



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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OFFICE OF THE CHIEF COUNSEL

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The Honorable Dennis Cardoza
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Cardoza:

I am responding to your letter dated November 1, 2011, about the tax treatment of payments provided under the Environmental Quality Incentives Program (EQIP) to agricultural producers to retrofit or upgrade to lower-emission farm equipment. You asked if these EQIP payments for clean air programs are tax-exempt under section 126 of the Internal Revenue Code (the Code).

Under section 126 of the Code, gross income does not include the excludable portion of payments received under certain programs specified by law. Programs eligible for section 126 treatment are found in sections 126(a)(1) through (8). Additionally, under section 126(a)(9), any *small watershed* program the Secretary of Agriculture administers that the Secretary of the Treasury or the Secretary's delegate determines as substantially similar to the type of programs described in section 126(a)(1) through (8) is also eligible for section 126 treatment (emphasis added). Finally, section 126(a)(10) excludes payments under substantially similar programs of states and certain other governmental entities (not including the Department of Agriculture or other federal agencies).

The "excludable portion" is that portion of a payment made to a person under any program described in section 126(a) that –

- The Secretary of Agriculture determines is primarily for conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife, and
- The Secretary of the Treasury or the Secretary's delegate determines does not increase substantially the annual income derived from the property.

In 1997, we issued Revenue Ruling 97-55. It provided that the EQIP is substantially similar to the type of programs described in section 126(a)(1) through (8) so that cost-share payments made under the EQIP for small watersheds are within the scope of

section 126(a)(9). (Rev. Rul. 97-55 enclosed). We issued Rev. Rul. 97-55 after the Secretary of Agriculture determined that cost-share payments made under EQIP are primarily for purposes of conservation.

Since 1997, the Congress has amended the statutory provisions of the EQIP (16 U.S.C. 3839aa *et. seq.*). Now the statute is broader and has additional purposes that were not part of the EQIP when we published Rev. Rul. 97-55. For example, the Farm Security and Rural Investment Act of 2002, Pub. L. 107-171, amended EQIP to include the purpose of assisting producers in complying with local, state, and national regulatory requirements for air quality. In addition, as you noted, the Food, Conservation, and Energy Act of 2008, Pub. L. 110-234 (the 2008 Farm Bill) expanded the EQIP to include payments such as those for air quality concerns from agricultural operations.

Therefore, we have not determined that payments under the EQIP clean air programs are eligible for exclusion under section 126 of the Code. The Secretary of Agriculture has not determined that the clean air programs of the EQIP are primarily for conservation purposes as required in section 126 of the Code. Also, the Secretary of the Treasury has not determined that the clean air programs of EQIP are substantially similar to the programs in section 126(a)(1) through (8). Finally, no determination has been made that the Clean Air Programs under the EQIP are small watershed programs. These determinations are necessary for payments under a program to be eligible for exclusion under section 126(a)(9). We will contact the Department of Agriculture and work with it to determine what payments under the clean air programs of the EQIP qualify for exclusion under section 126(9).

If recipients receive cost-share payments under a program eligible for exclusion under section 126, the full amount of the payments may not be excludable. The "excludable portion of the payment is that portion of a payment as the Secretary of the Treasury or the Secretary's delegate determines, that will not increase substantially the annual income derived from the property (section 126(b)(1)(B)). The Secretary has determined, in section 16A.126-1(b)(5) of the income tax regulations, that this "excludable portion" is the present fair market value of the right to receive annual income from the affected acreage of the greater of either 10 percent of the prior average annual income from the affected acreage or \$2.50 times the number of affected acres.

I am enclosing a copy of section 16A.126-1 of the regulations and an excerpt from Publication 225, *the Farmer's Tax Guide*. These documents both provide guidance about section 126, specifically the calculations of the excludable portion and the amount included in gross income.

I am sorry this response may be disappointing, but I hope this information is helpful. If you have any questions, please contact _____ or me at () _____ for further assistance.

Charles B. Ramsey
Chief, Branch 6
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures (3)