DRAFT

MEMORANDUM

Date: January 7, 2002

To: The Honorable Chair and Members
Pima County Board of Supervisors

From: C.H. Huckelberry
County Administrator

Re: **Tax and Estate Tax Planning Workshop**

I. Background

On October 27, 2001, Pima County and the Arizona Open Land Trust hosted a workshop on Tax and Estate Tax Planning as part of the Sonoran Desert Conservation Plan's Conservation Tools Workshop series. The verbatim proceedings and materials from this workshop are attached.

II. Conservation Easements: Tax Rules and Tax Savings

Mr. Stephen J. Small, the author of the Federal Income Tax Regulations on conservation easements and a text entitled *Preserving Family Lands*, discussed the tax regulations governing conservation easements and the importance of estate planning. Mr. Small's discussion emphasizes conservation easements as a tool to reduce a landowners tax liability and to preserve family lands. The workshop included a primer on the federal estate and gift tax. Section 2031(c) of the federal tax code, the new estate tax benefit, is also discussed. While a conservation easement on property will reduce the estate by the value of conservation easement, this section adds that an additional 40 percent of the land value can also be excluded from an estate under certain circumstances. Mr. Small described the tax benefits realized in various situations. In addition to providing information about tax rules and benefits, the workshop provided details as to how conservation easements work, what qualifies as a conservation easement, and the valuation of a conservation easement. Throughout the conference, the importance of having an estate plan is emphasized for the ranch owner.

III. Conclusion

The Tax and Estate Tax Planning workshop proceedings continue the series that is underway to support the development of the Ranch Conservation Element. Proceedings from the Conservation Easements workshop were published in December 2001; the Adaptive Management workshop proceedings will be published soon; and a conference on mitigation banking will be held in the near future.

Attachment

TAX AND ESTATE PLANNING WORKSHOP

OCTOBER 27, 2001

I. Introduction - Mr. Bob Sharp

This is going to be a morning where your time is well-spent. For those of you who are ranchers, tax and estate planning should be top priority in your operations.

It has nothing to do with cattle part of it, it doesn't have anything to do with the range, and it doesn't have anything with what the Sonoran Desert Conservation Plan and how the Plan may affect your lands.

What it does have an affect on is federal, state tax and family succession planning. How you plan for these issues will determine not only the future of your operations, but it also affects your day to day management.

Today's speaker wrote the Federal Income Tax Regulations on conservation easements. He will discuss these not only as a means to conserve private lands, but as a way to reduce your state tax liability.

Each of you has unique and different circumstances. Some of you will use conservation easements and some of you will not, but at least they are available. Today is the day to clear up any questions that you may have regarding conservation easements.

In 1993, our speaker came down to the San Raphael Valley of the San Raphael Ranch and he gave a presentation to the residents of the valley, mentioned conservation easements, and dealt with the state tax issues.

Since that time, he has given hundreds of talks, hundreds of speeches throughout the country, and has sold over one-hundred thousand copies of his books. One of his books it titled *Preserving Family Lands*.

The bottom line is that he is the best in this field and he knows what he is talking about. I suggest you take advantage of this opportunity to learn as much as you can.

I'd like to introduce Steve Small.

II. Speaker - Mr. Steve Small

A. Planning for the Land Owner

Thanks so much Bob and thanks to the County and the Trust for helping to bring me down here this morning.

I know it's a tough morning to come to a speech on taxes and I know you've all heard a lot of other speeches in this field. In addition, we've got the Arizona State Fair and Parents Weekend, the World Series is tonight, anthrax in the mail and so a lot of people probably decided to stay home.

