

Selling an Agricultural Conservation Easement: Capital Gains Tax Implications and Opportunities

By Jerry Cosgrove

DESCRIPTION

An agricultural conservation easement (ACE) is a deed restriction landowners voluntarily place on their property to protect productive agricultural land by limiting subdivision, non-farm development, and other uses that are incompatible with commercial agriculture. Landowners can convey an ACE to a public purchase of agricultural conservation easement (PACE) program or a local land trust to monitor and enforce the restrictions set forth in the agreement.¹ When a landowner sells an ACE, proceeds from the sale can free up capital to reinvest in their agricultural operation, acquire additional land, invest for retirement, or reduce debt. An ACE can also help keep farmland affordable for intergenerational transfer and for beginning farmers.

ISSUES AND OPTIONS

ACEs are substantial conveyances of real estate interests and should be undertaken with careful thought and planning. Four main planning issues to consider include:

- Land planning: How does the easement-restricted land relate to the agricultural operation or any other agricultural land that is owned or operated?
- Business planning: Will the easement provide the flexibility needed to adapt to changing business conditions?
- Financial planning: Will the sale or other conveyance of an easement affect taxes and other finances?
- Estate planning: Is the easement transaction integrated with other estate planning and transfer efforts?

Capital Gains

Participants generally are paid the appraised value of the easement at the closing in exchange for removing the non-agricultural development potential of their property. An easement is a capital asset—property expected to increase in value over time. Therefore, the sale of an easement may be subject to federal and state capital gains taxes to the extent that the proceeds exceed the basis in the property.² IRS Revenue Ruling 77-414 allows the *entire* basis—instead of the portion that could be attributed to the conservation easement³—to be deducted from the proceeds. This means that any capital gain will be reduced by the amount of the basis. For example, if Agricultural Landowner A sells an easement on Greenacre for \$1,000 and his basis in the property is \$100, he would owe federal and state capital gains

¹ PACE programs are also known as purchase of development rights (PDR) programs. Twenty-eight states and at least 95 localities have PACE programs that use public funds to buy ACEs. Land trusts that have prioritized the protection of agricultural land can work with landowners to identify available sources of funding, including the Agricultural Land Easements component of the federal Agricultural Conservation Easement Program.

² Generally, the basis is the value of the property when it was acquired adjusted by any improvements or depreciation over time.

³ 3 Rev. Rul. 77-414, 1977-2 C.B. 299 allows the entire basis to be applied in cases when apportioning it between the easement and the property subject to the easement is impractical or impossible.

tax on \$900. Federal capital gains tax is currently up to 20 percent for assets held for at least one year. Many states impose capital gains taxes as well.

Like-Kind Exchange

Because an easement is considered an interest in property in most states, the landowner may utilize a 1031 like-kind exchange to trade the value of the easement for additional land. The taxpayer will not have to recognize gain on the sale of the easement and will need to allocate the basis between the retained acreage (now subject to the conservation easement) and the carryover basis of the easement now allocated to the newly acquired property.⁴

BENEFITS

- Considering the sale of an easement can serve as a catalyst for landowners to develop an estate plan.
- Selling an agricultural conservation easement can generate cash for retirement or life insurance, or provide liquid assets that can be given to heirs – even those who do not wish to farm.
- Selling an agricultural conservation easement can help facilitate intergenerational farm transfer by reducing future market value to agricultural or restricted land value.

DRAWBACKS

- Selling an easement is considered the sale of a capital asset and is treated as capital gain to the extent that the proceeds exceed the basis in the property. There is currently no exclusion for gain on the sale of an agricultural conservation easement.⁵
- While cost-share payments are excluded from income under Section 126 of the Internal Revenue Code, this provision does not apply to easement payments as set forth in a tax court decision.⁶

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⁴ IRS private letter rulings 9621012, 9851039, 9232030, 9215049.

⁵ This means that state, local and private funds used for such purchases are subject to the capital gain taxes.

⁶ (C. Graves, 88 Tax Court Decision # 43617)