



CALIFORNIA
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Tax Treatment of Conservation Payments

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About the Instructor

Poppy Davis is a business and policy adviser to agricultural enterprises, nonprofits, and local governments. She works through programs around the country to deliver trainings on topics including agricultural taxation, accounting, credit, and cash-flow.

She began her career as a California CPA, and later worked for the USDA.

She holds a Juris Doctor with a certificate in Food and Agricultural Law from Drake University Law School, and a BS in Agricultural Economics from the University of California at Davis.



Overview

1. General Rule for Taxable Income and Business Deductions
2. Special IRS Rules for Conservation Payments
3. Examples
4. Additional Resources



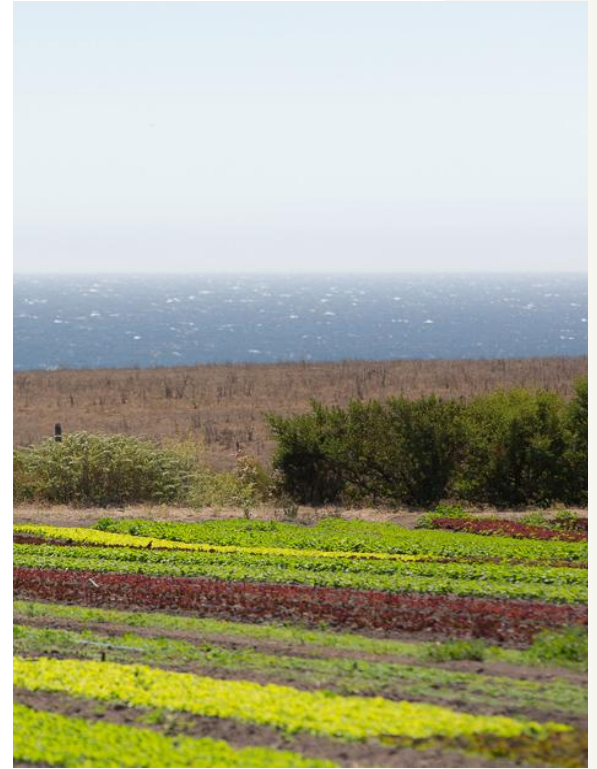
1. General Rule for Taxable Income



General Tax Rules and Exceptions

For the most part the tax treatment of conservation payments and associated deductions follow well established existing tax law.

There are also some special tax rules just for agricultural operations and conservation practices.



Short story...

Any income you receive is reported as business income. Associated project costs are reported as:

1. Ordinary and necessary business expenses (deduct in current year).
2. Depreciable assets used in the ordinary course of business (capitalize and depreciate).
3. Special election for NRCS project assets for conservation projects not directly tied to annual production practices (deduction limited to 25% of gross farm income each year - may carryforward till fully deducted).



Taxable Income Review

1040 taxable income includes: Salaries, Business Income, Investment Income, Pensions, etc.

Farm Income on the 1040:

- Salary from S-Corp owned by taxpayer
- Schedule F (sole proprietor, qualified marital joint venture)
- Schedule E
 - K-1 (from a farming partnership/LLC)
 - Farmland rental (non-participatory)
- Form 4797 Sale of Business Property
- Form 4835 Farmland rental (crop share)



Conservation Payments in Taxable Income

Conservation payments are included in taxable income unless it is explicit in the authorizing federal legislation that they are not.

Conservation payments are typically reported as business (or farm rental) income, and related expenses are typically business (or farm rental) expenses.



Net Business Income

Gross Business Receipts

Less: Ordinary and Necessary Expenses

Equals Net Business Income

Gross business receipts includes all income related to the business, including conservation payments and other government program payments unless there is a specific exemption in legislation.

Ordinary and necessary expenses are everything lawful that is ordinary and necessary to accomplish your business purpose - unless there are special IRS rules limiting or disallowing the deduction.



Income Reported to Tax Authorities

Conservation payments will* be reported to the IRS and state taxing authorities on a Form 1099.

- If you file a Schedule F, the 1099 will be reported to your SSN, which will match to your Schedule F.
- **If you are an S-Corporation:**
 - The 1099 should go to the S-Corp
 - If the 1099 comes to your SSN attach a statement to your personal return saying that the 1099 is reported on your 1120S

*Should be, but sometimes are not.