For those of you who came, I'm reminded of a joke. It's about a horse thief in the Old West who was captured and sentenced to be hung. There wasn't a lot to do in that area in those days and they built a big gallows in town, and a crowd came from miles and miles and miles around. As the Sheriff was tightening the noose around the horse thief's neck he said, "It's my job to inform you that under the laws of this territory you've got five minutes to talk on any subject you'd like." And the horse thief thought for a minute and he said, "I ain't got nothin' to say." And the Sheriff started tightening the noose some more and a fellow jumped up from the crowd and he said, "Sheriff, I'm a candidate for the Legislature from this territory, and if the gentleman up on the gallows doesn't want to use his five minutes I wonder if I could have his time to talk on behalf of my candidacy?" And the Sheriff thought for a minute and then he said, "Well, that's an unusual request, I'm going to have to check with the prisoner." And he turned to the horse thief and he says, "What do you think?" And the horse thief thought for a minute and he said, "You can let him talk, just hang me first." So thank you for showing up this morning.

Let me get a feel for who is here this morning or maybe who is not here. How many of you are here as landowners? Okay, how many of you are here as attorney's or other advisers? Appraisers? Land Use Planners? Any of that technical support? Government officials? Anyone from non-profits? Okay, anyone from the IRS here this morning? No, good. That's okay, I don't mind if someone from the IRS is here, I'd say the same thing anyway.

You all have three handouts this morning and the one I'm going to be using mostly is the short outline that's up there. Those of you who are attorney's or who are masochists, there's a much longer outline with citations and cases and letter rulings and so forth, and that's really for the six hour program for lawyers. This is a shorter version for people who just want to come hear a little bit about this. In addition, there are two other handouts, Section §170(h) of the tax code which is the tax code section that deals with conservation easements and Section 2031(c) of the tax code which is a relatively new estate tax benefit.

There was an article in a tax magazine, some of us read tax magazines from time to time, and there was an article in August and the author said it was on the new estate tax law that passed Congress this year. The author said, "Conservation easement donations have more tax benefits than any other kind of charitable gift," and this morning I'll tell you why that's true.

I'm going to be talking a lot about conservation easement donations but I'm also going to be talking about sales of conservation easements, sales of development rights, sales of agricultural easements or ranch easements. To me, they are all the same. You put some restrictions on your property that prevents it from being subdivided and turned into a shopping mall. You can still engage in ranching and agriculture and so forth, but whether it's a deductible conservation easement or the purchase of development rights or whatever you call it, I'm putting them all into the same basket and again, we'll get to that a little bit more as we go forward.

Let me tell you what is in store this morning. I'm going to spend time on the tax rules for conservation easements and on the tax benefits, tax savings, income tax deductions and estate tax savings and so forth. I want to talk about the new estate tax benefit that Section 2031(c), and I also want to talk about what I call succession planning for family lands, how to get the property from the current older generation of ownership to the next generation of ownership.

If you have a successful family business, mom and pop manufacture something old tech, low tech, a kind of business that manufacture a product, they sell it on the marketplace and they make a profit. It's successful and it's worth a million or two million, five million dollars or more. Mom and pop in that situation go to their local advisor and they lay out the facts. Maybe they've got four kids and two of the kids live in the area and want to follow mom and pop into the business. Two of the kids live somewhere else and they would rather have some of the cash from the business. Mom and pop lay that all out to the family lawyer and what does the lawyer say? Does the lawyer say, "Sell the business?" Probably not. Does the lawyer say, "Just leave the stock in the business to the four kids equally?" Probably not.

There are shareholder agreements, buy/sell agreements, Key Man Life Insurance, annual gifts of stock to the kids. There's an array of planning techniques that the professional planning community has come up with to get the family business through the tax system and into the hands of the next generation. Now what about that family ranch? What about that farm? What about that big piece of forest land? Or that place in the country? It could be as valuable. It could be more logged by the family, stronger emotional attachment, maybe four kids. Two of them live here and maybe one of them lives on the property, two of them have moved away. Mom and pop goes to the family advisor and they lay out all those facts and what does the lawyer say? Ninety-nine times out of a 100, either sell the land or leave it to the four kids equally. Standard disposition by will in this country and all the rest, the remainder, goes to the children.

One of the points that I want to make this morning is that landowners should be asking for the same kind of planning from their advisors that business owners are asking for. The asset may be more valuable. The asset may be as valuable, and it's certainly emotionally more important. It's a commitment to a way of life, and I think the private sector, the planning group, the lawyers and the appraisers and the accountants have lagged behind in being able to provide good service to landowners on this. So I'm also going to talk about succession planning. And if you have questions, feel free to ask them as we go forward.

