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Conservation Easements and Tax Planning

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This issue of the *NC State Economist* examines and illustrates options available to landowners to reduce income tax liability on the transfer of real property and property rights. We compare the various means of property transfer and the associated tax liabilities and benefits of each approach.

Property Law

The tax consequences of transferring development rights to farmland are governed, in part, by property laws. Property law allows landowners to divide the rights associated with property ownership and transfer part of the rights to another person or entity. Property rights can be viewed as a bundle of sticks. Each stick is a right that is associated with property ownership. One stick may be the right to mine property while another allows for property development. Property law then allows for the division of rights associated with property. It also permits the owners of farmland or any land to transfer the right to develop the property – one of the sticks – without transferring the rest of the property rights. One or more property rights may be transferred to another owner as an easement, which is placed on a property sometimes in exchange for something in return such as money, other real property or additional property rights.

The transfer of a single right does not necessarily impinge upon the remaining rights. A farmer may relinquish the right to put houses on some portion of his or her land and still retain the right to farm or manage timber on that portion and the surrounding land for which rights were not ceded. Granting an easement on the land may provide the landowner with ways to save money and at the same time generate income. Depending on how the easement is transferred, and for how long it is granted, the landowner may be able to offset income tax that would otherwise be owed if cash were received in exchange for granting the easement. Landowners may also reduce property taxes on their land if, for example, they donate development rights.

Income Taxes

Generally, transferring property triggers recognition of gain or loss for state and federal income taxes. If the gain or loss is recognized, the difference between the original purchase price of the property – usually referred to as the property's *basis* – and the amount realized from the transfer is reported as income or loss by the taxpayer.

Example 1. Guy Wyre sold land for $100,000. His income tax basis in the land was $40,000. Guy must include a $60,000 gain in his income.

Amount realized	$100,000
Basis	- $40,000
Gain	$60,000

The tax rate that applies to the gain or loss depends on the taxpayer's purpose for holding the property and the length of time the property is held. Most farmland is held for use in a trade or business—either the business of farming or the business of renting land. The taxation of the gain or loss also depends on the length of time the property is held. If land used in a trade or business is held for one year or less, the gain or loss from transferring the property is treated as ordinary income or ordinary loss.

If, however, the land is held for more than a year, then it is qualifies for tax rules that offer the taxpayer the best of two worlds. If the taxpayer has a net gain from the property for the tax year, the net gain is treated as long-term capital gain and qualifies for the long-term capital gains tax rate of 20% (10% if the taxpayer is in the 15% tax bracket). If the taxpayer has a net loss from the property, then the loss is allowed as a deduction from ordinary income.

Property Taxes

Local governments impose a property tax based on the value of real property. North Carolina tax law provides rules that value farmland according to average cash rents received on comparable land. The average cash rent is to be capitalized in a range of 6-7 percent (with a recommendation of 6.5% for 2004). Under North Carolina law, land must also be valued according to the encumbrances placed on it such as easements, which may lower the property value. If an easement prohibits land from being developed, that property may be worth less, and as a result the landowner may pay less in property taxes on that land.

Selling Land for Development - Fee Simple

If a landowner sells property to a developer, he or she must pay income tax on the gain realized on the sale.

Example 2. Rhoda Dendron owns farmland in North Carolina that she has owned for 30 years and has a $50,000 income tax basis in the land. Rhoda is single and has $150,000 of adjusted gross income and $120,000 of taxable income each year, placing her in the 30% marginal income tax bracket. If Rhoda sells the land to a developer for $500,000, her taxes on the sale are calculated as follows:

Sale price	$500,000
Basis	- $50,000
Gain	$450,000
Tax rate	x .20 (maximum capital gains rate)
Federal taxes	$90,000

In addition, Rhoda would pay about $31,500 of state income taxes, leaving her $378,500 after taxes.

