Emergency Forest Restoration Payment

Are They Taxable Income?

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Emergency Forest Restoration Payment (EFRP) are made to woodland owners who apply voluntarily to take emergency measure to restore land damaged by natural disaster.

Tax Rules in General. Governmental conservation, forestry, or agricultural payments to woodland owners are generally taxable income. However, Tax Code Sec. 126 provides an exception that excludes qualified government payment from the taxpayer's income.

Exclusions from Income. To qualify for exclusion from income, both of the following requirements must be met:

1. The payment was from qualified forestry or agricultural conservation programs. The tax law has a list of qualified federal and state programs, including emergency conservation programs initially authorized in 1978 (under "title IV of the Agricultural Credit Act") (Sec. 126(a) of the Tax Code).

   To qualify a program for Sec. 126 income exclusion, the Department of Agriculture makes purpose determination and the IRS issues ruling (Revenue Ruling) if such program's eligibility is not directly authorized in the tax law.

2. The payment was used for capital improvement. For example, payment used for reforestation generally is a capital expenditure.

Taxpayers may not exclude any part of the payment from income if *it was used for an expense that can be deducted in the year it was incurred or paid*. Instead, such payment received must be included in income (but offsetting expenses can be deducted).

The IRS provides a formula to calculate the excludable amount if a payment qualifies for income exclusion.

EFRP. It is not clear whether EFRP qualifies for income exclusion under Sec. 126.

According to the current tax law, payment from emergency conservation program under title IV of the Agricultural Credit Act of 1978 qualifies for the income exclusion (Sec. 126(a)). Since EFRP was added to title IV of the 1978 Act by the 2008 Farm Bill, taxpayers could argue that the new EFRP should also be qualified program.

It is advised to set aside a portion of the funds to cover the potential tax liability including any estimated tax payments to avoid penalty.

There seems not a specific ruling from the IRS on EFRP's eligibility for income exclusion.

Next, it is also not clear whether the use of the payment for debris cleanup and downed tree removal qualifies for capital expenditure. The IRS has provided that post-disaster debris cleanup for structures are generally capital expenditure (www.irs.gov). Such costs are not deductible but must be added to the property's cost (basis). However, there appear to be little guidance on whether tree debris cleanup is also a capital expenditure.

How to Report EFRP. Due to the uncertainty of whether EFRP qualify for income exclusion, taxpayers are well advised to consult with their personal tax advisors, preferably ahead of their applications for the payment. Also, it is advised to set aside a portion of the funds to cover the potential tax liability including any estimated tax payments to avoid penalty.

The conservative way is to include the payment as ordinary income. For business taxpayers, this is reported in Schedule C (or F for farmers). For those whose timber holdings are an investment, report the payment in the front page of Form 1040 as "Other income".