

Estate Planning and Conservation Easements



PHOTO: EDWIN REMSBERG

A conservation easement restricts development on the land. In exchange for this restriction, the landowner may receive a cash payment and/or a tax deduction if the qualifications are met.

Conservation easements can be a tool to include in your estate plan. Donation of a conservation easement can be one way to reduce federal and state estate taxes when your estate value minus permitted deductions exceeds the current estate tax exemptions (unified credits). Under current federal tax law, donating a conservation easement to a qualifying group can result in favorable federal tax deductions. Maryland also currently allows state income tax deductions for the donation of an easement to a qualifying group. Conservation easements are one way to reduce the size of a person's estate and ensure that the land will continue to be available for agricultural use.

This fact sheet presents several ways agricultural land preservation may be an estate planning tool for your farm family. Agricultural land preservation may assist you in avoiding excessive tax burdens and thus passing on the farm intact. Before deciding on preservation, though, you and your family need to set goals for your individual needs and desires. You also need to determine your net worth (*see University of Maryland Extension Farm Business Planning*). Once you have done these activities, you can determine the best planning strategy to achieve your stated goals. A general estate planning fact sheet is available through the Center for Agricultural and Natural Resource Policy entitled "Estate Planning for Farm Families."



PHOTO: EDWIN REINBERG

Conservation easements are a way to preserve family farmland for future generations. An easement can also be an estate planning tool if aligned with the landowner's goals.

While this fact sheet presents one tool you can consider when developing your estate planning, each individual's and family's circumstances will be different. Therefore, you should seek the advice of a tax attorney, accountant, or financial advisor. The information in this fact sheet should prepare you to have a fruitful session with these advisors.

Federal Estate Taxes and Unified Credit

Federal estate tax rate for 2013 is set at a maximum of 40 percent with no current expiration or sunset date, unlike in previous years. In 2013, the IRS increased the "unified credit" to allow a lifetime exemption of \$5.25 million; in 2014 the lifetime exemption can increase based on inflation. The unified credit is a tax credit given to every U.S. citizen and resident to use against wealth transfer taxes, either on taxable gifts or estates. People can use their unified credit to cover some or all of the estate taxes due.

Use the Unified Credit Fully

Taking advantage of the unified credit is one of the most effective estate planning techniques. Each spouse in a married couple¹ is able to take the full unified credit if his or her will and property ownership is set up to do so. Each spouse must have rights of ownership to transfer the property to the next generation. If Andrew and Beth Jamison, a married couple, were to die at the same time in 2013, under their estate plan, their children will inherit the farm. The estate including the farm is valued at \$10.5 million. Each parent could use the unified credit of \$5.25 million, which summed together equals \$10.5 million. The children would not have pay estate taxes on their inheritance.

In the past, if Andrew and Beth did not die at the same time, the estate plan would have needed to be structured in a way to allow both unified credits to be utilized if Andrew inherited the full value of Beth's share under the *marital deduction*. However, the current

estate tax provisions allow for *portability* of the unified credit between spouses permanently. The surviving spouse can add the unused portion of the predeceased spouse's applicable exclusion amount to his or her own without having to set up a specialized trust. The applicable exclusion amount acquired from a deceased spouse (provided that the surviving spouse does not remarry) may be used to offset either the tax on lifetime gifts or transfers upon death. This is not automatic, however. The unused portion of the deceased spouse's federal estate tax exemption must be preserved for the surviving spouse to use. To preserve the unused portion, the living spouse must file (including extensions) an estate tax return (Form 706) taking the remaining applicable exclusion amount. The remaining exclusion amount is calculated and included on

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the Form 706. A statement must also be included on the face of the return that the remainder is being taken by the surviving spouse.

Thus, if Beth had died first in 2012 and passed her share of the farm directly to Andrew, no estate tax would have been owed since Beth could give her share of the estate to her spouse tax-free under the *marital deduction*. Andrew files Form 706 with the exclusion amount calculated

¹ Married couples where one spouse is a non-U.S. citizen should work with a qualified attorney to handle the special issues that exist in this case.

Selling a conservation easement can

- 1) provide money to compensate non-farming children and*
- 2) decrease the fair market value of the land, thus decrease the estate tax owed*

and provides a statement that he will take Beth's unified credit. Andrew then dies in 2013. Given Andrew has his own unified credit (which exempts \$5.25 million of his estate) and Beth's (her unified credit exempt \$5.12 million of her estate because she died in 2012); the children can deduct \$10.37 million from the estate value of \$10.5 million. The remaining estate value would be \$130,000. Estimated estate taxes of:

$$\text{\$130,00} \times 40\% = \text{\$52,000}$$

would generally be due nine months after Andrew's death. For more information on the federal estate tax calculations, see the Center for Agricultural and Natural Resource Policy Fact Sheet "Estate Planning for Farm Families."

