

Conservation-Related Payments and Expenditures*

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Introduction

Concerns about soil erosion, air and water quality, wildlife habitat and environmental protection have resulted in the rapid expansion of conservation-related programs. Generally, the benefits associated with these conservation programs accrue to society as a whole, rather than just to those specific individuals who incurred costs from the implementation of a conservation-related program. For these individuals, costs may exceed benefits. To encourage increased participation in conservation-related activities, payments may be made to producers, rural landowners, and others by federal, state, and local governments and private institutions.

This fact sheet identifies six types of conservation-related payments and expenditures and discusses how they are handled for income and self-employment tax purposes by operating farmers, share lease landowners, cash rent landowners and non-farm landowners. Many of these programs are administered by the Natural Resources Conservation Service (NRCS), formerly the Soil Conservation Service, of the U.S. Department of Agriculture (USDA). Overviews and detailed information on these programs are available at www.nrcs.usda.gov/programs.

Deduction of Conservation Expenditures

Agricultural producers in most counties are eligible for cost-sharing payments from a variety of programs for expenditures on conservation practices consistent with an approved plan. Establishment of diversion ditches, grassed waterways and filter strips would be common examples. Because there is nothing to “wear out,” these expenditures are not eligible to be depreciated, and the costs would normally be added to the basis of the property.

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To encourage expenditures on conservation, Congress enacted Internal Revenue Code (I.R.C.) § 175, which allows a producer to elect to deduct conservation expenditures up to 25 percent of the gross income from farming (including income from crops, livestock, fruits, and other agricultural or livestock products as well as sale of livestock). Gains from the disposition of machinery and equipment or land are not included. If expenditures exceed 25 percent of the gross income from farming in a year, the excess conservation expenditures can be carried forward into future years with gross farm income.

To qualify, expenditures must be consistent with an approved conservation plan and involve land used in the business of farming. Land used for timber production, used in a not-for-profit (hobby) activity, or rented for a fixed amount is not considered as being used in the business of farming. Expenditures for depreciable conservation assets are not eligible for deduction as soil and water conservation expenses, and should be depreciated. Ordinary and necessary expenses that are otherwise deductible, such as periodic ditch cleaning, are also not soil and water conservation expenditures and are not subject to the 25 percent of gross farm income limitation, and should be deducted on Schedule F (Form 1040) as other expenses.

Reporting Cost Share Payments

Cost-sharing payments must be reported in income as government program payments on lines 4a and 4b of Schedule F (Form 1040), but the conservation-related expenditures are deducted on line 12. This reduces farm income for both income and self-employment purposes.

Example 1: Billy Contour, an operating farmer, spent \$10,000 on earthen erosion control structures on his farm and received a 75 percent cost sharing payment of \$7,500. Billy reports the \$7,500 cost sharing payment as income on lines 4a and 4b of Schedule F and deducts the \$10,000 expense on line 12 if his gross farm income is \$40,000 or more.

Example 2: Sara, Billy's older sister, is a landowner who leases her land to Billy for a share of the production. Sara reports her farm income and expenses on Form 4835. Sara is eligible to deduct qualified soil and water conservation expenditures up to 25 percent of her gross income from farming. Cost sharing payments would be reported on lines 3a and 3b and qualified conservation expenditures would be deducted on line 10 of Form 4835.

Example 3: Maria, Billy's younger sister, is a landowner who rents her land to Billy for a fixed cash rent. Maria would NOT be considered to be in the trade or business of farming and could not deduct soil and water conservation expenditures. If Maria planned to make soil and water conservation expenditures and switched to a share lease for 2013, she would be in the trade or business of farming and Maria would be eligible to deduct qualified soil and water conservation expenditures made in 2013.

Example 4: Ismail and Renee are rural recreational landowners who participate in the wildlife habitat improvement program (WHIP), spending \$2,000 on restoration of riparian buffers and invasive species management, receiving a \$1,500 payment. Because Ismail and Renee are not in the trade or business of farming, they cannot deduct these expenditures under I.R.C. § 175. The cost-sharing payment of \$1,500 would be reported as income on line 21 of Form 1040, but would not be earnings for self-employment tax. The total expenditure of \$2,000 would be added to the basis of the property.

If the land in Examples 1, 2, and 3 (if Maria converts to a share rental arrangement in Example 3) has been owned for five years or less, the gain on the sale of land is treated as ordinary income up to the amount of previously allowable deductions for soil and water conservation expenses. If the land has been held less than 10 years but more than five years, then a declining percentage of the previously deducted soil and water conservation expenses are treated as ordinary income. The recapture provisions are based on the time of ownership of the land, not time after the conservation expenditures were incurred. There is no recapture in Example 4 because no cost sharing payment was deducted.