B. Federal Estate and Gift Tax Primer

Let me start off with a look at the new estate tax rules that passed Congress this year because they have just confused people enormously. But in order to understand the new estate tax rules I think you need to start off understanding the old estate tax rules. What were the rules before Congress changed the law this year? Those rules begin at the bottom of page four, top of page five of the outline (see Attachment) and let's walk through those.

Our estate and gift tax system. I'm a tax lawyer, okay, and I'm going to be talking about tax law and tax planning this morning. I made up a joke, and I keep telling it, hoping that someone will tell it back to me. But it hasn't made the rounds enough yet. What do you get when you cross a tax lawyer with a Godfather? It's an offer you can't understand!

The General Rule

Our tax system starts from the proposition that every time you transfer wealth, every time you transfer value to a family member, it's either subject to gift tax if you make the transfer while you are alive, or it's subject to estate tax if you make the transfer by will. That's the general rule. But, there are exceptions to that rule and the first exception is the so-called $10,000.00/$20,000.00 rule.

The $10,000/$20,000 Exception

Many people are familiar with this. You can give as many people as you want $10,000.00 a year without any tax. Spouse's joined together, can give $20,000.00 a year without any tax. When I write the check to my daughter I don't get a deduction when she deposits it into her account because it's not income to her and it sort of falls outside the tax system.

Now I know a lot of people who would like to be able to give their children $20,000.00 a year each but they can't. They don't have the cash or they don't have the cash flow. And I know a lot of people who can give their children $20,000.00 a year each but they are not sure they want to because they are not sure what their kids are going to do with the money. But I know a lot of landowners who, when given the opportunity to give their kids interests in their land each year, interest in their real estate each year, welcome that opportunity because it's a good way to get value out of your estate and you don't have to write a check and it doesn't affect your cash flow.

Now let me just give this example. It isn't a model, it isn't the only way to do it and it isn't the way we do it in our office all the time, but it's a typical planning situation. Mom and pop own a ranch, it's a beautiful piece of property, that ranch is so valuable, it has gone up in value so much since they bought it that if they don't do any planning, that ranch is going to have to be sold to pay the estate tax and that's not what family wants. So mom and pop first put a conservation easement on it, which lowers the value of the ranch and then we've set up a family partnership or limited liability company. And mom and pop transfer the ranch to that partnership or that L.L.C., and I'll talk about those entities at the very end because there are some good ways to do that and there are some bad ways to do that. Then each year, using the $10,000.00/$20,000.00 rules, mom and pop give interests in that partnership to their kids every single year, $20,000.00 a year each, and they can give those interests to their kids, to their grandkids, to their kids spouses, and to trusts for the benefit of the kids and each year that helps reduce the estate. When landowners are given the opportunity to get that value out of their estate without losing control, and without having to write a check and without having to affect their cash flow, they welcome that opportunity.

I had a client years ago who didn't have a land problem. He had a cash problem, which is a good problem to have. He retired from a big corporation and he had sold a big block of stock he had accumulated. He'd been with them for 35 or 40 years and he was doing some tax planning. He was a widower, sixty-five, six grown children and I said to him, "I assume you are in the habit of giving your children $10,000.00 each, each year?" And he said, "Yes I am." And I said, "Do you give that to them outright or do you give that to them in trust?" He said, "Well, I don't like rules very much, I've had come up with my own kind of trust." I said, "Tell me what that is." He said, "Each year I tell the kids to show up at Christmas and to bring with them the account statement that shows that they haven't touched any of prior $10,000.00 gifts. They must all still be sitting in the account. They can spend the interest but they can't touch the principle. And if they show me that they haven't spent any of the prior gifts, I give them another $10,000.00." And he said, "You know, nobody's touched the principle yet and they keep showing up for more." That's a good way to save on legal fees. So that's the first exception, the $10,000.00/$20,000.00 rule.

