally proposed, the proposed regulations would not apply to Taxpayer. Accordingly, Taxpayer cannot exclude the $u lump-sum payment received from Factor in Year 3 on the basis that he entered into an obligation-shifting transaction with Factor. Likewise, Taxpayer may not take interest expense deductions on his amended Year 4 tax return and Year 5 tax return on that basis.