SAVE ESTATE TAXES and SAVE YOUR RANCH
How a Conservation Easement Can Help

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Approaching the Porcupine
One accountant I talked with who specializes in estate planning for farmers and ranchers describe the issue for many families as: "Like finding a porcupine in the cab of your pick-up truck, you know you have to do something, but you don't know what."

Families searching for ways to pass on the family ranch between generations face many challenges. Frequently there are multiple heirs. Some may wish to keep ranching while others would rather have the cash that could be raised by selling out. Or, all of the children are interested in ranching, but the property is too small to support everyone.

Another problem is the federal estate tax. While the estate tax lapsed at the end of 2009, it went back into effect January 1, 2011. The new tax allows up to $5 million in assets per estate to pass free of tax. With a simple plan a husband and wife can pass up to $10 million to pass free of tax. Any assets in excess of the $5 million or $10 million level will be taxed at 35%. However, in 2013, unless Congress acts, the estate tax reverts to year 2000 rules. In that case the amount exempt from tax drops to $1 million per estate and the top rate goes to 55%.

$10 million covers a substantial amount of land in Wyoming. However, while land values have stagnated recently, in many places land values are still near an all time high. This makes it imperative that ranching families take a serious look at the value of their operation. In many areas, land values have escalated rapidly, this can leave families with significant estate tax burdens when members pass on. If the family doesn't have much in the way of cash or stocks and bonds, the only way to pay the estate tax may be to sell the ranch. Similarly, high property values may increase the temptation of heirs to sell-out. This can be especially true with in-laws or other relatives who may not have grown-up on the ranch or do not have a similar associations.

These challenges create an environment where disputes may arise between family members when the ranch-owner dies. Such disputes may not only lead to ranches being broken apart and sold out of agriculture, but to permanent rifts within families.

Conservation Easement Basics
A conservation easement is a voluntary agreement between a landowner and a conservation organization ("land trust") or public agency. The agreement permanently limits the development potential of the land made subject to the easement (the "easement property"). Easements can be written to allow continued ranching, recreation (including hunting and fishing), and even limited residential development, provided that these uses are consistent with the conservation values of the easement property. Such values may be agricultural, scenic, wildlife habitat, or a combination of these. Conservation easements typically <u>do not</u> require public access.

Conservation easements can be donated or sold. In the case of an easement sale it is typical for the landowner to sell the easement for less than its fair market value and claim a tax deduction for the difference. This is known as a "bargain sale." In a bargain sale the difference between the fair market value of the easement and what

1 The authors thank Glenn Pauley who co-authored the first edition of this paper in 2006.

the landowner sold it for may be deductible as a charitable contribution.

A conservation easement can be granted during the owner's life-time or by will; it is even possible for a landowner's heirs to direct the landowner's executor to contribute a conservation easement that has retroactive effect, therefore saving estate taxes.

An easement may be placed on an entire property or on only a portion of the property. Conservation easements are typically granted in perpetuity. This means that the easement cannot be amended or revoked at the will of the person granting the easement, and that the easement binds future owners, ensuring the land will be maintained as ranchland and open space for future generations.

The value of a conservation easement donated by a landowner is deductible from the donor's federal income tax as a charitable contribution. In such cases, the tax code requires that the value of a conservation easement be determined by a qualified appraiser according to what is called the "before and after" method. In the "before and after" method the value of the easement is the difference in the value of property before the easement is in place and after the easement is in place. For example, a ranch may be worth $1 million with all of its development potential intact before an easement is donated over the property, and $400,000 after the easement is donated. The difference in value of $600,000 ($1,000,000 - $400,000) is the value of the easement and the amount of the charitable deduction allowed the donor.

The value of conservation easements vary widely depending on the terms of the easement and development pressure in the area. However, conservation easements used to preserve working agricultural operations typically range from 25% to 50% of the property's fair market value. In some places where development pressure is significant, a highly restrictive conservation easement may be worth as much as 90% of the unrestricted value of the property.

The ability of a conservation easement to limit development on a property and the related reduction in the land's apprised value may have a number of beneficial implications for transferring a ranch within a family and associated estate tax planning.

Estate Tax Basics

Valuation of Assets.
Estate taxes are based on the fair market value of a decedent's assets at the time of the decedent's death, not the original purchase price or current use value. Where ranch land is owned by a decedent, this can result in substantial estate tax burdens if a ranch has appreciated over time, especially if the increase is largely represented by the ranches' development potential.