Transfer Between Spouses Exception

The second exception is transfers between spouses. Spouses can give each other unlimited cash, unlimited value, land, art, cars, the federal tax code doesn't matter. You can give your spouse everything during lifetime, no gift tax under your will, no estate tax.

Charitable Gifts Exception

The third exception is charitable gifts. When you make a gift to charity, you get an income tax deduction. When you give an asset away and you don't own it anymore, it's not subject to estate tax in your estate.

Amount not Subject to Estate Tax

So for decades, in addition to the $10,000.00/$20,000.00 rule, the transfers between spouses and charitable gifts, every person could give to others during lifetime or at death, $600,000.00 with no estate tax. That was the number for decades. So if I died with a $600,000.00 estate, no estate tax.

In 1997, Congress raised that number to one million. In the 1997 Tax Act, they said that $600,000.00 is going to go to one million dollars but it's only going to get to that one million dollars by 2006. It's going to ratchet up step by step between 1997 and 2006. And that was the law until Congress changed the law this year. One more point and I almost forgot, I want to talk about Section 2031(c).

Section 2031(c)

In 1997, Congress also passed Section 2031(c) and added that to the tax code. That was formerly known as the American Farm and Ranch Protection Act. Now who could be against legislation with a name like that, the American Farm and Ranch Protection Act? In order to understand how Section 2031(c) works today, it helps to understand what it said when it was first introduced in 1990. When it was first introduced in 1990, it was really simple. It said, "If you have land subject to a conservation easement and you die, then that land will be exempt from estate tax. It was simple, it was easy, it was clear, it was breathtaking, and there were seven years of lobbying and political issues and budget restraints and fiscal constraints and so forth and then finally in 1997, Section 2031(c) passed and it became law. I'll give you a math example of how it works but here's the rule. The rule is, if you have land subject to a conservation easement and you die, then in addition to the reduced value because of the conservation easement, an additional 40% of the land value can also be excluded from your estate.

Now, let me give you my graphics here for this presentation this morning. I say to people, this is my Powerpoint right here.

Aunt Sally has a ranch and the ranch is worth two million dollars. She has three daughters and they want to inherit the ranch someday. If Aunt Sally doesn't do any estate planning, there is a two million dollar estate and the ranch has to be sold to pay the estate tax. Fortunately, Aunt Sally knows that and she puts a conservation easement on the ranch, which lowers its value to one million dollars. She gets an income tax deduction for the value of the easement and we'll come back to that in a few minutes because that's not what I'm paying attention to now. The two million dollar ranch easement lowers the value to one million dollars, and she dies. Prior to 1997, the ranch would have been subject to tax on Aunt Sally's estate at one million dollars and that would have been a good result for that family. But now, in addition to this already reduced value, the family gets to take another 40% off the million dollars, another $400,000.00 off of the estate tax base. So $600,000.00 is subject to estate tax and right now, if Aunt Sally dies this year or next year, there's no estate tax at all because she is under that threshold. So that's new Section 2031(c).

Now, there are two parts to Section 2031(c). This first part, this 40% reduction is known as the exclusion. You get to exclude an additional 40% of the value from your estate. The second part of §2031(c), which is really much more radical and much more dramatic and can be much more beneficial, is known as the ability to donate a post mortem conservation easement after the death of the landowner. Now let me give you an example of how that works.

Three situations:

Situation 1: This is the same as the one we just talked about. Aunt Sally has a ranch and she puts a conservation easement on it, which lowers the value to one million dollars. Then she dies, an additional $400,000.00 is excluded from the estate, and $600,000.00 is subject to estate tax. That's clear and everybody agrees that's how it works.

Situation 2: Aunt Sally has a ranch and it's worth two million dollars. She has a conservation easement in her will and just like any other charitable gift, you can include a conservation easement in your will. I leave money to the university, I leave money to the church of my choice, and I leave a conservation easement to the land trust. You can have that in your will and it only takes affect when you die like everything else in your will. And you can tear up your will and change it and rewrite it. Aunt Sally has a two million dollar ranch, she has a conservation easement in her will, she dies. Technically the way this works, the two million dollar ranch is included in her estate. There's a million dollar estate tax deduction for the conservation easement in her will, and a million dollars of ranch is subject to estate tax and her estate is also eligible for the 40% exclusion, so ending up with $600,000.00 in tax. That is situation 2.

