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Income Tax Implications for Farmers Receiving New York City Watershed Agricultural Program Payments

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I. Background

Farmers receiving cost-sharing payments from the Delaware County Soil and Water Conservation District as part of the New York City Watershed Agricultural Program (WAP) may be able to exclude all or part of program payments received from gross income for federal and state income tax reporting purposes.

Special tax treatment of WAP payments for capital projects was made possible under Internal Revenue Code (IRC) Section 126. Under IRC Section 126 the U.S. Secretary of Agriculture must determine that cost-share payments are primarily for the purpose of conserving soil and water resources, protecting or restoring the environment, improving forests, or a habitat for wildlife. The United States Secretary of the Treasury (or his delegate usually the Internal Revenue Service) must determine that program payments will not substantially increase the annual income derived from the property.

The U.S. Secretary of Agriculture has determined that WAP payments for the purchase and installation of capital improvements are primarily for soil and water conservation, protecting or restoring the environment, and improving the water quality of the New York City water supply system. This cleared the way for WAP payments to receive IRC Section 126 tax treatment.

In addition to the blanket Secretary of Agriculture determination, the Internal Revenue Service **on an individual taxpayer basis** will determine that payments made for the implementation of capital improvements do not substantially increase the annual income derived from the property that was improved. An increase in annual income is deemed to be substantial if it exceeds the greater of 10 percent of the average annual income derived from the affected property prior to receipt of the improvement, or an amount equal to $2.50 times the number of affected acres. The number of affected acres can be as little as the acres of a field to which a diversion is installed, or the total acreage of the farm with a comprehensive practice such as a manure storage facility that affects both crops and livestock. Very little guidance has been provided by the IRS relating to the determination of affected acreage. The lack of IRS direction on affected acreage is especially true for non-traditional water quality practices such as, barnyard water management systems, calf housing facilities, milkhouse waste systems and fuel storage facilities.

To the extent that IRC Section 126 exclusion applies, program participants must so indicate on an attachment to their tax return (or amended return) for the tax year they receive the last payment for the improvement. Program participants must state the dollar amount of the IRC Section 126 cost funded by the WAP payments, the value of the IRC Section 126 improvement, and the amount they are excluding under IRC Section 126.

Payments for projects that are allowable as a deduction for the taxable year on which they are paid may not be excluded from income under IRC Section 126. For example, payments used to pay for crop expenses are not excludable. The crop expenses can be deducted in the year they are incurred and will offset the program payments reported as income.

The basis of property to which capital improvements are implemented cannot be increased by the amount of excludable program payments.

II. Determining What Portion of WAP Payments for Capital Improvements Can Be Excluded From Gross Income

A. Under IRC Section 126, the amount included in gross income is **the value of the IRC Section 126 improvement** reduced by the **taxpayer's share of the cost of the improvement** and reduced by the **excludable portion.**

B. The **value of the IRC Section 126 improvement** is **the fair market value of the improvement** multiplied by the following fraction (cost percentage):

The **numerator** is the total cost of the improvement minus:

1) the portion of the government payment that is **not for conservation purposes,**
2) the portion of the government payment that **is compensation or rent to the taxpayer for services** and,
3) the amount that the taxpayer can **claim as a current deduction**;

The **denominator** is the total cost of the improvement.

C. The **excludable portion** is the "present fair market value" of the greater of:

1) $2.50 per acre, or
2) 10% of the average annual gross receipts from the affected property for the last three tax years before the tax year in which the installation of the improvement started.

To calculate the present fair market value -- the result of the larger of 1 or 2 above is divided by the program participants opportunity cost of capital (applying generally accepted finance theory the present value of a stream of earnings is determined by dividing the annual income to be received by a discounting factor. The discount rate may be the businesses cost of capital if the business is in debt or the return on an investment of similar risk if the business has no debt).

If all or part of WAP payments are excluded under IRC Section 126, all or part of the amount excluded may be treated as ordinary income under a recapture rule similar to the Section 1245 and 1250 recapture rules. Recapture may occur when improvements are sold, or when the land to which improvements have been made is sold. The recapture rules for excluded cost-sharing (WAP program payments) are set out in IRC Section 126. The recapture is reported on Form 4797.

Under these recapture rules, all the excluded payments must be reported as ordinary income to the extent that there is a gain upon the sale of the property within 10 years of receiving the payment. Gain in excess of the excluded payment is treated as capital gain.

