



**Agricultural Law Press**

Publisher/Editor

Robert P. Achenbach, Jr.

Contributing Editor

Dr. Neil E. Harl, Esq.

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# Agricultural Law Digest

Volume 16, No. 22

November 18, 2005

ISSN 1051-2780

## Reporting Conservation Security Program Payments

-by Neil E. Harl\*

Budget cuts could reduce the funding for conservation programs in the next federal fiscal year, but the long-term outlook is relatively bright for funds in support of conservation.<sup>1</sup> Pressure from the World Trade Organization to cut trade-distorting commodity programs means that the agricultural sector will have to be stabilized with funding through other channels, notably conservation. Thus, conservation programs are expected to become increasingly important channels for government funds to the sector.

One of the problems in the conservation area is that neither the Congress nor the Internal Revenue Service has provided a clear roadmap on how conservation benefits are to be taxed. The assumption has been that income tax consequences of payments under the various conservation programs would be handled under existing federal law. Even the programs authorized by the 2002 farm bill are without guidance on how the benefits are to be taxed.<sup>2</sup>

Here's how it appears that the existing federal income tax rules apply to the Conservation Security Program.

### Conservation Security Program

The Conservation Security Program (CSP) has been a high profile conservation program since its enactment in 2002.<sup>3</sup> The program provides for three tiers of conservation practices for which payments may be received.<sup>4</sup>

- A Tier I contract is to be for a period of five years and includes conservation practices appropriate for the agricultural operation that, at a minimum, address at least one "significant resource of concern for the enrolled portion of the agricultural operation at a level that meets the appropriate non-degradation standard" and covers "active management of the conservation practices that are implemented or maintained under the conservation security contract."<sup>5</sup> As for payments, Tier I contracts are eligible for payment of an amount equal to five percent of the "applicable base payment for land covered by the contracts", an amount not exceeding 75 percent (90 percent for a beginning farmer) of the average county costs of practices and an "enhanced payment" for additional enumerated practices.<sup>6</sup> The annual payments to an individual or entity cannot exceed \$20,000 under a Tier I contract.<sup>7</sup>

- A Tier II CSP contract is for a period of five to 10 years and is to include conservation practices appropriate for the agricultural operation that, at a minimum, address at least one significant resource of concern for the entire agricultural operation at a level that meets the appropriate non-degradation standard and covers active management of conservation practices that are implemented or maintained under the conservation security contract.<sup>8</sup> For Tier II

\* Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.

practices, an amount equal to 10 percent of the “applicable base payment for land covered by the “conservation security contract” can be paid.<sup>9</sup> That’s an amount not exceeding 75 percent (90 percent for beginning farmers) of the average county cost of adopting or maintaining practices and an enhanced payment for additional enumerated practices. The annual payments to an individual or entity cannot exceed \$35,000 under a Tier II contract.<sup>10</sup>

- A Tier III contract is to be for a period of not less than five and not more than 10 years and includes conservation practices appropriate for addressing all resources of concern.<sup>11</sup> Payments can be made equal to 15 percent of the “base payment for land covered by the conservation contract” up to 75 percent (90 percent for a beginning farmer) of the average county cost of adopting or maintaining practices and an enhanced payment for additional enumerated practices.<sup>12</sup> Annual payments to an individual or entity cannot exceed \$45,000 under a Tier III contract.<sup>13</sup>

### Expected income tax consequences

Although no official guidance has been published to date (and a recent unofficial USDA statement seems wide of the mark as to income tax consequences), here are the expected income tax consequences –

It is anticipated that cost-share payments for the adoption or maintenance of management and vegetative practices will not be excludible from income.<sup>14</sup> The exclusion provision is limited to cost-sharing for “capital improvements.”<sup>15</sup> If there are expenses associated with such practices, those may be deductible as soil and water conservation expenses if the taxpayer is “engaged in the business of farming.”<sup>16</sup> That would be a problem for cash rent landlords.<sup>17</sup> It’s also possible that the expenses incurred could be deducted as ordinary farm expenses for carrying on the trade or business of farming.<sup>18</sup>

Cost-share payments for the adoption of land-based structural practices should be eligible for exclusion from income *if the practice is a capital improvement*.<sup>19</sup> That’s an election and those who don’t want to exclude the payments from income (for example, because it involves a 20-year recapture provision if the property is disposed of within that period) may elect out of the exclusion.<sup>20</sup> Landlords – of all types – are eligible for the exclusion.<sup>21</sup>

Annual payments otherwise should be treated as conservation reserve program payments have been handled --- as ordinary income and subject to social security tax.<sup>22</sup> There’s still uncertainty over whether retired landowners would have to pay self-employment tax on the amounts received, based on two conflicting IRS rulings, one in 1988 and one in 2003.<sup>23</sup> In a June 8, 2004 conference with the Commissioner and staff, the Commissioner provided assurance that an attempt would be made to harmonize the conflicting rulings. That has not occurred to date.

### In conclusion

Several watersheds across the country have been approved for CSP contracts. More areas are expected to become eligible if funds are available. Guidance from IRS is critically important for those facing income tax reporting of payments under the program.

### Footnotes

<sup>1</sup> See generally 4 Harl, Agricultural Law §§ 27.03[4][a], 28.04[2], 28.05[17] (2005); Harl, Agricultural Law Manual §§ 4.02[1], 4.03[1] (2005).

<sup>2</sup> See Farm Security and Rural Investment Act of 2002, Pub. L. No. 107-171, 116 Stat. 134 (2002), enacting the Conservation Security Program, Act § 2001 and the Grasslands Reserve Program, Act § 2401, and amending and extending other conservation programs.

<sup>3</sup> Farm Security and Rural Investment Act of 2002, § 2001, 116 Stat. 134 (2002).

<sup>4</sup> *Id.*, § 2001, adding Food Security Act of 1985, § 1238A(d)(1)(A).

<sup>5</sup> *Id.*, § 2001, adding Food Security Act of 1985, § 1238A(d)(5).

<sup>6</sup> *Id.*, § 2001, adding Food Security Act of 1985, § 1238C(b)(1).

<sup>7</sup> *Id.*, § 2001, adding Food Security Act of 1985, § 1238C(b)(2).

<sup>8</sup> See note 5 *supra*.

<sup>9</sup> See note 6 *supra*.

<sup>10</sup> See note 7 *supra*.

<sup>11</sup> See note 5 *supra*.

<sup>12</sup> See note 6 *supra*.

<sup>13</sup> See note 7 *supra*.

<sup>14</sup> I.R.C. § 126. See Temp. Treas. Reg. § 16A.126-1(a).

<sup>15</sup> *Id.*

<sup>16</sup> I.R.C. § 175. See Treas. Reg. § 1.175-3.

<sup>17</sup> *Id.*

<sup>18</sup> See I.R.C. § 162.

<sup>19</sup> See note 14 *supra*.

<sup>20</sup> See Temp. Treas. Reg. § 16A.126-2(a).

<sup>21</sup> Ltr. Rul. 9014041, January 5, 1990 (no mention in ruling of type of lease; apparently, type of lease not relevant).

<sup>22</sup> See 4 Harl, *supra* note 1, § 27.03[4][e].

<sup>23</sup> Compare Ltr. Rul. 8822064, March 7, 1988 (landowner’s activities in retirement did not constitute material participation; no self-employment tax due) with CCA Ltr. Rul. 200325002, May 29, 2003 (landowner’s signup for CRP constituted material participation and self-employment tax due).