Situation 3: Aunt Sally has a beautiful ranch, it's worth two million dollars, and she wants to leave it to her three daughters. Her three daughters love it, they love ranching, and they love the lifestyle that the family has chosen. Aunt Sally has a conservation easement on her desk, it's not signed, she goes to sleep and she dies. The ranch is worth two million dollars and her daughters call you the next day and say, "Isn't there anything that we can do? This ranch has to be sold to pay the estate tax." Prior to 1997, the answer was that there is nothing that you can do. Nothing! By the way, it doesn't matter if Aunt Sally hated ranching, she didn't like cows, she didn't like the ranch but her daughters want to keep it intact. They want to preserve that way of life and they call me and say, "Isn't there something we can do?"

But now the answer is yes. Now her three daughters can donate a post mortem conservation easement after Aunt Sally's death and it has exactly the same estate tax effect as if Sally had donated it during her lifetime or if she had included it in her will. The ranch comes under estate at two million dollars, a million dollar estate tax deduction for the post mortem easement, a million dollars of value left and in addition, just like in the other two situations the estate is also eligible for the $400,000.00 exclusion under §2031(c). So that's a quick look at §2031(c).

QUESTION:

The question is, is there an income tax deduction benefit in that case? There isn't one, and what the statute says specifically is that if you do a post mortem easement, you can get the estate tax reduction but you don't get an income tax deduction. Her heirs could decide not to do a post mortem easement if they could afford the estate tax and then later do an easement and qualify for the income tax deduction. But the statute says you can't do both at the same time. Good question.

Okay, so that was the law prior to this year when Congress changed the estate tax rules and let me go through the new estate tax rules with you and those are on the middle of page 5 of the outline.

New Rules

Let me start off by mentioning here that while this legislation was being considered and when it passed and after it passed, there were a lot of people and there still are a lot of people who think that Congress repealed the estate tax and Congress did no such thing. Congress did not repeal the estate tax.

This is what Congress did and the numbers are on the middle of page 5. The $600,000.00 exclusion that was under the old law had gone up to $675,000.00 this year. Remember I said in 1997 it was going to go to a million. It had reached $675,000.00 this year. Here's what the new law does. This is under "D" on page 5. The $675,000.00 exclusion goes to a million dollars on January 1st next year, then to $1.5 million on January 1, 2004, to $2 million in 2006, to $3.5 million in 2009, and on January 2, 2010, there is no estate tax. The estate tax is gone for one year, and then it comes back on January 1, 2011.

How many of you plan to be alive in 2010? Hands, let's see. How many of you need more information to answer that question? This is ridiculous to me and inconceivable that Congress could have passed something like this. This means if they leave the law alone, if you die in 2010 with say a fifty million dollar estate you have no estate tax, and if you die on January 1, 2011, you have about twenty-six million dollars of estate tax. It's a ridiculous situation. It's inconceivable to me that Congress won't change the law within the next few years and do something. Of course if you had told me a year ago that Congress would have passed a law like this, I would have said, "It's inconceivable that Congress could pass a law like this." I think that within the next few years, Congress is going to come out somewhere between one and half and two and a half million dollars and leave it at that. That's my guess but you can't bank on that, and I wouldn't bet on it because all bets are off.

What Congress has done with this confusing law is create uncertainty for people who have estate planning to do, for people who have sizable enough estates so that estate planning is an issue. Congress has created uncertainty and what does that mean? It means that you have to work harder, whether you are a rancher, whether you are an attorney, whether you are an accountant, whether you are an advisor or a land trust person or a government official that works with people who have land, you have to work harder because you've got to pay attention to what the rules are and you've got to pay attention to what the values of people's or your assets are. There is no magic wand for this and there's no silver bullet for this. You've got to stay in touch with the value of your assets and what Congress is doing with the law.

