Woodland owners who receive a cost-share payment from a federal or state government program generally must report the payment as part of their gross income. However, under the provisions of Section 126 of the Internal Revenue Code, the recipients can then choose to exclude from their income all or part of such payments that meet two requirements.

The first requirement is that the Secretary of Agriculture must have determined that the payment is primarily for the purpose of conserving soil and water resources, protecting or restoring the environment, improving forests or providing a habitat for wildlife.

The second requirement is that the Secretary of the Treasury must have determined that the payment does not substantially increase the annual income derived from the property.

Qualifying Payments

For the most part, only cost-share payments made to assist in establishing or reestablishing trees can qualify for exclusion from income under Section 126. Payments for timber stand improvement practices or other silvicultural treatments must nearly always be included in gross income. However, those woodland owners who are engaged in timber growing for profit can then deduct such expenses. The Stewardship Incentives Program (SIP) is an exception to this general rule. Under Revenue Ruling 94-27, all SIP cost-share payments—whether for tree planting or other practices—qualify for exclusion from income.

Many state and federal programs meet the requirements for exclusion. Federal programs include, but are not necessarily limited to: the Forest Land Enhancement Program; the California Forest Improvement Program; the Illinois Forestry Development Program; the Louisiana Forestry Productivity Program; the Mississippi Forest Resource Development Program; the North Carolina Forest Development Program; the South Carolina Forest Renewal Program; and the Virginia Reforestation of Timberlands Act Program.

CRP Payments

The regulations for Section 126 specify that government payments that are in the nature of rent or compensation for services cannot qualify for exclusion from gross income. For this reason, annual land rental payments under the Conservation Reserve Program (CRP) do not qualify. CRP cost-share payments, however, have qualified for exclusion since 2003.

Options For Reporting

There are two options for reporting a cost-share payment that qualifies for exclusion from gross income for federal income tax purposes. The first choice is exclusion of all or part of the payment from gross income. The second is to include the payment in gross income, even if all or part of it qualifies for exclusion. Including a payment in gross income may provide a tax benefit in a few situations.

The exclusion is available to the individual or legal entity that receives the cost-share payment. The affected property may be either leased or owned.

Determining the Excludable Amount

The maximum amount of a cost-share payment that can be excluded from gross income is "the present fair market value of the right to receive annual income from the affected acreage of the greater of two amounts: either 10 percent of the prior average annual income from the affected acreage or $2.50 times the number of affected acres. This is the test that the Treasury Department developed to determine whether a cost-share payment substantially increases the annual income derived from the property. "Prior average annual income" is defined as the average of the gross receipts from the affected acres for the three tax years preceding the year in which a practice was commenced for which cost-share assistance was received.

The regulations do not spell out how to calculate the "present fair market value of the right to receive annual income". However, the accepted method of determining the present value of a stream of annual payments is to divide the amount of the payment by an appropriate interest rate.

The regulations are also silent as to the what is an appropriate rate of interest. Nevertheless, using the current Farm Credit Bank interest rate for this purpose has been informally accepted by the IRS.

The Calculation Procedure

The excludable amount of a qualifying cost-share payment can be determined by using a four-step procedure as follows:

1. Calculate 10 percent of the average annual income from the affected acreage during the past three years.
2. Multiply $2.50 times the number of affected acres.
3. Determine the present value of the larger of the two numbers above.
4. Compare the number from step 3 with the cost-share payment. The smaller of the two is the amount that can be excluded from gross income.

The following examples illustrate calculation of the excludable amount, with and without income from the affected acres.
property during the prior three years.

**Example 1**

Last year Mr. Smith harvested 40 acres and received $49,500 for the timber, his only income from the property for many years. This year Mr. Smith reforested the acreage at a total cost of $6,000 and received a $3,900 cost-share payment. Using the current Farm Credit Bank interest rate for his Farm Credit District of 6.59 percent, how much of the cost-share payment can Mr. Smith exclude from his 2005 gross income?

**Step 1:** $0.10 \times (\frac{49,500}{3}) = $1,650

**Step 2:** $2.50 \times 40 = $100.00

**Step 3:** $1,650 from step 1 is the larger number; $1,650 / 0.0659 = $25,037.94

**Step 4:** $25,037.94 is much larger than $3,900

Mr. Smith can therefore exclude the entire cost-share payment from his gross income.

**Example 2**

Suppose Mr. Smith had made his timber sale in 2001 and had no additional income from the property after that year. How much of the $3,900 cost-share payment can he exclude from this 2005 gross income?

**Step 1:** $0.10 \times 0 = 0

**Step 2:** $2.50 \times 40 = $100.00

**Step 3:** $100.00 / 0.0659 = $1,517.45

**Step 4:** $1,517.45 is less than $3,900

Mr. Smith can therefore exclude only $1,517.45 of the $3,900 cost-share payment from his 2005 gross income.

**How to Report on the Tax Return**

If a conservation cost-share payment from a federal or state government program is received, the recipient can expect to be sent a Form 1099-G (information return) for the amount of the payment. A copy is also sent to the IRS. Therefore, even if all or some of the payment is excluded from gross income, it...
still must be reported. This is done by attaching a plain sheet of paper to the tax return that shows the amount of the payment, the date it was received, the part of the payment that qualifies for exclusion from gross income, the details of how that amount was determined, and the amount actually excluded.

Including Cost-Share Payments In Gross Income

The amount of a cost-share payment that the recipient chooses or is required to include in his (her) gross income is reported as ordinary income on the tax return. Woodland owners who file as investors should enter the amount as “miscellaneous income” on the first page of Form 1040. Those who file as a sole proprietor of a business should attach Schedule C of Form 1040 and those who file as a farmer should use Schedule F of Form 1040. Cost-share payments included in gross income are subject to state and federal income taxes. They may also be subject to the self-employment tax. Self-employment income generally includes all items of business income, including conservation cost-share payments from government programs.

To the extent that a cost-share payment for planting trees for the commercial production of timber is included in gross income, it qualifies for the reforestation deduction and amortization. The new rules governing the tax treatment of reforestation expenditures was discussed in the last issue of National Woodlands.

Recapture Provisions

Recapture provisions apply if trees established using an excluded cost-share payment are disposed of within 20 years. During the first 10 years, the recapture amount is the lesser of the amount of gain from the disposal or the amount of the cost-share payment excluded. This base amount is reduced by 10 percent for each year or portion of a year the trees are held after year 10, until it is eliminated during year 20. Report a recapture amount as ordinary income on Form 4797, start on Part II of the form if the trees were held for a year or less and on Part III if the trees were held for more than a year.

Conclusion

Woodland owners who receive government cost-share payments sometimes neglect to exclude the allowable portion from their income. One of the reasons for this is because they have gotten a Form 1099-G, they believe the entire amount is taxable. The fact is, as discussed above, that at least part of every qualifying cost-share payment will be excludable. And, if there was substantial income from the property during the previous three years, all of the payment can be excluded.

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On the Cover: After a long, cold winter the Northern Forest springs back into action. Spring and summer in this part of the country is the most productive period for forests like these, as fresh supplies of clean water and air are produced, trees and other plants grow, and wildlife takes advantage of the ample supplies of food, water and warm weather. Staff Photo