Conservation Easements and the Current Tax Provisions

While using the unified credit helps reduce the estate tax burden, other considerations may apply. For example, the farm's value could be greater than the amount the unified credit exempts from estate tax or the family may need cash to compensate non-farm children. Selling a conservation easement can 1) provide money to compensate non-farming children and 2) decrease the fair market value of the land, thus decrease the estate tax owed.

You may wish to treat your children equally even if only one of them desires to stay on the farm. Because the estate's value is commonly tied up in the land, you may have limited cash on hand to give an equal value to any non-farming heirs. If the estate including the farmland is divided equally among all the children, the child taking over the farm may not have enough cash to "buy out" the non-farming heirs. It could be that the overall value of the

farm may be too high for the entering farmer to be able to buy out the others without selling off some of the land. This can result in a farm that is too small to support a family or no farm at all. Selling a conservation easement could generate the cash needed to buy-out other heirs while retaining the ability to earn a living through farming. Of course, you must consider estate planning options for any cash received from an easement sale.

Conservation easements restrict the land from converting to residential, commercial and/or industrial uses in most cases. To qualify for tax deductions, the conservation easements must be in perpetuity—that is, apply to all current and future owners of the property, serve a conservation purpose and be monitored and enforced by a "qualified organization." In Maryland, most land preservation programs and land trusts are qualified to buy or accept the donation of a conservation easement on farmland property. The programs and trusts acquire the "development rights," i.e., the right to develop the land for residential, commercial, or industrial uses in exchange for the conservation easement which is recorded as a restriction on the property deed. This attachment remains with the property even after the ownership has changed hands. Owners receive a cash payment; the ability to take a charitable tax deduction due to a donation or bargain sale, or both a cash and charitable tax deduction in exchange for restricting the possible uses on the property. Any cash payment will be treated as a capital gain (minus any basis) in the year it is received. Donations of land or conservation easements and sales of land or conservation easements via bargain sales are deductible as charitable contributions. (For details on assessing the capital gains owed, please see the Center for Agricultural

To qualify for the non-cash charitable deduction, the conservation easement must be in perpetuity, must be donated to a qualified organization, such as a land trust or an agricultural preservation program, and must satisfy the IRS's definition of serving a valid "conservation purpose" which includes the preservation of open space, farmland and forestland.

and Natural Resource Policy Fact Sheet "Taxes and Land Preservation: Computing the Capital Gains Tax.") By accepting the restrictions, the owner has most likely reduced the value of the property. In most cases, the new value of the land will be based on its value in an agricultural use, minus its development potential. Some properties, such as waterfront properties, have not seen large decreases in land value.

The value of the property is based on the decreased value of the land due to the development restrictions. Therefore, if the McDonalds' land value falls from a market value of \$5,400,000 for 300 acres to \$2,800,000 for the property with a conservation easement, the family's estate tax on the land will be based on the \$2,800,000 value, which will minimize their estate tax burden. Similarly, the gift tax would be based on the value of the land with a conservation easement. Thus, if the mother wants to give the land to a child before her death, the gift tax should be lower than it would be without the conservation easement on the property.

The IRS requires appraisals to determine the value of conservation easements that can be deducted from income and estate taxes. According to the IRS, the value of easement is calculated as the difference between the appraised value of the property before and after the development rights are removed. Public programs and land trusts use different rules and procedures to determine the exact quantity of money they will pay owners for these rights. The difference between the appraised easement value and the payments received can be taken as a charitable gift. For example, the Harris land has a fair market value of \$1,250,000 and a post-easement value of \$500,000, thus a conservation easement value of \$750,000. The land preservation



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The IRS permits a landowner to deduct up to 50 percent of his or her adjusted gross income in any one year, and any unused portion can be carried over for the next 15 succeeding years. Qualifying farmers and ranchers can deduct up to 100 percent of his or her adjusted gross income if the land remained available to agricultural production. Any unused portion can be carried over for the next 15 succeeding years.

program pays the Harris family part of this value to preserve the land, giving them a payment of \$500,000. Since the conservation easement value was \$750,000 and a payment of \$500,000 was received, the Harris family can take the other \$250,000 as a non-cash charitable deduction on their income taxes. This can be done by filing a non-cash charitable contribution form with their income tax return. The Harris family's basis in the land, or the amount originally paid for the land, is \$100,000. The Harris family would owe capital gains taxes on \$400,000 (\$500,000 - \$100,000) and this \$400,000 would be included in their adjusted gross income for the year. The basis of the property would be reduced by the amounts of the payments. For more information on calculating capital gains taxes, see Center for Agricultural and Natural Resource Policy Fact Sheet "Taxes and Land Preservation: Computing the Capital Gains Tax."

