

TAX BENEFITS OF CONSERVATION EASEMENTS

NOTE: Before entering into a conservation easement of any kind, landowners should consult with their attorneys. If an easement donor intends to capitalize on tax advantages provided by easements, the services of a tax professional and a certified land appraiser also will be needed. VCC can provide advice on acquiring these services.

Conservation easements enable owners to preserve the special natural, historic, and agricultural values of their property. For most people, meeting these personal conservation objectives is the primary motivation for entering into an easement. In meeting the conservation objectives of an individual landowner, however, easements can provide *documentable* benefits to the public by conserving water, open lands, forests, and other significant historic and natural resources. Because of these public benefits, the state and federal tax codes offer significant tax incentives for landowners who give easements to qualified private land trusts and public agencies. The following examples are based on tax laws as they stand in 1999. These examples are simple and general in nature and are intended only to explain how the tax benefits work.

Real Property Taxes

Local real property taxes in Virginia are based on the assessed value of land as measured by its “fair market value.”²⁷ Many localities give real estate tax relief to rural land through the “land-use” program which assesses property which qualifies for the program at its “use-value” rather than its “highest and best” value which is typically for development. Some forty localities have not adopted the use-value program and it is always possible for a locality to rescind an existing use-value program. For those localities without land-use, or in the event a land-use program

is rescinded, land subject to a perpetual (permanent) conservation easement is guaranteed a reduced assessment independent of use-value. The law also provides that land subject to a perpetual conservation easement automatically qualifies for use-value in those localities which have use-value programs. The guarantee of a reduced assessment for land subject to a perpetual easement reflects the fact that an easement reduces or removes the potential for development.

The Virginia Code states, "To ensure that the owner . . . is not taxed on the value of the interest of the holder of the easement, the fair market value of such land (j) shall be based only on uses of the land that are permitted under the terms of the easement and (jj) shall not include any value attributable to the uses or potential uses of the land that have been terminated by the easement," if it is "perpetual."²⁸

<p>An easement is placed on a 500-acre farm in a county that does not have use-value taxation. The county had been assessing the land at its appraised value of \$1,000,000, or \$2,000 per acre. The easement is appraised at \$300,000, reducing the property's value to \$700,000, or \$1,400 per acre. The owner's real property tax liability would be reduced as shown to the right.</p>	WITHOUT THE EASEMENT	
	Assessed Value: \$1,000,000	
	Tax Rate: \$0.58 per \$100 (in assessed value)	
	Annual Tax Due: \$5,800	
	WITH THE EASEMENT	
	Assessed Value: \$700,000	
	Tax Rate: \$0.58 per \$100 (in assessed value)	
	Annual Tax Due: \$4,060	
	Annual Real Property Tax Savings from the Conservation Easement: \$1,740	

Example 1: Effect on Real Property Taxes

Federal and State Income Tax Savings

The donation of a conservation easement that meets federal tax code requirements (Section 170(h) of the Internal Revenue Code) can be deducted from state and federal taxable income, just like tax-deductible gifts made to a church or community charity. For income tax purposes, the value of the easement is the difference between the land's value with the easement

and its value without the easement. The value must be determined by a certified land appraiser within six months of the date of the donation. For example, if a property is worth \$1,000,000 without an easement and \$700,000 with an easement, a charitable deduction of \$300,000 is generated. In other words, the value of the easement is \$300,000.

An individual can deduct the value of a donated conservation easement against up to 30 percent of his adjusted gross income in the year he makes the donation. Any unused balance of the deduction can be carried forward for up to five succeeding years. Of course, the total value of the gift may exceed the amount that can be deducted over six years in which case the unused portion of the deduction is lost, although it is possible to phase an easement gift to avoid this outcome. The value of the donation can therefore vary, depending on an individual's annual income and tax rate. Once again, it is always important for a prospective easement donor to seek competent professional advice when considering the tax ramifications of a donation.

Assume that Bob and Sue donate an easement on their 500-acre farm, Westwood, to the Virginia Outdoors Foundation. The appraised value is \$1,000,000 without the easement. The value of the land with the easement in place is \$700,000, therefore the value of the easement is \$300,000. The family has an annual adjusted gross income of \$145,000, after subtracting other tax deductions. Their income tax liability would be reduced as shown to the right.