> Example 1:
>
> Sally and Sam bought the Razorback Ranch in 1965 for $100,000. Sally died in 1980 and the ranch has been in Sam's name ever since. The Ranch is about 2,000 acres in size and has substantial "amenity values" such as trout fishing, beautiful views, springs and ponds. At the time that Sam dies, in 2011, the Ranch is valued by the IRS at $13,000,000. Taking into account the estate tax exclusion (discussed below) the estate tax on the Ranch will be $2,800,000. This tax is 28 times what Sally and Sam originally paid for the ranch.

*The Estate Tax Exclusion and Tax Rate.*The first $5 million of a decedent's estate is excluded from the federal estate tax. In other words, if you own assets with a net value less than $5 million, your estate won't be subject to tax. (However, remember that the current $5 million exclusion drops to $1 million in 2013.) In addition, all assets passing to a surviving spouse are exempt from this tax (this exemption is known as the "marital deduction").

In 2011, the first dollar of assets in a decedent's estate over $5 million will be taxed at 35%.

Doubling the Exclusion with "By-Pass Trusts."

It is typical for a husband and wife to provide that all of the first decedent's assets pass outright to the surviving spouse. This is accomplished through a simple will and by titling assets jointly with right of survivorship or as tenants by the entireties. Even if a person changes his or her will to name someone other than his or her spouse as a beneficiary, if all of that person's assets are jointly held with their spouse, those assets will pass directly to the spouse regardless of the provisions of the will. This is because the title controls.

As noted above, the law now allows the first $5 million of a decedent's estate to pass tax free. In addition, also noted above, all of a decedent's assets, no matter how valuable, may pass to the surviving spouse tax free. If a person leaves all of his or her assets to the surviving spouse there will be no tax. However, doing so will waste the $5 million exemption from tax because the marital exemption supersedes the $5 million exemption. It will also increase the value of the assets in the survivor's estate, potentially increasing the estate tax on that estate.

This is what can happen with "I love you" wills in which the first decedent gives everything to the surviving spouse. From an estate tax standpoint "I love you wills" are rather like pouring ten gallons of milk into a 5-gallon bucket: a lot spills out. If two 5-gallon buckets had been used, all of the milk would have been saved.

This is where "by-pass" trusts can make a huge difference; effectively doubling the $5 million exemption to $10 million. The by-pass trust works like this: Each spouse creates a trust that provides that the assets of the trust will be used to support and provide for the other spouse and, upon the death of that spouse, the trust assets will pass to the children, or other beneficiaries that the creator of the trust may name. The key is that the assets of the by-pass trust may be used for the benefit of the surviving spouse, *but do not become the property of the surviving spouse*. This qualifies the assets in the trust for the $5 million exemption. It also ensures that those assets do not increase the surviving spouse's estate, thereby exposing it to increased estate tax.

However because, as noted earlier, the title to property controls its disposition regardless of the provisions of a person's will, in order for a by-pass trust to work assets that are jointly held (other than relatively small items such as equipment or vehicles) should be transferred to a joint tenancy without rights of survivorship. This way, the jointly held assets do not automatically pass to the survivor, thus defeating the purpose of the by-pass trust.

Example 2:

Assume that John and Mary Smith own a 2,500-acre ranch along the Green River in the Pinedale area. The Ranch has high "amenity values" because of its scenic qualities and location along the Green. The value of the ranch for large lot development is $5,000 per acre, without considering improvements. John and Mary both die in 2011 and the IRS values their ranch at $12.5 million. The Smiths left other assets worth about $1,000,000, including buildings, investments and equipment making their total estate $13.5 million.

John and Mary have three married children, each in their 30s. All of the kids and their families make their home and living on the ranch. Although they could make a lot of money by selling the ranch, none of them wants to do so because they fear they could never afford to buy another place as nice to raise their children.

John and Mary had "I love you wills." They die in an auto accident in 2011. All of the assets end up in John's estate as he survived for two months after the accident. All of Mary's assets, including jointly titled property, pass to John, and there is no tax on her estate because of the marital deduction. John's estate can take advantage of the $5 million exclusion. However, that leaves $8.5 million subject to estate tax. The estate tax on this amount is $2,975,000 [($13,500,000 – $5,000,000) x 35%]. It is easy to figure out what will happen to John and Mary's ranch. Note that the estate tax can be paid in installments by heirs under certain conditions. However, the tax still must be paid, plus interest.

