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Tax Implications of Soil and Water Conservation Programs*

—by Neil E. Harl**

I. Basic provisions

A. Soil and water conservation expenditures

1. Until changed in 1954, expenditures related to soil and water conservation were subject to capitalization on the theory that the value of the land presumably was increased.

2. Since 1954, however, taxpayers engaged in the business of farming have been allowed to deduct soil and water conservation expenditures in the year incurred, under a one-time election, rather than to capitalize the expenditures.

   a. To make the election to treat soil and water conservation expenditures as current deductions, the taxpayer must be engaged in the business of farming.

      (1) A taxpayer who "cultivates, operates, or manages a farm for gain or profit, either as owner or tenant" is engaged in the business of farming.

      (2) A landowner under a crop share or livestock share lease is engaged in the business of farming.

         (a) However, a landowner under a cash rent lease is engaged in the business of farming only if the landowner "participates to a material extent in the operation or management of the farm." Legislation has been introduced to allow a soil and water conservation expense deduction on land rented to a member of the family regardless of whether the rental is cash or share.

         (b) Participation in the 1983 or 1984 payment-in-kind (PIK) farm programs, which arguably would have produced cash-rent like income, is considered for a qualified taxpayer to be the same as though the commodities were produced. "Qualified taxpayer" status requires that the taxpayer receive agricultural commodities in exchange for idling land under the PIK program.

      (3) A nursery engaged in the raising of ornamental plants is considered to be in the business of farming. However, a taxpayer engaged in forestry or the growing of timber is not in the business of farming.

      (4) According to the regulations, a person cultivating or operating a farm for recreation or pleasure rather than for profit is not in the business of farming.

   b. The expenditures for which an income tax deduction is permitted are those "paid or incurred for the purpose of soil or water conservation in respect of land used in farming, or for the prevention of erosion on land used in farming, but only if such expenditures are made in furtherance of the business of farming."

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(1) An income tax deduction may be claimed for several categories of expenditures including—

(a) The treatment or movement of earth such as leveling, conditioning, grading, terracing, contour furrowing or restoration of soil fertility. The cost of establishing Coastal Bermuda Grass to prevent erosion is eligible for the election to deduct currently.

(b) The construction, control and protection of diversion channels, drainage ditches, irrigation ditches, earthen dams, water courses, outlets and ponds.

[1] If an earthen dam has a definite life, the costs of constructing the dam are depreciable.

[2] Costs for the construction of ponds are not deductible if the ponds have an indeterminate life.

(c) The eradication of brush.

(d) The planting of windbreaks.

(2) The election also applies to assessments by soil and water conservation or drainage districts which, if paid by the taxpayer directly, would be deductible as a soil or water conservation expense.

(a) The portion of an assessment levied by a soil and water conservation or drainage district for depreciable property (such as pumps, locks, concrete structures and similar equipment) may also be deductible within limits under the special one-time election.

(b) The deductible assessment may not exceed 10 percent of the total assessment made against all members of the district to pay the costs of acquiring depreciable property. The costs in excess of 10 percent must be added to the income tax basis of the property involved.

[1] If the difference between the deductible assessment and 10 percent of the assessment paid is $500 or less, the entire amount may be deducted under the election with the deduction claimed in the taxable year the expenditure was made.

[2] If the difference is greater than $500, the amount may only be deducted ratably over a 10-year period.

(3) Several other categories of expenditures are specifically made ineligible for the election to deduct including expenditures of a character subject to depreciation or cost recovery.

(a) This includes expenditures for the purchase, construction, installation or improvement of "structures, appliances or facilities subject to the allowance for depreciation."

(b) Expenditures for earthen dams and terraces that are not subject to an allowance for depreciation are eligible for the election to deduct costs currently.

c. To be deductible under the soil and water deduction provision, expenditures must pertain to land used in farming. In general, the land must be used for the production of crops, fruits or other agricultural products (including fish) or for the sustenance of livestock.

(1) The term "livestock" includes cattle, hogs, horses, mules, donkeys, sheep, goats, captive furbearing animals, chickens, turkeys, pigeons and other poultry. Grazing land is considered used for the "sustenance of livestock."

(2) For land used in farming by the previous owner, the taxpayer is considered to be using the land in farming when soil and water conservation expenditures are made if the taxpayer's use of the land is substantially a continuation of its use in farming, whether for the same farming use as that of the previous owner or any of the other permissible uses.

