While estate planning for Maryland farm operators can be complicated, a conservation easement can be an effective tool to include in your plan. Conservation easements can help reduce the value of a farm estate and ensure the land will continue to be available for agricultural use. Donating a conservation easement is one way to reduce federal and state estate taxes when the value of your estate minus permitted deductions exceeds the current estate tax exemptions. Under current federal and Maryland tax laws, donating a conservation easement to a qualifying group can result in favorable tax deductions.
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 certain tax burdens and enable you to pass on your farm intact. Before deciding on preservation, however, 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 http://go.umd.edu/BusPlan). Once you have completed these activities, you can determine the best planning strategy to achieve your stated goals. A general estate planning fact sheet, “Estate Planning for Farm Families,” is available at http://go.umd.edu/FarmEstatePlan.

**Agricultural land preservation may assist you in avoiding certain tax burdens and enable you to pass on your farm intact.**

While this fact sheet presents one tool to consider when developing your estate plan, each individual’s and family’s circumstances will be different. 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.

**U.S. CITIZENS AND RESIDENTS MAY USE THE UNIFIED TAX CREDIT AGAINST WEALTH TRANSFER TAXES**

On January 1, 2013, the American Taxpayer Relief Act of 2012 set the maximum estate tax rate at 40% with no current expiration or “sunset” date. The Act increased the unified credit to allow a lifetime exemption of $5.25 million per person; since 2014, the lifetime exemption may increase based on inflation. In 2016, the unified credit is $5.45 million for an individual or $10.9 million for a couple. People may use their unified credit to cover some or all of the estate taxes due, either on taxable gifts or estates. Each spouse in a married couple¹ may take the full unified credit if their will and property ownership is set up correctly. Each spouse must have rights of ownership to transfer property to the next generation. For example, if married couple Andrew and Beth Jamison were to die at the same time in 2016, under their estate plan, their children will inherit the farm. The estate, including the farm, is valued at $10.9 million. The unified credit of $5.45 million applies to each parent for a total of $10.9 million. The children would not have to pay any federal estate taxes on their inheritance.

Current estate tax provisions allow for portability of the unified credit between spouses permanently. The surviving spouse can add the unused portion of the deceased spouse’s applicable exclusion amount to his/her exclusion without having to set up a specialized trust. Providing he/she does not remarry, the surviving spouse may use the applicable exclusion amount acquired from a deceased spouse to offset either the tax on lifetime gifts or on 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. The living spouse must file estate tax return Form 706 (including extensions) to take the remaining applicable exclusion amount. A statement must also be included on the face of the return saying the surviving spouse is taking the remainder.

Andrew died in 2014. Since Andrew had his own unified credit (which exempts $5.34 million of his estate) and Beth’s (her unified credit exempts $5.25

¹Married couples where one spouse is a non-U.S. citizen should work with a qualified attorney to handle the special issues in this case. For example, if Beth died in 2013 and passed her share of the farm directly to Andrew, he would not owe estate tax since Andrew can use receive Beth’s share of the estate tax-free under the marital deduction. Andrew files Form 706 with the exclusion amount calculated and provides a statement saying he will take Beth’s unified credit.
Current estate tax provisions allow for portability of the unified credit between spouses permanently. The surviving spouse can add the unused portion of the deceased spouse’s applicable exclusion amount to his/her exclusion without having to set up a specialized trust.

million of her estate because she died in 2013), the children can deduct $10.59 million from the estate value of $10.9 million. The remaining estate value would be $310,000.

Estimated estate taxes of $310,000*40% = $124,000 would be due 9 months after Andrew’s death. For more information on the federal estate tax calculations, see Estate Planning for Farm Families (http://go.umd.edu/FarmEstatePlan).

If a farm’s value exceeds the amount the unified credit exempts from estate tax or if one or more heirs decides not to farm, selling a conservation easement can: 1) provide money to compensate non-farming children; and 2) decrease the fair market value of the land, and therefore the estate tax owed. Because the estate’s value is commonly tied up in the land, there may be limited cash available to give an equal share to any non-farming heirs. The overall value of the farm, for instance, may be too high for heir(s) remaining on the farm to buy out the others without selling off some of the land. The sale could result in a farm 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 farm. Of course, you must consider estate planning options for any cash received from an easement sale.

CONSERVATION EASEMENTS USUALLY RESTRICT RESIDENTIAL, COMMERCIAL, AND INDUSTRIAL USES

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, many land preservation programs and land trusts are qualified to buy or accept the donation of a conservation easement on farmland property.

The programs and land trusts strip the “development rights,” i.e., the right to develop the land for residential, commercial, or industrial uses. Landowners accept a property-related conservation easement that is recorded as a restriction on the property deed. This attachment remains with the property even after the ownership...
has changed hands. In exchange, owners receive a cash payment, the ability to take a charitable tax deduction due to a donation, 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, such as the original cost of the property) in the year it is received. The value of donated land rights through a conservation easement is deductible as a charitable contribution. A landowner can also donate the value of the difference between the conservation easement value and the cash payment received in a “bargain sale.” A bargain sale is a sale of the development rights to a charitable organization for less than the easement’s full value.

