

# The Latest on Reporting CSP Payments

-by Neil E. Harl\*

On September 25, 2006, the Internal Revenue Service published Rev. Rul. 2006-46<sup>1</sup> which states that –

“. . . the Conservation Security Program is substantially similar to the type of program described in section 126(a)(1) through (8) of the Code within the meaning of section 126(a)(9). As a result, all or a portion of cost-share payments received under the CSP is eligible for exclusion from gross income to the extent permitted by section 126.

The language of the ruling echoed the language appearing in the *Federal Register*<sup>2</sup> in June of 2005 in which the Secretary of Agriculture stated that “this determination permits recipients to exclude from gross income, for Federal income tax purposes, all or part of the existing practice, new practice, and enhancement activity payments to the extent allowed by the Internal Revenue Service.”<sup>3</sup> However, as pointed out in articles appearing in the *Agricultural Law Digest* on November 18, 2005<sup>4</sup> and December 16, 2006,<sup>5</sup> the exclusion provision under I.R.C. § 126 is limited to “improvements.”<sup>6</sup> The language in the latest ruling, as with the language in the *Federal Register* announcement<sup>7</sup> may lead CSP participants to believe that more of the CSP cost-share payments are excludable than is justified under I.R.C. § 126.<sup>8</sup>

## Guidance in Rev. Rul. 2006-46

*Rev. Rul. 2006-46*,<sup>9</sup> after reciting that the Secretary of Agriculture had determined that payments under the Conservation Security Program (CSP) are “primarily for the purpose of conserving soil and water resources or Protecting and restoring the environment,”<sup>10</sup> proceeded to identify three areas of practices under CSP, one of which was deemed to be eligible for exclusion from income to the extent permitted by I.R.C. § 126, one of which was partially eligible and one of which was not eligible.

*Existing practice and new practice components.* The ruling agrees with the Secretary of Agriculture that the “existing practice and new practice components” of the program are “limited to a percentage of the average county costs of the practices and qualify as cost-share payments.”<sup>11</sup> The ruling then points out that those cost-share payments “are eligible for exclusion from gross income *to the extent permitted by § 126.*”<sup>12</sup>

*Enhancement component.* Likewise, the ruling agrees that the enhancement component qualifies as cost-share payments “if they are based on the activity’s cost rather than its expected conservation benefits.”<sup>13</sup> The cost-share payments received under the enhancement component are eligible for exclusion from gross income, again “*to the extent permitted by § 126.*”<sup>14</sup> The ruling states that payments under the enhancement component based on the activity’s expected conservation benefits rather than its cost *are not cost-share payments and are not excludable from gross income.*<sup>15</sup>

*Stewardship component.* The ruling takes the position that payments under the stewardship component are “based on the rental rate applicable to the land” and are not cost-share payments that are excludable from gross income.<sup>16</sup>

The ruling concludes that taxpayers should refer to I.R.C. § 126(b) and the regulations<sup>17</sup> “. . . to determine the extent to which cost-share payments under the existing practice, new practice, and enhancement components are excludable from gross income under § 126.”<sup>18</sup>

## Importance of “improvement” to excludibility

Although the recent IRS ruling<sup>19</sup> does not mention the word “improvement” once, the regulations mention the word “improvement” or “improvements” 19 times.<sup>20</sup> The regulations define “Section 126 improvement” as “. . . the portion of the improvement equal to the percentage which government payments

made to the taxpayer, which the Secretary of Agriculture has certified were made primarily for the purpose of conservation, bear to the cost of the improvement.”<sup>21</sup>

Moreover, the Tax Court in *Graves v. Commissioner*<sup>22</sup> referred to the “improvement” requirement in the regulations as “. . . payments related to capital improvements subject to depreciation.” The court cited to passages in the *Congressional Record* to that effect.<sup>23</sup> In a telling rejoinder to the implication that payments that are not capital improvements might be eligible for exclusion from income, the Tax Court stated –

Nowhere in any of the materials is there any indication that Congress intended to relieve from normal income tax obligations an outright payment for the use of land where there is no capital improvement subject to depreciation. All of the indications are to the contrary. Moreover, it is apparent that ‘cost-sharing does not mean, as contended by petitioners, reducing the amount of income received from property by entering into an agreement with the United States.

In *Graves*, the court held that payments under the Water Bank Program<sup>24</sup> were not excludible from income.<sup>25</sup>

### **In conclusion**

If the Internal Revenue Service intends to stake out a different interpretation of the regulations (and the statute) and to argue against existing case law, it is important for taxpayers to be apprised of that fact.

### **Footnotes**

<sup>1</sup> 2006-2 C.B. 511.

<sup>2</sup> 70 Federal Register 36,557 (June 24, 2005).

<sup>3</sup> *Id.*

<sup>4</sup> Harl, “Reporting Conservation Security Program Payments,” 16 *Agric. L. Dig.* 169 (2005).

<sup>5</sup> Harl, “More on Handling CSP Payments,” 16 *Agric. L. Dig.* 185, 186-87 (2005).

<sup>6</sup> Temp. Treas. Reg. § 16A.126-1(a).

<sup>7</sup> See note 2 *supra*.

<sup>8</sup> See Temp. Treas. Reg. § 16A.126-1(a); *Graves v. Comm’r*, 89 T.C. 49 (1987). See generally 4 Harl, *Agricultural Law* § 27.03[4][h] (2006); Harl, *Agricultural Law Manual* § 4.02[1][a] (2006).

<sup>9</sup> 2006-2 C.B. 511.

<sup>10</sup> 2006-2 C.B. 511.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.* Emphasis added.

<sup>13</sup> *Id.*

<sup>14</sup> *Id.* Emphasis added.

<sup>15</sup> *Id.*

<sup>16</sup> *Id.* Emphasis added.

<sup>17</sup> Temp. Treas. Reg. § 16A.126-1.

<sup>18</sup> Rev. Rul. 2006-46, 2006-2 C.B. 511.

<sup>19</sup> *Id.*

<sup>20</sup> Temp. Treas. Reg. § 16A.126-1.

<sup>21</sup> Temp. Treas. Reg. § 16A.126-1(b)(7).

<sup>22</sup> 89 T.C. 49 (1987).

<sup>23</sup> 124 Cong. Rec. 25118-25119 (1978); 124 Cong. Rec. 26398-26399; 124 Cong. Rec. 33456-33457 (1978), 34728-34733 (1978).

<sup>24</sup> 16 U.S.C. § 1301 *et seq.*

<sup>25</sup> *Graves v. Comm'r*, 89 T.C. 49 (1987).