If the property is sold more than 10 years after the last payment is received, then only a portion of the excluded payment will be treated as ordinary income. The portion is a percentage determined by reducing 100% by 10% for each year, or partial year, the property is held for more than 10 years.

WAP participants can avoid recapture by electing to include the excludable portion in income. If the program participant elects under IRC Section 126(c) not to have the IRC Section 126 apply to all program payments received, the income realized on the receipt of the IRC Section 126 improvement is the value of the IRC Section 126 improvement, less the sum of the taxpayers share of the cost of the improvement. Program participants can elect to include the excludable portion in income qualifying under IRC Section 126 for any or all payments received. The election not to have IRC Section 126 apply must be made not later than the due date (including extensions) for filing the return in the year in which the WAP payment is received.

III. Farmer/Owner Example

In June of 1994, as part of his whole farm plan Fred Farmer received $30,000 in WAP program (cost sharing) payments from the Delaware County Soil and Water Conservation District to reimburse him for the cost of the conservation practices. Fred received $27,000 in cost-sharing payments to construct a barnyard water management system, and $3,000 for crop expenses to establish new seedings. The payment was reported to the Internal Revenue Service and to Fred Farmer by the Delaware County Soil and Water Conservation District. Fred determined that the capital improvements increased the value of his farm by $10,000 (Fred figured that lost capital was substantial ($17,000) since the improvements did not improve the productive capacity of his farm). Fred received no WAP payments for services. The improvements were made on Fred's 300 acre farm, and Fred had average annual gross receipts from farming of $150,000 for the years 1991-93. Since Fred determined the manure handling facility and barnyard would affect his total farm system, he deemed the affected acreage to be the total farm acreage. Fred's taxable income is $20,000 for 1994 not including tax ramifications of receiving WAP program payments. Fred is a calendar year taxpayer, is married and files jointly.

1. Calculating the portion of WAP payments that Fred can exclude from gross income in 1994:

Since the $3,000 received for crop expenses to establish new seedings can be expensed in 1994, Fred should include the $3,000 in program payments as income and report the associated crop expenses on Schedule F for the 1994 tax year.

The following details the tax implications of Fred receiving program payments for IRC Section 126 capital projects:

A. Value IRC Section 126 of Improvement =

Fair market value of the improvement	$10,000	
Total cost of improvement	$30,000	
minus Portion not for conservation	$ 0	
minus Compensation for taxpayer services	$ 0	
minus Amount Fred can claim as a current deduction	$ 3,000	
= IRC Code Section 126 cost	$27,000	divided by
Total cost of the improvement	$30,000	
= IRC Code Section 126 cost percentage	90%	multiplied by the fair market value of the improvement
= Value of IRC Section 126 improvement	$ 9,000	

B. Excludable Portion = the greater of the "present fair market value" of:

1) $2.50 per affected acre = 300 acres x $2.50 = $750, or
2) 10% of average annual gross income from the affected acreage = 10% x $150,000 = $15,000.

Since 10% of average annual gross income from the affected acreage ($15,000) is greater than $750, Fred must calculate the present fair market value of $15,000. Fred does this by dividing $15,000 by his opportunity cost of capital which he estimates to be 8%. Therefore his excludable portion is $187,500 ($15,000/.08).

C. Amount Included in Income =

Value of the IRC Section 126 improvement	$ 9,000
minus Fred's share of the cost	$ 0
minus Excludable portion	$187,500
= Amount included in income	$ 0

Since Fred initially calculates the amount to be included in income to be negative (-178,500), the amount to be included in income is in effect zero. Fred is not required to include the WAP payments in gross income.

2. Calculating the tax ramifications if Fred sells the farm in July of 2004 for $225,000:

Fred holds the farm more than ten and less than eleven years after having received the WAP payments. He sells the farm for $225,000 and has a basis in the property of $25,000. Fred's gain on the sale of the farm is $200,000 ($225,000 sales price less basis of $25,000). Fred has no depreciation to recapture, but 90 percent of the $27,000 in WAP program payments received ($24,300) must be recaptured as ordinary income. The remaining $175,700 of gain on the farm sale will be treated as capital gain. The $24,300 recapture does not add to the amount of gain reported, it shifts $24,300 of gain from capital gain to ordinary income. Using 1994 federal income tax rates Fred determines the taxes paid on $24,300 recaptured as ordinary income are $8,748 ($24,300 x 36% marginal tax rate on ordinary income). Fred calculates that his taxes at the maximum capital gain tax rate would have been $6,804 ($24,300 x 28% maximum capital gains tax rate). Fred's added taxes as a result of the recapture of program benefits is $1,944 ($8,748-6,804).

