

ISSUE 4: EASEMENTS This issue addresses the taxation of payments for easements, including their effect on basis and the potential for deferral of gain.

An easement is the right to use (or to prevent others from using) for a specific purpose real estate that is owned by another person. Whoever owns land usually also owns the earth below it to the center of the earth, and everything above it to the heavens, and is free to divide and sell that ownership, often in the form of an easement. Through the years, the concept has been applied to air rights, development rights, water and flooding rights, and subterranean transmission rights.

An easement attaches to the land rather than simply being a contract between the current landowner and the person to whom the easement is granted. Both parties now have rights to the real estate. Property subject to an easement may be sold, gifted, bequeathed, and so forth, just like any other property, but the easement remains with the property. Many tax concepts that apply to the fee-simple sale or exchange of real estate also apply to the granting of easements.

Types of Payments

A landowner granting an easement may receive multiple types of payments that have different tax consequences. These can include payments for an actual land purchase (fee-simple sale), for temporary access to the work site (rent payments), for a continuing right-of-way for a pipeline or electrical transmission line (the easement), for the diminished value of other property (severance award), and for loss of income (actual crop damage or inability to plant and harvest). Negotiating and documenting the details of the payments in the written agreement is a crucial first step.



Practitioner Note Sale or Lease

If the right to use the property is granted for a limited term of years, rather than being perpetual, the payment is treated as a lease, rather than as a sale of property. In *Wineberg v. Commissioner*, T.C. Memo 1961-336, the Tax Court held that a timber company's payments for the right to use a road for 10 years were rents because there was no sale of the property. A lease of at least 30 years, however, is treated as an interest in real estate for the I.R.C. § 1031 like-kind exchange rules [Treas. Reg. § 1.1031(a)-1(c)].

Easements may be granted for a variety of uses, including

1. Aviation
2. Beach access
3. Conservation (limiting development of the land)
4. Driveways to land-locked parcels
5. Solar access (the availability of natural light)
6. Utilities (drainage, electricity, fuel, phone, sewage, water)
7. Views (payments to an adjoining landowner to prevent the landowner from obstructing a view or to allow the owner of the easement to clear the view)



Practitioner Note Aviation Easements

Aviation easements grant the right to airspace above a certain altitude. An easement granted on property in close proximity to an airport gives up the right to build above a certain height on the property. It could also limit the ability to grow trees and some agricultural crops. A farmer may be required to buy an aviation easement from adjoining landowners to apply crop spray by plane to his own land. The latter is referred to as an *aviation right*.

Payment for Easement

Because an easement is a property right, it is an I.R.C. § 1202 capital asset or an I.R.C. § 1231 business asset. The landowner who is paid for granting an easement must determine his or her basis in the portion of the land that is affected by the easement, which often is not the entire property.

However, the landowner is not required to allocate the basis of the property affected by the easement between the rights that were sold and those that are retained. The affected property's full basis is used to offset the payment received, so gain is generated only if the payment exceeds the property's basis (Rev. Rul. 68-291, 1968-1 C.B. 351, and Rev. Rul. 77-414, 1977-2 C.B. 299).

If the payment for the easement exceeds the property's basis, the gain is reported as a sale of the property.

Example 8.16 Treatment of Easement Payment

Samantha Farmer granted an easement for electric transmission lines affecting 12 acres of her 300-acre property. Samantha paid \$2,500 an acre for the land 10 years ago. The \$24,000 she was paid for the easement reduces her basis in the 12 acres from \$30,000 ($\$2,500 \times 12$ acres) to \$6,000 ($\$30,000 - \$24,000$).

Question 1. What if Samantha received \$40,000 for a pipeline easement on another 12 acres?

Answer 1. She would recognize a \$10,000 gain ($\$40,000 - \$30,000$).

Question 2 How is this gain taxed?

Answer 2. Because Samantha used the land in farming and she held it more than 12 months, the gain is I.R.C. § 1231 gain that is reportable on Form 4797, Sales of Business Property. If Samantha had held the land only for personal or investment purposes, the easement transaction would be reported on Schedule D (Form 1040) as a long-term capital gain.