Offsetting Expenses

If you were paid based on receipts for expenses incurred, you may offset your taxable income with deductible expenses.

But...

- Some expenditures need to be capitalized as assets and then depreciated.
- There are special rules for expenditures that do not improve profitability.
- *More on these two in a moment...*

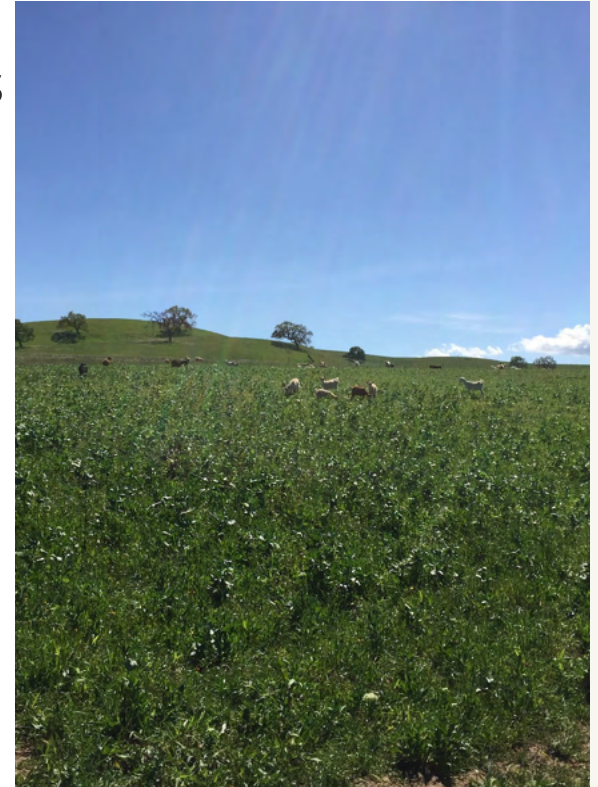


Owner's Labor - Sole Proprietor or Partnership

If your conservation payment includes amounts to compensate you for your own time and labor you will not have an offsetting deduction.

You never get a deduction for your own labor.

Your net taxable income is always your business income minus your business expenses - the equivalent of your taxable salary, only a sole proprietor or a partner does not get a true salary.



Owner's Labor - S Corporation

The same is true for an S Corporation, it just looks a little different.

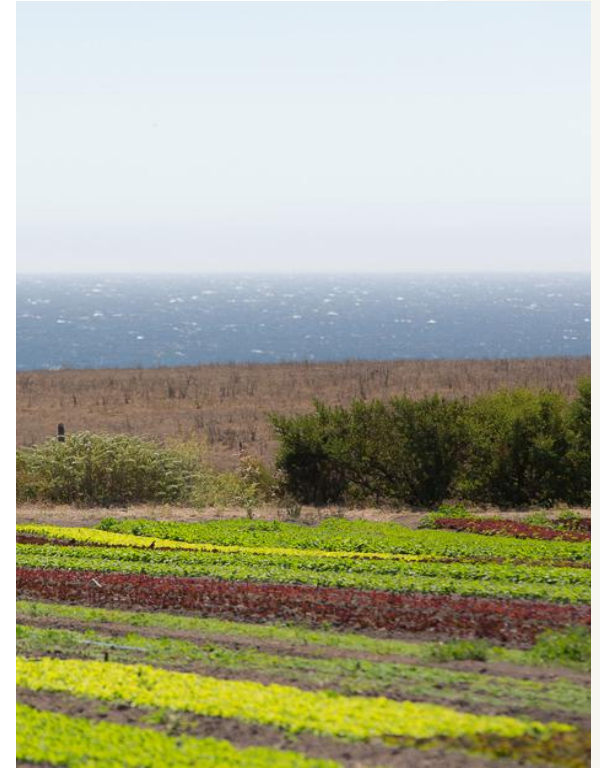
- A conservation payment may allow the S-Corp to increase the owner's salary, but that just increases the owner's taxable income with no offsetting deduction.
- An S-Corporation deducts the salary it pays an owner. There is no additional deduction related to any work the owner performs, the salary deduction is for the owner's work.