If John and Mary had used by-pass trusts, and properly titled their property, the estate tax would have been reduced from $2,975,000 to $1,225,000 [($13,500,000 – $5,000,000 – $5,000,000) x 35%].

How Conservation Easements can Help Pass on the Ranch

In the right circumstances, conservation easements can be a very effective and relatively simple estate planning tool. In cases in which ranch property is the primary asset, conservation easements can reduce ranch values to levels that can substantially reduce, or eliminate, the estate tax.

Example 3: In the previous example, the Smith's life is their ranch and neither they nor their children have any intention of developing. John and Mary's by-pass trusts reduced the estate tax on their assets dramatically, but still left over $1 million in estate tax liability.

Now assume that, in addition to providing for by-pass trusts, John and Mary contributed a conservation easement over 1,000 acres of their ranch. The easement covered the 1,000 acres along the Green River, which was prime wildlife habitat (and development land as well), but not very good for ranching. Assume that the easement allowed the 1,000 acres to be divided into two 500-acre parcels, each with one homestead.

With the easement in place, the value of the ranch is reduced from $12.5 million to $10 million because of the removal of the potential for large-lot development on the 1,000 protected acres. The easement allows the family (and their successors in title) to continue to use the 1,000-acre protected portion of the ranch just as they always have, and by reserving two division rights it provides for some financial flexibility in the future. The easement also insures that 1,000 acres will remain available for ranching and recreational use, such as fishing and hunting in the future.

The conservation easement reduces the taxable value of John and Mary's assets from $13.5 million to $11 million, an amount that can mostly be sheltered by the two $5 million exemptions available to each estate (due to the by-pass trusts). Note that, in addition to the reduction in value of the ranch due to the conservation easement, the law also allows each of John's and Mary's estates to exclude 40% of the value of the Ranch remaining after the easement is in place. However, there is a $500,000 per estate limit on the amount of that exclusion. Nevertheless, it reduces the taxable estate by an additional $1 million to $10 million.

In any event, the combination of the use of by-pass trusts and a conservation easement have entirely eliminated the estate tax on John's and Mary's estates, saving their children

$3,850,000 in the estate taxes that would have been due if John and Mary had done nothing to plan for estate taxes.

John and Mary could have contributed the easement over the entire ranch, and in order to ensure that it continued to be available for ranching purposes might very well have done so. However, given these particular circumstances, the 1000-acre easement was all that was needed for estate tax purposes.

As seen in the preceding example, the estate tax code (Section 2031(c)) allows the Smith's executor to elect to exclude up to 40% of the restricted value of the ranch included in each estate (up to a maximum of $500,000 for each estate), from each of their estates. This additional exclusion for land subject to a conservation easement further reduces the estate tax due. Both the reduction in value due to the conservation easement <u>and</u> the 40% exclusion will be available to the Smith's children if they own the ranch when they die.

"Post Mortem" Easements

If a decedent's estate includes valuable land, the decedent's heirs may direct the estate's executor to put a conservation easement on the land. If the easement is put in place before the due date for the estate tax return (9 months after the decedent's death, plus extensions, if any) it can qualify the estate for the same estate tax benefits that would have been available if the decedent had donated the easement during his or her lifetime.

All persons with an interest in the estate must consent to the easement, and no income tax deduction can be allowed. However, the donation of a "post mortem" easement can mean the difference between keeping the ranch in the family, and selling to pay estate taxes.

For example, if John and Mary, from the preceding example, had done nothing, their children, assuming they acted together and quickly, could have directed John's and Mary's executor to contribute a conservation easement over the Ranch that reduced its value sufficiently to eliminate the estate tax due. Unless John's and Mary's wills authorized their executors to do this, the children would probably be required to go to court to obtain that authority for the executors.

Note that NO income tax deduction may be claimed in connection with the contribution of a post-mortem easement.

Conservation Easements to Assist with Inter-generational Ranch Transfers During the Owner's Life.

A typical estate planning tool is the annual gift. Federal tax law allows an individual to give up to $13,000 to other individuals without paying a gift tax, and without reducing the $5 million estate tax exemption. By taking advantage of this "annual gift tax exemption" individuals over a period of years can transfer a substantial amount of assets to their children, thereby avoiding either gift or estate tax on the value of what has been transferred.

> Example 4: John's and Mary's three children have a total of four children among them. Using the annual exclusion, and making joint gifts, John and Mary can make gifts sheltered by the gift tax exclusion amounting to $260,000 per year. This can be done by making a $26,000 joint gift to each child (amounting to $78,000 for all three children); similar joint gifts to the spouse of each child (also amounting to $78,000); and four $26,000 joint gifts to each of the four grandchildren (amounting to $104,000).