WITHOUT THE EASEMENT	
Adjusted Gross Income:	\$145,000
Federal Income Tax @ 31%:	\$44,950
Virginia Income Tax @ 5.75%:	\$8,337
Annual Income Tax Due:	\$53,287
WITH THE EASEMENT	
Adjusted Gross Income:	\$145,000
Easement Deduction:	-\$43,500
Taxable Income:	\$101,500
Federal Income Tax @ 31%:	\$31,465
Virginia Income Tax @ 5.75%:	\$5,836
Annual Income Tax Due:	\$37,301

Bob and Sue can only deduct \$43,500, or 30 percent, of their adjusted gross income a year, for an annual tax savings of \$15,986. They can take that deduction for six consecutive years, however, for total savings of \$95,916 on their federal and state income taxes combined.

Annual Income Tax Savings from the Conservation Easement: \$15,986

Example 2: Effect on Federal and State Income Taxes

Estate Tax Benefits of Easement Donation and the New Exclusion

The greatest impediment to keeping a farm in the family is often the estate tax, which is levied at rates as high as 55 percent and effectively begins at 37% on the first dollar over \$650,000. Rising property values in the Shenandoah Valley can easily push a farm's value well above \$650,000. The combined impact of increasing land values and high estate taxes can force children to sell a farm bequeathed to them, just to pay taxes. Too often, heirs learn the federal estate tax on a property is in the hundreds of thousands of dollars, after their parents have died. Because estate taxes are usually due nine months after a parent's death, the children may be forced to sell all or part of a farm they would rather keep in order to pay the estate tax.

An easement that protects land from future development also lowers its fair market value and therefore the owner's taxable estate. The effect of a conservation easement on estate taxes is most important to families with valuable real estate holdings, because the first \$650,000 of assets are generally exempt from estate taxes due to the "unified credit." The unified credit against estate tax (and gift tax) for 1999 is \$211,300. This credit is subtracted from the tax due on a decedent's estate to determine the net tax payable. It effectively shelters the first \$650,000 in assets in a decedent's estate from tax liability.

It is important to note, however, that with some very simple estate planning a husband and wife can maximize the use of the unified credit in each of their estates thereby allowing them to pass up to \$1,300,000 in property to their children estate tax free.

In addition to the reduction in the size of the estate (and therefore estate taxes) due to the donation of a conservation easement, under the provisions of the Taxpayer Relief Act of 1997 which added Section 2031c to the Internal Revenue Code, 40 percent of the remaining value of land after subtracting the value of the easement may be excluded from the estate thereby further reducing estate taxes. The maximum value which may be excluded under the provisions of the new Section 2031c is \$500,000 phased in over the next four years. The amount which may be excluded in 1999 is \$200,000. However, as is true of the unified credit, with a very simple estate plan the value of the exclusion can be doubled for a husband and wife.

The new exclusion requires that the easement reduce the value of

the land by at least 30 percent and there are other qualifications as well. However, most easements meeting the guidelines of the Virginia Outdoors Foundation will qualify for both of these benefits. The example below reveals the significant estate tax savings from the use of a conservation easement.

Assume that Bob and Sue donate an easement on their 500-acre farm, Westwood, to the Virginia Outdoors Foundation. The appraised value is \$1,000,000 without the easement. The easement is appraised at \$300,000, reducing the property's value to \$700,000. In addition to their land, their estate includes their home, farm machinery, and Angus herd, with a total value of \$200,000. The easement donation would reduce estate taxes as shown to the right.

In this example, Bob and Sue are able to bring most of the value of their estate under the level exempted from estate taxes (assume that they

did not do any other estate planning which could have effectively doubled the value of both the unified credit and the new estate tax exclusion for easements). In the process, their family would save over 90 percent of the taxes due from their estate at death. Estate taxes can have a dramatic effect on a family's ability to keep a family farm in the family. Conservation easements can be equally effective in reducing this tax burden. A \$216,500 tax burden could easily break a family's efforts to keep their land.