**To qualify for tax deductions, conservation easements must apply to all current and future owners of the property, serve a conservation purpose, and be monitored and enforced by a “qualified organization.”**

By accepting the development restrictions associated with a conservation easement, the owner has most likely reduced the value of the property. For farmland, the new value of the land will be based on the income stream from an agricultural use. The value of the property for estate tax purposes will be based on the lower value of the land due to the development restrictions. Similarly, the gift tax would be based on the lower value of the land with a conservation easement. Thus, if a farmland owner wants to give the land to her children before her death, she would pay a lower gift tax due to the conservation easement on the property.

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**Conservation Easements Must Be Appraised to Establish Value**

The Internal Revenue Service (IRS) requires appraisals to determine the value of the conservation easements which can be deducted from income and estate taxes. According to the IRS, the value of the easement is calculated as the difference between the appraised value of the property with the development rights intact and with the development rights removed.

Public programs and land trusts use different rules and procedures to determine the exact amount they will pay owners for development rights. A landowner can take the difference between the appraised easement value and the payments received from a program or land trust as a charitable deduction.

For example, the Harris land has a fair market value of $1.25 million and a post-easement value of $500,000; thus the conservation easement is valued at $750,000. A land preservation program pays the Harris family $500,000. Since the conservation easement value was $750,000, the Harris family can take the remaining $250,000 as a non-cash charitable deduction on their income taxes by filing Form 8283 (a non-cash charitable contribution form) with their income tax return. The Harris family would most likely have a capital gain from the sale of the conservation easement which is added to their adjusted gross income for the year they receive the payment. For information on calculating capital gains taxes, see Taxes and Land Preservation: Computing the Capital Gains Tax (http://go.umd.edu/CapGains).

The IRS permits a landowner to deduct up to 50 percent of his/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 adjusted gross income if the land remains available for 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 16-year period (the current year plus 15 succeeding years) or $15,625 per year assuming his adjusted gross income is $31,250.

In 2015, Congress made the 15-year carryover period, the deduction of 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 permanent features of tax law. The changes to the tax law give landowners, conservation programs, and land trusts the certainty of continued federal tax exemptions for conservation easement donations.

When a landowner has received a payment amount of $250,000, the cash payment for the development rights may increase the family’s income substantially. In Mr. Harris’ case, he received a payment amount of $500,000 for the easement. His adjusted gross income will increase by $500,000. Fifty percent of the income from the easement sale is $250,000. In this case, he may be able to deduct the entire donation amount of $250,000 in the first year and not carry it forward. Under federal estate tax rules, the heirs of a deceased landowner who donated a conservation easement have the right to exclude additional value from estate taxes calculations. Owners of farmland with a conservation easement attached to its deed may 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 is worth less than 30 percent 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 three 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, the estate tax liability.

**IRS 2032A Gives Farmers an Estate Tax Advantage**

Under the terms of IRS Code Section 2032A—the “Special Use” Valuation—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, which is often lower than its fair market value, for estate tax purposes. Special use valuation applies only to the land portion of a farm estate.

Section 2032A allows farmers to reduce the fair market value of the farm estate by up to $1.11 million for estate tax purposes. This amount is indexed to inflation, so the limit will be adjusted each year. If the property is jointly owned by a married couple passing on the land to the next generation, each spouse can take the additional deduction, permitting exemption of up to an additional $2.22 million 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 the family to pay the estate tax plus interest on the full market value at the time of death.
To be eligible for Section 2032A, a family must “elect to take” the farm valuation i.e., select this option, within 9 months of the landowner’s death. In addition, at least half of the estate must consist of real or personal property (such as buildings and livestock), which on the decedent’s date of death, was being used by the decedent or a family member for a qualified purpose such as farming, 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. The decedent or a family member must have owned and actively worked this real property for a qualified purpose for 5 of the 8 years prior to the owner’s death.

In certain cases, families have chosen to use the Section 2032A 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 agreements from each person with an interest in the property that they will be liable for any future estate tax recapture when making a 2032A election.

Thus in 2016, a family planning to farm the land for the next 10 years can pay estate tax only on the portion of the estate exceeding the $5.45 million exempted amount coupled with special use valuation of up to an additional $1.11 million. If both you and your spouse take maximum advantage of the §2032A benefits and you both die in 2016, you can pass up to $13,120,000 to your heirs without incurring federal estate tax liability.

Aside from the 10-year recapture provision, the biggest drawback of using the special use valuation to reduce the value of the taxable estate is the heir is not able to receive a step-up in the basis of the farm property. Often the original purchase price of the farm is much lower than its actual market value, resulting in significant capital gains taxes owed if the owner sells some of the land or other assets. Upon the owner's death, however, heirs inherit the farm at its current market value—referred to as a step-up in basis. With a step-up in basis, the land is valued at market price at the time of owner’s death, not the cost at which the decedent purchased the property. For more information, see Estate Planning for Farm Families, http://go.umd.edu/FarmEstatePlan.

