Overview

Water quality in Iowa has been in the spotlight for many months. In honor of soil and water conservation week, we are addressing a topic that comes up frequently: What is the tax treatment for various water quality measures rural landowners or farm operators can implement? Are there some measures that would be more advantageous than others, from a tax point of view? This article—not meant to provide in-depth treatment of this somewhat complex topic—provides a general overview of the tax implications of various water quality measures, specifically those targeting nitrogen reduction.

Using the Iowa State University Publication, *Reducing Nutrient Loss: Science Shows What Works* as a guide, we review common practices, in turn, for their tax consequences.

Nitrogen Management through Cover Crops

One of the key strategies for reducing nitrate concentration in row crop farm ground is to plant *cover crops*. If a farm operator plants cover crops, he may deduct the cost of the seed and/or fertilizer as a trade or business expense in the year he plants the cover crop.[i]

Cost Share: Often, cost sharing programs are available to fund these practices. If a farmer receives an EQIP payment, for example, to cover the cost of the cover crops, that payment would be treated as ordinary income, subject to self-employment tax. Cost-sharing payments are only eligible for income exclusion under the tax code if the payment is not associated with a deductible expense. [ii]

Land Use

CRP

Another option for improving water quality is to enroll targeted lands in the *Conservation Reserve Program* (CRP). Under this program, farm operators or landowners receive annual payments for contractually agreeing to keep CRP-enrolled parcels out of production. CRP payments are typically reported as Schedule F Income, subject to self-
employment tax. As part of the 2008 Farm Bill, however, Congress has specifically excluded CRP payments to recipients of Social Security benefits (retirement or disability) from the definition of self-employment income. As such, Social Security recipients must include their CRP payments as Schedule F income. They are not, however, required to pay Self-Employment Contributions Act (SECA) taxes on this income. While recent litigation has called into question whether certain non-farmers who receive CRP payments are liable for SECA, IRS has taken the position that they are for all taxpayers outside the Eight Circuit and for taxpayers in the Eighth Circuit who have received CRP payments since 2008. For more information on this issue, please read the IRS Action on Decision and this TaxPlace article.

Cost Share: Cost-share payments received under the CRP may be eligible for income exclusion to the extent permitted under IRC §126 (see below).

Conservation Easements
Conservation easements can be an effective method of enhancing or maintaining water quality. These binding agreements implementing permanent land use restrictions can be purchased or donated or they may be implemented through a combination of both.

Purchased
A purchased easement would include, for example, a Wetland Reserve Easement purchased from a landowner by the Natural Resources Conservation Service (NRCS). Permanent and 30-year easements are treated for tax purposes like a sale of the property. The landowner would reduce his or her basis in the property in the amount of the purchase price of the easement. Any amount below zero would be IRC § 1231 gain reported on Form 4797. It is taxed at long-term capital gains rates as long as the property was owned for more than one year. Easement payments offered for easements in place less than 30 years are taxed as ordinary income. Easement payments are not subject to self-employment tax.

It should be noted that easements granted for 30 years or more can qualify for like-kind exchange treatment under IRC § 1031.

Donated
Landowners can also donate conservation easements for the purpose of improving water quality. Such an easement, for example, might allow for the implementation of a wetland on a portion of current crop ground. If tax code requirements are met, the landowner can claim the deduction as a charitable contribution and recognize significant tax savings. This is a complex area of tax law that requires the assistance of an experienced tax practitioner. IRS evaluates these donations very carefully to ensure they are not "abusive transactions." To recognize the tax benefit, a donated conservation easement must be a legally binding, permanent restriction on the use, modification, and development of the property. As such, the land use restrictions will bind all current and future owners.

Under the tax code, a qualified conservation contribution is a donation of a (1) qualified real property interest to a (2) qualified organization, (3) exclusively for conservation purposes. A "qualified real property interest" is one granting a restriction on the use of real property granted in perpetuity. A "qualified organization" is defined by regulation as a governmental or charitable organization committed to protecting the conservation purposes of the donation. Easements with a "conservation purpose" include easements that:

- Preserve land areas for outdoor recreation by, or the education of, the general public.
- Protect a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem.
- Preserve open space (including farmland and forest land) for a public benefit, including those donated for a use consistent with public programs to protect water supplies or maintain or enhance water quality.
- Preserve of a historically important land area or a certified historic structure.

Generally, a donor of a qualifying conservation easement can deduct the value of the easement in an amount up to 50 percent of the donor’s adjusted gross income if the land can no longer be used for farm and ranch purposes.
land can continue to be used for farming, however, the deduction can be in an amount up to 100% of adjusted gross income. A 15-year carry-forward provision allows contributions in excess of the limitation to be carried over to future tax years. The Protecting Americans from Tax Hikes Act of 2015 made these conservation easement tax benefits permanent.

**Edge-of-Field Practices**

**Saturated Buffers, Diversion Ditches, Filter Strips, Grade Stabilization, Terraces, etc.**

Active farmers may be able to presently deduct the cost of conservation practices implemented as part of an NRCS (or comparable state)-approved plan. The IRC § 175 soil and water conservation deduction (which is taken in the year the improvements are made) can be elected for conservation expenditures in an amount up to 25 percent of the farmer’s gross income from farming. The deduction can only be taken for improvements made on “land used for farming.” Excess amounts may be carried forward to future tax years. Non-farming landowners (such as those who cash rent their ground) must capitalize these expenses (add the cost of the improvement to the basis of the property) because the IRC § 175 deduction only applies to taxpayers “engaged in the business of farming.”

