Like-Kind Exchange of Conservation Easements

Abstract:
With the increasing interest in preserving open space, conservation easements are becoming more popular. If certain requirements are met, the owner can make a like-kind exchange for additional land. The requirements are listed in this excerpt.

ISSUE 6: LIKE-KIND EXCHANGE OF CONSERVATION EASEMENTS

Local government units and non-profit organizations that are interested in preserving open space have offered to buy conservation easements from farmland owners. The effect of the purchase is to allow the land to continue in its farming use but to prevent the land from being developed. The landowner often benefits from lower property taxes in addition to the purchase price that is received for the conservation easement.

A disadvantage the landowner may face is paying income taxes on the amount received. If a landowner sells a conservation easement, the proceeds of the sale are first used to reduce the basis of the affected land. To the extent that the proceeds exceed the basis of the land, they must be reported as gain on the seller' s income tax return.

Example 6.1. Rhoda Dendron owns farmland (Whiteacre) along a scenic coastline. Her local Land Trust Commission would like to acquire a conservation easement on Whiteacre to preserve the scenic view by preventing the land from being developed. Whiteacre is worth $500,000 before the conservation easement is transferred. The conservation easement is worth $200,000, and Whiteacre without the conservation easement is worth $300,000. Rhoda has owned Whiteacre for 30 years and has a $50,000 income tax basis in it.

If Rhoda sells the conservation easement to the Land Trust Commission for $200,000, she will have to report $150,000 ($200,000 – $50,000) of capital gain on her income tax return. Rhoda will have to pay $30,000 ($150,000 × 20%) of federal income tax and about $4,000 of state income tax on that gain, leaving her $166,000 of after-tax proceeds from the sale. She would also have a zero basis in Whiteacre without the conservation easement. Therefore, if she later sells the rest of her interest in Whiteacre for $300,000, she will have to report the entire $300,000 as capital gain and pay about $68,000 of federal and state income taxes on that gain.

EXCHANGING CONSERVATION EASEMENTS FOR OTHER PROPERTY

One option for avoiding the recognition of gain from the sale of a conservation easement is to exchange the conservation easement for other real property. The IRS has ruled that exchanging a scenic conservation easement on one piece of land for a fee interest in another piece of land is a like-kind exchange for purposes of I.R.C. § 1031. Ltr. Rul. 9621012. An exchange of development rights for a fee interest in land is also a like-kind exchange. Ltr. Rul. 9851039; Ltr. Rul. 9232030; Ltr. Rul. 9215049.

Example 6.2. Assume the same facts as in Example 1 except that Rhoda trades the conservation easement on Whiteacre for a fee interest in other farmland (Greenacre). Greenacre is worth $200,000.

Rhoda does not have to recognize any gain from the exchange. However, her basis in Greenacre is a carryover basis from the conservation easement. Therefore, to calculate her basis in Greenacre, she must allocate her $50,000 basis in Whiteacre between the interest in Whiteacre that she retained and the conservation easement. The allocation is based on the fair market value of the conservation easement she transferred and the fair market value of Whiteacre without the development rights. Her basis is allocated as follows:

Interest in Property	Fair Market Value	Percent of Fair Market Value	Portion of $50,000 Basis
Whiteacre without conservation easement	$300,000	60%	$30,000
Conservation Easement	$200,000	40%	$20,000
Total	$500,000	100%	$50,000

Practitioner Note. The entity that is buying the conservation easement may not want to (or may not have authority to) buy the property that the farmland owner wants to acquire in the trade. In that case, a deferred exchange can be arranged under the Starker rules that have been codified into I.R.C. § 1031. Under those rules, the money for the conservation easement will go into an escrow account that can be used to purchase the replacement property.

EXCHANGING CONSERVATION EASEMENTS FOR OTHER PROPERTY SUBJECT TO A CONSERVATION EASEMENT

The like-kind exchange rules will also apply to an exchange of a conservation easement for an interest in property that is subject to a conservation easement.

Example 6.3.

Phil O. Dendron owns a farm (Farm A) that is near a metropolitan area. His local Land Trust Commission has purchased the farm next to his (Farm B) in order to acquire the development rights to Farm B. The Land Trust Commission is willing to sell Farm B without the development rights and wants to buy the development rights to Phil' s Farm A.

Phil' s basis in Farm A is $60,000. The fair market value of Farm A is $300,000. The fair market value of the development rights to Farm A is $100,000 and the fair market value of Farm A without the development rights is $200,000. The fair market value of Farm B without the development rights is $150,000. The Land Trust Commission has offered to exchange Farm B without the development rights for the development rights to Farm A and $50,000 of cash.

If Phil accepts this offer, the exchange will qualify as a like-kind exchange and Phil will not have to recognize any gain. His basis in Farm A and Farm B are calculated as follows:

Interest in Property	**Fair Market Value**	**Percent of Fair Market Value**	**Portion of $60,000 Basis**
Farm A without development rights	$200,000	66 2/3%	$40,000
Development rights to Farm A	$100,000	33 1/3%	$20,000
Total	$300,000	100%	$60,000

Basis in Farm B

Carryover basis from development Rights in Farm A	$20,000
Plus cash paid in exchange	50,000
New basis	$70,000