Center For Agricultural & Natural Resource Policy

FACT SHEET • FS-780

Taxes and Land Preservation: Computing the Capital Gains Tax

Many farmers have their wealth tied up in their land and would like to convert some of this land value into cash. Others want to ensure that their land stays in farming forever. Some farmers want to preserve their property's characteristics and amenities. Others want to make it more affordable for their children to buy the land.

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Farmers may want to extract part of the land's value in order to minimize estate taxes. For these landowners, Maryland has established a variety of programs to assist in the preservation of farmland and purchasing certain rights connected to the land for cash.

The state runs a successful farmland preservation program, the Maryland Agricultural Land Preservation Foundation (MALPF). Maryland has also introduced a Rural Legacy program to further its goals of protecting rural character, environmental resources, and land parcels with significant historical or cultural value.

Many counties have also introduced programs to promote farmland preservation. These include purchase of development rights programs, which use tax monies to buy the rights to residential, commercial, and industrial development, and transfer of development rights programs, where landowners and developers negotiate prices for development rights. The sale of development rights is affected through placing an easement on a property. An easement binds all

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current and future landowners to the agreed-upon development (or use) limitations. Often the terms "sale of development rights" and "sale of an easement" are used interchangeably.

Selling development rights or easements has tax implications for landowners, especially those who have owned their farms for a long period of time and seen land values escalate. This fact sheet discusses some of the implications for capital gains taxes. For estate tax implications, see the Center for Agricultural and Natural Resource Policy's Fact Sheet, "Estate Planning for Farm Families."

Uses of the Easement Payment

Farmers who do not anticipate selling farmland for development can receive all or part of the value of the farm's development rights by selling an easement to the state or local land preservation program. Holding title to a parcel of land can be viewed as having a bundle of rights to exercise. These rights can include farming the land, subdividing it as permitted under local zoning ordinances, selling it, or giving it to one's children. Because these rights can be exercised separately, you can sell some of them without losing the ownership rights to the property. Selling the right to develop your land is one such right. Most land preservation programs pay at least part of the value of these rights in exchange for restricting use of the land through an easement. Agricultural preservation easements restrict or prohibit most residential, commercial, and industrial uses. Having the value of the development rights paid out in cash can provide new opportunities.

Selling development rights is an important decision which needs to be carefully considered with the input of all family members. While making the decision, you should consider the range of programs and options available. You also need to determine if you need cash for the full value or want to take a charitable deduction on your taxes by selling easement below its fair market value. You may also want to consider what plan works best for your situation for cash flow and tax considerations, including a one-time payment or an installment payment plan.

Capital Gains Tax Rates

Because you are selling part of the bundle of rights associated with your land (an asset), you probably will be subject to a capital gains treatment rather than ordinary income for the preservation program payment received.

Short-term assets held for one year or less are currently taxed at the ordinary income tax rate. For assets held longer than one year or "qualified" dividend income, the current rates are 0 percent for those in the 10- and 15-percent income tax brackets; 15 percent for those in the 25-, 28-, 33-, and 35-percent tax brackets; and 20 percent for those in the 39.6-percent tax bracket.

Starting in 2013, certain individuals face a new 3.8-percent Medicare tax on capital gains: those taxpayers with modified adjusted gross income greater than $200,000 for single filers or $250,000 for those married filing a joint return.

Allocating the Land's Basis

To calculate the capital gains tax owed from selling an easement, you must determine the basis of the property and value of the easement. You also need to settle with the preservation program what the actual payment will be for the development rights, since if it is less than the value of the easement, also known as the shortfall, it can be deducted from your taxes as a charitable deduction, depending on your tax situation.

Original Basis. The original basis of the land is determined by its purchase price and any improvements (which have not been depreciated) made since becoming an owner. For example, if Mr. Edwards purchased his 100-acre farm for $200 an acre and made no improvements, the basis would be $20,000. If Ms. Stevens purchased her 100-acre farm for $3,000 an acre and erected a farm building for $50,000 for which she took no depreciation, her basis would be $350,000. Any selling or purchasing transaction expenses related to the easement sale may be added to the basis. These might include legal fees or appraisal costs.

Fair Market Value. The fair market value (FMV) is based on an appraisal conducted by a licensed independent appraiser which includes an evaluation of prices received by comparable properties in the surrounding areas.

Agricultural Value. The agricultural value of the land is the value of today's stream of income expected from the farm based on a combination of county-level land rents and the soil types of the property. For example, the Maryland Agricultural Land Preservation Foundation (MALPF) determines the agricultural value by a formula based on land rents and soil productivity or the 5-year average cash rent in the county where the farm parcel is located. This value is often used to determine the easement payment made. With donated easements or bargain sale easements, Section 170(h) requires a qualified appraisal of the conservation easement from a qualified independent appraiser to satisfy income tax deductions and estate tax reductions.

