Tax Consequences of Transferring Development Rights

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Introduction

Several different laws affect the tax consequences of transferring development rights.

Property Law

The tax consequences of transferring development rights to farmland are governed, in part, by the underlying property law rules. Property law allows property owners to divide up the rights associated with property ownership and transfer part of the rights to another person or entity. This rule allows the owner of farmland to transfer the right to develop the property without transferring the rest of the rights to the property.

Income Taxes

Generally, transferring property triggers recognition of gain or loss for state and federal income taxes. If gain is recognized, the difference between the taxpayer's basis in the property and the amount realized is reported as income or loss by the taxpayer.

If the property was held one year or less, the gain or loss is treated the same as other income or expenses of the taxpayer, except that only $3,000 of losses can be used to reduce ordinary income if the land was not used in a trade or business.

If the property was held more than one year, gains are taxed at the lesser of the taxpayer's marginal tax rate or the applicable capital gains rates, which are 20% or 10% for land sold in 1998. Losses from land that was not used in a trade or business first reduce long-term capital gains, then short-term capital gains and then up to $3,000 of ordinary income.

Estate and Gift Taxes

The federal government imposes a gift or estate tax on transfers of assets when the accumulated value of the assets transferred exceeds the applicable exclusion amount. The applicable exclusion amount for 1998 is $625,000 and will increase gradually to $1,000,000 by 2006. In addition, the first $10,000 given to each person each year is not subject to the gift tax.

Wisconsin no longer imposes a gift tax. It does impose an estate tax, but only to the extent the taxpayer can claim a credit against the federal estate tax. Therefore, the Wisconsin estate tax does not increase the total taxes paid, it merely shift the taxes from federal government to the state government.

Property Taxes

Local governments impose a property tax based on the value of real property. Wis. Stat. §70.32(2r) provides for some reduction in the value of land used in agriculture. The intent is to move toward imposing property taxes only on the value of the land for farming.

Selling Development Rights

If a landowner transfers development rights by sale, the proceeds of the sale are first used to reduce basis of the affected land. To the extent the proceeds exceed the basis of the land, they must be reported as gain on the seller's income tax return.

Example 1. Lucy Landowner owns farmland that is within 25 miles of a metropolitan area. Her local Land Trust Commission would like to acquire the development rights on the land to manage development in the area. The land is worth $500,000 before the development rights are transferred. The development rights are worth $200,000 and the land without the development rights is worth $300,000. Lucy has owned the land for 30 years and has a $50,000 income tax basis in the land. Lucy is single and has $150,000 of adjusted gross income and $120,000 of taxable income each year, which places her in the 31 % marginal income tax bracket.

If Lucy sells the development rights 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. Lucy will have to pay $30,000 ($150,000 x 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 the land without the conservation easement. Therefore, if she later sells the rest of her interest in the land 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.

Example 2. Assume the same facts as in Example 1 except that Lucy has a $300,000 income tax basis in the land.

If Lucy sells the development rights to the Land Trust Commission for $200,000, she will have to reduce her basis in her land from $300,000 to $100,000 but will not have to report any gain on her income tax return. If she later sells the rest of her interest in the land for $300,000, she will have to report $200,000 as capital gain and pay about $45,000 of federal and state income taxes on that gain.

Exchanging Development Rights for Other Property

If a landowner exchanges development rights for an interest in other real property and meets the requirements of the like-kind exchange rules under IRC §1031, no gain is recognized.

Example 3. Assume the same facts as in Example 1 except that Lucy trades the development rights in her land for other land without the development rights. The land she acquires is worth $200,000 without the development rights.

Lucy does not have to recognize any gain from the exchange. She must allocate her basis in the land she originally owned between her original land and the land she acquired in the exchange based on the fair market value of the development rights she gave up and the fair market value of the land she retained without the development rights. Therefore, she has a $30,000 ($50,000 x $300,000 ¸ $500,000) basis in the land she originally owned and a $20,000 ($50,000 x $200,000 ¸ $500,000) basis in the land she acquired in the exchange.

