AN IMPORTANT ESTATE TAX INCENTIVE FOR LANDOWNERS

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In 1997, for the first time in more than a decade, Congress added to the law significant new tax incentives for voluntary land protection by private landowners.

Let's start with a few important observations.

1. Every single conservation easement must now take into account the provisions of the new law as part of the planning process.
2. Every single family lands situation must now take into account the provisions of the new law as part of the planning process.
3. Many conservation easements that have already been recorded should now be reviewed because of the provisions of the new law.
4. The new law will make planning immediately after the death of many landowners complex, difficult, expensive, possibly highly beneficial, and absolutely necessary.
5. With proper comprehensive planning, owners of important land can protect that land and save many more estate tax dollars than was possible under the old law.

Background

In mid-1997, President Clinton signed into law the Taxpayer Relief Act of 1997. The commentary on that legislation generally focused on the cut in the capital gains rate to 20%, education and retirement-saving incentives, and lower estate tax rates for individuals and some family-owned businesses.

For landowners and land trusts, however, there is more news and good news. The new legislation also included a modified version of The American Farm and Ranch Protection Act, an important new tax incentive for landowners

The original version of The American Farm and Ranch Protection Act was first introduced in Congress in 1990 by Senator John Chafee and Congressman Richard Schulze. The proposal originated with the Piedmont Environmental Council ("PEC"), based in northern Virginia. Some PEC supporters and representatives became convinced of the need for additional tax code incentives for land protection and came

up with the following simple, direct proposal for relief: land subject to a conservation easement under Section 170(h) of the tax code should be totally exempt from estate tax. That was essentially the provision introduced by Senator Chafee and Congressman Schulze in 1990. Over the next several years, as the federal legislative process moved forward, the proposal became more complex and less comprehensive. However, it remains an important new incentive for private, voluntary land conservation that landowners, their advisors, and land trusts must become familiar with.

How The New Law Works

The American Farm and Ranch Protection Act adds to the tax code a new Section 2031(c), "Estate Tax With Respect to Land Subject to a Qualified Conservation Easement."

Before we review the specific rules of Section 2031(c), let us clarify what this all means and what it doesn't mean.

It does mean that all of the existing conservation easement rules of Section 170(h), the current conservation easement section, are still intact and that Section 170(h) works exactly the same way it did before the 1997 tax code changes. If you donate an easement on land you own, and if the easement meets the requirements of Section 170(h), you are entitled to an income tax deduction for the value of the conservation easement. In addition, the value of the land is reduced for estate tax purposes.

After you have met the requirements of Section 170(h), then you can look at the additional benefits potentially available under Section 2031(c). However, at this point two things can happen. First, and more on this below, it is entirely possible that even though your easement qualified under Section 170(h) your situation may not be eligible for the additional benefits of Section 2031(c). Second, your situation may be eligible for the benefits of Section 2031(c) but for tax or other reasons the executor of your estate may decide not to elect Section 2031(c).

Put another way, an easement must qualify under Section 170(h) to be eligible for the benefits of Section 2031(c), but if the easement doesn't qualify under Section 2031(c) that has no impact whatsoever on qualification for all of the benefits of Section 170(h).

In a nutshell, this is what new Section 2031(c) says: if you have land subject to a conservation easement that meets the requirements of Section 170(h), and if you own that land when you die, and if you meet the requirements of Section 2031(c), then you can exclude an additional percentage of the value of that land from your estate in addition to the reduction in value already attributable to the easement. Here are the important parts of new Section 2031(c).

I. The new law will allow an executor to elect to exclude from a decedent's estate for federal estate tax purposes up to 40% of the value of land (not structures) subject to a conservation easement if:

- the land is within a 25-mile radius of a Metropolitan Statistical Area, as defined by the Office of Management and Budget (typically an area with a population over 50,000), or a national park or wilderness area, or within 10 miles of an Urban National Forest;
- the easement was donated, is perpetual, and otherwise meets the requirements of Section 170(h). Easements qualifying solely because they protect historic assets are not eligible for Section 2031(c) benefits;
- the land was owned by the decedent or a member of the decedent's family for at least three years immediately prior to the decedent's death;
- the easement was donated by the decedent or a member of the decedent's family; and
- the easement prohibits all but minimal commercial recreational use of the land (see more on this point below).

II. The maximum amount that may be excluded from an estate under the new provisions was $100,000 in 1998, increasing by $100,000 each year up to the maximum exclusion of $500,000 in 2002 and after. The exclusion applies regardless of when the easement was donated.

Here is the simplest possible example of how the new exclusion will work.

John owns land worth $2,000,000. In 1998, he donated a qualifying conservation easement that reduces the value of his land to $1,000,000. He dies in 2003. The land is valued in his estate at $1,000,000. His executor elects to take the Section 2031(c) exclusion; 40% of the $1,000,000 land value is excluded from John's estate; $600,000 of land value is subject to estate tax.