Exclusion of Cost-Sharing Payments from Income

Some cost-sharing payments may involve expenditures for assets, such as metal or concrete structures, which can be depreciated. Such expenditures are not eligible for deduction as soil and water conservation expenses, but would be depreciated. However, if the cost-sharing payment was reported as income and depreciation was deducted, the net effect would be to increase the producer's income for the year in which the cost-sharing payment was received. I.R.C. § 126 allows the exclusion of the cost-sharing payment from income if the payment is from an authorized list of programs, is for a capital expenditure, does not substantially increase gross receipts from the property that was improved and the Secretary of Agriculture certifies that the payment was made primarily for conservation purposes.

The amount that can be excluded is the present value (discounted cash flows) of the greater of:

- 1) 10 percent of average gross receipts from the affected property for the last three years, or
- 2) \$2.50 per acre.

Some expenditures, such as erosion control structures, may have clearly defined areas of impact. Other expenditures, such as manure storage facilities, may have less well-defined areas of impact. Because the exclusion is partially based on total receipts of the affected area, producers will want to define the affected area as being as large as possible. The present value computation involves dividing the dollar figure derived from 1 or 2 above by an assumed discount rate. A lower discount rate will result in a larger present value and a larger potential amount that would be excludible.

Example 5: Assume the erosion structure affected 100 acres, 10 percent of average gross receipts is \$20 per acre, and the discount rate is 4 percent. In this instance, the present value of the amount to exclude would be calculated as:

(1) $(100 \times \$20) / 0.04 = \$2,000 / 0.04 = \$50,000$

(2) $(100 \times \$2.50) / 0.04 = \$250 / 0.04 = \$6,250$

Thus, up to \$50,000 of a cost-sharing payment could be excluded from income. For an operating farmer, the cost-sharing payment would be reported on line 4a of Schedule F (Form 1040) but not line 4. The share-lease landowner would follow a similar procedure on lines 3a and 3b of Form 4835, while the cash rent landowner reports on Schedule E (Form 1040). Each of the taxpayers would attach an explanation of how the amount of the cost-sharing exclusion was determined.

If the land were sold at a gain within 10 years of receiving the cost-sharing payment, the gain, to the extent of the income exclusion, would be treated as ordinary income. This is similar to recapture of depreciation. If sold for a gain more than 10 years after the payment was received, the recapture is reduced by 10 percent for each year or part of a year that the property is held beyond 10 years.

Stewardship Payments

The current Conservation Stewardship Program (CSP) makes stewardship payments to qualified farmers for attaining minimum soil and water quality standards before enrollment in the program. The Secretary of Agriculture previously determined that the “Payments for Performance” made under the CSP were primarily for conservation purposes and, if they met the requirements of I.R.C. §126, could be excluded from income. It was later clarified that stewardship payments under CSP do not involve new capital expenditures on the part of the farmer and are not eligible for exclusion under I.R.C. §126. Stewardship benefits would be ordinary income and earnings for self-employment tax for operating farmers, share-lease landowners and rural landowners in the timber business.

Incentive Payments

Incentive payments may be made to farmers under a variety of programs to encourage them to sign up for specific programs (Signing Incentive Payments or SIP) or to adopt certain production practices (Production Incentive Payments or PIP). The SIPs and PIPs are ordinary income and earnings for self-employment tax purposes for operating farmers.

Annual Program Payments

The Conservation Reserve Program (CRP) can make several types of payments to producers. The annual program payment, often referred to as a “rent” payment is treated as ordinary income. There have been differences of opinion whether these payments were earnings for self-employment or not. In the 2008 Farm Bill, Congress indicated that CRP recipients receiving

social security benefits would not include CRP payments as earnings for self-employment tax purposes. Although this clarified some tax situations, it did not address all of the situations.

Payments can also be made under programs such as the Environmental Quality Incentives Program (EQIP), which may affect livestock producers, the Wetlands Reserve Program (WRP), Conservation Reserve Enhancement Program (CREP), and several others. Annual program payments and incentive payments that are made to encourage adoption of certain production practices are ordinary income and generally subject to self-employment tax. The cost-sharing payments are generally handled as deductible soil and water conservation expenditures under I.R.C. §175, or they may be excludible from income under I.R.C. §126 as discussed earlier.

Traditionally, government payments have been assumed to take the same form as other farm income. For an operating farmer, government payments were earnings for self-employment taxes. A share-lease landowner who did not materially participate in the farming activities reported income and expenses on Form 4835 and net income was not included as earnings for self-employment tax. A cash rent landowner reported income and expenses on Schedule E (Form 1040) and, for most tax purposes, was not considered to be a farmer. Recreational landowners may receive payments for conservation-related activities. These payments generally must be reported as income. Although normally not subject to self-employment taxes, these payments must usually be added to the basis of the property rather than deducted as an expense.