Selling Development Rights - Fee Simple

If a landowner transfers development rights by sale, the proceeds of the sale are first used to reduce basis of the affected land. To the extent that the proceeds exceed the basis of the land, they must be reported as gain on the seller's income tax return.

Example 3. A Land Trust Commission would like to acquire the development rights on Rhoda Dendron's (from Example 2 above) land to manage development in the area. The land is worth $500,000 before the development rights are transferred. The development rights are worth $200,000 and the land without the development rights is worth $300,000.

Development rights	$200,000
Basis	- $50,000
Gain	$150,000
Tax rate	x .20 (maximum capital gains rate)
Federal taxes	$30,000
State taxes	+$10,500
Total taxes	$40,500

Development rights	$200,000
	- $40,500
After tax Income	$159,500

She would also have a zero basis in the land because it is subject to the conservation easement. Therefore, if she later sells the rest of her interest in the land for $300,000, she will have to report the entire $300,000 as capital gain and pay about $81,000 of federal and state income taxes on that gain.

Donating Development Rights

Tax rules that went into effect in 1998 make donating development rights even more attractive than under prior law. Since that time, donations qualify the donor for four tax benefits:

1. No gain has to be recognized on the transfer of the development rights,
2. The value of the gift can be claimed as an income tax deduction (charitable contribution for the year of the contribution and five carryover years,
3. The value of the gift can be claimed as a gift tax deduction, and
4. The donor's estate can be reduced by up to 40% of the remaining value of the property for 2002 and beyond (limited to a cap of $500,000).

Example 4. Assume the same facts as in Example 3 except that Rhoda donates the development rights to the Land Trust Commission. Rhoda will be allowed to claim a $200,000 charitable contribution deduction on her income tax return. That deduction can be used to reduce her taxable income by up to $45,000 (30% of her adjusted gross income of $150,0000) each year for the current year and the next two tax years.

The amount of income tax saved will vary according to the tax bracket in which the donor falls. Note also that donation of development rights are often made for purposes other than purely financial ones, such as preservation of natural amenities or estate planning considerations. These represent additional benefits to landowners.

Bargain Sale of Property or Property Rights

Another option for decreasing tax liability on a transfer of property or a property right is through a bargain sale. A bargain sale – also known as a charitable sale – is where property is sold for a price that is below the market value for that property. The difference between the sale price and the market value is considered a charitable deduction that may be taken on income taxes for a period of up to six years. This charitable donation will help to offset the tax consequences of the cash transaction. Under IRS regulations, criteria must be met for a bargain sale to occur and for the landowner to receive the tax benefits. The sale must be made to a 501(3) (c) charity such as a land trust or government agency. It must also be made on a capital asset held for more than one year, such as appreciated property. Finally, the sale price should be less than 80% of the market value.

Exchanging Conservation Easements and Development Rights for Other Property

One option for avoiding the recognition of gain from the sale of a conservation easement is to exchange the conservation easement for other real property. The IRS has ruled that exchanging a scenic conservation easement on one piece of land for a fee interest in another piece of land is a like-kind exchange. An exchange of development rights for a fee interest in land is also a like-kind exchange.

Example 5. Assume the same facts as in Example 3 except that Rhoda trades the development rights in her land for other land without the development rights. The land she acquires is worth $200,000 without the development rights.

Rhoda does not have to recognize any gain from the exchange. She must allocate her basis in the land she originally owned between her original land and the land she acquired in the exchange based on the fair market value of the development rights she gave up and the fair market value of the land she retained without the development rights. In this case, the development rights amount to 40% of the total value of the land ($200,000 ÷ $500,000). Therefore, she has a $30,000 (60% x $50,000) basis in the land she originally owned and a $20,000 (40% x $50,000) basis in the land she acquired in the exchange.

Conclusion

In this article we have highlighted various means available to landowners to reduce income tax liability on the transfer of real property. Individuals considering strategies discussed in this article should contact their professional tax advisor. Facts and circumstances unique to each case will determine the outcome.

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