MARYLAND COOPERATIVE EXTENSION
UNIVERSITY OF MARYLAND
COLLEGE PARK•EASTERN SHORE

Fact Sheet

Fact Sheet 794

Taxes & Costs-share Payments for Soil & Water Conservation Expenses

Many farmers have adopted soil and water servation practices. These practices prevent erosion, protect water resources, assist in improving the water quality in the Chesapeake Bay, and provide or protect wildlife habitat. A myriad of local, state, and federal programs exists to the cost of implementing these practices farmland owners.

Many of the practices encouraged by the passage of the Maryland Water Quality Improvement Act of 1998 may be partially financegB'y cost-share programs to increase their adoption. The cost-share payments provided by the programs are considered income by the Intgmal Revenue Code. The programs will usually supply farmers with a Form 1099-G, which reports the amount of payment received. Payments can also be received as materials and services. While both of these payments must be reported as income, most farmers can deduct their soil and wyr conservation expenses. In addition, some types of cost-share payments for capital improvements such as structures and facilities that can be depreciated can be excluded from income. (See Excluding Cost-share Payments below.)

This fact sheet provides some basic information about cost-share payments for soil and water conservation practices. To answer quesitons aobut specific situation, you should consult with your tax tax attorney or accountant. The Internal Revenue Service (IRS) *Farmer's Tax Guide* contains addtional informationa in Chapter4, "Farm Income"; Chapter 6, 'Soil and Water Conservation Expenses"; and Chapter 20, "Sample Return".

Report Payments on Schedule F

You should report the cost-share payments received and listed on Form 1099-G on Line 6a and 6b of your Schedule F (Form 1040), "Profit or Loss from Farming," as part of Agricultural program payments. The program will report the payment amount to the Internal Revenue Service as income.

For example, you installed grass buffers on 10 acres at a cost of $500 per acre or a total of $5,000 under the Conservation Reserve Enhancement Program (CREP). If you received cost-share pay- ments equaling 95 percent of this expense, you will receive aL1099-G from the U.S. Department of Agriculture (USDA) and a 1099-G from the Maryland Department of Agriculture Agricultural Cost-Share Program (MACS) for $4,750. You must report this amount as income on line 6a of Schedule F.

You report the actual expenditures related to the soil and water conservation practices on line 14. You can claim thie full cost of the practice installation rather than just the cost-share payment. The grass buffers installed above cost $5,000 for the 10 acres and you can report the full $5,000 as the expenditure even though the cost- share payment was only 95 percent or $4,750. Thus, deductible expenses are more than the revenue from the cost share. The project must fit certain criteria explained below. Deduction cannot exceed 25 percent of gross farm income. In addition, this provision is only open to farms and farmers following an approved individual or county-level conservation or water quality plan.

What Conservatioh Expenses Are Deductible?

Conservation expenses are deductible if they are on farmland.[1] You must keep these conservation expenses clearly distinct from your ordinary expenses in your farm records. Deductible conservation expenses include earth movement or treatment such as leveling, conditioning, grading, terracing, contour furrowing, and restoration of soil fertility. They also include the construction, control and protection of diversion channels, drainage ditches, irrigation ditches, earthen dams, riparian buffers, and watercourses, outlets and ponds that include filter strips. If you do not deduct these expenses as soil and water conservation expenses, they are added into the basis of the land.

If you installed 5 acres of riparian forest buffer on your property and incurred the expense of $800 per acre in 2000, you can declare $4,000 on line 14 of Schedule F.

The costs associated with draining or filling wetlands are not deductible as soil and water conservation expenses. Neither are the expenses to prepare land for center pivot irrigation systems. Expenses for clearing the brush off of farmland and for removing sediment from drainage ditches are deductible as ordinary farm expenses, not as soil and water conservation expenses.