C. Donation of a Conservation Easement: An Overview

Why Landowners Donate Conservation Easements

Now, let me make a couple of observations. The first observation is that generally over the years I found that there are three types of landowners who donate conservation easements.

The first type is the Aunt Sally loves her land absolutely, the tax benefits aren't even an issue. She's been brought up on that ranch, she cares about it, it's a lifestyle commitment, and it's a way of life. She wants to see that ranch continue intact as long as she can possibly see to that and she puts a conservation easement on it. Most conservation easement donors are like that, although not all.

The second type of conservation easement donor is a landowner who is motivated primarily by the income tax deduction. This landowner loves the land but wants a big income tax deduction to shelter income. There aren't a lot of those but there are some and there are more than there used to be and as land values continue to go up, the income tax deduction for conservation easements will continue to go up.

The third type of landowner is motivated by love of the land and estate tax issues. A landowner like that, looking at the possibility that there might be no estate tax in 2010 or thinking that the estate tax was repealed, is going to hesitate. Maybe that landowner will say, "Nope, this isn't for me, I'm going to wait and see what happens." Whether that's right or wrong remains to be seen. But if the change in the tax laws affects conservation easements giving, that's the situation where it's going to make a difference.

Now, let me make another observation. To me there are two parts to estate planning. The first part is, what if you died this year? Are your documents right? Is your estate plan right? Is your will current? Do you have whatever trusts you need and powers of attorney, if heaven forbid, you should die this year? That's easy to do because you know what the current law is and you know what the values of your assets are, or you should.

The second part of estate planning is, what if you don't die this year? You want to make sure that you don't tie your hands unnecessarily to make sure that if you live for 20 or 30 or 40 or 50 or 60 more years, you can carry out whatever activities you want to carry out. So what that means to me is that it puts a premium on being current, having a good current estate plan, knowing what your goals are and making sure you can carry them out. So again, there's no silver bullet or magic wand. There is confusion and we don't know how the law is going to settle out. If you look back up that chart in the middle of page 5, you'll see that the $675,000 goes to $1 million on January 1, 2002, and it doesn't go up again until 2004. So what that means, and I think it's a pretty good bet, is that threshold is going to be $1 million dollars for the next couple of years. Congress is probably not going to go any lower than that in the next couple of years and may not act on the law currently. So pay attention to what you are doing and pay attention to your documents.

QUESTION: At some point in your presentation will you talk about the difference between estate tax and the income tax?

Yes, the question was the differences between the estate tax and the income tax and yes, that's coming up.

AUDIENCE: I just wanted to mention that, I didn't understand it was coming up.

Right, I apologize for that but by the end I hope you will understand everything, or we'll all be totally confused by the end, one of the two or maybe somewhere in between.

Tax Code and Conservation Easements

Now again as I said earlier, I'm going to talk mostly to start about donating a conservation easement. The tax rules for qualifying for a conservation easement are very important and they set the frame work, and then later I'll talk a little about selling the conservation easement.

I have a treat for those of you here this morning. How many of you here this morning have ever read Section §170(h) of the tax code? Great, all right. Okay, I want you all to look at the handout, Section §170(h) of the tax code because we're going to do something really exciting this morning. We're going to take a look at this statute and I'm not going to go through it in detail but to me, this is a pretty simple statute and it really demystifies what is the tax law saying about conservation easements? And let me give you a little background about this statute.

Congress, first in 1976, amended the tax code to allow deductions for conservation easement donations and I went to the IRS in 1978 and went to chief counsel's office in 1978 and I was assigned to write income tax regulations under the 1976 law. The 1976 law had a five year sunset date and it was due to expire in 1981 if Congress didn't change it. And in 1979 and 1980 it became clear that Congress was going to amend the statute and extend the statute and the Treasury Department, which is the boss of the IRS, said to me, "Okay, stop work on that project because that law is going to be changed and you participate in the drafting sessions and the hearings and so forth as the IRS representative in connection with the new statute," and so I did that. What you have in front of you, Section §170(h), Qualified conservation contribution is the statute that passed Congress in December of 1980 and became law. Today its almost exactly identical to the one that passed in 1980, except for one change only. It was a change having to do with separated mineral interests, which is relevant generally in the west and I'll talk about that, but it's a very simple change.