3. Tax ramifications if Fred decides not to exclude program payments from gross farm income:

The economic analysis of Fred's decision whether or not he should elect to include program payments in income is based on comparing the present value of taxes paid on $9,000 (the value of the IRC Section 126 improvement) of income declared in 1994 less the tax advantage of additional depreciation and potential remaining basis in the year Fred sells his farm, versus the present value of potential increased taxes paid on the recapture of program payments as ordinary income in the year of sale. (Note: Tax rates on capital gains and ordinary income will likely change over time. 1994 tax rates were used for this analysis). For the purposes of this example, Fred assumes he will be selling the farm July 2004 as in Part III.2. above.

First, Fred would include the $3,000 received for the establishment of new seedings as ordinary income. He would report the cost of seedings as an operating expense. This reporting is no different than the scenario in which Fred decides to exclude the receipt of program payments under IRC Section 126.

Second, Fred calculates the value of the IRC Section 126 improvement as shown previously in Part III.1.A. The value of Fred's IRC Section 126 improvement ($9,000) is included in gross income in 1994. Fred's combined federal and NYS income and self-employment tax on $9,000 would be approximately $3,363, or 37 percent (Fred includes his $20,000 of ordinary income before receiving WAP payments in determining his tax rates for all years involved in the analysis). Assuming Fred pays the $3,363 of income tax one year after receiving program payments, the present value of this payment (using Fred's after- tax cost of capital, e.g. Fred's borrowing rate, less the tax savings of interest) is $3,200. Fred will be able to depreciate the $9,000 of income reported, over 20 years using MACRS, 150 percent recovery rates. The present value of Fred's additional depreciation for 10 years is $1,434. Fred's present value of tax savings due to remaining basis in the barnyard system in the year of sale is $876. The present value of taxes paid by electing to include WAP payments in income less the tax advantage of depreciation and additional basis upon the sale is $974 ($3,200-$1,434-$876).

In Part III.2. above Fred calculated his additional taxes paid on the recapture of program benefits in the year 2004 will be $1,944. The present value of the $1,944 tax payment is $1,125.

The net present value of Fred's decision to elect to include program payments in income versus electing to exclude is $151 ($1,125-974). If our assumptions are correct, Fred should elect to include program payments in income for the 1994 tax year.

The most significant factors in Fred's analysis of whether or not to exclude program payments are; the amount of lost capital (which affects the value of the Section 126 improvement), the likelihood recapture will be triggered, ability to utilize depreciation, the cost of capital (which affects the discount rate), and future tax rates.

IV. Farmer/Lessee Example

Assume the facts of the case are the same as in the Fred Farmer Example except that Bill Renter is renting the whole farm. The tax computations on the receipt of program benefits would be the same as in the Fred Farmer example. Let's assume that Bill terminates his lease in July of 2004. Bill will have to declare as income the lesser of the amount of WAP payments received for capital projects ($27,000), or the fair market value of the IRC Section 126 improvements in the year of disposition (see IRC Section 16A.1255-1). Bill determined that the fair market value of the improvements in July of 2004 to be $2,000. Bill will report the $2,000 as income for the 2004 tax year.

Since the lessor did not receive program benefits, the payments received by Bill would not directly affect the lessor's tax reporting or liability (unless the improvement was in lieu of a rental payment, see IRC Section 109, and the lessor has no basis in the improvement, see IRC Section 1019). If the program payments increased the subsequent sales price, the lessor would benefit economically from sales proceeds and would in-turn have to pay income taxes on the additional gain (in this scenario the lessor is better off after having paid the additional taxes).