If you spend money for depreciable conservation assets, you cannot deduct these costs as soil and water conservation expenses.[2] Expenditures for structures or facilities subject to a depreciation allowance must be capitalized. These structures include tanks, reservoirs, pipes, conduits, canals, dams (earthen terraces and dams are deductible), wells, or pumps. The IRS stipulates that the cost of items such as materials, supplies, wages, fuel, or hauling and moving dirt incurred when making the structures cannot be deducted. You can recover these expenses through annual depreciation. Information about depreciation can be found in the IRS *Farmer's Tax Guide*, Chapter 8, "Depreciation, Depletion, and Amortization."

Sometimes the adopted practices impact land y, that is not considered farmland. If that is the case, the expenses have to be allocated between the two types of land. For example, if you implement a practice on your 150-acre parcel, of which 100 acres is farmland, therf'only two-thirds (1OO acres) of the expenses incup'ed on the farm can be. deducted on line 14.

Plan Certification

To deduct these expenses, the implemented practices must be consistent with a plan approved by the USDA Natural Resources Conservation Service (NRCS) or with a comparable state agency such as Maryland Department of Agriculture or Department of Natural Resources. NRCS-approved plans and state agencies' approved plans can be designed specifically for your farm parcel. Alternatively, a county-level plan may be available that fits most farms in the area. These plans will list approved conservation practices for the area where you farm. You can deduct expenses incurred for these approved practices.

Limit on Deductions

You can only deduct up to 25 percent of your gross farm income in any given tax year for conservation expenses. However, you can carry over the expenses into future years. For example, say your gross farm income in 2000 was $25,000. During the year, you purchased materials and services for conservation practices equal to $8,250. You can deduct expenses up to 25 percent of the gross farm income ($25,000), or $6,250. The difference between what you spent and what you are able to deduct in the 2000 tax year is $8,250 minus $6,250, or $2,000. This $2,000 can be carried over and deducted in later tax years. The carryover is also subject to the 25 percent of gross farm income rule.

Gross farm income includes receipts for the production of crops, fish, fruits, other agricultural products, or livestock. You may include any gains from the sale of livestock that were held for draft, breeding, or dairy listed on Form 4779 in calculating the gross farm income. For example, if you sell $5,000 of breeding stock, your total gross farm income in the example above is $30,000. Then, you can deduct $7,500 and only carry over $750. On the other hand,-you cannot include any gains from the sale of timber, farm machinery, or farmland. [3]

If you choose to deduct the oil and water conservation expenses on your tax returns, you must deduct the full allowable amount in the year the expenses are incurred. If you do not deduct the expenses, you must capitalize them.

The soil and water conservation expenses that you deducted can be recaptured as ordinary income (rather than as a capital tain) if you sell or give the land to another less than five years after the deductions are taken. In addition, if you own the land more than five years but less than ten years, these deductions will be partially recaptured as ordinary income rather than as a capital gain. This computation is discussed in Chapter 11, "Disposition of Property Used in Farming," in the IRS Fanner's Tax Guide under Other Gains.

Changing from Capitalization to Deduction

If you had been capitalizing these expenses and you now wish to change your method of treating soil and water conservation expenses to deduct them, you need to get approval from the IRS. You can change the method for a specific project or on a permanent basis. You must request approval by the due date of your return for the tax year you want the new method to apply. So if your return is due on April 15, 2001, for the tax year 2000, you need to write a letter requesting a change for tax year 2000 by April 15, 2001. On the request, you must include your name and address, the first tax year to which you want the method to apply, whether the method will apply to all soil and water conservation expenses or only to those of a particular project, the amount you spent, and a statement verifying that you have kept a separate accounting of the expenses from your normal farm books.