Deductible Expenses

Deductible expenses benefit or are consumed or used in the current period.

- Meet the IRS definition of “ordinary and necessary” business expenses
- Must relate to earning business income
- Anything ordinary and necessary, except things with special rules:
 - Auto mileage rules
 - Limits on meals and gift deductions
 - Assets - so many special rules!



Assets

Assets benefit multiple periods.

- IRS requires capitalization - capitalization is IRS for “special rules about how much and when you may deduct”

Depreciable Assets are assets that have an ascertainable life - that’s IRS for “we can ascertain that one day it won’t exist”

- If an asset is depreciable then you may deduct the cost of the asset using an allowable **IRS Tax Life** and **Depreciation Method**.



Land and Land Improvements

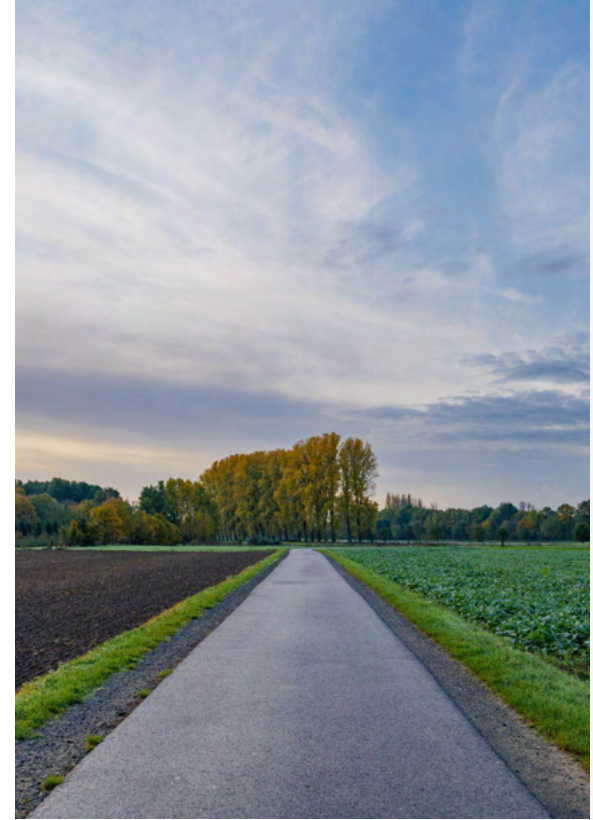
- Land benefits multiple periods - therefore, it is an asset.
- **Land has no ascertainable life** - therefore, it **may not** be depreciated.
- Land **improvements** may or may not have an ascertainable useful life.
- If there is an ascertainable useful life then land improvements can be depreciated using the appropriate IRS tax life and allowable depreciation method.



What are Land Improvements?

- Grading, terracing
- Roads
- Retaining walls
- Ponds

In California, between earthquakes, fires and floods, it is more certain than not that any land improvement has an ascertainable life because we can ascertain it will not last forever.



Soil Improvements

- Improved soils benefit multiple periods - therefore it is an asset.
- Costs are also normal annual farming costs.
- IRC Section 180 allows deduction of soil improvement costs in the year incurred - even though they may benefit multiple future periods.

NOTE: IRC 180 has important tax implications for purchased or inherited land. This topic is not covered here. See additional resources slide for more information.

