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2002 Farm Bill Tax Issues

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Farm Security and Rural Investment Act of 2002 (the Act), which governs Federal farm programs for the next 6 years was signed into law on May 13, 2002. New and existing commodity program payments, conservation incentives, and a revised peanut program will impact farm tax returns for many years. Also, provisions in the 2002 Job Creation and Worker Assistance Act will impact farm returns already filed for 2001 and future years.

The 2002 Farm Bill alters the farm payment program and introduces counter-cyclical farm income support, expands conservation land retirement programs, and emphasizes on-farm environmental practices, relaxes rules to make more borrowers eligible for Federal farm credit assistance, restores food stamp eligibility for legal immigrants, adds various commodities to those requiring country-of-origin labeling, introduces provisions on animal welfare.

Tax Consequences – General Rule

While the new farm bill changes the way commodity program payments are computed, most payments are designed to replace farm income and as such are reported as farm income in the year received on Schedule F, subject to state and federal income tax and self-employment tax. (For tax consequences associated with the Farm Bill buyout of peanut quota, see F-990, "Tax Consequences of the 2002 Farm Bill Mandated Peanut Quota Buyout.")

Example 1: John farmer received $24,500 in wheat program payments and production flexibility contract payments from Farm Service Agency for 2002. John received Form 1099-G for 2002 that included the $24,500 payments received.

Question 1: How should John report these government payments on his 2002 tax return?

Answer 1: John must include the $24,500 as ordinary taxable income and subject to self-employment tax by including that amount on Schedule F, line 6a, Agricultural Program Payments Received, and on line 6b, taxable amount.

Exceptions

Every IRS rule has many exceptions and the general rule (most commodity program payments are reported as farm income in the year received and subject to state and federal income tax and self-employment tax) is no exception.

Disaster Payments and Crop Insurance Proceeds

When a farmer receives disaster payments or insurance proceeds because of destruction of or damage to a specific crop, taxation of the proceeds can be postponed to the following year if all requirements are met. To elect relief from bunched income resulting from crop insurance proceeds, a separate signed statement must be attached to the return for the tax year of destruction or damage. The election can be attached to the taxpayer's original or amended return.

Cost-Sharing Payments Received from the Government

The U.S. Department of Agriculture and some states administer programs under which the government pays part of the cost of projects to enhance natural resource and wildlife protection. Under the Code, gross income does not include the "excludable portion" of these cost-sharing payments. If any property that is acquired, improved, or modified by application of the excluded cost-sharing conservation payments is disposed of prematurely, ordinary income is recaptured. If the taxpayer elects not to have the code exclusion apply to the payment received, the entire payment is includible in gross income in the year received.

Gross income does not include the "excludable portion" of such cost-sharing payments received from:

1. The rural clean water program authorized by the Federal Water Pollution Control Act.
2. The rural abandoned mine program authorized by the Surface Mineral Control and Reclamation Act of 1977.
3. The water bank program authorized by the Water Bank Act.
4. The emergency conservation measures program authorized by the Agricultural Credit Act of 1978.
5. The agricultural conservation program authorized by the Soil Conservation and Domestic Allotment Act.
6. The Great Plains conservation program authorized by the Soil Conservation and Domestic Policy Act.
7. The resource conservation and development program authorized by the Bankhead-Jones Farm Tenant Act and the Soil Conservation and Domestic Allotment Act.
8. The forestry incentive program authorized by the Cooperative Forestry Assistance Act of 1978.
9. Any small watershed program administered by the Agriculture Secretary which is determined by the Treasury to be substantially similar to the above programs, such as (1) the Stewardship Incentive Program (established by

Title XII of the Food, Agriculture, Conservation, and Trade Act of 1990), (2) the Wetlands Reserve Program (WRP) (authorized by Title XII of the Food Security Act of 1985 and reauthorized by the Federal Agriculture Improvement and Reform Act of 1996), (3) the Environmental Quality Incentives Program (EQIP) (established by the Federal Agriculture Improvement and Reform Act of 1996), and (4) the Wildlife Habitat Incentives Program (established by the Federal Agriculture Improvement and Reform Act of 1996).