What I want to do is take a very quick look at how §170(h) works. This is the tax code section on conservation easements.

Section §170(h):
In general, for purposes of subsection F3B3i, just trust me on that one, the term qualified conservation contribution means a contribution of:

(A) A qualified real property interest,
(B) To a qualified organization,
(C) Exclusively for conservation purposes.

So these are the three things the tax code says you have to have if you want the tax benefits. A qualified real property interest includes three different things:

(A) The entire interest of the donor other than a qualified mineral interest

This doesn't happen very much but here's what it is. " Here, land trust. Here's the deed to my ranch, you own it but I reserve the right to extract ore, gas and subsurface minerals." It doesn't happen very much but it's a deductible gift if you do it that way. I understand there have been gifts like that in Louisiana. "Here Land Trust, here's the deed, but I reserve the right to extract oil from my property."

(B) A remainder interest:

"Here county, here's the deed to my land, you own it but I reserve the right to live here for the rest of my life, both my spouse and I reserve the right to live here for the rest of our lives," a life estate. That's a remainder interest and that also qualifies, and

(C) A restriction granted in perpetuity on the use which may be made of the real property.

What the regulations say is it doesn't matter what you call it under state law, in Louisiana it's an equitable servitude. In Massachusetts by statute, it's called a conservation restriction. In most states it's called a conservation easement. It doesn't matter whether it's a perpetual conservation easement or a conservation easement or conservation restriction, if it's enforceable under state law as a restriction on your property, it works and you're in. And I use the term again, conservation easement, conservation restriction, I use them interchangeably.

Qualified organization, this is one of my favorite little tax code sections, easy to read and easy to understand.

For the purposes of Paragraph 1, the term qualified organization means an organization which is described in Clause 5 or 6 of Subsection B1(a) or is described in Section 501(c)3 and meets the requirements of section §509(a)2 or meets the requirements of Section §509(a)3 and is controlled by an organization described in sub paragraph A or clause 1(I) of the subparagraph. Questions? Any questions on that?

Let me tell you what that means and then let me tell you why that's in there and then I'll tell you what it means. When this statute was being discussed in 1980, the Treasury Department said, "We've heard that people are setting up their own little neighborhood private foundations and giving each other easements on their backyards and taking big tax deductions." And nobody ever put any evidence forward that happened.

Two kinds of charitable organizations generally:

> One is a publicly supported charity that gets its money from a broad-base of the public, it has a lot of members.
>
> The second is the so called private foundation that is funded by one individual, or one family, or one business and the tax rules for each are different.

Private foundations by definition are more closely controlled and more closely held. So in response to Treasury's complaint, even though Treasury never substantiated its complaint, Congress said, "Okay, we will write a law that says you can't give a conservation easement to a private foundation. It has to go to a public charity and that's essentially what this says. But it also says, "A conservation easement has to go either to a public charity or a unit of government."

Now, we get to the heart of the statute, conservation purpose. A couple of observations here:

(1) One of the most common myths about conservation easements is that you have to let the public on your property once you put a conservation easement on it. That is absolutely incorrect! The federal tax rules do not require public access to private property.

(2) A lot of real estate developers for example think, "Well you know, if I take that land over there and if I, let's say it's zoned 2 acres but instead I do 5 acre house lots, or it's zoned 10 acres and I do 20 acre house lots, if I do less building than I'm allowed to by law then I can get a deduction for that and that's not how it works.

What the tax code says is, "The first thing you need to do is protect something with some significant value, some significant conservation value. This could be open space, wildlife habitat, ranch land, or forest land. Once you've done that then you get a deduction for the value that you've given up and we'll go through some examples of that later.

