IOWA STATE UNIVERSITY

Center for Agricultural Law and Taxation

Tax Considerations for a Contract with a Pipeline Company

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Rural landowners are sometimes asked to enter into an agreement to allow a developer to run a pipeline or power lines across their property. These are important decisions with permanent consequences. Landowners considering entering into such a contract should seek legal counsel to carefully review and negotiate the terms. They should also seek the advice of trusted tax counsel to understand how the payments will be taxed.

Although the terms of these agreements will vary, this article summarizes common categories of payments made pursuant to a pipeline or power line easement agreement and their general tax treatment.

Permanent Easements

Companies seeking to run a pipeline or power lines across a landowner's property will general seek a permanent easement for the portion of the property throught which the pipeline or power lines are installed.

An easement is a *property* right, and the sale of a permanent easement is generally treated for tax purposes like the sale of land. They are reported to the landowner on a Form 1099-S. Because the landowner is selling only a portion of the rights to the property, however, tax rules require a basis allocation, meaning that only that portion of the property impacted by the easement will be considered when calculating taxable gain. This usually means that the amount received in exchange for granting the easement is subtracted from the basis of the portion of the property affected by the easement. If it is impossible or impractical to separate the basis of the part of the property on which the easement is granted, the basis of the whole property is reduced by the purchase price. If the purchase price does not exceed the basis, the landowner will reduce the basis of the affected parcel by the amount of the purchase price. If the purchase price exceeds the basis, the difference is taxable gain that must be reported as a sale of real property.

> **Example – No Taxable Gain**
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> A company paid Lionel $25,000 to run a pipeline across the northern section of his 160-acre land parcel. He receives a Form 1099-S reporting the transaction. The easement affects five acres of Lionel's property. Lionel's basis in the whole tract is $1,280,000. His allocated basis in the property impacted by the easement is $40,000 (5/160 x $1,280,000). Lionel will subtract the purchase price from the basis of the impacted parcel, reducing his basis in the impacted parcel to $15,000 ($40,000 - $25,000). Because the purchase price does not exceed basis, Lionel has no taxable gain.
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> **Example - Taxable Gain**
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> The company instead paid Lionel $50,000 to run a pipeline across the northern section of his 160-acre land parcel. He receives a Form 1099-S reporting the transaction. The easement affects five acres of Lionel's property. Lionel's basis in the whole tract is $1,280,000. His allocated basis in the property impacted by the easement is $40,000 (5/160 x $1,280,000). In this example, the purchase price exceeds the basis in the affected parcel by $10,000. ($40,000 - $50,00-). As such, Lionel must recognize $10,000 in gain. Because this is farm property that Lionel has owned for more than a year, the gain is I.R.C. § 1231 gain, subject to *capital gain* rates. The gain is reported on Form 4797, Sales of Business Property.

"Temporary" Easements

Companies seeking to build a pipeline or install power lines will often seek to purchase temporary "easements" as well. These access rights are generally for the purpose of temporary access or construction and will end after the pipeline is installed. For tax purposes, payments to secure a temporary or term easement are generally treated as rent payments. This means they are reported on Schedule E (Form 1040), Supplemental Income and Loss. They are treated as ordinary income, but not subject to self-employment tax. These payments are typically reported to the landowner on a 1099-MISC.

> **Example – Temporary Easement**

The pipeline company paid Lionel $1,000 a year for three years in exchange for a temporary easement allowing the company to use an additional two acres of Lionel's property during the construction phase of the pipeline. Lionel reports these payments on Schedule E (Form 1040), Supplemental Income and Loss, for the year in which they are received.

Crop Damage Payments

A farmer who grants an easement may receive payments for crop damage during the construction phase or for long-term damage caused to crops growing over a pipeline. If construction occurs when a crop is not already growing and it cannot be planted, the farmer may also receive a payment for loss of income. Any of these payments are designed to replace farm income, and would be reported as income from a crop sale, typically on Schedule F (Form 1040), Profit or Loss from Farming (on line 8, rather than line 2). A non-materially participating landlord would report this income on Form 4835, Farm Rental Income and Expenses.

Example - Crop Damage Payments

Lionel alternates corn and soybeans on the land impacted by the pipeline. The pipeline company pays him $12,000 for actual and future damage to his crop caused by the pipeline. Lionel includes the $12,000 in the amount he reports on line 2 of Schedule F (Form 1040) for the year in which the payment is made.

Note: Any unharvested crops sold with the permanent easement are treated as part of the sale of land and not as crop damage.