10. Any program of a state, U.S. possession, political subdivision, or of the District of Columbia, providing payments to individuals primarily for conserving soil, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.

Commodity Credit Corporation (CCC) loans

The CCC program lets the farmer borrow the support price for the farmer's crop against the crop itself. If the market price does not rise above the support price, he will keep the loan proceeds and surrender the crop. If the market price rises above the support price, he may repay the loan and sell the crop for his own account.

If the loan is not repaid, the loan proceeds become income when the CCC takes the crop upon the maturity of the loan (that is, when it becomes part of the producer's pool). Depending on the maturity date of the loan, this could result in bunching of two or (more) years' income in one year and loss of the benefit of deductions for costs of raising the crop.

To prevent this, producers of agricultural commodities may elect to treat loans from the CCC on the security of such commodities as though the commodities had been sold in the year of the loan for the amount of the loan. Thus, instead of a loan, the money advanced to borrowers by the CCC may be treated as the sales price of the commodity pledged for the loan. If the option to treat these loans as income is adopted, this method of treating the loans must be adhered to with respect to all later years, unless IRS approves a change to a different method, Code Sec. 77(b). The election is binding when made. The farmer cannot later file an amended return and reverse his election.

Conservation Reserve Program (CRP) Payments as Self-Employment Income

The Sixth Circuit held that CRP payments received by a farmer are self-employment income. Under the CRP, the Secretary of Agriculture enters into long-term contracts with farm owners or operators to convert highly erodible croplands to soil-conserving uses in return for annual payments. The Sixth Circuit's decision reversed the Tax Court, which had held that the payments were rentals from real estate and were thus excluded from self-employment earnings.

The court said that the CRP payments were farm income, because a sufficient linkage exists between the payments and the farming operations. Taxpayers were engaged in farming before and during the term of their CRP contract, and the contract required them to perform ongoing tasks on the land. The court also held that the CRP payments were not rentals from real estate, despite being designated as "rental" payments in the CRP statute, regulations, and contract. Taxpayers kept control over and free access to their property while the government's access was limited to inspections, Wuebker, Frederick v. Com., (2000, CA6) 85 AFTR 2d 2000-1057, 205 F3d 897, 20 00-1 USTC ¶50254, revg (1998) 110 TC 31.

Conservation Programs

The 2002 Farm Bill emphasizes conservation on working land by increasing funding for the EQIP and establishing a new Conservation Security Program, which pays producers to adopt or maintain practices that address resources of concern. Land retirement programs are expanded placing particular emphasis on wetlands. Funding is expanded for farmland protection. A new Grassland Reserve is created to assist landowners in restoring and conserving grassland. A new provision aims at ensuring regional equity in conservation funding.

Under the 2002 Farm Act, producers can choose from a wide range of voluntary conservation and environmental programs designed to protect a wide range of resources. Like the three previous farm acts, the 2002 Act continues the trend of increasing the size and scope of agri-environmental programs. While programs that support better conservation and environmental management on working land have accounted for less than 15 percent of Federal conservation expenditures over the past 15 years, they receive more than 60 percent of the $17.1 billion increase in conservation spending.

These existing programs get acreage or funding increases:

- The Conservation Reserve Program (CRP) offers annual payments and cost sharing to establish long-term, resource-conserving cover on environmentally sensitive land. The acreage cap is increased from 36.4 million acres to 39.2 million acres. Funding is through the CCC. The Congressional Budget Office estimates increased spending of $1.5 billion over 10 years.
- The Wetlands Reserve Program (WRP) provides cost sharing and/or long-term or permanent easements for restoration of wetland on agricultural land. The acreage cap is increased from 1.075 million acres to 2.275 million acres. The Secretary of Agriculture is required (to the greatest extent practicable) to enroll 250,000 acres per year. Funding is through the CCC. Congressional Budget Office estimates increased spending of $1.5 billion over 10 years.
- The Environmental Quality Incentives Program (EQIP) provides technical assistance, cost sharing, and incentive payments to assist livestock and crop producers with conservation and environmental improvements. EQIP is slated to receive $5.8 billion in CCC funding for fiscal years (FY) 2002-07 and a total of $9 billion over 10 years. Funding is phased up to $1.3 billion annually by FY 2007, compared with annual funding of roughly $200 million per year under the 1996 Farm Act. Additional CCC funding of $250 million over FY 2002-07 is provided for ground and surface water conservation. An additional $50 million (to be made available as soon as practical) is allocated to water conservation activities in the Klamath Basin.
- The Wildlife Habitat Incentives Program provides cost sharing to landowners and producers to develop and improve wildlife habitat. Total CCC funding of $360 million is mandated over FY 2002-07 ranging from $15 million in FY 2002 to $85 million in FY 2005-07 and a total of $700 million over 10 years.

- The Farmland Protection Program (FPP) provides funds to state, tribal, or local governments and private organizations to help purchase development rights and keep productive farmland in agricultural use. Total CCC funding of $597 million is mandated over FY 2002-07 ranging from $50 million in FY 2002 to $125 million in FY 2004-05 and totaling $985 million over 10 years.

New programs will also receive significant funding while expanding the overall scope of USDA conservation programs:

- The Conservation Security Program will provide payments to producers for maintaining or adopting a wide range of structural and/or land management practices that address a variety of local and/or national resource concerns. Conservation Security Program will be funded through the CCC. Congressional Budget Office estimates spending of $369 million for FY 2003-07 and $2 billion over 10 years.
- The Grassland Reserve Program will protect up to 2 million acres of grassland. CCC funding of up to $254 million is available.

Funding shifted toward working land—the increase in funding for conservation on working agricultural land is large relative to the increase in funding for land retirement. Past conservation funding had been skewed toward land retirement and the funding shift is a major change in conservation program emphasis. EQIP and the new CCC are slated to receive new funding of $11 billion over 10 years, compared with a combined increase of $3 billion for CRP and WRP over the same period. This change may lead to a broader array of options and greater flexibility for producers to develop conservation strategies that deliver agri-environmental gains at the lowest possible cost. Greater overall funding should increase the overall level of conservation effort on farms, providing higher benefits from increased environmental quality to consumers.

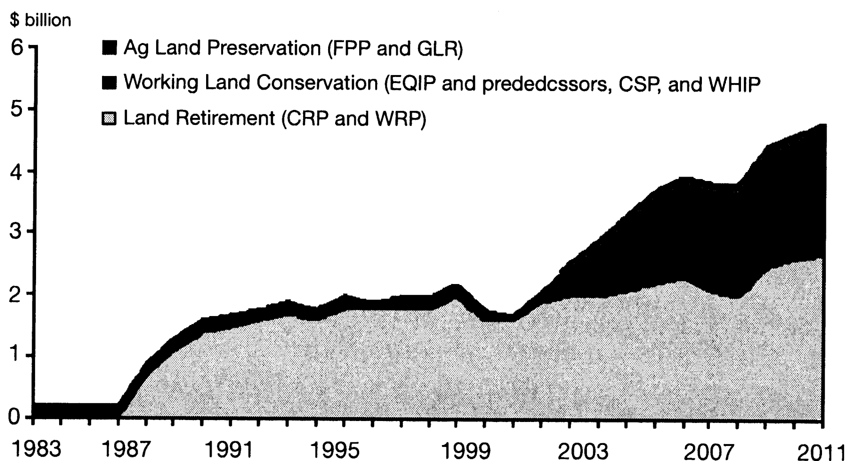
Increase in land retirement to emphasize wetlands— Land retirement programs, principally CRP and WRP, are also expanded. The Act expands authority for land retirement by a total of 4 million acres, an increase of nearly 11 percent over current authority. A significant share of the increase will be devoted to wetland restoration as the WRP enrollment cap more than doubles, increasing from 1.075 million acres to 2.275 million, an increase of 1.2 million acres. In the CRP, 500,000 acres of the 2.8-million-acre increase in the acreage cap could be used to enroll farmed wetlands and associated buffer acreage. Increased land retirement could affect commodity production and prices. Because these programs are voluntary and not commodity-specific, the subsequent commodity output, price, and environmental effects will depend on which producers bid and how bids are selected for CRP or WRP enrollment.

