

A Taxing Issue for Landowners: The Bluegrass Pipeline

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This article analyzes the general tax planning strategies that Kentucky landowners (the “taxpayer”) should consider if Bluegrass Pipeline Company (herein “Pipeline Company”) is permitted, by future statute or court ruling, to use eminent domain by condemnation to obtain land for pipeline purposes, or if landowners sell their land pursuant to the threat of condemnation.

Background

The proposed Bluegrass Pipeline project has received extensive media attention in recent months. The project seeks to install an underground natural gas pipeline across 13 Kentucky counties, which would allow natural gas liquids from the Marcellus and Utica shale regions in the Northeast to be transported to Louisiana. Before construction can begin, the Pipeline Company must obtain easements from all landowners whose property is located in the proposed route. Of course, some landowners have been resistant to granting such an easement. There are various concerns, including destruction of farmland, the inconvenience of construction, safety issues involving natural gas liquids, and fair compensation, among others.

Leery landowners beware: the Pipeline Company asserts that it has the authority to condemn private property for pipeline construction and installation. A condemnation is the process by which the federal government, a state government, a political subdivision or a private organization legally takes private property for public use without the owner’s consent. The owner receives a condemnation award, money or property, in exchange for the property taken, making the process akin to a forced sale.

At the heart of the Bluegrass Pipeline controversy is KRS 278.502, which provides, in part:

Any corporation or partnership organized for the purpose of ... constructing, maintaining, or operating oil or gas wells or pipelines for transporting or delivering oil or gas, including oil and gas products, **in public service** may, if it is unable to contract or agree with the owner after a good faith effort to do so, condemn the lands and material ... (emphasis added)

Opponents of the Pipeline Company’s eminent domain claim, argue that the company is not a public utility regulated by the Kentucky Public Service Commission and therefore does not satisfy the statute’s “in public service” requirement. The Pipeline Company, on the other hand, contends it meets the criteria of a common carrier because it will provide open access to any potential Kentucky customer that is willing to meet the company’s tariff conditions and pay the tariff rate.

On December 6, 2013 a nonprofit organization, Kentuckians United to Restrain Eminent Domain (KURE), filed a declaratory judgment action in Franklin County Circuit Court challenging any attempt by the Pipeline Company to exercise eminent domain power.

Until clarification arrives in the form of statute or case law, subject landowners are left with a tough choice, whether they should grant an easement to the Pipeline Company pursuant to the threat of condemnation or wait for the land to possibly be condemned. An often overlooked factor in this difficult decision is the tax planning considerations of a condemnation.

Voluntary Sale Pursuant to the Threat of Condemnation

If Pipeline Company representatives (also known as “right-of-way agents”) are representing to Kentucky landowners that they have the right to eminent domain and, based on that threat of condemnation a taxpayer sells his property, then the involuntary conversion tax provisions should be taken into consideration.

As noted by the Internal Revenue Service (IRS), a threat of condemnation exists if a representative of a government body, or a public official authorized to acquire property for public use, informs a taxpayer that the government body or official has decided to acquire his property. The taxpayer must have reasonable grounds to believe that, if he does not sell voluntarily, his property will be condemned. Kentucky landowners are encouraged to obtain a threat of condemnation letter, whether friendly or hostile, to evidence the threat of condemnation.

Under the involuntary conversion tax provisions, a taxpayer may voluntarily sell his property, either to the condemning authority or to a third party pursuant to the threat of condemnation. If the taxpayer receives proceeds exceeding the adjusted basis of the property sold, the taxpayer must recognize gain, unless the nonrecognition of gain exception applies.

The nonrecognition of gain exception allows a taxpayer to postpone the recognition of gain when the taxpayer purchases other property similar or related in service or use to the converted property. However, the purchase must occur within a prescribed period. The prescribed period begins with the earlier of the date of disposition of the converted property, or the earliest date of the threat or imminence of requisition or condemnation of the converted property. The prescribed period ends two years after the close of the first taxable year in which any part of the gain upon the conversion is realized, except that, for the condemnation of real property held for productive use in trade or business or for investment, the prescribed period ends three years after the close of the first taxable year in which any part of the gain upon the conversion is realized.

If it is later determined that the Pipeline Company is precluded from using eminent domain, Kentucky landowners will likely be unable to use the involuntary conversion tax provisions for sales made pursuant to a threat of condemnation from the Pipeline Company after the date of such a determination.

Receipt of a Condemnation Award

If the Pipeline Company is allowed to use eminent domain by condemnation, and the Pipeline

Company condemns a taxpayer’s property, then the taxpayer will receive a condemnation award. In this scenario, the involuntary conversion tax provisions should also be taken into consideration.

When a taxpayer’s property is converted by condemnation and the taxpayer receives property similar or related in service or use to the converted property, the taxpayer does not recognize any gain. The taxpayer’s basis in the converted property becomes his basis in the new property. If the taxpayer receives money or property *not* similar or related in service or use to the converted property, to the extent that the condemnation award received exceeds the adjusted basis of the converted property, the taxpayer must recognize gain, unless the nonrecognition of gain exception, as described earlier, applies.

Involuntary Conversion of Principal Residence

When a taxpayer’s principal residence is condemned, or sold pursuant to the threat of condemnation, the taxpayer may generally exclude up to \$250,000 (up to \$500,000 if married filing jointly) of any gain from his income as if he had sold or exchanged his home.

If the gain from condemnation of a principal residence exceeds the exclusionary amount, the taxpayer may use the nonrecognition of gain exception described earlier to postpone the recognition of the excess gain. The taxpayer must use the proceeds exceeding the principal residence exclusion to purchase other property similar or related in service or use to the property sold and the purchase must occur within a four-year prescribed period.

Receipt of Severance Damages

Severance damages are not part of a condemnation award; they are the proceeds paid in a condemnation proceeding to compensate an individual for a decrease in value in property retained by the taxpayer that arises as a result of that property being severed from the condemned property.

Severance damages are an important consideration when it comes to the Bluegrass Pipeline. It is possible that the Pipeline Company, if legally allowed to exercise eminent domain, will only partially condemn a taxpayer’s parcel. Additionally, a sale made pursuant to the threat of condemnation may not encompass a taxpayer’s entire parcel. The property that the taxpayer retains could be subject to a significant decrease in property value as a result of the pipeline installation.

Net severance damages reduce the basis of the remaining property. However, if the severance damages are based on damage to a specific part of the remaining property, a taxpayer should reduce the basis of only that part by the net severance damages. If the net severance damages exceed the basis of the retained property, the taxpayer has a gain which he may be able to postpone by buying replacement property or restoring the remaining property to its former usefulness within the prescribed period as described earlier.

Conclusion

Condemnation, or the threat of it, can significantly impact easement negotiations and compensation terms. If the Pipeline Company is granted eminent domain power, or if taxpayers have already sold land or easements pursuant to a reasonable threat of condemnation, taxpayers will be left with no choice regarding whether the Bluegrass Pipeline runs through their property. In this event, taxpayers should turn their eye toward tax planning strategies to help maximize the compensation that they receive from the Pipeline Company.

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Editor’s note: McBrayer, McGinnis, Leslie & Kirkland currently represents property owners affected by the Bluegrass Pipeline. This article is intended as a summary of state and federal law and does not constitute legal advice. ■



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