

Tax Issues Associated With Easement Payments – Part 2

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Overview

In Part 1 of this series, I noted that an increasingly common issue for rural landowners is that of companies seeking easements across farmland. Often the easements are sought by energy companies for the placement of pipelines or some form of transmission line. The easement transaction involves the landowner receiving compensation for the loss of certain property rights. In Part 1 of this series I focused on the nature of the transaction and the likely tax characterization of the payments a landowner might receive. In today's Part 2, I look more in-depth at the type of payments a landowner might receive and how they should be reported for tax purposes.

Tax issues associated with easement payments – Part 2 in a series. It's the topic of today's post.

Types of Payments

“Bonus” payments. Sometimes a company interested in acquiring an easement will pay an upfront amount to the landowners. The payment will typically reserve the exclusive right to obtain an easement for a period of time with the landowner retaining the payment regardless of whether the company actually acquires an easement within the specified timeframe. The landowner properly reports such a “bonus payment” on Schedule E with the amount flowing to Form 1040. The company would issue a Form 1099-MISC to the landowner, showing the amount of the payment in Box 1.

Damage payments. As noted above, an initial payment made to a landowner for acquisition of an easement could result in income to the landowner or a reduction of the landowner's basis in the land, or both. That means that a lump sum payment for the right to lay a pipeline across a farm may result in income, a reduction in basis of all or part of the land or both. An amount for actual, current damage to the property caused by construction activities on the property subject to the easement may be able to be offset by basis in the affected property. Examples of this type of payment would be payments for damage to the property caused by environmental contamination and soil compaction. A payment for damage to growing crops, however, is treated as a sale of the crop reported either on line 2 of Schedule F or line 1 of Form 4835 for a non-material participation crop-share landlord. Any payment for future property damage (e.g., liquidated damages), however, is generally treated as rent and reported as ordinary income.

Severance damages. Involuntary conversion concepts may also come into play in an easement transaction. “Severance damages” might be paid when only a part of a property is directly impacted by an easement as compensation for loss of value in the portion not directly impacted. These damages might be paid, for example, when the easement impairs access to the property. But it is important that the easement transaction (or condemnation proceeding if there is one) refer specifically to such damages as “severance damages.” If they are not specifically delineated, they will be treated simply as damage payments. This is an important distinction. Under the involuntary conversion rules of I.R.C. §1033, it is possible for the landowner to defer gain resulting from the payment of severance damages by using the severance damages to restore the property that the easement impacts or by investing the damages in a timely manner in other qualified property.



There is no requirement that the landowner apply the severance damages to the portion of the property subject to the easement. Also, if the easement so impacts the remainder of the property where the pre-easement use of the property is not possible, the sale of the remainder of the property and use of the sale proceeds (plus the severance damages) to acquire other qualified property can be structured as a deferral transaction under I.R.C. §1033.

Temporary easement payments. Some easements may involve an additional temporary easement to allow the holder to have space for access, equipment and material storage while conducting construction activities on the property subject to the easement. A separate designation for a temporary easement for these purposes will generate rental income for allocated amounts. As an alternative, it may be advisable to include the temporary space in the perpetual easement which is then reduced after a set amount of time. Under this approach, it is possible to apply the payment attributable to the temporary easement to the tract subject to the permanent easement. Alternatively, it may be possible, based on the facts, to classify any payments for a temporary easement as damage payments.

Negative easements. A landowner may make a payment to an adjacent or nearby landowner to acquire a negative easement over that other landowner's tract. A negative easement is a use restriction placed on the tract to prevent the owner from specified uses of the tract that might diminish the value of the payor's land. For instance, a landowner may fear that their property would lose market value if a pipeline, high-power transmission line or wind aerogenerator were to be placed on adjacent property. Thus, the landowner might seek a negative easement over that adjacent property to prevent that landowner from granting an easement to a utility company for that type of activity from being conducted on the adjacent property. The IRS has reached the conclusion that a negative easement payment is rental income in the hands of the recipient. *F.S.A. 20152102F (Feb. 25, 2015)*. It is not income derived from the taxpayer's trade or business. In addition, the IRS position taken in the FSA could have application to situations involving the government's use of a taxpayer's property to enhance wildlife and/or conservation.