(a) Prior to amendment of the regulations in 1980, it was necessary for the taxpayer or tenant to use the land for substantially the same purpose as the previous owner.

(b) In a 1978 case, where the prior cultivation of the land was so remote ("not within recorded history") that the area had to be recleared and developed into cultivable fields, the court was unable to find a "continuation" of use.

(c) If only part of a tract of land has been used for farming, only soil and water conservation expenditures allocable to the part actually farmed are deductible. The allocation is made on the basis of the area actually used in farming compared to the total area of the tract unless some other method of allocation is shown to be more reasonable.

d. The deduction for soil and water conservation expense may not exceed 25 percent of the taxpayer's "gross income derived from farming" in any taxable year.

(1) Any excess above the 25 percent level is deductible in succeeding taxable years, in order of time, but the carryover utilized in any year plus any soil and water conservation expenses paid or incurred that year may not exceed 25 percent of the gross income from farming in that year.

(2) If the amount of soil and water conservation expense is less than the 25 percent limit, all must be claimed; the taxpayer may not deduct only part of the expense in order to carry forward the rest to a year in which the income from farming is expected to be greater.

(3) The term "gross income derived from farming" is calculated under the taxpayer's regular accounting method and includes gain from the disposition of livestock held for draft, dairy, breeding or sporting purposes. However, gains from the sale of other Section 1231 assets such as farm machinery and land, are not included.

(4) If the deduction for any year creates a net operating loss for the year (as computed after the 25 percent limitation), the loss is available under the general carryback and carryforward rules for net operating losses even though the taxpayer has a 25 percent deduction for soil and water conservation expenditures in the year to which the loss is carried. The part of a net operating loss carryback or carryforward that is attributable to the soil and water conservation deduction is not subject to the 25 percent limitation in any year to which it is carried as a net operating loss.

(5) For a taxpayer engaged in the business of farming, who is also the beneficiary of a trust engaged in farming, the taxpayer cannot include the distributive share of trust income in determining "gross income from farming" for purposes of the 25 percent limitation on the taxpayer's deduction for soil and water conservation expense.

(a) If the trust has soil and water conservation expenditures in excess of the 25 percent limitation, the excess is not available as a deduction by the beneficiary, whether or not the beneficiary is engaged in farming.

(b) Upon termination of a trust, any loss carryover resulting from the allowable deduction of conservation expenses by the trust and any "excess deductions" from the last taxable year of the trust, including the allowable conservation expense deduction, are available to the beneficiary. However, any excess of the trust's soil and water conservation expense deduction over the 25 percent limitation, which is allowable as a carryover by the trust so long as it remains in existence, is not available to the beneficiary upon termination of the trust.

(6) The election is made at the entity level by S corporations and, presumably, partnerships.

e. After 1986, soil and water conservation expenditures that may be deducted currently are limited to amounts incurred consistent with a conservation plan approved by the Natural Resource Conservation Service of the U.S. Department of Agriculture.

(1) If there is no Natural Resource Conservation Service plan for the area, plans of a state conservation office may fulfill the requirement.

(2) After 1986, expenditures to be deductible must be with respect to land in the United States.

(3) Expenditures for draining and filling wetlands or land preparation for center-pivot irrigation are not deductible as soil and water conservation expenses.

f. Making the election

(1) The election to deduct or capitalize soil and water conservation expenditures is made in the first year the taxpayer pays or incurs expenditures. The election does not require IRS consent and is made by entering the expenditures on the taxpayer's income tax return.

(2) The election is binding for all subsequent years unless the District Director of Internal Revenue consents to a change. A taxpayer may, however, request consent to capitalize or deduct soil and water conservation expenditures with respect to a special project of a single farm without disturbing the treatment of regularly occurring soil and water conservation expenditures.

(3) The consent applies only to expenditures incurred after the effective date of the change.

(4) A taxpayer who fails to make the election to deduct soil and water conservation expenditures for the first year such expenses were incurred may nonetheless apply for consent to deduct conservation expenses in a subsequent year. The consent does not, however, permit a deduction for items paid or incurred in a prior year.

(5) Whenever consent is required for an adoption or change of method, the request must be made not later than the due date for the return for which the adoption or change is to be effective. The request must state the amount of all conservation expenditures incurred for that year and must state that the taxpayer "will make an accounting segregation in his books and records of the expenditures to which the election relates."