To qualify for the non-cash charitable deduction, the conservation easement must be in perpetuity, must be donated to a qualified organization, such as a land trust or an agricultural preservation program, and must satisfy the IRS's definition of serving a valid "conservation purpose" which includes the preservation of open space, farmland

and forestland. The IRS permits a landowner to deduct up to 50 percent of his or her adjusted gross income in any one year, and any unused portion can be carried over for the next 15 succeeding years. Qualifying farmers and ranchers can deduct up to 100 percent of his or her adjusted gross income if the land remained available to agricultural production, and any unused portion can be carried over for the next 15 succeeding years. For example, Mr. Harris could carry over his \$250,000 donation over a sixteen-year period (this current year plus 15 succeeding years) or \$15,625 per year if his AGI is \$31,250 and he donated the easement in 2013. Currently, the 15 year carry over period, the deduction up to 50 percent of a landowner's adjusted gross income, and the 100 percent deduction of a qualifying farmer/rancher's adjusted gross income will expire at the end of 2013.

Under federal estate tax rules, the estate of the deceased landowner may donate a conservation easement and exclude additional value from the estate tax calculations.

In cases when the landowner has received a payment as well as made a non-cash charitable deduction, the cash payment for the development rights may increase the family's income substantially. In the case of Mr. Harris, he has received a payment of \$500,000 for the easement, which will be included in his adjusted gross income if he has a low basis in the land, 50 percent of the income just from the easement sale is \$250,000. In this case, he could deduct the entire donation in the first year and would not need to carry it forward.

Under federal estate tax rules, the estate of the deceased landowner may donate a conservation easement and exclude additional value from the estate tax calculations. Farmland with a conservation easement attached to its deed may also exclude up to an additional 40 percent of the residual land value (the value of the property remaining after granting the easement) from the estate if it meets IRS eligibility requirements for a "qualified conservation contribution." This deduction is currently capped at \$500,000. Under the Internal Revenue Code Section 2031(c), the percentage of land value excluded from an estate is reduced when the easement itself is worth less than 30% of the total value of the land. This provision currently has no expiration date.

Qualifying land must have been owned by the deceased or a member of the deceased's family for 3 years before the deceased's death. If the property owners have retained any right to develop the land (such as to build a house for the children), these rights will be included in the estate valuation and thus to estate tax liability.

Special Use Valuation under IRS Code Section 2032A

Farmers have an estate tax advantage in Internal Revenue Code Section 2032A: the Special Use Valuation. Under the terms of this section, families with qualifying heirs who plan to continue farming or remain "materially engaged" in farming for at least 10 years can have the farmland valued at its agricultural use value, which is often lower than its fair market value, for estate tax purposes. Special use valuation applies only to the land portion of one's estate.

Section 2032A allows one to reduce the fair market value of the farm estate by up to \$1,070,000 for estate tax purposes in 2013. This amount is now being indexed to inflation, so the limit can be adjusted each year by the IRS. If the property is jointly owned by a married couple and each is passing on the land to the next generation, each spouse can take the additional deduction, permitting up to an additional \$2.14 million to be exempted from estate tax liability. The farm must be passed on to the spouse or other family member, known as a qualified heir. If the family stops farming the property within 10 years, a recapture provision requires that the family pay the estate tax plus interest on the full market value at the time of death.

To be eligible, the family must elect to take the valuation within nine months of the landowner's death. In addition, at least half of the estate must consist of real or personal property which on the decedent's date of death was being used for a qualified purpose such as farming by the decedent or a family member, and which passed from the decedent to a qualified heir. At least one quarter of the estate must consist of real property such as farmland or other type of farm real estate, which passed from decedent to a qualified heir. This real property must have been owned and actively worked for a qualified purpose by decedent or a family member for five of the eight years prior to the owner's death. In certain cases, families have chosen to use this valuation only on part of the estate. This allows some property, such as buildings and livestock, to be sold without invoking the recapture provision. The executor must include executed



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agreements from each person with an interest in the property to be liable for any future estate tax recapture when making a 2032A election.

Thus in 2013, a family that plans to farm the land for the next 10 years can pay estate tax only on the portion of the estate that exceeds the \$5,250,000 exempted amount coupled with special use valuation of up to an additional \$1,070,000. If both you and your spouse take maximum advantage of the 2032A benefits and you both die in 2013, you can pass up to \$12,640,000 to your heirs without incurring federal estate tax liability.