Conservation easements can facilitate this type of annual gifting plan by increasing the amount of land that can be transferred each year. An easement does this by reducing the value of the land, allowing more to be transferred at one time.

Example 5: Assume that a couple owns 2,000 acres of land that they wish to transfer to their two children. They can transfer a maximum of $52,000 per year under the annual gift tax exemption ($13,000 x 2 x 2 = $52,000). Assume that the land is worth $3,000 per acre making the entire property worth $6 million. It will take 116 years to transfer the entire property (assuming no increase in the value of the land) using only the annual gift tax exclusion ($6,000,000/ $52,000 = 115.38).

Now, suppose that the couple contributes a conservation easement over the 2,000 acres reducing its value to $1,000 per acre. The property is now worth $2 million and can be entirely transferred to the children using the annual gift tax exemption in 39 years ($2,000,000/ $52,000 = 38.46).

Of course there are many other factors to be considered here and the annual gift alone isn't going to allow the couple to effectively transfer the entire value of the property, even with a conservation easement in place. However, this illustrates the role that a conservation easement can play in facilitating annual transfers of land (or memberships in an LLC, family partnership, or shares in an S corporation) using the annual gift tax exemption.

Conservation Easement Sales

Conservation easements can also be sold. In these instances, landowners receive a direct cash payment for entering into the conservation easement. A landowner's ability to sell a conservation easement is often most limited by the availability of funding for this purpose in their area and the natural features of their land. Funding for conservation easement purchases in Wyoming has been available from such sources as the USDA Farm and Ranchland Protection Program and Grassland Reverse Program, Wyoming Wildlife and Natural Resources Trust Fund, Wyoming Game and Fish Habitat Conservation and Sportsmen Access Programs, as well as mitigation dollars from energy development. Historically, funding has been limited, competition intense, and the application process may be long and complex. <u>In other words, it is unlikely, given existing funding, that more than a very few conservation easements can be sold in Wyoming annually.</u>

Most conservation easement sales are structured as "bargain sales." This means the easement is sold to a land trust or government agency at a price below its appraised value. The good news is that the difference between the appraised value of the easement and its purchase price can be considered a charitable contribution, and may entitle the landowner to income tax benefits if the easement meets the requirements of the federal tax code. Because of the limited dollars, and the time and work involved in completing a conservation easement purchase, the larger the bargain sale the more attractive the purchase is to both land trusts and funding agencies.

Example 6: Jack agrees to sell a conservation easement on his ranch to the local land trust. The land trust has $500,000 in grant money available for the purchase. However, Jack estimates that the easement will be worth $2 million. The land trust and Jack strike a bargain to sell the easement for $500,000, with the expressed intention that any difference between the sale's price and the actual value of the easement, as determined by a qualified appraisal, is to be treated as a charitable contribution by Jack to the land trust. After the easement is sold, Jack obtains a qualified appraisal showing that the easement was worth $1.8 million. Jack is entitled to a federal income tax deduction of $1.3 million ($1.8 million - $500,000).

While the obstacles to selling a conservation easement can be significant, the benefits for ranch estate planning can be equally rewarding. Money from selling a conservation easement can be used to provide retirement income, retire debt, buy additional equipment or land (where easement sale's proceeds are used to acquire more land, the transaction may qualify as a "tax-deferred exchange" so that no income tax is due on the proceeds). The landowner may choose to give the proceeds of the easement sale to one heir and the land encumbered by the easement to another. The proceeds of easement sales can also be used to buy life insurance for the same purpose. Additionally, the same reduction in the value of land that occurs with a contributed conservation easement also occurs with an easement that is sold, so that estate taxes will be reduced. Of course, the reduction in the value of the land will be offset to the extent of cash received for the easement.

Additional Ranch Planning

Beyond potential financial benefits, conservation easements can assist with inter-generational ranch transfers by providing a mechanism for making decisions about the land's future when everyone is at the table. All too often heirs agonize over "what mom and dad would have done." A conservation easement is a permanent decision. Everyone knows at the signing of the easement whether and how the ranch may be subdivided and what lands may and may not be developed. Portions of the ranch suitable for development can be left out of the conservation easement or incorporated into designated building envelopes; areas with high scenic, agricultural, wildlife or historic qualities may be preserved in the easement. These choices are made by the landowner. Such options not only offer new possibilities for finding equitable arrangements among family members, but also provide an opportunity to insure a permanent tribute to a family's agricultural legacy and the land they love.