(6) One court has held that the election to deduct soil and water conservation expenditures currently could not be made in a year for which a return had not been filed.

(7) In the event a taxpayer has not elected to deduct soil and water conservation expenses currently, the expenditures are added to the income tax basis of the property.

(a) However, expenditures in excess of the limit of 25 percent of gross income do not increase the income tax basis of the property even if the property is sold before the deduction has been absorbed.

(b) For expenditures in excess of the limit, the carryover merely remains in abeyance until the taxpayer again has gross income from farming.

(8) For tax years after 1986 and before 1996, taxpayers claiming soil and water conservation expenses had to file Form 8645 with their tax return, unless the conservation expenses were paid or incurred primarily to produce an agricultural crop. Form 8645 is no longer required. The required information can be reported on Schedule F or Form 4835.

g. Recapture on disposition

(1) If land (which the taxpayer has held for less than 10 years) is disposed of, part or all of the soil and water conservation deductions previously claimed may be recaptured with that part of the gain taxed as ordinary income.

(2) The amount of recapture is the lesser of—

(a) The “applicable percentage” of soil and water conservation expense deductions made with respect to the land, or

(b) The amount realized (in the case of sale, exchange or involuntary conversion) or the fair market value of the land over its adjusted income tax basis (in the case of any other type of disposition).

(3) Note that recapture is not based upon the number of years since soil and water conservation expenditures were paid or incurred, but upon the number of years the land was held by the taxpayer.

(4) As noted above, recapture is limited to the "applicable percentage" of deductions previously claimed.

(a) For land held five years or less, 100 percent of the deductions are subject to recapture; for land held ten years or more, none of the deductions is recaptured.

(b) For land held between five and ten years, a percentage of the deductions is recaptured—

If the land is disposed of…	**the applicable percentage is:**
Within five years after the date acquired	100
Within the sixth year after acquisition	80
Within the seventh year after acquisition	60
Within the eighth year after acquisition	40
Within the ninth year after acquisition	20
After the ninth year following acquisition	0

(5) If only a portion of a parcel of land is disposed of, the deductions attributable to the entire parcel are allocated to each part in proportion to the fair market value of each at the time of disposition.

(6) For land disposed of with installment reporting of gain—

(a) Income on each installment is first deemed to consist of gain attributable to recapture of soil and water conservation expense and land clearing expense deductions, until all of that gain has been reported. .

(b) The remainder of the gain is ordinary income or capital gain depending upon the type of property, holding period and applicability of other recapture provisions.

(7) In general, no gain is recognized from recapture of soil and water conservation expenses on disposition of land—

(a) By gift.

(b) On gift to a charitable organization; however, the donor's charitable deduction is reduced by the amount that would have been reported as ordinary income on sale.

(c) On transfer of land at death.

(d) For tax-free exchanges, except to the extent of gain recognized.

(8) The regulations specify that any dispositions of land not provided for under I.R.C. § 1252 regulations are to be treated according to the rules under I.R.C. § 1245.

B. Reporting cost-share payments

1. A provision in the Revenue Act of 1978 permits some cost sharing amounts received under several state and federal programs to be excluded from gross income to the extent the amounts are for capital improvements

a. Excludible amounts include those under—

(1) The rural clean water program.

(2) The rural abandoned mine program.

(3) The water bank program.

(4) The emergency conservation measures program.

(5) The agricultural conservation program.

(6) The Great Plains Conservation Program, as in effect before the amendment made by the Federal Agricultural Improvement and Reform Act, *§ 336(b)*, which merged the Great Plains Conservation Program into the Environmental Quality Incentives Program.

(7) The resource conservation and development program.

(8) The Forest Land Enhancement Program.

(9) The excludible portion of payments from any small watershed program administered by the Secretary of Agriculture that is determined by the Secretary of the Treasury to be substantially similar to the types of programs described above qualify for the exclusion. Improvements made in connection with small watersheds under the “Stewardship Incentive Program” are within the scope of I.R.C. § 126(a)(2).

(10) Cost-share payments received under the Wetlands Reserve Program, Environmental Quality Incentives Program and the Wildlife Habitat Incentives Program are eligible for exclusion from gross income under I.R.C. § 126.

(11) Cost-share payments under the Soil and Water Conservation Assistance Act.