Excluding Cost-share Payments from Income

Some cost-share payments may be excluded from income if they satisfy the following three criteria:

1. The expenses were for a capital expense such as structures or facilities that cannot be deducted in the year you paid them. If you are able to deduct the expenses for the conservation practice as described above, then you need to report the cost-share income on line 6a and deduct the expenses on line 14.
2. The cost-share payments did not substantially increase your annual income from that farm parcel. If your average annual income increased more than 10 percent due to the conservation practice, you must claim the cost-share payments. For example, if the practice pennits more land to be farmed (reclaims land) or increases yield on farmland substantially, your income may increase substantially.
3. The Secretary of Agriculture certifies that the payment was for conserving soil and water resources, protecting or restoring the environment, improving forests, or providing wildlife habitat.

If these criteria are met, you can exclude the payments from reported income. If you do exclude these payments, however, part or all of these excluded payments will be "recaptured" as ordinary farm income4 if you sell or dispose of your land within 20 years. In addition, you can take no deductions for the practices adopted if you choose not to report the cost-share payments as income. You should discuss excluding these payments with your tax attorney or accountant to determine if this is the best strategy for you to take.

If you choose to exclude a payment, attach a statement to your tax return outlining the value of the improvement made, the government contribution to the cost, and the amount you are excluding from your income. If you excluded a payment and now wish to declare the payment, you can file an amended return within six months of your due date for your taxes. Write "Filed pursuant to section 301.9100-2" at the top of the new return.

If these three criteria are met, then the following programs' payments can be excluded:

- Federal Water Pollution Control Act's Rural Clean Water Program
- Surface Mining Control and Reclamation Act's Rural Abandoned Mine Program
- Water Bank Act's Water Bank Program
- Agricultural Credit Act's Emergency Conservation Measures Program
- Soil Conservation and Domestic Allotment Act's Agricultural Conservation Program
- Bankhead-Jones Farm Tenant Act's Resource Conservation and Development Program
- Cooperative Forestry Assistance Act's Forest Incentives Program (FIP)
- State programs that conserve soil, protect or restore the environment, improve forests, or provide wildlife habitat. For example, USDA determined that cost-share payments from the Maryland Agricultural Cost-Share Program (MACS) "are for soil conservation, or protecting or restoring the environment." Therefore, "this permits payment recipients to exclude from gross income, for federal income tax purposes, all or part of such payments made under the Maryland Agricultural Cost Share Program after July 1, 1983." (Federal Register, 12/10/84). Payments from the Maryland Non-Structural Shore Erosion Control Cost-Share Program are also exempt.[5]

In addition, you can exclude payments from:

- Stewardship Incentive Program (SIP)
- Watershed Protection and Flood Prevention Act's program
- Flood Control Act's flood prevention projects
- Emergency Watershed Protection Program
- Wetlands Reserve Program
- Environmental Quality Incentive Program (EQIP)
- Wildlife Habitat Incentives Program (WHIP)

Conclusion

Soil and water conservation practices on agricultural parcels have wide-reaching benefits to farmers and the general public. The tax provisions outlined in this fact sheet were enacted to provide additional incentives and remove disincentives for farmland owners to implement such practices. Landowners should consider both the available cost-share programs and these tax provisions to determine the long-run economic benefits they may experience with implementation of the many conservation practices.

References

Internal Revenue Service. Fanner's Tax Guide, 2000. http://www.irs.gov

United States Federal Register, December 10, 1984.

Footnotes

[1] Farms are defined in the IRS Farmer's Tax Guide. Land with forest-related production (timber and Christmas trees) and farms cultivated for recreation and pleasure are not eligible.

[2] If the expenses are due to an assessment that a soil and water conservation or drainage district levied against your farm, you may be able to get an exception and deduct these costs.

[3] Landowners who rent the land under a cash rental agreement are not eligible to deduct soil and water conservation expenses. They can, however, add the cost of the conservation practices to the basis of the land.

[4] In the year of sale or passing on of the farm, you would report the payments as ordinary income on Form 4797.

[5] The Commerce Clearing House can be used for lists of Notices of Determination; however, you must look far enough back for earlier determinations.

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