Conservation Easements and Income Tax

In December 2010 Congress reinstated a law that was initially enacted in 2006, but that expired at the end of 2009. The law greatly enhances a landowner's ability to use the federal income tax deduction for the contribution (or bargain sale) of a conservation easement.

Generally speaking, the difference between the value of land before granting a conservation easement and the value of that land after the easement is deductible as a charitable contribution, provided that the conservation easement meets the requirements of section 170(h) of the Internal Revenue Code. This is also true of the bargain sale of a conservation easement, except that the deduction will be reduced by the amount of cash received for the conservation easement.

Under the old law an easement donor was allowed to use the deduction against 30% of his contribution base (essentially, adjusted gross income). Any amount of that deduction that could not be used in the year of the contribution could be "carried-forward" to future years, up to a total of five years. If the value of a conservation easement was substantial only people with large annual incomes could fully enjoy the tax benefits of the contribution of the easement.

The law enacted in December makes it possible for easement donors with smaller incomes to enjoy a much greater amount of the deduction arising from the contribution or bargain sale of a conservation easement. The law now allows the deduction to be claimed against 50% of the donor's adjusted gross income, and it allows unused portions of that deduction to be carried-forward for 15 years. In addition, if over 50% of the donor's income is from the business of farming or ranching the deduction can be used against 100% of the donor's adjusted gross income, with unused portions allowed to be

carried forward for 15 years – at the 100% write-off rate, regardless of the source of the donor's income in future years.

This new law applies to easements granted in 2010 and 2011. It is set to expire at the end of 2011.

Example 7:

Under the old law, a landowner earning $50,000 a year who donated a $1 million conservation easement could take a $15,000 deduction for the year of the donation and for an additional 5 years – a total of $90,000 in tax deductions. The new law allows that landowner to deduct $25,000 for the year of the donation and for an additional 15 years. That equals $400,000 in deductions. If the landowner qualifies as a farmer or rancher, he can deduct the full amount of his annual income ($50,000 in this case) annually until the deduction is used up, or for up to fifteen years after the original contribution, whichever period is shorter. In this example, the landowner could use $800,000 of the $1 million deduction, essentially paying no income tax for 16 years. However, if his income did not increase, the landowner could still not use the entire deduction within the 16-year period allowed. Additionally, estate the tax benefits for conservation easement donations, both through a reduction in the land's appraised value, and additional exclusions, remain unchanged.

The maximum income tax benefit that can be enjoyed for the easement donation under federal tax law is easily calculated: simply multiply the deduction by the top federal tax rate (35% in 2011). In the preceding example, the maximum federal income tax benefit would be $350,000 ($1,000,000 x 35%). If the donor were a resident of California, which has a top income tax of 9% and recognizes easement contributions, he or she could save an additional $90,000 in state income tax from the contribution ($1,000,000 x 9%). However, in calculating tax benefits it is important to keep in mind the annual limitation on the amount that may be deducted, and to consider other deductions that the taxpayer may have available.

The only reliable way to estimate the tax benefits of a particular easement contribution is to obtain a preliminary appraisal of the value of the easement. This preliminary value should then be given to someone familiar with the tax benefits of conservation easements and with the landowner's income circumstances who can then calculate how the potential deduction will actually affect future tax liability.

The tax code further requires that the amount of any conservation easement deduction resulting from a contribution made during the first year of ownership of the property subject to the easement be limited to the donor's basis in the easement (not the property itself). After the first year of ownership the deduction is not limited.

Caution

It is important to remember that the tax consequences of the contribution or bargain sale of a conservation easement are complex and that the federal requirements for properly substantiating any deduction claimed for the conveyance of a conservation easement are strict. It is important to obtain the advice of a professional experienced in and knowledgeable about conservation easements.

For more information you may want to obtain a copy of *A Tax Guide to Conservation Easements* by Tim Lindstrom (a co-author of this article) which was published by Island Press in 2008 (note that examples of both the new and old law are contained in this text). It can be purchased through Amazon.com or directly from Island Press.

Additional Estate Planning

There are many effective techniques for inter-generational ranch transfers and estate tax planning. These and other approaches should be examined with an estate tax professional. Proper estate planning is the only way to insure that the federal government does not become one of your biggest heirs.

Organizations which hold conservation easements in Wyoming include:

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