**Note:** The IRC § 175 deduction is not available for the purchase of depreciable assets (those that have a useful life). Furthermore, the cost of seed and other “ordinary and necessary” business expenses would be deductible in the year expended as ordinary business expenses, apart from IRC § 175.

**Cost share:** Cost sharing or incentive payments received to implement these conservation programs would be taxed as ordinary income. The IRC § 126 income exclusion provisions (see below) only apply to depreciable capital assets.

**Drainage Water Management**

Some water quality measures may involve drainage water management. Drainage tile modifications or installations are generally depreciable over a 15-year period. This should include the cost of most water control structures that are part of the system and the cost of the installation. Materially participating operators would also be eligible for IRC § 179 expensing and 50 percent bonus depreciation for the cost of new tile installation. Non-materially-participating landowners could also depreciate the cost of the drainage tile improvements over a 15-year period. Although they would not be eligible for IRC § 179 expensing (since they are not in the business of farming), they would be eligible for 50 percent bonus depreciation for the cost of new tile.

**Cost share:** Cost sharing or incentive payments would be taxed as ordinary income, unless determined to be excluded from income under IRC § 126 (see section below). This might be especially useful for non-farming landowners not eligible for IRC § 179 expensing.

**Bioreactors**

Bioreactors have become a very popular tool for removing significant amounts of nitrates from water passing out of a drainage tile system. These structures can cost thousands of dollars and don’t increase production or otherwise improve the bottom line of a farming operation. As such, economic incentives to implement bioreactors are particularly important.

A bioreactor does not show up on any MACRS table. It would likely be depreciated over a seven-year period. Materially participating producers installing a bioreactor would be eligible for Section 179 and 50 percent bonus depreciation. Non-materially-participating landowners could likely depreciate the cost of the bioreactor over a 7-year period (as equipment) and would be eligible for 50-percent bonus depreciation.

**Cost share:** Cost sharing or incentive payments could likely be excluded under IRC §126 (see section below). This might be especially useful for non-farming landowners not eligible for IRC § 179 expensing.
Cost-Share Payment Exclusion

IRC § 126 provides for the exclusion of income for certain cost-sharing payments made pursuant to a recognized federal or state conservation, reclamation, or restoration program. The cost-sharing exclusion provisions do not apply to expenses a taxpayer can deduct in the year of purchase. The § 126 exclusion was put into place for capital assets, such as a concrete erosion control structure, built in furtherance of recognized conservation programs. This incentive was implemented to prevent farmers or landowners from having to recognize excessive income in the year the cost-sharing payment was made since the cost of such improvements could only be depreciated over years. Since these structures or devices enhance conservation, but typically do not increase farm income, IRC § 126 was designed to offset the financial disincentive.

To qualify for IRC § 126 income exclusion, four “tests” must be met:

1. The payment must be made pursuant to a “qualifying program.”
2. The cost-sharing payment must be for a capital expense. Payments for a presently deductible expense are not covered by IRC § 126.
3. The payment must not substantially increase annual income from the property for which it is made. An increase in annual income is substantial if it is more than the greater of the following amounts.
4. The Secretary of Agriculture must certify that the payment was primarily made for conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.

The provision is complex, but generally, the amount of the cost-sharing payment that the taxpayer may exclude from income is the present value of the greater of:

1. Ten percent of the average annual income derived (gross receipts) from the affected property for the last three years or
2. $2.50 times the number of affected acres.

The taxpayer is responsible to define the “affected property.” The larger the area defined, the greater the income exclusion amount. Section 126 applies to operating farmers and crop share or cash rent landowners, as well as rural non-farming landowners. Taxpayers claiming this exclusion must attach a statement to their tax return including the (1) dollar amount of the government payment, (2) the value of the improvement, and (3) the amount the taxpayer is excluding. Cost-share payments are reported on Schedule F, line 4a, with the taxable amount reported on line 4b.

It’s important to realize that payments excluded from income are subject to income recapture in much the same way as excess depreciation or expense deductions. If a taxpayer who claims a § 126 income exclusion for a cost sharing payment sells or otherwise disposes of the property within 20 years of receiving the excluded payment, he or she must treat as ordinary income all of the cost-sharing payments excluded. It should also be noted that taxpayers cannot take depreciation, amortization, or depletion deductions for the part of the cost of the property for which cost-sharing payments were excluded from income.

Access a summary table of this article here.

[i] IRC § 162.
[ii] IRC § 126(b).
[iii] IRC § 1402(a)(1).
[iv] IRC § 170(h).

[vii] IRC §170(b)(1)(E)(this amount is technically equal to the excess of 50% of the taxpayer’s contribution base over the amount of all other allowable charitable contributions. AGI is computed without regard to any net operating loss carryback).

[viii] 100% of the taxpayer’s contribution base over the amount of all other allowable charitable contributions. AGI for this purpose is computed without regard to any net operating loss carryback.

[ix] There is no limit on the number of carryforward years.

[x] A bioreactor or water control structures, if implemented pursuant to a qualifying program should be eligible for cost-sharing income exclusion treatment.

[xi] Enhanced federal section 179 and bonus depreciation provisions may for some eligible improvements overcome such disincentives for materially-participating farmers. Non-farming landowners would benefit especially from the cost-sharing income exclusion provisions in such cases.


[xiii] Publication 225 contains a list of qualifying programs.

[xiv] See Publication 225 for further information.