

**§ 16A.126-0 Effective dates.**

These temporary regulations shall apply to any payments received under a contract signed by the taxpayer and the appropriate agency after September 30, 1979.

**§ 16A.126-1 Certain cost-sharing payments—in general.**

(a) *Introduction.* In general, section 126 provides that recipients of payments made after September 30, 1979 under certain conservation, reclamation and restoration programs may exclude all or a portion of those payments from income if the payments do not substantially increase the annual income derived by the taxpayer from the affected property. For purposes of this section, the term “payment” as used in section 126 means payment of the economic benefit, if any, conferred upon the taxpayer upon receipt of the improvement. An increase in annual income is substantial if it exceeds the greater of 10 percent of the average annual income derived from the affected property prior to receipt of the improvement or an amount equal to \$2.50 times the number of affected acres. The amount of gross income which a taxpayer realizes upon the receipt of a section 126 payment is the value of the section 126 improvement, reduced by the sum of the excludable portion and the taxpayer’s share of the cost of the improvement (if any).

(b) *Definitions.* For purposes of this section, the term:

(1) “Cost of the improvement” means the sum of amounts paid by a government and the taxpayer, whether or not with borrowed funds, for the improvement.

(2) “Section 126 cost” means the cost of the improvement less the sum of

(i) Any government payments under a program which is not listed in section 126(a),

(ii) Any portion of a government payment under a program which is listed in section 126(a) which the Secretary of Agriculture has not certified is primarily for purposes of conservation,

(iii) Any government payment to the taxpayer which is in the nature of rent or compensation for services.

(3) “Value of the section 126 improvement” means the fair market value of

the improvement multiplied by a fraction, the numerator of which is the section 126 cost and the denominator of which is the cost of the improvement.

(4) “Affected acreage” means the acres affected by the improvement.

(5) “Excludable portion” means the present fair market value of the right to receive annual income from the affected acreage of the greater of 10 percent of the prior average annual income from the affected acreage or \$2.50 times the number of affected acres.

(6) “Prior average annual income” means the average of the gross receipts from the affected acreage for the last three taxable years preceding the taxable year in which installation of the improvement is commenced.

(7) “Section 126 improvement” means 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.

(c) *Income realized upon receipt of a section 126 improvement—(1) Section 126 exclusion applied.* Unless a taxpayer elects not to have section 126 apply, the amount of gross income realized on receipt of the section 126 improvement is the value of the section 126 improvement less the sum of the taxpayer’s share of the cost of the improvement and the excludable portion.

(2) *Section 126 exclusion not applied.* If a taxpayer elects under section 126(c) not to have section 126 apply in whole or in part, the amount realized on the receipt of the section 126 improvement is the value of the section 126 improvement less the sum of the taxpayer’s share of the cost of the improvement and the excludable portion that applies, if any.

(d) *Payments under watershed programs—(1) Programs within section 126(a)(9).* Section 126(a)(9) covers certain programs affecting small watersheds.

These programs must be administered by the Secretary of Agriculture and be determined by the Commissioner to be substantially similar to the type of program described in section 126(a) (1)

through (8). The Commissioner has determined that section 126 improvements made in connection with small watersheds are within the scope of section 126(a)(9) if they are made under one of the following programs:

(A) The Watershed Protection and Flood Prevention Act, Pub. L. 566, 68 Stat. 666, as amended (16 U.S.C. 1001, *et seq.*), as funded by the Act of November 9, 1979, Pub. L. 96-108, 93 Stat. 834.

(B) Flood Prevention Projects, Pub. L. 86-468, sec. 1, 74 Stat. 131, as amended (16 U.S.C. 1006a); Pub. L. 78-534, sec. 2, 58 Stat. 889 (33 U.S.C. 701a-1); Pub. L. 78-534, sec. 13, 58 Stat. 905;

(C) Emergency Watershed Protection, Pub. L. 81-516, sec. 216, 64 Stat. 184 (33 U.S.C. 701b-1), and

(D) Colorado River Basin Salinity Control Act, Pub. L. 93-320, 88 Stat. 266:

(1) Title 1—Programs downstream from Imperial Dam, and

(2) Title 2—Measures upstream from Imperial Dam.

(2) *Other programs.* The Commissioner may announce further determinations under section 126(a)(9) from time to time in the Internal Revenue Bulletin.

(3) *Small watershed defined.* A watershed is a "small watershed" under this paragraph and section 126(a)(9) if the watershed or subwatershed does not exceed 250,000 acres and does not include any single structure providing more than 12,500 acre-feet of floodwater detention capacity, nor more than 25,000 acre-feet of total capacity.

(e) *Basis of property not increased by reason of excludable amounts.* Notwithstanding any provision of section 1016 (relating to adjustments to basis) to the contrary, basis of any property does not include any amount which is excludable from gross income under section 126.

(f) *Cross reference.* For rules relating to the recapture as ordinary income of the gain from the disposition (within 20 years of the date of receipt) of property for which an exclusion is claimed for a section 126 improvement, see section 1255 and the regulations thereunder.