Donating Development Rights

New tax rules that are effective beginning in 1998, make donating development rights even more attractive than under prior law. Donations after 1997 qualify the donor for four tax benefits:

1. No gain has to be recognized on the transfer of the development rights,

2. The value of the gift can be claimed as an income tax deduction,

3. The value of the gift can be claimed as a gift tax deduction, and

4. The donor's estate can be reduced by up to 40% of the remaining value of the property.

Example 4. Assume the same facts as in Example 1 except that Lucy donates the development rights to the Land Trust Commission. Also assume that she is expected to live past 2005 and is likely to have an estate worth $1.25 million, which places her in the 41% marginal estate tax bracket.

Lucy will get the following tax benefits:

1. She will not have to report any gain on the sale of the development rights, which will save her $34,000 of federal and state income tax.

2. She will be allowed to claim a $200,000 charitable contribution deduction on her income tax return. That deduction can be used to reduce her taxable income by $45,000 (30% of her adjusted gross income) each year for the current year and the next three tax years. She can claim the remaining $20,000 as a deduction in the fourth tax year after the current year. Those deductions will reduce her federal and state income taxes by about $75,000.

3. She can claim a gift tax exclusion of $200,000, which means her gift will neither cause her to pay any gift taxes nor reduce her applicable exclusion amount. This $200,000 reduction in the value of her estate will reduce her estate taxes by $82,000 ($200,000 x 41%).

4. Her estate will be allowed to exclude $120,000 (40% of $300,000) from the value of her estate, which would reduce her estate taxes by $49,200 ($120,000 x 41%).

In summary, by making a gift of the development rights, Lucy forgoes the $200,000 of sale proceeds, but saves $240,200 ($34,000 + $75,000 + $82,000 + $49,200) in income, gift and estate taxes. Therefore, Lucy's heirs will have $40,200 more than they would have if Lucy sells the development rights.

The tax savings are not as dramatic for taxpayers who are in income tax brackets and estate tax brackets that are lower than Lucy's in the above example. However, most taxpayers save some taxes, which reduces the cost of donating the development rights even if it does not fully offset that cost.

Example 5. Fred Farmer owns farmland that is within 25 miles of a metropolitan area. His local Land Trust Commission would like to acquire the development rights on the land to manage development in the area. The land is worth $500,000 before the development rights are transferred. The development rights are worth $200,000 and the land without the development rights are worth $300,000. Fred has owned the land for 30 years and has a $50,000 income tax basis in the land. Fred is married and has $75,000 of adjusted gross income and $65,000 of taxable income each year, which places him in the 28% marginal income tax bracket. He is expected to live past 2005 and is likely to have an estate worth $750,000, which is less than the $1 million applicable exemption amount available beginning in 2006, so there will be no estate taxes due on his death.

If Fred sells the development rights to the Land Trust Commission for $200,000, he will have to report $150,000 ($200,000 - $50,000) of capital gain on his income tax return. Fred will have to pay $30,000 ($150,000 x 20%) of federal income tax and about $4,000 of state income tax on that gain, leaving him $166,000 of after-tax proceeds from the sale. He will also have a zero basis in the land without the development rights. Therefore, if he later sells the rest of his interest in the land for $300,000, he will have to report the entire sale price as capital gain and pay about $68,000 of federal and state income taxes.

By contrast, if Fred donates the development rights to the Land Trust Commission, he will be get the following tax benefits.

1. He will not have to report any gain on the sale of the development rights, which would save him $34,000 of federal and state income tax.

2. He will be allowed to claim a $200,000 charitable contribution deduction on his income tax return. That deduction can be used to reduce his taxable income by $22,500 (30% of his adjusted gross income) each year for the current year and the next five tax years. He cannot claim the remaining $65,000 ($200,000 - ($22,500 x 6)) as a deduction since the carryover of charitable contribution deductions is limited to five years. Those deductions will reduce his federal and state income taxes by about $47,000.

3. He can claim a gift tax exclusion of $200,000, which means his gift will neither cause him to pay any gift taxes nor reduce his applicable exclusion amount. This $200,000 reduction in the value of his estate will not reduce his gift and estate taxes since his estate is already under the $1 million that can pass tax free in 2006 and later years.

4. His estate will be allowed to exclude $120,000 (40% of $300,000) from the value of his estate. This reduction will not reduce his estate tax since his estate is already under the $1 million that can pass tax free in 2006 and later years.

In summary, by making a gift of the development rights, Fred forgoes the $200,000 of sale proceeds, but saves $81,000 ($34,000 + $47,000) in income taxes. Therefore, Fred's $200,000 donation cost him $119,000 in after-tax dollars.