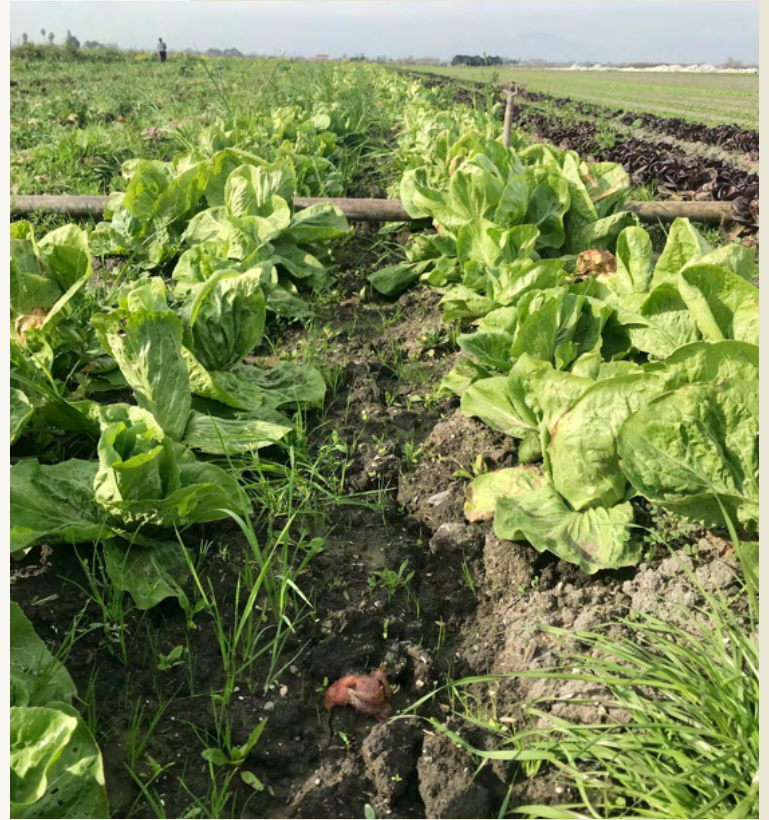


Accelerated and Bonus Depreciation

- Accelerated depreciation allows for more deduction in early years (as opposed to straight line depreciation which is spread equally over the tax life).
- IRC Section 179 Bonus depreciation allows 100% depreciation in the year of acquisition - but it is limited to certain assets
 - Self-constructed assets, and assets purchased from related parties do not qualify.



2. Special Rules for Conservation Practices



Conservation Practices - Expense or Asset

It is an expense if you can show that it is ordinary and necessary and **primarily benefits your current year operations.**

- There may be a lingering benefit to future years, but you would do it anyway just for the current benefit.

If it is an expense then your associated reimbursement income is offset by your reimbursed costs, and you only have taxable income to the extent that you were paid for your time.



Conservation Practices - Expense or Asset

It is an asset if most of the economic benefit is to future years.

- You can **not** deduct the full cost in the current year, you have to **depreciate** the cost over the **ascertainable useful life** of the asset.
- OR - there are special rules for deducting assets installed as part of an NRCS-approved plan (more in a moment).



Conservation Practices - Expense or Asset

If it is an asset:

- In the year you receive the payment you will have taxable income in excess of the related depreciation deduction.
- In subsequent years you will have a depreciation deduction with no associated income.



Conservation Practices that are Annual Expenses

Conservation practices that are part of your normal annual farming practices are usually deducted as ordinary and necessary business expenses if they are part of how you:

- Increase annual soil fertility
- Manage weeds and pests
- Improve the quality of your product
- Provide pasture or forage



Conservation Expenditures for Assets

Assets that are a key part of your normal farming operation and also a key part of a conservation strategy are treated like any other farm asset.

- Cross fencing
- Livestock ponds
- Trees to shade and shelter livestock



Conservation Expenditures for Assets

You buy or build a hoop house and use it in your normal operations.

Capitalize the cost (that means treat the hoop house as an asset) and take a depreciation deduction according to the usual rules for asset depreciation.



Conservation Expenditures for Assets

You cross-fence your property to improve pasture-management.