Note that if the planning is done correctly, the estates of both spouses can be eligible for the new Section 2031(c) exclusion.

III. "Development rights" retained in the easement will be subject to estate tax. Neither the statute nor the congressional committee reports answer all the questions about exactly what is a development right. The statute defines "development right" as a right that is retained for any commercial purpose which is "not subordinate to and directly supportive of the use of such land" for farming, ranching, etc., purposes. Reserved rights to continue agricultural, farming, ranching, and forestry activities are permissible and are clearly not development rights. The right to subdivide and convey additional house lots (of whatever size) clearly is a development right and clearly will be subject to estate tax (although see more on this point below). The right to own and maintain an existing residence is not a development right.

However, development rights retained in the easement will not be subject to estate tax (which is due nine months after the decedent's death) if within nine months of the decedent's death the heirs of the property agree to give up permanently some or all of those

development rights. Those rights do not actually have to be given up within nine months; the heirs have nine months to agree to eliminate them and then have up to two years after the decedent's death to give up those rights.

Some landowners and/or donee organizations prefer leaving potential future house lot sites outside of the tract of land to be covered by a conservation easement. The ability to retain or extinguish those rights may make it prudent to include them under the easement. This can provide a very important "second look," for estate planning purposes, after the landowner's death. In fact, if the extinguishment of the development rights takes the form of a conservation easement that meets the requirements of Section 170(h), the conservation easement section, the heirs may be entitled to an income tax deduction.

"Development rights" are not the same as commercial recreational activities. A golf course is clearly a commercial recreational activity, and Congress did not want a landowner to be able to reserve this sort of activity under an easement and still benefit from the Section 2031(c) exclusion. If an easement does not prohibit all but what the law calls "de minimis" commercial recreational activities the estate will not be eligible for the Section 2031(c) exclusion.

IV. If there is a mortgage on the property, an amount of land value equal to the amount of the indebtedness will not be eligible for the exclusion. In other words, if land subject to an easement is worth $1,000,000, but there is a $300,000 mortgage on the property, only $700,000 of the land value will be eligible for the exclusion. Of course, the mortgage will usually be deductible as a debt of the estate.

V. To the extent the estate takes the exclusion, land will retain the same basis as it had in the hands of the landowner/decedent, rather than being entitled to a stepped-up basis, for calculating any gain on a subsequent sale. These terms need a brief explanation.

The concept of "basis" is a tax law concept. In many (but not all) situations, for tax purposes "basis" and "cost" mean the same thing. This is a very simple illustration, but if you buy stock for $1,000 and sell it for $2,000, you will pay tax on the $1,000 gain, which is the difference between what you sold it for and your basis of $1,000.

If you hold that stock until you die, the estate tax will be based on the $2,000 value of that stock. However, when your children inherit the stock it will have a basis in their hands of $2,000. The tax law refers to this as a "stepped-up basis." If the children sell it for $2,000, there will be no tax on the gain (but remember that there was an estate tax on the $2,000 value). Once again, to the extent an estate takes advantage of the exclusion, a portion of the basis of the land would not be "stepped up" but would remain the same as it was in the hands of the decedent; that is, it would be "carried over."

VI. The exclusion is available when land is owned by family

corporations, partnerships, or trusts as long as the decedent owned at least a 30% interest in the corporation, partnership, or trust at the time of death.

VII. The amount of the exclusion will be reduced below 40% by two percentage points for each one percentage point by which the easement fails to reduce the value of the land by 30%. This complicated rule is intended to discourage “marginal” easements that don’t reduce the value of land very much, although the percentage reduction in value often has little or nothing to do with the importance of the conservation values to be protected by the easement.

Here is how this rule works. If land is worth $1,000,000 without an easement and, say, $650,000 subject to an easement, the full 40% exclusion under the statute will apply because the easement reduced the value of the land by more than 30%. On the other hand, if the easement reduced the value of the land from $1,000,000 to $800,000, because this 20% reduction in value is ten percentage points less than 30%, the exclusion is reduced from 40% to 20% (two percentage points for each point the easement fails to reduce the land value by 30%).

Put another way, if an easement reduces land value from $1,000,000 to $650,000, using the exclusion the total value subject to estate tax will be $390,000 ($650,000 minus 40% of $650,000). If the easement reduces land value from $1,000,000 to $800,000, using the exclusion the total value subject to estate tax will be $640,000 ($800,000 minus 20% of $800,000). These examples assume the maximum individual exclusion amount of $500,000 is fully phased in.

One obviously critical issue that has come up about the way this particular rule works is the question of whether the 30% reduction in value is to be calculated on the date the easement was donated (assuming the donation was made during the landowner’s lifetime) or on the date of the decedent’s death. Although making the determination on the date of the donation would ensure certainty, it now appears that the calculation will need to be made as of the date of the landowner’s death. Although there is very little data on this, in the vast majority of cases the evidence seems to indicate that once an easement is donated the percentage reduction in value attributable to the easement is not likely to decrease. In fact, the value of the easement seems likely to increase as development pressure and real estate values in the area increase.

