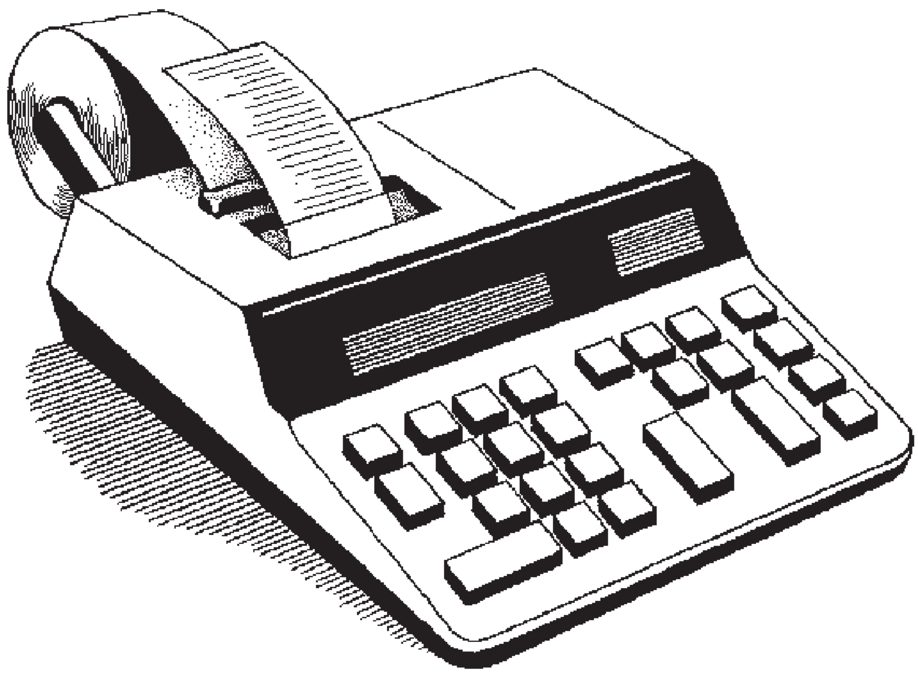
MARYLAND COOPERATIVE EXTENSION
UNIVERSITY OF MARYLAND
COLLEGE PARK•EASTERN SHORE

Fact Sheet

Fact Sheet 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. Farmers may also 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 to purchase certain rights connected to the land for cash. The state runs a successful farm land preservation program, the Maryland Agricultural Land Preservation Foundation (MALPF). The state also has 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 also have introduced programs to promote farmland preservation. These include both 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 that have landowners and developers negotiate prices for development rights. The sale of development rights is enforced through the placing of an easement on a property. An easement binds all 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 have seen escalating land values. This fact sheet discusses some of the implications for capital gains taxes. For estate tax implications, see the Maryland Cooperative Extension Fact Sheet 778 *Estate Planning: Farm Families and the Provisions of the Taxpayer Relief Act* and Maryland Cooperative Extension Fact Sheet 779 *Farmland Preservation: An Estate Planning Tool.*

Uses of the Easement Payment

If you do not anticipate selling your farmland for development, you can receive all or part of the value of the development rights in your farm 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 that you can exercise. For example, these rights can include farming the land, subdividing it as permitted under local zoning ordinances, selling it, or giving it to your 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 of the land preservation programs pay at least part of the value of these rights in exchange for restricting the use of the land through an easement. Agricultural preservation easements restrict or prohibit most residential, commercial, and industrial uses of the land. Having the value of the development rights paid out in cash can provide you with new opportunities.

Selling your development rights is an important decision that needs to be carefully considered with the input of all family members as to the options. While making the decision, you should consider the range of programs available to you. You also need to determine if you prefer to be paid cash for the full value or want to take a charitable deduction on your taxes. You may also want to consider what plan works best for your situation: a one-time payment or an installment 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 earning a capital gain rather than ordinary income from the preservation program payment received. The IRS will treat this easement payment as such.

Before the Taxpayer Relief Act of 1997, gains on capital assets were taxed at a rate of 28 percent for those in high income brackets and at 15 percent for those taxpayers in the lower income bracket. Assets held for less than one year were taxed at the ordinary income tax rate. These short-term assets continue to be treated the same. For assets held longer than one year, the 1997 law reduced the rate 28 to 20 percent for high income tax brackets, and from 15 to 10 percent for those taxpayers in the lower income bracket. Beginning in 2001, capital gains on assets held more than five years will decrease to 18 percent for higher income taxpayers and 8 percent for those in the lower income bracket.