Conservation Easements

The CRP, WRP, and, in some instances, other programs may involve the landowner granting conservation easements to government organizations or qualified private organizations. These conservation-related easements are treated as other easements. Easements for a 30-year period or more are treated as permanent and are reported as the sale of the asset. The payment is first treated as a return of basis in the property and, to the extent it exceeds the producer's basis in the affected property, as long-term capital gain. The gain is not subject to the self-employment tax. The easement for 30 years or more qualifies for like-kind exchange treatment, which allows for the deferment of income tax. Specific rules must be followed to obtain the tax deferral.

The payment received for granting a conservation-related easement that is for less than 30 years is treated as ordinary income in its entirety. The payment would not be subject to self-employment tax.

Summary

Concerns about soil erosion, air and water quality, wildlife habit and environmental protection have resulted in the rapid expansion of conservation-related programs. To encourage participation in the programs some payments and expenditures qualify for special tax treatment. This fact sheet identifies six types of conservation-related payments and expenditures and discusses how they are handled for income and self-employment tax purposes by operating farmers, share lease landowners, cash rent landowners and non-farm landowners and are summarized in Table 1.

Table 1. Income and Self-Employment Tax Treatment of Conservation Payments by Type of Taxpayer

Type of Payment	Type of Taxpayer			
	Operating Farmer Schedule F (Form 1040)	Share Lease Landowner (Form 4835)	Cash Rent Landowner Schedule E (Form 1040)	Rural Non-farm Landowner (Form 1040)
Cost-Sharing for Nondepreciable Capital Expenditures (I.R.C. §175)	Payment reported as income, deduction taken for expenses Net generally \$0 for SE tax	Payment reported as income, deduction taken for expenses Net generally \$0 for SE tax	Payment reported as income, arguably not subject to SE, expenditures added to basis*	Payment reported as income, arguably not subject to SE, expenditures added to basis*
Cost-Sharing for Depreciable Capital Expenditures (I.R.C. §126)	Payment excluded from income to the extent allowable. Unexcluded portion is ordinary income, subject to SE tax	Payment excluded from income to the extent allowable. Unexcluded portion is ordinary income, arguably not subject to SE tax*	Payment excluded from income to the extent allowable. Unexcluded portion is ordinary income, arguably not subject to SE tax*	Payment excluded from income to the extent allowable. Unexcluded portion is ordinary income, arguably not subject to SE tax*
Stewardship	Ordinary income, subject to SE	Ordinary income, arguably not subject to SE tax*	Generally not applicable	Generally not applicable**
Incentive	Ordinary income, subject to SE tax	Ordinary income, subject to SE tax	Ordinary income, not subject to SE tax*	Generally not applicable**
Annual (e.g., CRP)	Ordinary income, subject to SE tax	Ordinary income, arguably not subject to SE tax*	Ordinary income, arguably not subject to SE tax*	Generally not applicable**
Permanent Easements	Payments reduce basis of affected land, payments in excess of basis result in §1231 gain, not subject to SE tax	Payments reduce basis of affected land, payments in excess of basis result in §1231 gain, not subject to SE tax	Payments reduce basis of affected land, payments in excess of basis result in §1231 gain, not subject to SE tax	Payments reduce basis of affected land, payments in excess of basis result in capital gain, not subject to SE tax
<p>*These payments would generally not be considered as earnings for SE tax purposes. The IRS, based on CCA 200325002 and Notice 2006-108, could argue that these payments are subject to SE tax. ** Forest landowners can qualify for these payments which would be ordinary income. Whether the payments would be subject to SE tax depends on the facts and circumstances of the individual.</p>				

IRS Publications

For further information, see IRS Publication 225, The Farmer's Tax Guide.

To access IRS forms and publications, go to www.irs.gov and click on "Forms and Publications". Then click on "Publication number" under "Download forms and publications by:" Type the publication number in the find box to search for the publication. Publications may be viewed online or downloaded by double clicking on the publication.

Additional Topics

This fact sheet was written as part of Rural Tax Education a national effort including Cooperative Extension programs at participating land-grant universities to provide income tax education materials to farmers, ranchers, and other agricultural producers. For a list of universities involved, other fact sheets and additional information related to agricultural income tax please see RuralTax.org.

This information is intended for educational purposes only. You are encouraged to seek the advice of your tax or legal advisor, or other authoritative sources, regarding the application of these general tax principles to your individual circumstances. Pursuant to Treasury Department (IRS) Circular 230 Regulations, any federal tax advice contained here is not intended or written to be used, and may not be used, for the purpose of avoiding tax-related penalties or promoting, marketing or recommending to another party any tax-related matters addressed herein.

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