V. Cash Rent Landowner Example

Laura Landowner owns a 200 acre dairy farm in the New York City Watershed for which she has received a fixed cash rent of $7,000 per year for the last three years. In 1995, Jim Renter the tenant had a barnyard water management system installed as part of his whole farm plan. The barnyard improvement cost $25,000. Laura received a WAP payment of $25,000 from the Delaware County Soil and Water Conservation District which was reported by the District to Laura and the IRS. The payment was for capital improvements. Laura deemed the affected acreage to be the total farm acreage. Laura determined that the improvement increased the value of her farm by $10,000.

1. Calculating the portion of WAP payments Laura can exclude from gross income in 1995:

The following details the tax implications of Laura, a cash rent landowner, receiving program payments for IRC Section 126 capital projects:

A. Value IRC Section 126 of Improvement =

Fair market value of the improvement	$10,000	
Total cost of improvement	$25,000	
minus Portion not for conservation	$ 0	
minus Compensation for taxpayer services	$ 0	
minus Amount Laura can claim as a current deduction	$ 0	
= IRC Code Section cost	$25,000	divided by
Total cost of the improvement	$25,000	
= IRC Code Section cost percentage	100%	multiplied by the fair market value of the improvement
= Value of IRC Section 126 improvement	$10,000	

B. Excludable Portion = the greater of the "present fair market value" of:

1) $2.50 per affected acre = 200 acres x $2.50 = $500, or
2) 10% of average annual gross income = 10% x $7,000 = $700.

For the purposes of IRC Section 126, gross income from the affected property is equal to the rent received by the landowner. Since 10% of average annual gross income from the affected acreage is greater than $500, Laura must calculate the present fair market value of $700. Laura does this by dividing $700 by her opportunity cost of capital which she estimates to be 5%. Therefore her excludable portion is $14,000 ($700/.05).

C. Amount Included in Income =

Value of the IRC Section 126 improvement	$10,000
minus Laura's share of the cost	$ 0
minus Excludable portion	$14,000
= Amount included in income	$ 0

Since Laura calculates the amount to be included in income to be zero, she is not required to include the WAP payments in gross income. The tax implications upon Laura's disposition of the farm are calculated in the same manner as detailed in the Fred Farmer example.

VI. Conclusion:

It appears that for many farmers -- much, if not all of WAP program payments for capital projects will be excludable from gross income. The initial exclusion may increase taxable income in later years due to the IRC Section 126 recapture rules. Calculating the tax consequences of the receipt of WAP program payments is relatively complex for the average farm taxpayer. Farmers should acquire the services of a competent professional to assist them with this analysis.

Watershed Agricultural Program Payments
Income Tax Calculation Worksheet
for Taxpayers

A. Value IRC Section 126 of Improvement =

Fair market value of the improvement	$________	
Total cost of improvement	$________	
minus Portion not for conservation	$________	
minus Compensation for taxpayer services	$________	
minus Amount Fred can claim as a current deduction	$________	
= IRC Code Section 126 cost	$________	divided by
Total cost of the improvement	$________	
= IRC Code Section 126 cost percentage	________%	multiplied by the fair market value of the improvement
= Value of IRC Section 126 improvement	$________	

B. Excludable Portion = the greater of the "present fair market value" of:

1) $2.50 per affected acre =

	________	acres
	x $2.50	
	$________	

or:

2) 10% of average annual gross income from the affected acreage =

	$________	gross farm income from affected acreage
	x 10%	
	$________	
The greater of 1) or 2) above	$________	
	÷________%	opportunity cost of capital
= Excludable Portion	$________	

C. Amount Included in Income =

Value of the IRC Section 126 improvement	(A.)	$________
minus Farmer/owner's share of the cost		$________
minus Excludable portion	(B.)	$________
= Amount included in income		$________

Sources:

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Casler, George L. and Smith, Stuart F, Farm Income Tax Management and Reporting Reference Manual, E.B. 94-23, Cornell University, 1994.

Farmer's Tax Guide- For Use in Preparing 1994 Returns, Internal Revenue Service Publication 225, 1993.

Internal Revenue Service Tax Code Section 126, Certain Cost-Sharing Payments.

Internal Revenue Service Tax Code Section 16A.126, Temporary Income Tax Regulations Relating to the Partial Exclusion for Certain Conservation Cost-Sharing Payments.

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OTHER A.R.M.E. EXTENSION BULLETINS

No. 95-15	Dairy Farm Business Summary Central New York and Central Plain Regions 1994	Stuart F. Smith Linda D. Putnam Charles H. Cuykendall Michael L. Stratton
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