Farmland Protection will receive a major funding increase—FPP will receive 10-year funding of $985 million which represents a nearly twenty-fold increase over the $53.4 million provided since 1996. The cap on enrolled acreage is removed. How much land is ultimately preserved, and the location of that land, depends on a number of factors. FPP money is expended through states, local governments, and private organizations that pay at least 50 percent of the cost of purchasing development rights, so it will protect farmland where those programs or organizations exist. Like CRP and WRP, FPP is a voluntary program, so the location and extent of enrollment—and ensuing environmental benefits—will depend on who submits bids and how these bids are selected for enrollment.

Conservation Programs Tax Consequences

The new and existing conservation programs provide incentives for agricultural producers to conserve natural resources in a variety of ways. If producers meet the many and varied requirements of these programs, they will be rewarded or compensated. Types of payments include:

1. Cost sharing payments
2. Incentive payments



Source: Office of Budget and Policy Analysis, USDA, and the Congressional Budget Office

Figure 1. Conservation emphasis will shift from land retirement to working land.

3. Annual rental payments
4. Temporary easement
5. Permanent easements

Incentive Payments, Annual Rental Payments, and Temporary Easements

Incentive payments and annual rental payments would be reported for tax purposes similar to CRP payments. Temporary easements, less than 30 years, would receive the same tax treatment. Payments would be reported on schedule F, as ordinary income subject to self-employment tax for active farmers and materially participating landlords. Non-materially participating landlords would report income on Form 4835, taxable as ordinary income but not subject to self-employment tax.

Permanent easements

A permanent easement payment (30 years or more) would be treated for tax purposes the same as the purchase of a utility easement. The payment is treated first as a return of basis, with the excess taxed as long-term capital gain.

Sale of a permanent easement raises two important tax issues:

1. How much of the total property has been effected by the easement? Thus how much of the property's total basis is allocated to the easement? The property's basis may be the purchase price, the fair market value at the decedent's date of death if inherited, or the donor's basis if acquired by gift.
2. What is the portion of the total property rights given up in the easement relative to the rights retained by the landowner? Thus how much of the effected property's basis is allocated to the easement?

Example 2: Joan Jones granted the local electric company a permanent easement to build overhead lines and towers across 40 acres of her 200 acre farm. Joan's basis is $500 per acre. The electric company agreed to pay her $45,000 for the permanent easement.

Question 1: How should this transaction be reported on Joan's tax return?

Answer 1: Joan will report the $45,000 received on IRS Form 4797, Sale of Property. She can reduce the gain by the amount of her basis in the affected 40 acres, $20,000. $25,000 would be taxed as long-term capital gain. Rev. Rul. 77-414 does not require Joan to prorate the $20,000 basis between rights given up and rights retained. She is allowed to allocate the full amount of basis for the effected acres.

Example 3: The highway department has decided to build a 4-lane road down the middle of Jane's 160 acre farm. The department plans to fence both sides of the road and will not provide Jane access to the other side of her farm. Jane will receive $60,000 for the easement, which will affect 60 acres of her farm. Jane's basis is $100 per acre.

Question 1: How should this transaction be reported on Jane's tax return?

Answer: Like Joan, Jane's payment of $60,000 will be reported on IRS Form 4797, Sale of Property. It is clear that Joan can reduce the gain by $6,000 her basis in the affected land. However, some taxpayers have successfully argued with IRS, that the basis in all the land can reduce the gain where the easement restricted the taxpayer's rights to all the land and thus the fair market value of all of the land was reduced. If Jane takes this position, her reduction would be $16,000.

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