(12) Cost-share payments under Conservation Reserve Program; “rental” payments and incentive payments do not qualify and are includible in gross income.

(13) Cost-share payments allowed under the Agricultural Management Assistance Program.

(14) Cost-share payments under the Forest Land Enhancement Program, Texas Forest Service Oak Wilt Suppression Program and Wisconsin Department of Natural Resources Forest Landowner Grant Program.

(15) The excludible portion of payments made under any state program under which payments are made for the purpose of conserving soil, protecting or restoring the environment, improving forests or providing a habitat for wildlife are excludible from gross income. *I.R.C. § 126(a)(10).* See *50 Fed. Reg. 37017, September 11, 1985 (Minnesota Soil and Water Conservation Board Cost-Share Program payments excludible); Ltr. Rul. 9014041,* January 5, 1990 (exclusion available to whomever received payment, whether owner or lessor); *51 Fed. Reg. 27229, July 29, 1986 (Alabama Agriculture and Conservation Development Commission Program payments excludible); 52 Fed. Reg. 19746, May 27, 1987* (Wyoming Abandoned Mine Land Reclamation Program payments excludible). See *51 Fed. Reg. 30383 (August 26, 1986)* (Wisconsin Animal Waste Water Pollution Grant Program cost-sharing payments excludible from income); *52 Fed. Reg. 25425 (July 7, 1987)* (Maryland Nonstructural Shore Erosion Control Cost-Sharing Program payments excludible from income); *52 Fed. Reg. 29557 (August 10, 1987)* (Wisconsin Nonpoint Source Water Pollution Abatement Program payments excludible from income); *52 Fed. Reg. 30934 (August 18, 1987)* (Ohio Abandoned Mined Lands Program payments excludible from income); *52 Fed. Reg. 34970 (September 16, 1987)* (Illinois Forestry Development program cost-sharing payments excludible from income); *52 Fed. Reg. 35120 (September 17, 1987)* (Colorado Inactive Mine Reclamation Program cost-sharing payments excludible from income); *52 Fed. Reg. 38805(October 19, 1987)* (payments under federal Resource Conservation and Development Program excludible from income); *52 Fed. Reg. 12550 (April 15, 1987)* (Iowa Financial Incentive Program for Soil Erosion Control payment excludible from income); *54 Fed. Reg. 9239(March 6, 1989)* (Ohio Agricultural Pollution Abatement Program payments excludible from income); *54 Fed. Reg. 9240 (March 6, 1989)* (Virginia Agricultural Best Management Cost-Sharing Program payments excludible from income); *54 Fed. Reg. 37012 (September 6, 1989) (Ohio Multiflora Rose Control Program)*; *55 Fed. Reg. 42,868 (October 24, 1990)* (cost-sharing payments under Colorado River Basin Salinity Control Program); *55 Fed. Reg. 47,354 November 13, 1990* (cost share payments under Washington State Game Farm Alternative Program eligible for exclusion); *56 Fed. Reg. 8109, March 6, 1992* (cost share payments under Florida Okeechobee Dairies Best Management Practices Program); *58 Fed. Reg. 32343, June 9, 1993* (cost-share payments made by State of Wisconsin under Petroleum Environmental Cleanup Fund Act); *61 Fed. Reg. 50801, September 27, 1996* (payments for the purchase and installation of capital improvements or implementation of best management practices made under New York State Agricultural Nonpoint Sources Abatement and Control Matching Grant Program). See *Ltr. Rul. 8647098, August 4, 1986* (cost-share payments under state land reclamation program includible in income where state had not submitted program for determination that program payments were excludible from income).

(16) The Conservation Security Program. See *Rev. Rul. 2006-46, 2006-2 C.B. 511*.

b. For amounts received under the above programs to be excludible—

(1) The Secretary of Agriculture must determine that the payments are made "primarily for the purpose of conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife."

(2) The Secretary of the Treasury must determine that the payments are not "increasing substantially" the annual income from the property. An increase in annual income is not substantial unless it exceeds the greater of $2.50 per acre or 10 percent of the average annual income derived from the property prior to the improvement.

c. A taxpayer may elect not to have the exclusion rules apply to all or part of an improvement. The taxpayer is to attach a statement to the income tax return indicating the dollar amount of the cost funded by a government payment, the value of the improvement and the amount that is being excluded from income.

d. The exclusion is available to lessors of property. Apparently, the type of lease and the extent of landlord involvement in management are not relevant.

e. If property acquired, improved or otherwise modified by the application of payments excluded from gross income is disposed of within 20 years, part or all of the excluded payments are taxed as ordinary income.