Allocating the Land's Basis

To calculate the capital gains tax that will be owed from selling an easement, you must determine the basis of the property and the value of the easement. You will 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, it can be deducted from your taxes as a charitable deduction.

Original Basis. The original basis of the land is determined by its purchase price and any improvements (that have not been depreciated) made since becoming an owner.[1] 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 appraiser that includes an evalua-

Table 1. Allocating the Basis

	Development Sale	Easement Sale
Fair market value (FMV)	\$800,000	\$800,000
Basis	\$200,000	\$200,000
Easement value = FMV – ag value		\$500,000
% 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 0.20 = \$120,000	\$375,000 x 0.20 = \$75,000

tion of prices received by comparable properties in the surrounding areas.

Agricultural Value. The agricultural value of the land is based on the current value of the 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 five-year average cash rent in the county where the farm parcel is located. This value is often used by programs to determine the easement payment made. With donated easements or bargain sales easements, Section 170(h) of the Internal Revenue Code requires a qualified appraisal of the conservation easement from a qualified appraiser to satisfy income tax deductions and estate tax reductions.

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 the 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 that rates land characteristics such as soil type, distance to a city, and road frontage to determine payment. Other programs such as Montgomery and Calvert Counties' transfer of development rights programs let landowners and developers negotiate a price to enact a 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 gains tax would be for selling one's development rights, one may 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 Mr. 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), which equals \$500,000.

If Mr. 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 20 percent, capital gains taxes would be the gain multiplied by 0.20 ($600,000 x 0.20), which equals $120,000. This is illustrated in Table 1 under "Development Sale."

If Mr. 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 percent of the basis that 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), which equals 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), which equals $125,000. The gain from the easement sale is the value of the easement minus the basis ($500,000 – $125,000), which equals $375,000. The tax on this capital gain at the 20 percent rate is $375,000 x 0.20, which equals $75,000. Table 1 has the calculations for Mr. Andrew's easement sale. There is another ruling, Revenue Rule 77-414, 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 $60,000. Landowners considering easement sales should discuss with their accountant or tax attorney the appropriate approach to take.

When or if Mr. 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), which equals $75,000. Thus if he sold the restricted land for $325,000, there would be a gain of the price minus the basis ($325,000 – $75,000), which equals $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 farm, to Ms. Carter. Mr. Beatty's purchase price or basis and the fair market value are identical due to the recent purchase. Ms. Carter, on the other hand, has owned her farm for 50 years and has 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, which equals $350,000. They will receive this $350,000 as a lump sum payment from the agricultural preservation program. For both farmers, the percent 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 Mr. Beatty, this is 63.6 percent of $550,000, which equals $350,000. For Ms. Carter, this is 63.6 percent of the basis of $50,000, which equals $31,800, a much lower figure. When Mr. Beatty subtracts this

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 0.20 = $63,640

percentage of the basis from the easement payment of $350,000, there is no gain, thus no tax is owed. However, Ms. Carter finds tax is owed on $318,200 ($350,000 minus the basis of $31,800). Capital gains taxes are 20 percent of this amount, $318,200; the tax bill is $63,640.

Installment Payments

If you receive part of the easement payment after the close of the tax year of the easement sale, this is considered an installment sale. You must report the part of the gain or profit that you receive in each installment payment in the year the payment is received. The 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 that you receive them. The interest income from each payment is reported as ordinary income and will be taxed at your income tax rate. To determine the basis to use, you compute what percent of the full value of the land is represented by the easement value. You use the percentage in the same way as is demonstrated in Table 1 to compute the proportion of the original basis you can apply to this easement sale. The gain is the part of each installment payment that is the gross profit from the sale.

For example, Mr. Zeller sells an easement on a 50-acre property that has a fair market value of $400,000, for $200,000. The property's basis is $100,000. Since the easement value is 50 precent of the fair market value ($200,000/$400,00) Mr. Zeller can use 50 percent of the basis in the land (50 percent of $100,000) which equals $50,000. Thus, the gross profit from the easement sale is the amount received, $200,000, minus the percent of the basis Mr. Zeller can apply to the sale, $50,000; thus $200,000 minus $50,000, which equals $150,000. The percentage of the gross profit is the profit from the easement sale divided by the fair market value: $150,000 divided by $400,000, which equals 37.5 percent. The net annual payment is each installment payment minus the interest portion. One owes capital gains tax on 37.5 percent of this net payment in the tax year that the installment payment is received.