The qualified heir will not be able to cash-rent the property to another person to continue the farming operation, although he/she may be able to cash rent the property to another qualified heir. Courts have considered cash rent leases a cessation in the farming operation by a qualified heir, making him/her subject to the recapture provision because he/she 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. Obtaining professional advice on specific arrangements is advised.
if you are considering a crop-share arrangement. The IRS is more likely to allow renting the property to a family farm corporation or LLC in which the qualified heir fully participates.

Under Section 2032A, land value is determined by taking difference between the 5-year average annual gross cash rental for comparable, local farmland and the average annual state and local real estate taxes for comparable land and dividing the resulting amount 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. In a rapidly urbanizing county like Montgomery County, Maryland, a 100-acre farm can have a market value of $10,000,000 but a use value of only $88,073. Section 2032A allows qualified heirs to reduce the fair market value of the land by up to $1.11 million for estate tax purposes.

Does Selling or Donating a Conservation Easement When Farm Is Under Section 2032A Trigger the Recapture Provisions?

Prior to 1997, the recapture provisions of §2032A would be triggered if a qualified heir granted a qualified conservation easement because it would have been disposing of “an interest in the qualified real property” (26 U.S.C. §2032A(c)(1)(A)). To correct this, Congress amended §2032A in 1997 to state that a qualified conservation easement by gift or “otherwise” is not disposing 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 opting for §2032A and received a cash payment from the Maryland Agricultural Land Preservation Foundation (MALPF), would this trigger the recapture provision? The answer to this question is still unclear.

The IRS has stated in a private letter ruling that the sale of a conservation easement on §2032A qualified real property to a farmland preservation program or land trust would prompt the recapture provision. The IRS found the phrase “or otherwise” does not necessarily include sales and exchanges of conservation easements for valuable consideration. According to the IRS, a qualified heir who gifted the conservation easement to a land trust would not trigger the recapture provision. In other words, the IRS would view the sale of a conservation easement to MALPF as triggering the recapture provisions, but would not view the donation of a conservation easement to MALPF as triggering the recapture provision. But IRS private letter rulings are only binding on the taxpayer who requested them and the IRS, and only provide some guidance to landowners considering this option.

2 Please check with an experienced attorney or tax expert before leasing the property to a qualified heir to ensure all necessary qualifications are met.
3 This assumes a cash rental payment of $76 an acre and a preferential property tax payment of $4 an acre.
The U.S. Court of Appeals for the Third Circuit 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. In 1993, the heir 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 court’s 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, it would have triggered recapture, though the court offered no explanation why.

A family which elected to use a 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.

Maryland Created Special Estate Tax for Agricultural Property in 2012

The Maryland estate tax exemption allows a deceased individual’s heirs to exempt the first $5 million in agricultural property from the estate’s value, compared to the $1 million exemption for non-agricultural property. 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 for non-agricultural property estate tax.

In order to use the agricultural property tax exemption, the deceased individual’s agricultural property will need to be: 1) “qualified agricultural property” 2) used for “farming purposes” and 3) 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 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 10-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 as is required by the federal estate tax law. If the qualified individual stops using the agricultural property for farming before the end of the 10 years, the state will be able to recapture the exempted Maryland estate taxes. For more information about this change, see “Estate Planning for Farm Families,” http://go.umd.edu/FarmEstatePlan.
In Some Cases, the Executor May Defer Payment of Estate Taxes for Up to 5 Years

If a “closely held” farm business constitutes 35 percent 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. This deferment of the estate taxes provides farm families with the time to raise the money for the estate taxes if they do not have the capital on hand thus preventing them from having to sell property immediately to cover the tax liability. The estate is still required to make interest payments during the 5-year period.

After making the final interest payment during the 5-year period, the farm family can pay the remaining estate tax liability in up to 10 annual installments of 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 that the family can defer is equal to the farm or farm business’ share of the total estate value. For example, if the farm business was 75 percent of the adjusted gross estate value, heirs can defer up to 75 percent of the taxes owed. The IRS has also set the interest rate at 2 percent, which is below the current market rate. The estate taxes on the 25 percent of the estate that is the non-farm portion are due within 9 months. And the non-farm portion of the estate will not be eligible for the lower interest rate.

Revisit Your Estate Plan Every 3 to 5 Years to Ensure It Still Meets Your Needs

Revisiting one’s estate plan is important for farm families as things change with the business, one’s family, and the laws. In some cases, the initial estate plan may have incorporated a plan to pass on the farm. However, if the farm is passed on when the owner retires, this component, i.e. the disposition of the farm at death, will no longer be a necessary component of the estate plan. In other cases, the landowner might wish to alter the estate plan because of the birth of a new child or grandchild. In addition, new tools can appear to facilitate the transfer of farmland to minimize tax impacts. 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 to set goals and provides the road map to get there. While tinkering with the estate plan is probably not needed each year, families should consider looking at it every 3 to 5 year to ensure it meeting the goals of the family as things change.

Closely held is a business with a limited number of shareholders and whose stock is rarely publicly traded.
DISCLAIMER: This publication is intended to provide general information about legal issues and should not be construed as providing legal advice. It should not be cited or relied upon as legal authority. State and federal laws vary and no attempt is made to discuss laws of states other than Maryland. For advice about how these issues might apply to your individual situation, consult an attorney.

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