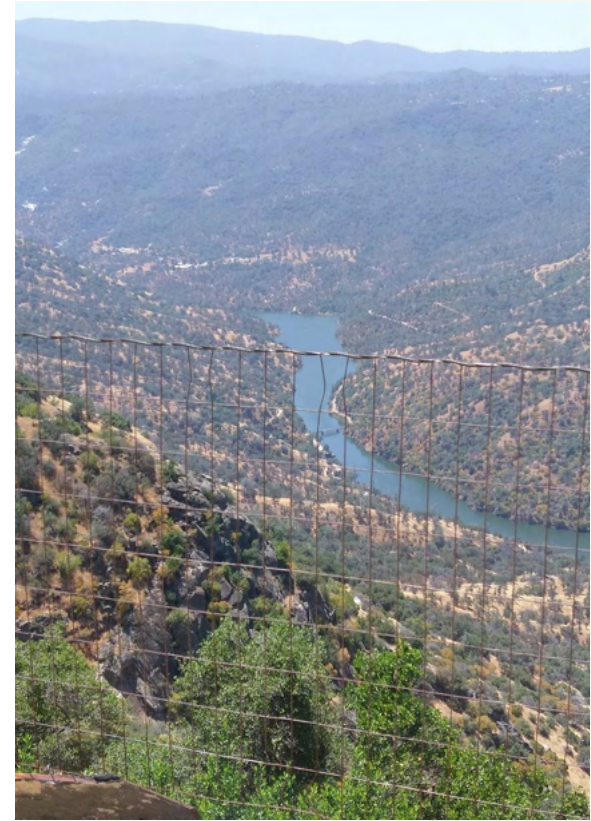
Capitalize the cost (that means treat the fence as an asset) and take a depreciation deduction according to the usual rules for asset depreciation.



Conservation Expenditures Not Directly Tied to Production

A third type of conservation expenditures are those that are **not directly related to producing crops or livestock**. These include:

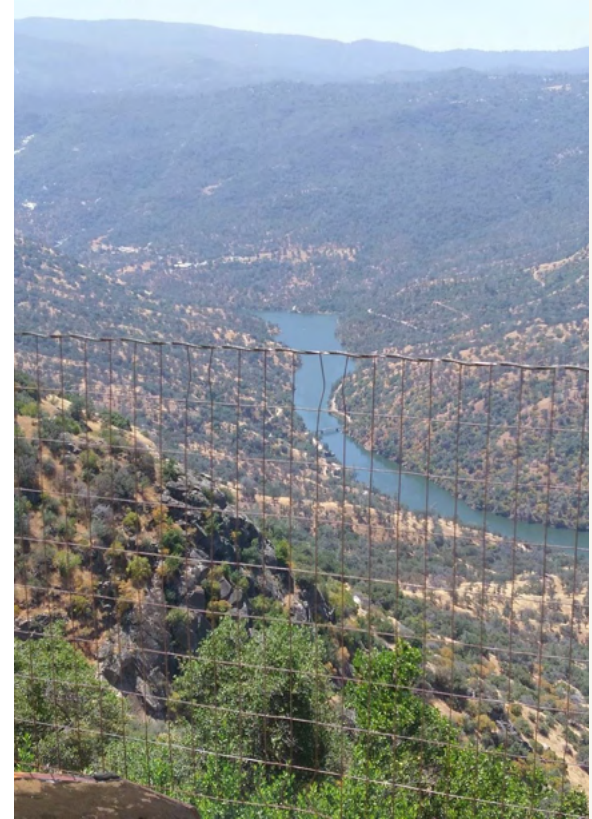
- Soil conservation projects such as grading or terracing if they do not increase yields
- Projects to create or enhance habitat, such as planting trees or hedges for wildlife habitat, or fencing off natural waterways



Conservation Expenditures Not Directly Tied to Production

Taxpayers may elect to deduct these as long as:

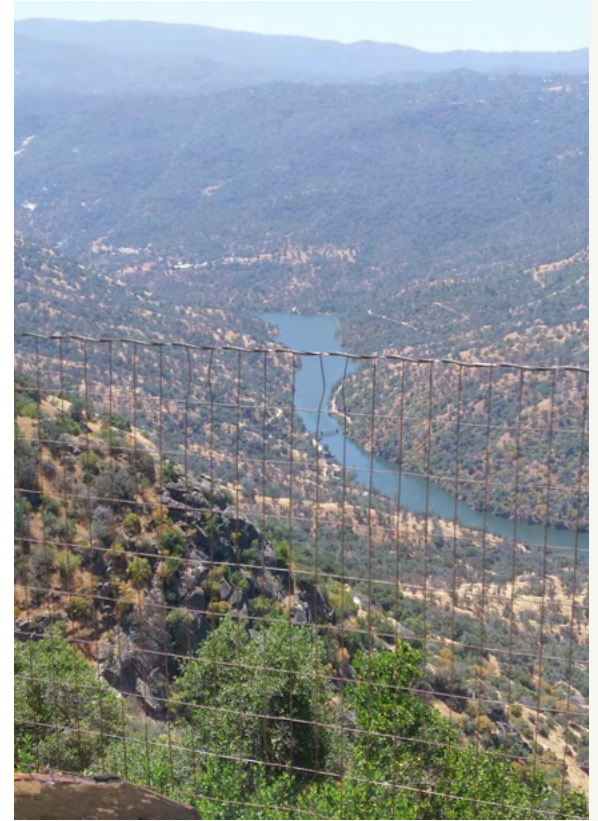
1. The land is used and was previously used in the business of farming or ranching.
2. Expenditures are to implement a plan approved by the USDA Natural Resources Conservation Service