There may be additional legislative efforts to change this rule to a date-of-donation determination, but for now a date-of-death calculation seems likely.

Some Important Issues
“Post-mortem” easement donation (easement donation after the death of the landowner). Prior to the new law, if a landowner died without having either donated an easement during lifetime or including an easement donation in his or her will, the estate tax was

based on the full, unrestricted, fair market value of the land. The new law includes a very important provision that will allow executors and trustees to elect to donate a qualified conservation easement after the death of the landowner. This is a so-called "post-mortem" or "after-death" easement donation.

I believe this new opportunity to donate a post-mortem easement is terribly important and very poorly understood.

The legal rules on when and under what circumstances an executor or heirs can make such a donation can vary widely from state to state, and may require changes in some state laws under some circumstances. In some states, for example, title to real estate vests in the heirs as of the date of death, while in other states the executor of the estate may hold title. It is important to check with your advisors on this and any other state law issues concerning the post-mortem easement donation.

If state law issues can be satisfactorily addressed, here is the simplest possible example of how the post-mortem donation will work.

John owns land worth $2,000,000. He did not donate an easement during his lifetime and he did not include an easement in his will. He dies in 2003 and leaves the land to his children. The land is valued in his estate at $2,000,000. His executor and his children agree to donate a conservation easement; the easement reduces the value of his land to $1,000,000 and that $1,000,000 of value is subject to estate tax. In addition, his executor elects to take the Section 2031(c) exclusion; an additional 40% of the $1,000,000 land value is excluded from John's estate, with the result that $600,000 of land value is subject to estate tax. (Under these circumstances, even though the easement met the requirements of Section 170(h), the easement rules, apparently neither the estate nor the children will be able to take an income tax deduction for donating the easement.)

Commercial recreational activities. Here is another important post-mortem planning opportunity. Assume Mary dies owning land restricted by an easement that met the requirements of Section 170(h) but that the easement does not prohibit commercial recreational activity and therefore the estate is ineligible for the Section 2031(c) exclusion. If the executor can in fact make a post-mortem easement donation in order to qualify for Section 2031(c), it also appears that the executor can make a post-mortem easement amendment in order to eliminate any prohibited commercial recreational activity so as to be eligible for Section 2031(c).

Note of caution. The post-mortem easement donation and the post-mortem easement amendment are important. However, while these planning opportunities are useful additions to the planner's toolbox, a landowner or a family should not take the position that comprehensive planning during lifetime should be put off because of the availability of post-mortem planning opportunities. For one thing, the law is absolutely clear on the income tax and estate tax savings

that are available when an easement is donated during lifetime. All the issues are not clear in the case of a post-mortem donation. In addition, using these post-mortem tools successfully means addressing a complex array of state law and other related questions and reaching agreement among all necessary parties within a relatively short period after the death of the decedent. It is certainly better to see to it that the proper planning is done during the lifetime of the landowner.

Planning Observations

- Land that falls outside the geographic limitations of new Section 2031(c) simply will not be eligible for the benefits of that section. However, continued urban sprawl will inevitably result in the addition of new Metropolitan Statistical Areas to the map, and that will mean greater coverage under Section 2031(c).
- Every single conservation easement must now take into account the provisions of Section 2031(c) as part of the planning process. Retained development rights can be extinguished after the death of the landowner, but more than "de minimis" retained commercial recreational rights can disqualify the easement from Section 2031(c) eligibility.
- Every single family lands planning situation must now take into account the provisions of Section 2031(c) as part of the planning process. Do the current owners want to gift the property to children over a period of years as part of the estate planning and succession planning process? Does the family want to remain eligible for the Section 2031(c) benefits? There is no "right" answer to these questions, but now we have an important additional planning tool in the landowner's toolbox.
- Every recorded easement should be reviewed with Section 2031(c) eligibility in mind (to look for a prohibition on commercial recreational activities, for example) if the land is still owned by the same family that donated the easement.
- One of the "costs" of the new Section 2031(c) benefit is that planning after death becomes much more complicated. Experienced appraisers will need to be available to give the family accurate valuation numbers (land value before and after the easement for purposes of the 30% test, the post-mortem election, and the value of retained development rights) in sufficient time for the family to make an informed judgment about what to do. In connection with the new post-mortem easement provision, a conservation easement that satisfies state law rules and has the agreement of all necessary parties must be successfully completed after the decedent's death. New Section 2031(c) is a very important incentive for land conservation. It will take some time to sort out all of the planning issues, and to answer some of the planning questions that have already come up, but landowners and their advisors and land trusts must begin to work with the new law. Saving important land and saving tax dollars is a tough combination to beat!

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