

Tax Issues Associated With Easement Payments – Part 1

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Overview

Rural landowners often receive payment from utility companies, oil pipeline companies, wind energy companies and others for rights-of-way or easements over their property. The rights acquired might include the right to lay pipeline, construct aerogenerators and associated roads, electric lines and similar access rights. Payments may also be received for the placement of a “negative” easement on adjacent property so that the neighboring landowner is restricted from utilizing their property in a manner that might decrease the value of nearby land.

How are these various types of payment to be reported for tax purposes. It’s an important issue for many farmers, ranchers and rural landowners.

Tax issues with easement payments Part 1 of a series – it’s the topic of today’s post.

Characterizing the Transaction

The receipt of easement payments raises several tax issues. The payments may trigger income recognition or could be offset partially or completely by the recipient’s income tax basis in the land that the easement impacts. Also, a sale of part of the land could be involved. In addition, a separate payment for crop damage could be involved.

Sale or exchange. A sale or exchange triggers gain or loss for income tax purposes. *I.R.C. §1001*. Is the grant of an easement a taxable event? It depends. In essence, a landowner’s grant of an easement amounts to a sale of the land if after the easement grant the taxpayer has virtually no property right left except bare legal title to the land. For instance, in one case, the grant of an easement to flood the taxpayer’s land was held to be a sale. *Scales v. Comr.*, 10 B.T.A. 1024 (1928), *acq.*, 1928-2 C.B. 35. In another situation, the IRS ruled that the grant of an easement for air rights over property adjoining an air base that caused the property to be rendered useless was a sale. *Rev. Rul. 54-575*, 1954-2 C.B. 145. The grant of a perpetual easement on a part of unimproved land to the state for a highway, as well as the grant of a permanent right-of-way easement for use as a highway have also been held to be a sale. *Rev. Rul. 72-255*, 1972-1 C.B. 221; *Wickersham v. Comr.*, T.C. Memo. 2011-178. Also, the IRS has determined that the grant of a perpetual conservation easement on property in exchange for “mitigation banking credits” was held to be a sale or exchange. *Priv. Ltr. Rul. 201222004* (Nov. 29, 2011). Under the facts of the ruling, the taxpayer acquired a ranch for development purposes, but did not develop it due to the presence of two endangered species. The taxpayer negotiated a Mitigation Bank Agreement with a government agency pursuant to which the taxpayer would grant a perpetual conservation easement to the government in return for mitigation banking credits to allow the development of other, similarly situated, land. The IRS determined that the transaction constituted a sale or exchange.



Note: The buyer of mitigation credits is likely to be a dealer that won't hold the credits long enough to achieve capital gain status on sale. But, the ultimate answer to the question of the buyer's tax status is a fact-dependent determination.

Ordinary income or capital gain? If the payments for the grant of an easement are, in effect, rents for land use the characterization of the payments in the hands of the landowner is ordinary income. For example, in *Gilbert v. United States*, 574 F. Supp. 177 (D. Wyo. 1983), *aff'd.*, and *rev'd. by*, 808 F.2d 1374 (10th Cir. 1987), the taxpayers, a married couple, raised cattle on their 6,480-acre ranch. They held title to the surface rights and a fractional interest in the minerals. The federal government reserved most of the mineral rights. In 1976 and 1977, the taxpayers negotiated more than 50 contracts with oil and gas lessees and pipeline companies to receive payments for anticipated drilling activities on the ranch. The taxpayers reported the payments as non-taxable recovery of basis in the entire ranch with any excess amount reported as capital gain. The IRS disagreed, asserting that the payments were taxable as ordinary income. The taxpayers paid the asserted deficiency and sued for a refund.

The trial court dissected the types of payments involved concluding that the "Release and Damage Payments" were *not* rents taxable as ordinary income. Instead, the payments from pipeline companies for rights-of-ways and damage to the land involved a sale or exchange and were taxable as capital gain – the pipeline companies had obtained a perpetual right-of-way. On further review, the appellate court held that the "Release and Damage Payments" were not a return of capital to the taxpayers that qualified for capital gain treatment to the extent the amount received exceeded their basis in the land. However, the appellate court affirmed the trial court's holding that the amounts received from the pipeline companies were properly characterized as the sale of a capital asset and constituted a recovery of basis with any excess taxable as capital gain.

Limited Easements. The grant of a limited easement is treated as the sale of a portion of the rights in the land *impacted by the easement*, with the proceeds received first applied to reduce the basis in the land affected. Thus, if the grant of an easement deprives the taxpayer of practically all of the beneficial interest in the land, except for the retention of mere legal title, the transaction is considered to be a sale of the land that the easement covers. That means that gain or loss is computed in the same manner as in the case of a sale of the land itself under I.R.C. §1221 or §1231. In addition, only the basis of the land that is allocable to that portion is reduced by the amount received for the grant of the easement. Any excess amount received is treated as capital gain. The allocation of basis does not require proration based on acreage. Instead, basis allocation is to be "equitably apportioned" based likely on fair market value or assessed value at the time the easement is acquired.

Location of the easement. In rare situations where the entire property is impacted by the easement, the entire basis of the property can be used to offset the amount received for the easement. This might be the situation where severance damage payments are received. These types of payments may be made when the easement bisects a landowner's property with the result that the property not subject to the easement can no longer be put to its highest and best use. This is more likely with commercial property and agricultural land that has the potential to be developed. Severance damages may be paid to compensate the landowner for the resulting lower value for the non-eased property. If severance damages exceed the landowner's basis in the property not subject to the easement, gain is recognized.



Note: Whether the easement impacts the entire parcel is a question of fact. An easement located across a corner of a tract or along a fence line, may be less likely to be found to impact the entire parcel than would an easement down the middle of a tract.

Conclusion

In Part 2 in this series, I will break down the various types of payments that landowners receive for easements and the proper reporting of those payments. I will also look at the possibility of eminent domain concepts applying to the easement transaction.

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