(1) The amount taxable as ordinary income is the lesser of—

(a) The gain realized on sale of the property, or

(b) The applicable percentage of the amount of the payment that had been excluded from income. The applicable percentage for the first 10 years after the date payments are received and excluded is 100 percent. Thereafter, the applicable percentage is reduced annually by 10 percentage points. After the nineteenth year, there is no recapture.

(2) The exclusion and recapture rules do not apply to government cost sharing payments to the extent a deduction is allowed in the year paid or incurred.

f. If the exclusion is claimed, expenditures may neither be used to generate deductions or credits nor be added to the income tax basis of property acquired.

2. On September 25, 2006, IRS issued guidance indicating that several categories of CSP benefits would be excludible *as permitted by I.R.C. § 126*. *Rev. Rul. 2006-46, 2006-2 C.B. 511.*

a. The ruling states that the following would be excludible "to the extent permitted by § 126"—

(1) Existing practice and new practice components, and

(2) Enhancement component. *Id.*

b. The ruling also states that payments for the stewardship component are not excludible. *Id.*

c. The regulations limit the exclusion to "improvements." *Temp. Treas. Reg. § 16A.126-1(a).*

d. The Tax Court has referred to "…capital improvements subject to depreciation…and has stated—

> "…nowhere…is there any indication that Congress intended to relieve from normal income tax obligations an outright payment for the use of land where there is no capital improvement subject to depreciation…. It is apparent that 'cost sharing' does not mean…reducing the amount of income received from property by entering into an agreement with the United States." *Charles Graves, 89 T.C. 49) (1987).* See Harl, "The Latest on Reporting CSP Payments," *17 Agric. L. Dig. 153 (2006).*

C. Fertilizer, lime and other soil conditioning expenditures

1. A taxpayer may, despite the carryover in the soil of benefits to later years, elect to deduct expenditures for fertilizer, lime and other soil amendments or conditioners currently rather than capitalizing the expenditures over the period soil fertility is affected.

a. Before enactment of the provision permitting a current deduction, soil conditioning expenditures were considered capital in nature if the effect lasted for more than one year.

b. IRS in 1989 took the position that the cost of fertilizer applied to an existing stand of timber may not be deducted immediately and must be amortized. However, that GCM has been withdrawn "pending further consideration of the issue." A change in how post-establishment fertilization is treated is a change in accounting method.

2. Under the statutory provision authorizing a current deduction, expenditures may be deducted that are paid or incurred during the taxable year for the "purchase or acquisition of fertilizer, lime, ground limestone, marl, or other materials to enrich, neutralize or condition land used in farming."

   a. The term "land used in farming" is defined as land used by the taxpayer or tenant for the production of crops, fruits or other agricultural products or for the sustenance of livestock.

   b. Expenditures on land brought into production for the first time apparently are not eligible for the election to deduct the expense currently.

      (1) For land used by the immediately preceding owner for farming purposes, the taxpayer is considered to be using the land in farming when the expenditures are made if the taxpayer's use of the land is substantially a continuation of its use in farming, whether for the same farming use as that of the predecessor or any of the other permissible uses.

      (2) The regulations also imply that land not used previously by the taxpayer or tenant in farming is not eligible for the election.

3. The election to deduct fertilizer and other soil conditioner expenses currently may be made only by a taxpayer engaged in the business of farming.

   a. To be engaged in the business of farming, a taxpayer must be engaged in a farming operation, be leasing under a crop share or livestock share lease or be materially participating in the operation or management of the farm (in the case of a cash rent lease).

      (1) The same definition of "business of farming" is used as for purposes of the soil and water expense deduction under I.R.C. § 175.

      (2) A nursery engaged in the raising of ornamental plants is considered in the business of farming for purposes of the election.

   b. Where land was sold with the "residual fertilizer supply" purchased by a corporation that became the tenant under a farm lease from the new owners, an amortization deduction for the fertilizer was denied.

   c. An election is not required for expenditures which are not capital in nature.