(g) *Examples.* The provisions of this section are illustrated by the following examples:

*Example (1).* In 1981, 100 acres of the taxpayer's land is reclaimed under a Rural Abandoned Mine Program contract with the

Soil Conservation Service of the U.S. Department of Agriculture. The total cost of the improvement is \$700,000. USDA pays \$690,000, the taxpayer \$10,000. The Secretary of Agriculture certifies that 95% of the \$690,000 USDA payment was primarily for the purpose of conservation. Therefore, \$34,500 (\$690,000×.05) is a nonsection 126 payment. \$150,000 of USDA's payment is compensation for the taxpayer's service in the reclamation project and is includable in gross income as compensation for services. The taxpayer has \$20,000 of allowable deductions in 1981, \$15,500 of which are properly attributable to the USDA payment. Based on all the facts and circumstances, the value of the improvement is \$21,000. The taxpayer elects not to have section 126 apply. The taxpayer computes the amount which is included in gross income as a result of receipt of the improvement as follows:

(1)	
Cost of improvement .....	\$700,000
Nonsection 126 payment .....	(34,500)
Compensation for services .....	(150,000)
Current deductions .....	(15,500)
	500,000
(2)	
Value of improvement .....	21,000
Multiplied by section 126 cost .....	×500,000
	700,000
Value of section 126 improvement .....	15,000
(3)	
Value of section 126 improvement .....	15,000
(Taxpayer's contribution) .....	10,000
	5,000

*Example (2).* The facts are the same as example (1) except that section 126 applies. Based on all the facts and circumstances, the present fair market value of the right to receive annual income from the property of 10 percent of the prior average annual income of the affected acreage prior to the receipt of the improvement is \$1,380 and the present fair market value of the right to receive \$250 (\$2.50×100 acres) is \$1,550. The excludable portion is, therefore, \$1,550. The taxpayer computes the amount included in gross income as follows:

Value of section 126 improvement .....	\$15,000
(Taxpayer's contribution) .....	(10,000)
(Excludable portion) .....	(1,550)
	3,450

*Example (3).* The facts are the same as example (2) except that the present value of 10 percent of the prior average annual income is \$5,600. The taxpayer realizes no income as a result of receipt of the section 126 project.

(1)	
Value of section 126 improvement .....	\$15,000
(Taxpayer's contribution) .....	(10,000)

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(Excludable portion) .....	(5,600)
Amount included in income .....	0

*Example (4).* In 1983, the taxpayer signs a contract under the water bank program under which he will maintain 20 acres of undisturbed wetlands as a wildfowl preserve. In return he will receive \$90 an acre as rent from the government. Although the payment is made under a program listed in section 126(a) and the Secretary of Agriculture has certified that the entire amount of payment was made primarily for the purpose of conservation, there is no income eligible for section 126 exclusion because the full payment is rent. The rent is included in full in gross income.

*Example (5).* In 1980, the taxpayer reforests 200 acres of nonindustrial private forest land by planting tree seedlings. The taxpayer pays the full cost of the reforestation, \$15,000. Under the cost-sharing provisions of the forestry incentives program, the taxpayer receives a reimbursement from USDA of \$12,000. The Secretary of Agriculture certifies that 100% of the USDA payment is primarily for the purpose of conservation. Assume that the excludable portion is \$3,500 and that based on all the facts and circumstances, the value of the improvement is \$15,000. The amount which is includable in income is the value of the section 126 improvement, reduced by the excludable portion and the taxpayer's share of the cost of the improvement. Therefore the taxpayer includes \$8,500 in gross income as a result of the USDA payment, computed as follows:

Value of the section 126 improvement .....	\$15,000
(Excludable portion) .....	(3,500)
(Taxpayer's contribution) .....	(3,000)
Amount included in gross income ....	8,500

[T.D. 7748, 46 FR 27637, May 21, 1981; 46 FR 41043, Aug. 14, 1981]

**§ 16A.126-2 Section 126 elections.**

(a) *Election for section 126 not to apply in whole or in part.* A taxpayer may elect under section 126(c) not to have section 126 apply to all or any part of an improvement described in section 126.

(b) *Application of the section 126 exclusion.* To the extent the section 126 exclusion applies, the taxpayer should so indicate on an attachment to the tax return (or amended return) for the taxable year in which the taxpayer received the last payment made by a government for the improvement. The attachment should state the dollar amount of the section 126 cost funded by a government payment, the value of the section 126 improvement, and the

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amount that the taxpayer is excluding under section 126.

**§ 16A.1255-1 General rule for treatment of gain from disposition of section 126 property.**

(a) *Ordinary income—(1) General rule.* Except as otherwise provided in this section and §16A.1255-2, if section 126 property is disposed of after September 30, 1979, then under section 1255(a)(1) there shall be recognized as ordinary income the lesser of—

(i) The “excludable portion” under section 126, or

(ii)(A) The excess of the amount realized (in the case of a sale, exchange, or involuntary conversion), or the fair market value of the section 126 property (in the case of any other disposition), over the adjusted basis of the property, less

(B) The amount recognized as ordinary income under the other provisions of Chapter I, Subchapter P, Part IV of the Code.

(2) *Application of section.* Any gain treated as ordinary income under section 1255(a)(1) shall be recognized as ordinary income notwithstanding any other provision of subtitle A of the Code except that section 1255 does not apply to the extent the gain is recognized as ordinary income under the other provisions of Subchapter P, Part IV of the Code. For special rules with respect to the application of section 1255, see §16A.1255-2. For the relation of section 1255 to other provisions, see paragraph (c) of this section.

(3) *Meaning of terms.* For purposes of section 1255 and these regulations—

(i) The term “section 126 property” means any property acquired, improved, or otherwise modified as a result of a payment listed in section 126(a) which has been certified by the Secretary of Agriculture as primarily for the purpose of conservation;

(ii) The term “excludable portion” is defined in §16A.126-1(b)(5);

(iii) The term “disposition” has the same meaning as in §1.1245-1(a)(3);

(iv) The term “date of receipt of the section 126 payment” means the last date the government made a payment for the improvements.

(4) *Applicable percentage.* If section 126 property is disposed of less than 10