Property Affected

Contractual documentation of the property affected is vital in negotiating and reporting the tax consequences when an easement is granted. The impact of an easement often stretches beyond the actual acreage for which the easement is granted and may affect the value of surrounding land owned by the same taxpayer. Severance damages may arise from the granting of a surface-level easement, or the easement may impair the taxpayer's view.

In *Inaja Land Co., Ltd. v. Commissioner*, 9 T.C. 727 (1947), the Tax Court held that it was practically impossible to allocate a separate basis to the easement granted, so the net amount received was applied to reduce the taxpayer's basis for the entire property. But in *Fasken v. Commissioner*, 71 T.C. 650 (1979), the court required an allocation of basis, finding that the usefulness of the property as a whole was not affected by utility easements.

Example 8.17 Severance Award

Samantha (from Example 8.16) was paid \$40,000 for a pipeline easement that runs across the surface of her property. As a result, access to 100 acres of her property is reduced; she must go out to a road to get around the pipeline. She negotiated an additional \$15,000 payment from the utility company for the reduced access to her land. This is a severance damage award.

The additional award does not change the treatment of the \$40,000 payment: Samantha still reports a \$10,000 I.R.C. § 1231 gain from it. But she can apply the \$15,000 of severance damages against the \$250,000 ($\$2,500 \times 100$) basis of her severed property, and she has no additional reportable gain from the severance award. Her basis in the 100 acres is reduced to \$235,000.

Taxation of Other Payments

A taxpayer who grants an easement may also give up all rights to a portion of the land. Sales and leases entered into concurrently with the granting of easements are treated as separate transactions for tax purposes and are reported as usual, as sales on Form 4797 or Schedule D (Form 1040) and lease payments on Schedule E (Form 1040).



Practitioner Note Multiple Easement Request

A sale could occur if a utility company purchases land for a transmission station in addition to requesting a power line easement. More typically, the utility will enter into a long-term lease for the ground on which the various equipment and towers are placed, and it will also acquire an air rights easement for the transmission lines, a visual easement for reduced aesthetic value, and a surface easement for access to towers and equipment for maintenance.

If the taxpayer is a farmer, there may be payments for crops damaged during the construction phase or when the easement is used for maintenance. If construction occurs when a crop is not already growing, there may be a payment for loss of income. In either case, the payment is reported as if the taxpayer had actually sold the crop, typically on Schedule F (Form 1040), Profit or Loss From Farming (on line 10, rather than line 4, for a farmer with material participation), and on Form 4835, Farm Rental Income and Expenses, for a landowner with a crop-share lease.



Practitioner Note Unharvested Crop Included in Easement

I.R.C. § 1231 treats an unharvested crop on land that is used in a trade or business and held more than 1 year as property used in a trade or business (and potentially eligible for capital gains treatment) if the crop and land are sold or exchanged at the same time and to the same person. Therefore, if a payment is received for a growing crop from the purchaser of the easement, the crop payment should qualify for I.R.C. § 1231 treatment. This preferential tax treatment does not apply to an income replacement payment for crops that were not planted because the easement was granted.

Like-Kind Exchange or Involuntary Conversion

When an easement is considered an interest in real property under state law, the easement can be exchanged for other qualifying property under the I.R.C. § 1031 like-kind exchange rules or replaced with other property under the I.R.C. § 1033 involuntary conversion rules. Several revenue rulings support this treatment for the exchange of agricultural conservation easements (development rights) and scenic conservation easements:

- Rev. Rul. 76-69, 1976-1 C.B. 219, held that a scenic easement sold to the United States under threat of condemnation was an involuntary conversion of an interest in real property for purposes of I.R.C. § 1033, allowing the payment to be reinvested in other ranch land.
- Rev. Rul. 72-433, 1972-2 C.B. 470, held that proceeds received for flowage easement rights on a farm that were immediately reinvested in other farmland to restore the volume of production qualified for nonrecognition of gain.
- Rev. Rul. 72-549, 1972-2 C.B. 472, concluded that real property held for business use or for investment that was acquired with proceeds from an easement and right-of-way granted to an electric power company qualified as like-kind replacement property.
- Rev. Rul. 69-240, 1969-1 C.B. 199, held that spending severance damages to acquire adjacent farmland was an acquisition of property similar or related in service or use for purposes of nonrecognition.
- The IRS has also issued two letter rulings holding that an agricultural conservation easement qualifies as like-kind with a fee-simple interest in replacement real property [P.L.R. 92-15-049 (January 15, 1992) and P.L.R. 92-32-030 (May 12, 1992)].

Example 8.18 Like-Kind Exchange of Easement

Samantha (from Examples 8.16 and 8.17) wanted to explore her options rather than pay tax on her \$10,000 gain from the pipeline easement payment. A 20-acre adjoining parcel of farm land is available for \$40,000. If Samantha can arrange a

like-kind exchange, she can defer the gain from the easement, and her basis in the newly acquired 20-acre parcel will be her \$30,000 basis in the property she is giving up in the easement. The transaction is reported on Form 8824, Like-Kind Exchanges, to document Samantha's basis and deferred gain in the 20-acre parcel.

If property is involuntarily converted, the taxpayer can receive cash and reinvest it. If real property used in a trade or business is condemned, the taxpayer has 3 years from the end of the year of in which gain is realized to purchase replacement property for the deferral of gain.

Example 8.19 Condemnation for Easement

Samantha (from Example 8.18) does not know of any property that is currently available in order to complete a like-kind exchange, so she refused to grant the easement. The pipeline company looked at alternate routes, and then returned to Samantha, stating that they planned to condemn her property under the right of eminent domain. The condemnation threat allows Samantha to accept the

\$40,000 payment and then reinvest it within 3 years to defer taxation of the \$10,000 gain.



Practitioner Note Election to Defer Gain

There is no IRS form for reporting an election to defer the gain from a condemnation by purchasing replacement property. The election is made by submitting a statement with the tax return, providing the date, details of the condemnation, the proceeds received, and the calculation of realized gain.

When replacement property is acquired, the taxpayer attaches a statement to the tax return for the year of replacement describing the replacement property, its cost, the basis of the property after reduction for gain deferred from the condemnation, and any gain that is recognized if the taxpayer does not reinvest all of the proceeds.

Recognized gain is reported on the tax return for the year of condemnation, which requires an amended tax return.

ISSUE 5: KIDDIE TAX I.R.C. § 1(g) requires some unearned income received by children to be taxed at a parent's rate. This "kiddie tax" provision now applies to many college students.

Children under age 14 at the close of the tax year have been subject to the *kiddie tax* since 1987. The Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, extended it to children under age 18 for tax years beginning after 2005, and the Small Business and Work Opportunity Tax Act of 2007, Pub. L. No. 110-28, further extended it to most children age 18 and to many full-time students ages 19 through 23 for tax years beginning after May 25, 2007. Congressional reports said this expansion of the kiddie tax is expected to increase revenue by \$1.4 billion over a 10-year period.

If the child's net unearned income exceeds \$1,800 for 2008, the unearned income above that threshold is taxed at the parent's marginal tax rate if the parent's marginal tax rate is higher than the child's. The child's other taxable income (earned income plus unearned income up to the \$1,800

threshold, minus the child's standard deduction or itemized deductions) is taxed at the child's rate.

Criteria for Tax

Three criteria apply regardless of the child's age. If all criteria are met, the kiddie tax applies regardless of whether the child can be claimed as a dependent by a parent.

1. At least one of the child's parents must be alive at the end of the tax year.
2. The child must have unearned income exceeding twice the amount of a dependent's standard deduction. (The 2008 standard deduction is \$900.)
3. The child's filing status is not married filing a joint return.