4. The election to deduct fertilizer, lime and other soil conditioner expenses currently is made by claiming the deductions on the appropriate schedule on the income tax return.

   a. Revocation of the election requires the consent of the District Director of Internal Revenue and is made by application to that office with a statement of reasons for the requested action to revoke.

   b. As a practical matter, most farm taxpayers assume that expenditures for fertilizer, lime and like materials are currently deductible and give little thought to the election procedure.

   c. An election is not required for expenditures which are not capital in nature.

5. Whether I.R.C. § 180 preempts amortization—

a. It is clear that I.R.C. § 180 does not preempt amortization of fertilizer deductions. See *Ltr. Rul. 9211007, December 3, 1991*—

> "If a taxpayer does not make a section 180 election for farm fertilizer expenditures, they are not deductible under section 180 but they are chargeable to a capital account. This account is amortizable over the period of the fertilizer's effectiveness."

b. However, the same letter ruling makes it clear that three conditions must be met to amortize the premium fertility in soil—

(1) The taxpayer must be the beneficial owner of the fertilizer in the soil,

(2) The taxpayer must establish the presence and extent of the fertilizer, and

(3) The taxpayer must be exhausting the fertilizer in the soil.

II. Specific conservation programs

A. Environmental Quality Incentive Program (EQIP).

1. EQIP is an eligible program for cost-sharing under I.R.C. § 126 so payments meeting the tests of that section can be excluded. Four of USDA's farmer conservation programs were combined in EQIP—The Agricultural Conservation Program, Water Quality Incentives Program, Great Plains Conservation Program and Colorado River Basin Salinity Control Program.

2. Incentive payments made to encourage on-going maintenance practices are includible in income and can be offset with allowable deductions.

B. CRP Continuous Signup Enhancements.

1. Since May 1, 2000, producers have been allowed to make offers at their local USDA Service Center for a continuous sign-up for CRP contracts for several "targeted" practices—

a. Filter strips

b. Riparian buffers

c. Grassed waterways

d. Field windbreaks

e. Shelter belts

f. Living snow fences

2. An up-front CRP signing incentive payment (SIP) of $100 per acre for 10-year contracts and $150 per acre for 15-year contracts can be paid. These payments do not qualify for the exclusion and are reportable into income (as ordinary income).

3. A practice incentive payment (PIP) equal to 40 percent of eligible installation costs can be paid. As with SIPs, these payments must be reported as ordinary income and are not eligible for the exclusion.

C. Conservation Reserve Enhancement Program (CREP).

1. Under CREP, cost-sharing payments, incentive payments and annual rental payments are provided. CREP payments can include a payment for temporary or permanent easements.

2. The cost-sharing payments, incentive payments and annual rental payments are treated the same as those payments are treated under CRP.

3. For permanent easements, payments are treated first as a return of basis with remaining gain qualifying as long-term capital gain if the land has been held for more than one year.

4. A payment for a temporary easement that lasts less than 30 years is apparently treated as ordinary income. Payments for a temporary easement that lasts 30 years or more appear to be treated the same as a permanent easement.

D. Wetlands Reserve Program (WRP).

1. WRP is a voluntary program to restore wetlands. Participating landowners can enter into conservation easements or restoration cost-sharing agreements where no easement is involved.

2. Easements are treated the same as easements under the CREP program.

3. Cost-sharing under WRP are eligible for the I.R.C. § 126 exclusion.

E. Emergency Conservation Program (ECP).

1. This program provides financial assistance to farmers and ranchers for the restoration of farmland or ranchland where normal farming operations have been impeded by natural disasters.

2. ECP is an eligible program under I.R.C. § 126 for permanent improvements. Expenses for permanent improvements that are not depreciable may be eligible for the soil and water conservation deduction to the extent they are not compensated by cost-sharing payments that are excluded under I.R.C. § 126.

3. Payments in the nature of maintenance (such as the removal of debris) are reported into income which can be offset by any deductions.

F. Emergency Watershed Protection Program (EWP).

a. The EWP program is designed to reduce threats to life and property in the wake of natural disasters. The program provides technical and cost-sharing assistance.

b. Inasmuch as EWP is an eligible program under I.R.C. § 126, the income tax consequences are the same as for the Emergency Conservation Program.

G. Small Watershed Program (SWP).

1. The Small Watershed Program provides both technical and financial assistance for various purposes including watershed protection, flood prevention, erosion and sediment control, water supply, water quality, fish and wildlife habitat enhancement, wetlands creation and restoration and public recreation in watersheds of 250,000 acres or less.