Aside from the ten-year recapture provision, the biggest drawback of using this special use valuation election is that the heir is not able to receive a step-up in the basis of the farm property, if the special use valuation reduced the value of the taxable estate. Often the original purchase price of the farm is much lower than its actual market value, resulting in significant capital gains taxes owed if one sells some of the land or other assets. When the farm is inherited at the current market value of the estate, the family

receives a stepped up basis to the current value of the farm. For more information, see the Center for Agricultural and Natural Resource Policy Fact Sheet “Estate Planning for Farm Families.”

The qualified heir will not be able to cash rent the property to another person to continue the farming operation, although a qualified heir may be able to cash rent the property to another qualified heir.² Courts have found cash rent leases to be a cessation in the farming operation by the qualified heir and the qualified heir has been subject to the recapture provision because the qualified heir has no financial risk in the farming operation (*Estate of Gavin*, 1997). Crop-share arrangements have been considered material participation because the qualified heir would have a financial risk in the operation, but professional advice on specific arrangements would be worth obtaining if considering a crop-share arrangement. IRS is more likely to allow the renting of the property to a family farm corporation or LLC that the qualified heir fully participates in.

Under Section 2032A, the land value is determined by dividing

the excess of the five-year average annual gross cash rental for comparable, local farmland over the average annual state and local real estate taxes for comparable land by the average annual effective interest rate for all new Federal Bank Loans. If a similar county cash rent amount cannot be found, the IRS may use the state agricultural assessment values or comparable sales of farmland. Thus, in a rapidly urbanizing county like Montgomery County, a 100-acre farm can have a market value of \$10,000,000 but a use value of only \$61,162.³ Section 2032A will only allow qualified heirs to reduce the fair market value of the land by up to \$1,070,000 for estate tax purposes.

Selling a Conservation Easement When Farm Is Under IRS Code Section 2032A

In 1997, Congress attempted to clarify whether donating or selling a conservation easement on the property while in the 10-year post-death period triggers the recapture provisions. Prior to 1997, a qualified heir granting a qualified conservation easement would have triggered the recapture provisions of § 2032A. The recapture provisions would have been triggered because granting a conservation easement would be disposing “an interest in the qualified real property” (26 U.S.C. § 2032A(c)(1)(A)). To correct this, Congress amended § 2032A to state that a qualified conservation easement by gift or “otherwise” is not disposing

² Please check with an experienced attorney or tax expert before leasing the property to a qualified heir to ensure that all necessary qualifications are met.

³ This assumes a cash rental payment of \$54 an acre and a preferential property tax payment of \$4 an acre.

of the farm, and should not result in recapture. However, there remains some need to qualify the “otherwise.” For example, if the family sold a conservation easement after electing § 2032A and received a cash payment from the Maryland Agricultural Land Preservation Foundation, would this trigger the recapture provision?

The IRS has stated in a private letter ruling that the sale of a conservation easement on § 2032A qualified real property to a land trust would trigger the recapture provision. The IRS found the phrase “or otherwise” does not necessarily include sales and exchanges of conservation easements for valuable consideration. A qualified heir who gifted the conservation easement to a land trust would not trigger the recapture provision, according to the IRS. Private letter rulings by the IRS however are only binding on the taxpayer that requested them and the IRS. Because they are not binding as precedent upon any court, they only provide some guidance to landowners considering this option.

The U.S. Court of Appeals for the Third Circuit has stated that receiving a cash payment for a conservation easement can trigger recapture. In *Estate of Gibbs v. U.S.*, 161 F.3d 242 (3rd Cir. 1998), the sole heir elected for special use valuation in 1984 and in 1993 sold a conservation easement to the state of New Jersey. In this case, the sale of the conservation easement to the state took place before 2032A was amended in 1997 to allow granting a conservation easement on the subject property. The ruling allowed the IRS to recapture the estate taxes. The Third Circuit court of appeals mentioned in passing that even if this sale had taken place after 2032A was amended in 1997, this sale would have triggered recapture. However, the court offered no analysis as to why recapture would have been triggered in this case. A family that has elected to use Special Use Valuation and now wishes to donate or sell a conservation easement on the qualified property should talk with an attorney or tax specialist to determine if the donation or sale will trigger the recapture provision.

Special Maryland Estate Tax Exemption For Agricultural Property

In 2012, the Maryland legislature created an estate tax exemption for agricultural property. Maryland will exempt the first \$5 million in agricultural property value from the estate tax value for Maryland estate tax purposes. Non-agricultural property can only exempt the first \$1 million for Maryland estate tax calculations.