Lease Payments

A right of use that is not an easement generates ordinary income to the landowner and is, potentially, net investment income subject to an additional 3.8 percent tax. *I.R.C. §1411*. Thus, transactions that are a lease or a license generate rental income with no basis offset. For example, when a landowner grants surface rights for oil and gas exploration, the transaction is most likely a lease. Easements for pipelines, roads, surface sites and similar interests that are for a definite term of years are leases. Likewise, if the easement is for "as long as oil and gas is produced in paying quantities," it is lease.

The IRS has ruled that periodic payments that farmers received under a "lease" agreement that allowed a steel company to discharge fumes without any liability for damage were rent. In *Rev. Rul. 60-170, 1960-1 C.B. 357*, the payments from the steel company were to compensate the farmers for damages to livestock, crops, trees and other vegetation because of chemical fumes and gases from a nearby plant. The IRS determined that the payments were rent and, as such, were not subject to self-employment tax.

Note: A lease is characterized by periodic payments. A lease is also indicated when failure to make a payment triggers default procedures and potential forfeiture. In addition, lease payments are not subject to self-employment tax in the hands of the recipient regardless of the landowner's participation in the activity. Accordingly, the annual lease payment income would be reported on Schedule E (Form 1040), with the landowner likely having few or no deductible rental expenses.

Eminent Domain

Proposed easement acquisitions can be contentious for many landowners. Often, landowners may not willingly grant a pipeline company or a wind energy company, for example, the right to use the landowners' property. In those situations, eminent domain procedures under state law may be invoked which involves a



condemnation of the property. The power of eminent domain is the right of the state government (it's called the "taking power" for the federal government) to acquire private property for public use, subject to the constitutional requirement that "just compensation" be paid. While eminent domain is a power of the government, often developers of pipelines and certain other types of energy companies are often delegated the authority to condemn private property. The condemnation award (the constitutionally required "just compensation") paid is treated as a sale for tax purposes.

Note: The IRS view is that a condemnation award is solely for the property taken. But, if the condemnation award clearly exceeds the fair market value of the property taken, a court may entertain arguments about the various components of the award. Thus, it's important for a landowner to preserve any evidence that might support allocating the award to various types of damages.

Involuntary conversion. While a condemnation award that a landowner receives is treated as a sale for tax purposes, it can qualify for non-recognition treatment under the gain deferral rules for involuntary conversions contained in I.R.C. §1033. *Rev. Rul. 76-69, 1976-1 C.B. 219; Rev. Rul. 54-575, 1954-2 C.B. 145.* I.R.C. §1033 allows a taxpayer to elect to defer gain realized from a condemnation (and sales made under threat of condemnation) by reinvesting the proceeds in qualifying property within three years. See, e.g., *Rev. Rul. 72-433, 1972-2 C.B. 470*

The election to defer gain under I.R.C. §1033 is made by simply showing details on the return about the involuntary conversion but not reporting the condemnation gain realized on the return for the tax year the award is received. A disclosure that the taxpayer is deferring gain under I.R.C. §1033, but not disclosing details is treated as a deemed election.

Note: If the taxpayer designates qualified replacement real estate on a return within the required period and purchases the property at the anticipated price within three years of the end of the gain year, a valid election is complete. If the purchase price of the replacement property is lower than anticipated, the resulting gain should be reported by amending the return for the election year. If qualified replacement property within the required three-year period, the return for the year of the election must be amended to report the gain.

Conclusion

Rural landowners are facing easement issues not infrequently. Oil and gas pipelines, wind energy towers, and high voltage power lines are examples of the type of structures that are associated with easements across agricultural land. Seeking good tax counsel can help produce the best tax result possible in dealing with the various types of payments that might be received.

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