2. SWP is an eligible program under I.R.C. § 126 with respect to federal government assistance. Some state programs are also eligible. For information about the status of state programs, contact the Natural Resource Conservation Service (NRCS) or the Farm Service Agency (FSA).

3. Expenditures for practices that protect farmland and that are consistent with an approved conservation plan can qualify as soil and water conservation expenses under I.R.C. § 175 if the expenditure—

a. Is not currently deductible;

b. Is not for a depreciable asset; and

c. Was not compensated by a cost-sharing payment that was excluded under I.R.C. § 126.

4. *Example:* a taxpayer received a $10,000 cost-sharing payment from SWP to help pay the costs of $25,000 of soil erosion improvements. The taxpayers had average gross income of $10,000 from the affected area in the previous three years. The "value" of the § 126 improvement" is $20,000.

   The taxpayer's excludible portion of the cost-sharing payment is the present value of the greater of—

   a. 10 percent of the average annual gross receipts (10 percent of $10,000 or $1,000) or

   b. $2.50 per acre ($2.50 x 100 acres or $250).

      Assuming an eight percent discount rate, the excludible portion would be—

$$= \frac{1{,}000}{.08} = \$12{,}500$$

      The portion of the $10,000 cost-sharing payment that must be included in income is calculated as follows—

Value of the § 126 improvement	$20,000
Less the excludible portion	12,500
	7,500
Less the taxpayer's contribution ($25,000 – 10,000)	15,000
Amount included in income	0

H. Wildlife Habitat Incentives Program (WHIP).

1. This program provides financial incentives to help develop habitat for fish and wildlife on private lands under 5 to 10-year cost-share agreements for wildlife habitat development.

2. WHIP is an eligible program under I.R.C. § 126.

3. Expense incurred under the program appear not to be eligible for the soil and water conservation deduction (I.R.C. § 175) because the expenses are not incurred to protect land used in farming.

I. Forest Land Enhancement Program (FLEP). 16 U.S.C. § 2013, 7 C.F.R. §§ 701.27-701.45, Farm Security and Rural Investment Act of 2002, Pub. L. No. 107-171, 116 Stat. 134 (2002) (Forest Land Enhancement Program, replacing the Forestry Incentives Program (FIP)).

1. FIP (and presumably FLEP) support good forest management practices on privately-owned, non-industrial forestlands. The program pays up to 65 percent of the cost of tree planting, timber stand improvement and related practices.

2. FIP (and presumably FLEP) are eligible for the I.R.C. § 126 exclusion. However, if no annual income has been produced on the land in the last three years, the limit on the exclusion is the present value of $2.50 per acre.

Example: a taxpayer received $6,500 in cost-sharing payments for the $10,000 cost of planting trees and related improvements on 100 acres of forestland. The taxpayer had no income from the land for the last three years. The excludible portion would be the present value of $2.50 per acre—

$$= \frac{100 \text{ acres x } 2.50}{.08} = \$3{,}125$$

The amount reportable income would be—

Value of the § 126 improvement	$10,000
Less excludible portion	3,125
	$6,875
Less the taxpayer's contribution	3,500
Amount included in income	$3,375

If, in the example, the taxpayer had sold $30,000 of timber from the land in the previous three years, the excludible portion would be the present value of the greater of—

a. 10 percent of average annual gross receipts (10 percent of $10,000 or $1,000) or

b. $2.50 per acre ($2.50 x 100 acres or $250).

Assuming an eight percent discount rate, the excludible portion would be—

Value of the § 126 improvement	$10,000
Less excludible portion	12,500
	0
Less the taxpayer's contribution	3,500
Amount included in income	0

J. Conservation Security Program (CSP)

1. It is anticipated that cost-share payments for the adoption or maintenance of management and vegetative practices will not be excludible from income. The expenses for which the cost-share payment is received will be deductible either as an ordinary farm expense (currently deductible) or as soil and water conservation expense.

2. Cost-share payments for the adoption of land-based structural practices under the existing practice and new practice components and the enhancement component are eligible to the extent the payments are for improvements. Payments for the stewardship components are not excludible.

3. It is expected that annual payments will receive the same income tax treatment as the annual payments under CRP.

K. Grasslands Reserve Program (GRP)

1. The program involves—

   a. 10-year, 15-year, 20-year or 30-year contracts, or

   b. 30-year or permanent easements.