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If the agricultural property is valued at more than \$5 million, the amount above \$5 million will be taxed at 5 percent, compared to the 16 percent non-agricultural property Maryland estate tax rate.

In order to use the agricultural property tax exemption, the deceased individual’s agricultural property will need to: 1) be a “qualified agricultural property” 2) be used for “farming purposes” and 3) be passed to a “qualified recipient.” Qualified agricultural properties are defined as all real or personal property chiefly used for farming purposes. This includes not only the land used for agricultural production but also the agricultural



PHOTO: EDWIN REMSBERG

Recent additions to Maryland’s estate tax law for agriculture could allow a qualified recipient to sell a conservation easement to a land conservation group and not be forced to repay exempted Maryland estate taxes, but a qualified recipient should seek professional advice before granting a conservation easement.

The Maryland exemption makes no mention of the qualified recipient's ability to dispose of an interest in the property. This suggests that a qualified recipient could grant a conservation easement over the inherited agricultural properties if the conservation easement did not limit the ability of a qualified heir to continue farming.



PHOTO: EDWIN REMSBERG

Unlike §2032A, Maryland's recent estate tax changes make no mention of granting a conservation easement if one chooses to use the agricultural exemption.

equipment and buildings. "Farming purpose" is broadly defined to include most agricultural uses. A "qualified recipient" is simply any person willing to enter into a ten-year agreement to use the qualified agricultural property for a farming purpose after the decedent's death. There is no requirement that the "qualified individual" be a family member of the deceased. If the qualified individual stops using the agricultural property for a farming purpose before the end of the 10-years, the state will be able to recapture the exempted Maryland estate taxes. For more information of this change, see the Center for Agricultural and Natural Resource Policy "Estate Planning for Farm Families."

Maryland's Agricultural Estate Tax Exemption's Impact on Conservation Easements

Unlike §2032A, Maryland's recent estate tax changes make no mention of granting a conservation easement. Section 2032A states that both the property need to continue

in an agricultural use and that the qualified heir cannot dispose of any interest in the property, noting that gifting a conservation easement does not qualify as disposition of an interest. Maryland's recent changes only require the qualified recipient to continue an agricultural use. The Maryland exemption makes no mention of the qualified recipient's ability to dispose of an interest in the property. This suggests that a qualified recipient could grant a conservation easement over the inherited agricultural properties if the conservation easement did not limit the ability of a qualified heir to continue farming. For example, Steve inherited agricultural property and signed an agreement to continue farming the land for 10 years to get the special Maryland agricultural estate tax exemption. Nine years into the agreement, Steve is approached by a local land trust to grant a conservation easement over the agricultural property Steve inherited. The conservation easement would not allow production agriculture to continue on the property if granted.

This conservation easement would require Steve to repay Maryland estate taxes. However, if the conservation easement has no provision to prohibit agriculture, Steve may be able to grant the easement without recapture.

Deferred Payment of Estate Taxes

If a "closely held" farm business constitutes 35% of the adjusted gross estate value, the executor can defer the estate tax payments related to the farm business value for up to 5 years. The decedent must have been "actively involved" in the farm business. The purpose for this deferment of estate taxes is to provide farm families with relief if they do not have the capital on hand to make tax payments and prevents having to sell property immediately to cover the tax liability. The estate is still required to make interest payments during the five year period. After making the final interest payment during the five year period has elapsed, the estate can pay the remaining tax liability in up to 10 annual installments

(interest and principal). Basically this extends the time period for paying these taxes to 14 years (compared to 9 months) if the requirements are met. The percent of the estate tax the family can defer is the percent of the total estate value that is the farm or the farm business. Thus, if the farm business was 75% of the adjusted gross estate value, one can defer up to 75% of the taxes owed. The IRS also has set a lower than current market interest rate on the tax owed of 2 percent. The non-farm portion of the estate will not be eligible for the lower interest rate. And the estate taxes on the non-farm portion are due within 9 months.

Ongoing

Although many of us think estate planning is a one-time process, the actual plan needs to be revisited from time to time (every three to five years) to ensure

it continues to satisfy our needs and fulfill our goals. In some cases, the farm will be passed on when the owner retires, and therefore disposition at death is not a necessary component of the estate plan. In other cases, the birth of a new child or grandchild might require an alteration. In addition, new tools can appear to facilitate the transfer of farmland with a minimum of tax impact. Laws also change. For both the federal and the state estate taxes, new provisions were added and exemption amounts adjusted. In addition, certain provisions such as the special use valuation must be utilized within a short period of time following death or it may be unavailable. Therefore, an estate plan allows families set goals and the road map to get there. ■

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