The easement value is usually considered the difference between the fair market value of the property in its "highest and best use" and the agricultural value or the value of the land once easement restrictions are in place.

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To calculate the capital gains tax owed from selling an easement, you must determine the basis of the property and value of the easement.

Easement Valuation. Each agricultural land preservation program determines easement values in a different way. The easement value is usually considered the difference between the fair market value of the property in its "highest and best use" and the agricultural value or the value of the land once easement restrictions are in place. Programs such as Montgomery and Howard Counties' purchase of development rights programs calculate the easement value based on a point system which rates land characteristics such as soil type, distance to a city, and road frontage to determine payment. Still other programs such as Montgomery and Calvert Counties' transfer of development rights programs let landowners and developers negotiate a price for the transfer of development rights from the agricultural property to another property. In some cases, the programs do not pay the full easement value to the farmer. A farmer may be willing to receive only part of this value as cash and take the remaining portion as a charitable deduction.

Calculating the Tax. To determine what the capital gain tax would be for selling one's development rights, one must subtract part of the basis from the easement value. Mr. Andrews paid $2,000 per acre for his 100-acre farm and therefore has a basis for the property of $200,000. If Andrews has agricultural land with a fair market price of $800,000 and an agricultural value of $300,000, the easement value would be the fair market price minus the agricultural value ($800,000 - $300,000), or $500,000.

If Andrews decided to sell the land outright to a developer for the

full $800,000, he would have to pay capital gains on the fair market price minus the basis ($800,000 - $200,000), which equals $600,000. At a rate of 15 percent, capital gains taxes would be the gain multiplied by 0.15 ($600,000 x 0.15), or $90,000 (table 1).

If Andrews instead decided to sell the development rights for $500,000, he would have to determine which portion of the basis could be applied to the sale before calculating the gain, since the easement value is not the full value of the land. If the easement was valued at $500,000, the percentage of the basis which could be applied to compute the tax would be the percentage of the fair market value of the property that is the easement value ($500,000/$800,000), or 62.5 percent. The part of the basis to apply to the easement sale would be 62.5 percent of the total basis of $200,000 (0.625 x $200,000), or $125,000. The gain from the easement sale is the value of the easement minus the basis ($500,000 - $125,000), or $375,000. The tax on this capital gain at the 15-percent rate is $375,000 x 0.15, or $56,250. Table 1 has the calculations for Andrew's easement sale.

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A landowner would pay a capital gains tax on the easement payment minus the proportional part of the basis. If the payment is 50% of the land's value, 50% of the basis can be subtracted.

There is another ruling, Revenue Rule 77-414 known as "Basis Recovery," which says one can claim the entire basis in the land when selling an easement. If one followed this rule, the basis for the easement sale would be $200,000, the capital gain would be $300,000, and the resulting tax owed would be $45,000. Landowners considering easement sales should discuss with their accountant or tax attorney the appropriate approach to take.

When or if Andrews sells the farm parcel in the future, there will be some basis remaining. This is the basis of $200,000 minus the part already used for the easement sale ($200,000 - $125,000), or $75,000. Thus, if Andrews sold the restricted land for $325,000, there would be a gain of the price minus the basis ($325,000 - $75,000), or $250,000.

The gain from selling development rights depends a great deal on the basis in the farm. In table 2, we compare Mr. Beatty, who has just purchased a

Table 1.

Allocating the Basis

	DEVELOPMENT SALE	EASEMENT SALE
Fair market value (FMV)	$800,000	$800,000
Easement value = FMV – ag value		$500,000
Basis	$200,000	$200,000
% of value realized	100%	$500,000/$800,000 = 62.5%
% of basis applied to easement sale	1.00 x $200,000 = $200,000	0.625 x $200,000 = $125,000
Capital gain = sale price – basis	$800,000 - $200,000 = $600,000	$500,000 - $125,000 = $375,000
Taxes paid on gain	$600,000 x 0.15 = $90,000	$375,000 x 0.15 = $56,250

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If you receive part of the easement payment after the close of the tax year of the sale, this is considered an installment sale. You must report the part of the gain or profit received in each installment payment in the year payment is received.

farm, to Ms. Carter. Beatty's purchase price or basis and the fair market value are identical due to the recent purchase. Carter, on the other hand, has owned her farm for 50 years and seen the value increase from the original purchase price of $50,000 to $550,000. Both farmers sell the development rights, which are valued at the fair market price of $550,000 minus the agricultural value of $200,000, or $350,000. They will receive this $350,000 as a lump sum payment from the agricultural preservation program. For both farmers, the percentage of the easement value of the full market value is equal to 63.6 percent ($350,000/$550,000). They use this percentage to determine the basis they can deduct from the easement payment. For Beatty, this is 63.6 percent of $550,000, or $350,000. For Carter, this is 63.6 percent of the basis of $50,000, or $31,800, a much lower figure. When Beatty subtracts this percentage of the basis from the easement payment of $350,000, there is no gain, and thus no tax is owed. Carter, however, finds tax is owed on $318,200 ($350,000 minus the basis of $31,800). Capital gains taxes are 15 percent of this amount, $318,200; the tax bill is $47,730.