2. Because the minimum easement period is 30-years, payments received for easements will first be used to reduce the basis of the affected land. Payments in excess of basis should result in capital gain treatment.

3. Cost-share payments, to restore the function and value of grasslands, will be includible in income unless the payment is a reimbursement for a practice covered under I.R.C. § 126. Expenses should be deductible as a trade or business expense or deductible as soil and water conservation expense.

L. Easements

1. Upon sale of an easement, *Treas. Reg. § 1.61-6(a)* provides general guidelines—

> "When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned amount the several parts, and the gain realized or loss sustained on the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to such part. The sale of each part is treated as a separate transaction, and gain or loss shall be computed separately on each part. Thus, gain or loss shall be determined at the time of sale of each part and not deferred until the entire property has been disposed of."

2. Thus, on sale of an easement the allocation of basis involves two issues—

   a. The allocation of basis between the portion of the property subject to the easement and the rest of the property.

   b. The allocation of basis between the rights created by the easement and the rest of the rights in the property.

3. Property affected

   a. In general, only the basis allocable to the immediate area covered by the easement may be reduced.

   b. If the entire property is affected by the easement, the basis of the entire tract can be reduced.

4. Rights created by the easement

   a. The general rule is that the basis of the property must be allocated between the interest sold and the interest retained in the proportions that their respective fair market values bear to the fair market value of entire property.

   b. If it is impossible to allocate the basis of the entire property between the interest that is sold and the interest that is retained, the amount received for the easement can be used to reduce the basis in the entire property affected.

   c. However, in a ruling involving a sale of property with a retained possessory interest for 20 years, an allocation was determined to be appropriate. .

   d. In the event a landowner sells or grants a perpetual easement to a portion of the land owned, with no beneficial interest retained in the portion of the land subjected to the easement, the sale or grant of the perpetual easement is treated as a sale of the land for federal income tax purposes.

M. Conservation Reserve Program payments–

1. In a letter ruling, IRS has indicated that, for a retired taxpayer who is not materially participating, payments received under the federal Conservation Reserve Program would not be considered net income from self-employment. Otherwise, payments are considered as earned income.

a. The Associate Chief Counsel, Technical, of IRS has stated that where the farm operator or owner is materially participating in the farm operation, CRP payments constitute receipts from farm operations includible in net earnings from self-employment. The Commissioner of Social Security agrees.

b. IRS and the Social Security Administration initially seemed to be taking the position that **someone** must be materially participating.

2. The Tax Court in 1998 held that conservation reserve payments (CRP) are rental payments and are not subject to self-employment tax.

   a. The Tax Court said the primary purpose of the CRP contract was to achieve specified environmental benefits by converting highly erodible cropland to soil conserving use. Thus, the contract payments represented compensation from the use restrictions on the land rather than remuneration for the taxpayer's labor.

   b. Earlier, the Tax Court had held that, for taxpayers who materially participate in the operation, CRP payments are to be reported as self-employment income.

   c. Legislation has been introduced to treat CRP payments as rent for self-employment tax purposes.

3. IRS, in a Chief Counsel's Letter Ruling dated May 29, 2003, took the position, directly contrary to *Ltr. Rul. 8822064, March 7, 1988,* that a landowner's activities under a CRP contract amount to material participation and the payments should be reported on Schedule F, not Schedule E or Form 4835.

   a. That is the Chief Counsel's position for retired landowners as well as those conducting a farming business and those who are not conducting a farming business. That will place even more pressure on Congress to enact S. 665 or S. 1316, *supra*.

   b. Meetings in Bismarck, North Dakota, on March 26, 2004, and Washington, D.C., on June 8, 2004, (at which Commissioner Mark Everson was present) were held to get IRS to harmonize its conflicting rulings (Prof. Harl was present by teleconference at the March 26 meeting and present in person at the June 8 meeting.) IRS has not released further guidance as of early November, 2006.

4. Participation in the CRP program and receipt of CRP payments does not establish that the taxpayers were actively engaged in the trade or business of farming and thus entitled to claim Schedule F deductions.

5. For landowners who retire after bidding land into CRP–

   a. Some authorities have focused on the taxpayer's status at the time the agreement was entered into.

   b. Other authorities suggest that it is the taxpayer's status at the time that payment is received that determines liability for self-employment tax.

6. The assignment of rights to receive CRP payments producing a lump sum payment results in ordinary income in the year of receipt.