Conservation Expenditures Not Directly Tied to Production

If the taxpayer makes this election:

- The deduction for each year is limited to 25% of gross income from farming and ranching for that year.
- The excess may be carried forward for future tax years until fully deducted.



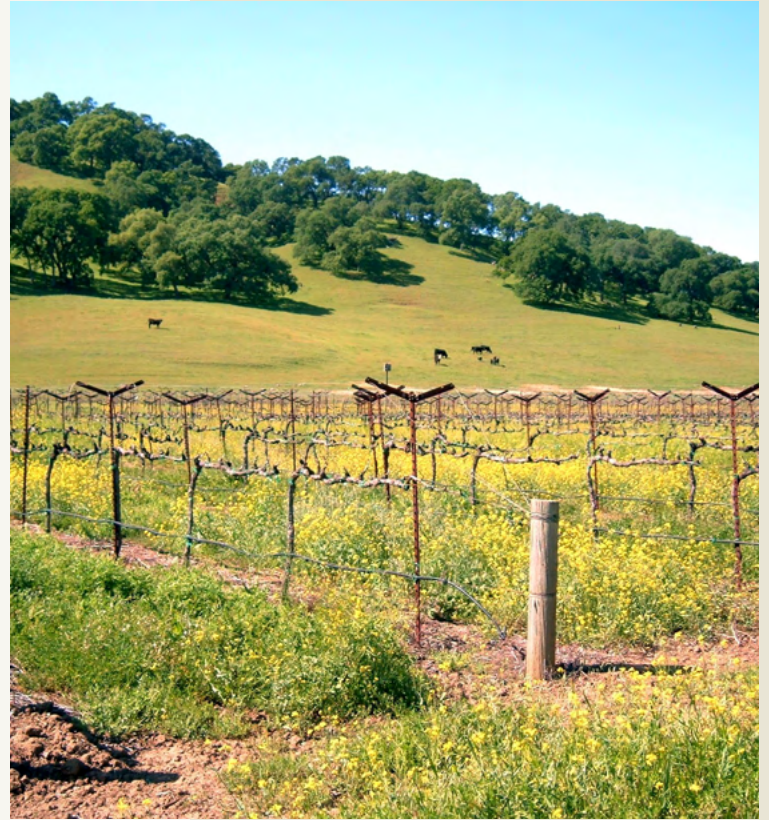
Summary

Any income you receive is reported as business income. Associated project costs are reported as:

1. Ordinary and necessary business expenses (deduct in current year).
2. Depreciable assets used in the ordinary course of business (capitalize and depreciate).
3. Special election for NRCS project assets for conservation projects not directly tied to annual production practices (deduction limited to 25% of gross farm income each year - may carryforward till fully deducted).



3. Examples



Timing Mismatches - Expenses Lead

Example:

Expenses paid in 2025	\$5,000
Reimbursement received in 2026	\$5,000

2025 Expense with no related income = \$5,000

2026 Income with no related expense = \$5,000

2025 - taxable income is less than it should be.

2026 - taxable income is more than it should be.

Timing Mismatches - Income Leads

Example:

Cash Advance made in 2025 \$6,000

Expenses paid in 2026 \$6,000

2025 Income with no expenses = \$6,000

2026 Expenses no related income = \$6,000

2025 - taxable income is more than it should be.

2026 - taxable income is less than it should be.