Total Estate Savings from the Conservation Easement: \$198,000

WITHOUT THE EASEMENT	
Land Value:	\$1,000,000
Other Assets:	+\$200,000
Total Estate:	\$1,200,000
Federal Tax in 1999 (41% marginal rate):	\$427,800
1999 Unified Credit:	-\$211,300
Total Estate Tax Due:	\$216,500
WITH THE EASEMENT	
Land Value Before Easement:	\$1,000,000
Value of Easement:	-\$300,000
Remainder Value After Easement:	\$700,000
Other Assets:	+\$200,000
Total Estate:	\$900,000
Reduction Due to New Exclusion (40% x \$700,000, but capped at \$200,000 in 1999):	-\$200,000
Net Taxable Estate:	\$700,000
Federal Tax in 1999 (41% marginal rate):	\$229,800
1999 Unified Credit:	-\$211,300
Net Tax Due:	\$18,500

Combining Tax Benefits From Easement Donation

The income and estate tax benefits previously described (and the real estate tax benefits as well) can be enjoyed in combination, they are not mutually exclusive. For example, in the previous examples we have seen that an easement donation saved Bob and Sue \$95,916 in income taxes and it saved their children \$198,000 in estate taxes. Thus the total tax savings due to the donation of this \$300,000 easement is \$293,916, or 98% of the value of the easement itself. Where easement donors are in higher tax brackets, or when the ultimate allowable exclusion of \$500,000 is fully phased in, combined tax savings can easily exceed the value of the easement.

Easements Donated After the Landowner Dies

Under the Taxpayer Relief Act of 1997, and a subsequent amendment in 1998, it is possible for the family of a landowner who failed to donate an easement during his lifetime to reap the estate tax benefits of easement donation through a "post mortem" easement donation. A post mortem easement is one donated by the decedent's executor or trustee. Such easements will qualify for both an estate tax deduction for the value of the easement and the 40 percent exclusion described above. Of course, a post mortem easement will not qualify for an income tax deduction. However, the estate tax benefits of a post mortem easement may mean the difference between success or failure for a family trying to save the family farm from being sold to pay estate taxes.

Under current Virginia law a decedent's executor or trustee is not authorized to make a post mortem easement donation. However, legislation is pending in the General Assembly as of this writing (January 1999) which would give executors and trustees this authority. In the meantime, it is possible for a landowner to make express provision in his will authorizing his executor or trustee to make such a donation. Even better would be for the landowner to make the easement donation himself thereby gaining the advantage of the estate tax benefits and income tax benefits. It is also possible for a landowner to expressly donate an easement by the terms of his will thus insuring that the easement will be conveyed at his death.

The Benefits of "Value Replacement"

It is possible to use the income tax savings accruing from the donation of a conservation easement to actually increase the size of the donor's estate, providing more liquidity for the donor's heirs while keeping the land under easement in the family. The technique depends upon investing the

income tax savings resulting from easement donation in a life insurance policy. This technique is called “value replacement” because it replaces the value given up in the easement donation with the proceeds of a life insurance policy.

Where a policy bought with income tax savings from easement donation is placed in an “inter-vivos” trust (one set up during the donor’s lifetime) and where all of the “incidents of ownership” of the policy (the rights to revoke the policy, borrow against the policy, change beneficiaries, etc.) are relinquished the proceeds of the policy will not be subject either to income or estate tax. Furthermore, if the income tax savings are used to buy a “second to die” policy which pays out on the death of the survivor of a husband and wife the cost of the policy is dramatically reduced, thereby increasing the benefits of value replacement.

Example 4: The Benefit of “Value Replacement”

Assume that Bob and Sue in our second example had decided to use part of their income tax savings for value replacement. Assume that Bob and Sue are 51 and 42 years old respectively and in good health. Given these assumptions they could buy a second to die insurance policy paying

\$1,000,000 upon the death of the survivor of them for a cost of around \$60,000. The result would be that instead of passing an estate on to their children worth \$881,500, they could pass on an estate worth \$1,821,500 of which nearly \$1,000,000 would be cash.

Total Value Passing to Children: \$1,821,500

EFFECT OF VALUE REPLACEMENT	
Value of Estate:	\$1,200,000
Reduction Due to Easement	-\$300,000
Reduction Due to Estate Tax Payment:	-\$18,500
Net Estate Before Value Replacement:	\$881,500
Face Value of "Second To Die"	
Policy (not subject to tax):	\$1,000,000
Less Cost of Policy:	-\$60,000
Net Value of Policy:	\$940,000
Total Value Passing to Children:	\$1,821,500