For Mr. Carsen and other farmers who have seen substantial appreciation in their property values, installment payments of the easement value may be a better payment plan. Mr. Carsen 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 Mr. Carsen in the two payment systems is shown in Table 3. The installment sale plan earns Mr. Carsen an extra $16,234 in interest income

Table 3. Comparing Lump-sum vs. Installment Payments for Mr. Carsen

	Lump-sum		10-year Installment Payment	
Capital gains taxes due	$62,860		$62,860	
Capital gain tax due each year	Year 1	$62,860	Year 1	$6,286
	Year 2	$0	Year 2	$6,286
	Year 3	$0	Year 3	$6,286
	Etc.	$0	Etc.	$6,286
Total interest @ 6%	$0		$22,547	
Ordinary income tax on interest @ 28%	$0		$ 6,313	
Net interest earned	$0		$16,234	

Table 4. Easement Sale with Charitable Donation

Original purchase price (basis)	\$350,000
Fair market value	\$750,000
Easement value	\$500,000
Ratio of easement value to fair market value	\$500,000/\$750,000 = 0.667
Basis to apply to easement sale	\$350,000 x 0.667 = \$233,333
Payment received for easement	\$400,000
Charitable donation = easement value – payment	\$500,000 – \$400,000 = \$100,000
Income tax savings with deduction[a]	\$100,000 x 0.28 = \$28,000
Capital gain tax on easement payment	\$166,667 x 0.20 = \$ 33,333
Tax owed	\$33,333 – \$28,000 = \$5,333

[a]This may overstate the tax savings from the charitable contribution if other itemized deductions are less than the standard deduction.

after paying taxes on the extra interest 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 can claim a charitable deduction of the difference between the appraised value and the actual payment. 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 that is lower than the easement value. For this shortfall, you can file IRS Form 8283 for Noncash Charitable Contributions in the year the easement was sold. For example, Mr. Harris has development rights valued at \$500,000 but receives a payment of \$400,000. Mr. Harris can take a charitable deduction on his income taxes of \$100,000. The easement provisions must satisfy Section 170(h) requirements to be eligible for this deduction. Maryland agricultural land preservation programs' easement provisions will satisfy these requirements in almost all cases. The IRS permits a landowner to deduct only 30 percent of his or her adjusted gross income in any one year.[2] Thus, if Mr. Harris had an adjusted gross income of more than \$350,000, then he could deduct the full "gift" of \$100,000 in one year. If Harris has an income equal to \$75,000, then he can deduct \$22,500 in the first year and in each of the following years, up to five additional years. The donation can be spread out for up to six years. In most easement sales with a partial bargain sale, landowners will receive a large payment that will be added into the income. Therefore, in this case, Mr. Harris received \$400,000 for the easement, more than enough money to deduct the entire \$100,000 as a noncash contribution. Even if the Harris farm did not produce a high income, the easement payment increases the income sufficiently.

When calculating the tax implications, Mr. Harris needs to take into account how this deduction will change the capital gains. Table 4 demonstrates the calculation for the Harris farm. The Harris land has a fair market value of \$750,000 and an agricultural value of $250,000, thus an easement value of $500,000. The basis of the land is $350,000. Mr. Harris can apply 66.7 percent of this basis against the easement sale ($500,000/$750,000), which equals $233,333. Thus, the total gain on the easement sale is the purchase price of $400,000 minus the basis of $233,333, which equals $166,667. Because the easement is valued at more than the payment received, Mr. Harris can also take a charitable deduction of $100,000. The capital gains tax is 20 percent of $166,667, which equals $33,333. The income tax savings from the charitable deduction is 28 percent of $100,000, or $28,000, assuming the Harris family will be in the upper-income bracket. Therefore the resulting tax owed due to the easement payment is $5,333.

An outright donation of an easement to an agricultural preservation program or land trust can also be treated as a charitable deduction. The value of the charitable deduction is the difference between the fair market price with no restrictions and the value of the property restricted by the easement. If the easement is valued at $300,000 and given as a donation with no payment received, the landowner can deduct $50,000 per year for a total of six years, so long as his or her annual income is more than $167,000.

Notes

[1] In some cases, an adjusted basis must be used. The adjusted basis is the original basis plus any improvements minus any depreciation recapture. Depreciation recapture applies to equipment and special-purpose buildings, such as poultry houses, if depreciation was taken faster than straight-line depreciation. This would usually not apply to an easement sale.

[2] Landowners may elect to deduct up to 50 percent of their adjusted gross income if they are willing to accept other limitations, including limiting their total deduction to their basis in the easement.

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