Timing Mismatches - Income Leads

A cash advance is not earned income, it is actually a liability.

- You must either perform the tasks covered by the advance or return the advance. **Since you have not earned the income it is not taxable.**

Since the paying agency has issued a 1099, the IRS will expect to see the income reported on your return. You may:

- Report as income and negative income
- Attach a statement explaining that you will report it in the year earned.

Timing Mismatches - Income Leads

Part I Farm Income – Cash Method. Complete Parts I and II. (Accrual method. Complete Parts II and III, and Part I, line 9.)			
1a	Sales of purchased livestock and other resale items (see instructions)	1a	
b	Cost or other basis of purchased livestock or other items reported on line 1a	1b	
c	Subtract line 1b from line 1a		1c
2	Sales of livestock, produce, grains, and other products you raised		2
3a	Cooperative distributions (Form(s) 1099-PATR)	3a	
		3b	Taxable amount
4a	Agricultural program payments (see instructions)	4a	
		4b	Taxable amount
5a	Commodity Credit Corporation (CCC) loans reported under election		5a
b	CCC loans forfeited	5b	
		5c	Taxable amount
6	Crop insurance proceeds and federal crop disaster payments (see instructions):		
a	Amount received in 2024	6a	
		6b	Taxable amount
c	If election to defer to 2025 is attached, check here <input type="checkbox"/>	6d	Amount deferred from 2023
7	Custom hire (machine work) income		7
8	Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)		8
9	Gross income. Add amounts in the right column (lines 1c, 2, 3b, 4b, 5a, 5c, 6b, 6d, 7, and 8). If you use the accrual method, enter the amount from Part III, line 50. See instructions		9

See Stmt 1

Statement 1: The 1099 from NorthState Conservation Partners in the amount of \$10,000 was for an advance paid in 2025 for costs to be incurred in 2026. Taxpayer will follow the matching principle and include the \$10,000 income in 2026 when it has been earned and the associated expenses incurred.

Testing and Compost Application

Practice	2024 Expense Reimbursement
Soil Samples	\$ 550
Compost Application (USDA NRCS CPS 808) Compost (C:N > 11) 6 ton/ac	\$ 3,108
Total 2024 1099	\$ 3,658
Schedule F Part 1 Line 8 Other Income	\$ 3,658
Schedule F Part 2 Expenses	
Line 17 Fertilizers and Lime	3,108
Line 32 Other 32 a Soil Testing	550
Net Taxable	\$ -

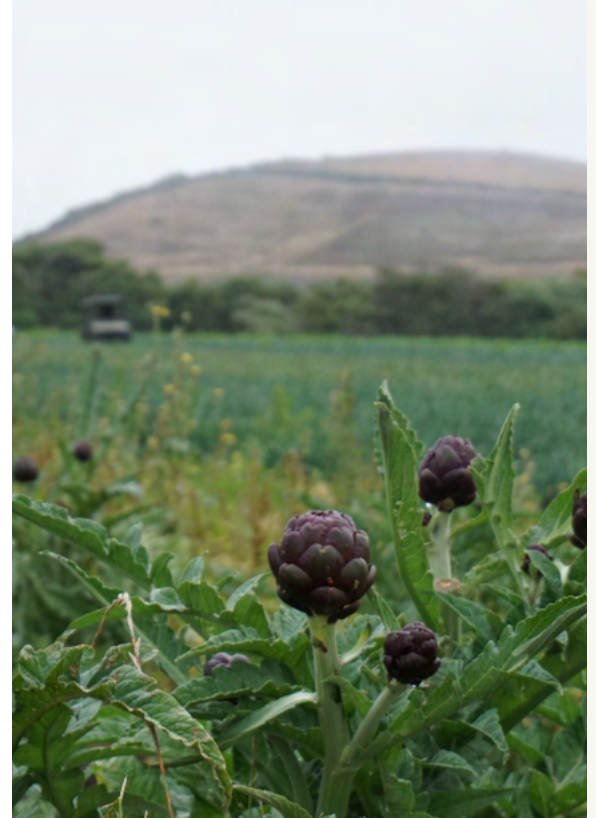
Tax Justification for expensing: Soil testing and compost application are standard practices for ensuring the high-quality pasture needed to support healthy animals and promote gain.