Installment Payments

If you receive part of the easement payment after the close of the tax year of the sale, this is considered an installment sale. You must report the part of the gain or profit received in each installment payment in the year payment is received. Installment payments usually consist of three parts: gain on the sale, interest income, and return of your basis in the property. Taxes are computed on the gain and the interest payments in the tax year received. The interest income from each payment is reported as ordinary income and is taxed at your income tax rate. To determine the basis to use, compute what percentage of the full value of the land is represented by the easement value. Use the percentage in the same way as shown in table 1 to compute the proportion of

Table 2.

Calculating the Basis for Selling Development Rights

	MR. BEATTY	MS. CARTER
Purchase price of farm	$550,000	$50,000
Fair market value	$550,000	$550,000
Appraised easement value	$350,000	$350,000
Ratio of easement value to farm market value	$350,000/$550,000 = 63.6%	63.6%
Allocating basis (ratio x basis)	0.636 x $550,000 = $350,000	0.636 x $50,000 = $31,800
Capital gain	$350,000 - $350,000 = 0	$350,000 - $31,800 = $318,200
TAX ON GAIN	0	$318,200 x 0.15 = $47,730

Table 3.
Comparing Lump-sum versus Installment Payments for Ms. Carter[1]

	LUMP-SUM		10-YEAR INSTALLMENT PAYMENT	
Capital gains taxes due (from Table 2)		$47,730		$47,730
Capital gain tax due each year	Year 1	$47,730	Year 1	$4,773
	Year 2	$0	Year 2	$4,773
	Year 3	$0	Year 3	$4,773
	Etc...	$0	Etc...	$4,773
Total interest @ 6%		$0		$15,751
Ordinary income tax on interest @ 28%		$0		$4,410
Net interest earned		$0		$11,341

the original basis to apply to this easement sale. The gain is the part of each installment payment that is the profit from the sale.

For example, Mr. Zeller sells an easement on a 50-acre property, which has a fair market value of $400,000, for $200,000. The property's basis is $100,000. For the easement sale, the basis would be 50 percent ($200,000/$400,000) of the total basis ($100,000 x 0.50), or $50,000. Thus, the gross profit from the easement sale is $150,000 ($200,000 - $50,000). The gross profit percentage is the profit from the sale divided by the sale value: $150,000 divided by $200,000, which equals 75 percent. One determines the appropriate net payment by taking each installment payment minus the interest portion. One takes 75 percent of this net payment as the gain from the sale in the tax year the installment payment is received.

For Carter and other farmers who have seen substantial appreciation in their property values, installment payments of the easement value may be a better payment plan. Carter could receive interest on the money that would have been paid out for capital gain taxes in the first year. The capital gain taxes paid will be the same, whether under a lump-sum or an installment payment plan. The difference for Carter in the two payment systems is shown in table 3. The installment sale plan earns Carter an extra $11,341 in interest income after paying taxes on the extra income. This can be viewed as similar to the benefits of deferring taxes.

Easement Sales and Charitable Deductions

If you sell an easement for less than its appraised value, you may possibly claim a charitable deduction of the difference between the appraised value and the actual payment based on your individual tax situation. Some programs such as MALPF base their payment on the lower of the appraised easement value or the asking price from a landowner. This permits landowners to ask or bid a lower price in hopes of being one of the landowners selected in a particular year.

Because of this, a landowner may receive a payment lower than the easement value. For this shortfall, which has to be valued independently of the state's appraisal, you can file IRS Form 8283 for Noncash Charitable Contributions in the year the easement was sold. In situations where you will be donating a portion of the easement value, you should always work with a certified tax professional experienced in handling conservation easement donations.

NOTES

[1] This illustrative example uses 10 easement payments of the same amount annually.

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Disclaimer: This publication is intended to provide general information in understanding some aspects of tax issues associated with land preservation and is not intended to provide tax advice. It should not be cited or relied upon as a tax authority. State laws vary and no attempt is made to discuss laws of states other than Maryland. For advice about how the issues discussed here might apply to your individual situation, you should consult a certified tax professional.

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