Mulching and Cover Cropping

Mulching (USDA NRCS CPS 484)

Cover Crop (USDA NRCS CPS 340)

Tax Justification for expensing: Mulching and cover cropping are standard practices for managing weeds and promoting soil fertility to maximize crop yields.



Establishing Habitat

Riparian Forest Buffer (NRCS CPS 391)

Silvopasture (NRCS CPS 381) trees/shrubs on grazed grasslands

Windbreak/ shelterbelt on grazed grasslands (NRCS CPS 380)

Tax Justification for expensing:

Does it help the taxpayer increase current revenue? Probably not.

Tax Justification for a depreciable business asset: Will it help the taxpayer increase future revenues? Perhaps if it improves diversity and thus pasture health or provides better quality shade and water for livestock. Can you get the IRS to agree?

Safe Harbor: Treat as a conservation expense, limited to 25% of gross income/year.

Permanent Planting - Conservation Practice

Practice		2024
Hedgerow Planting - Expense Reimbursement		\$ 7,500
Total 2024 1099		\$ 7,500
Option 1 - treat as a conservation expense		
Schedule F Part 2 Sale of Crops or Livestock		25,000
Schedule F Part 1 Line 8 Other Income		7,500
Schedule F Gross Income		32,500
Schedule F Part 2 Expenses		
Line 12 Conservation Expenses	7,500	
Line 12 Limit = 25% of gross income	8,125	
Line 12 Allowable Deduction		7,500
Net Taxable - this practice only		-

Advantageous if the cost of the practice is not much more than 25% of gross farm income.

Not the best method to use if the cost of the practice is significantly more than 25% of gross farm income.

Permanent Planting - Farm Asset

	2024	2025
Practice		
Hedgerow Planting - Expense Reimbursement	\$ 7,500	
Total 2024 1099	\$ 7,500	
Option 2 - treat as a farm asset		
Schedule F Part 1 Line 8 Other Income	7,500	
Schedule F Gross Income	7,500	
Schedule F Part 2 Expenses		
Line 14 Depreciation Deduction from Form 4562	750	1,350
Net Taxable - this practice only	6,750	(1,350)
Depreciation Deduction on Form 4562	Asset	Deduction
Hedgerow Asset	7,500	
10 year life, ADS Depreciation, Half-Year Convention Depreciation Expense		
Year 1		750
Year 1		1,350
Years 1-10 =10%, 18%, 14%, 12%, 9%, 7%, 6% of cost.		

Advantageous if the cost of the practice is significantly more than 25% of gross farm income.

Also advantageous in the early stages of developing a business. Allows taxpayer to save deductions for future years when they will be more valuable.

Other depreciation methods may further reduce current depreciation - consult a CPA.

Other Practices

Practice	Benefit to current period?	Asset that benefits future profits?	Treatment
Replace 20% of Annual Cropland with Woody Plants (NRCS CPS 311)	No	No	Conservation Practice limited to 25% of gross farm income/year
Prescribed Grazing (NRCS CPS 528)	Yes	Fencing	Ordinary expense, business asset (fences)
Range Planting (NRCS CPS 550)	Yes	Yes	Ordinary expense, business asset (shrubs)

Other Practices

Practice	Benefit to current period?	Asset that benefits future profits?	Treatment
Riparian Forest Buffer (NRCS CPS 391)	?	?	Conservation Practice limited to 25% of gross farm income/year
Silvopasture (NRCS CPS 381) Trees/shrubs on grazed grasslands or Windbreak/ shelterbelt (NRCS CPS 380)	No	Yes, shade and shelter for livestock	Labor, supplies, irrigation are ordinary expenses, trees and shrubs are business assets or conservation practices

4. Additional Resources



Additional Resources

1. [IRS Publication 225 - The Farmer's Tax Guide](#)
2. [RuralTax.org](#)
3. [Center for Agricultural Law and Taxation at Iowa State](#)
4. [California FarmLink's Tax Toolshed](#)
5. [Agricultural Finance, Tax and Asset Protection Program from the Southern Extension Risk Management Education Center](#)





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Questions?





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