Well, let me just give you a typical example. Let's take Aunt Sally and her ranch. Aunt Sally's got a ranch that's worth two million dollars, Aunt Sally puts a conservation easement on her ranch and she gives it to the land trust. Land trust means a tax exempt charitable organization dedicated to protecting open space. Some kind of open space, whether it's ranch land, whether it's farm land, whether it's forest land, or whether it's a wildlife habitat. The Nature Conservancy is a land trust that looks for particular kinds of things to protect. The Colorado Cattlemen's Agricultural Land Trust is a land trust and they take conservation easements on cattle ranches in Colorado. So whether or not the term land trust is in the name, the issue is that's the kind of donee organization and government agencies that I'm talking about.

So Aunt Sally puts a conservation easement on her ranch and the conservation easement essentially says, "I reserve the right to continue ranching and agriculture, I reserve the right to build additional buildings associated with ranching and agriculture in the general vicinity of the barn and the other out buildings, I can do corrals, I can do fencing, I can do irrigation, I can do ditches and streams and whatever else I need to do, and I can stay in the ranching business forever, but I can't have any other commercial activities. I can't have any other industrial activities and no further residential subdivision of this property forever, period." You don't have to say that. You don't have to give up all of your development rights to have a conservation easement. Aunt Sally could have said everything that I said but at the end, she could say, "And I reserve the right to have three 40 acre house lots, or two 100 acre ranchettes" or whatever it is that is appropriate in that area as long as the additional development doesn't interfere with the ranching activity, or as additional development doesn't interfere with the scenic view of the property across the property from the road, and so forth.

So let's say Aunt Sally has a 26 page document that says "Ranching and agriculture forever, no commercial subdivision, I reserve the right to have three more house lots on my property," and let's say that reduces the value of the property to one million dollars after the conservation easement. That's the Aunt Sally situation that we're talking about.

Let's go back to the conservation purposes test and the tax code now. The tax rules say, you only have to meet one of the conservation purposes tests. Many good conservation easement donations meet more than one, but you only have to meet one.

The first one, the preservation of land areas for outdoor recreation by or the education of the general public. This is the only conservation purposes test that requires public access. By definition, I put a conservation easement on my ranch and people can cross the ranch to get to the river for recreational activities. Or the Boy Scouts and the Girl Scouts can come camp and have activities on my property. Most people don't do that. Most people don't want public access, even limited public access to private property, but if that's the conservation purposes test that you choose to meet, then that requires public access. The others don't. The protection of a relatively natural habitat or fish, wildlife or plants or similar ecosystem. If you have a large enough property, and large is subjective and it varies depending upon where you live, but if you have a large property chances are pretty good you have some significant habitat on it.

There are two open space tests. The preservation of open space, and I'm going to read this a little bit differently from the way the tax code does it, "The preservation of open space including farm land and forest land where such preservation is for the scenic enjoyment of the general public and will yield a significant public benefit; will where it's pursuant to a clearly delineated federal, state or local governmental conservation policy and will yield a significant public benefit." Now many easements on ranch land protect important habitat. They protect scenic open space because people can see it when they get on the road and they further some local or state of federal governmental policy as far as protection of open space and ranch land and agricultural land and so forth.

The last conservation purpose test is the historic preservation test. The last two points I want to point out in the statute are under (h)5, exclusively for conservation purposes, 5 (a): a contribution shall not be treated as exclusively for conservation purposes unless the conservation purpose is protected in perpetuity. Now, most people read that and they think, well I know that. I've heard that a conservation easement needs to be perpetual in order to meet the tax code rules and that's correct, it does, but that's not all that means. There is something else that means. What it means is, you can have a piece of property that absolutely qualifies under the conservation purposes test, a beautiful property, scenic, productive agricultural land, or important habitat. Your property's great and you qualify, but if you reserve the right to put 50 houses on it or 20 houses on it or whatever the number might be depending on the size, if the rights that you reserve are so significant that you are going to destroy the conservation values then it doesn't work. So it's a combination one, qualifying with a good property and being in, and two, not reserving rights that would destroy the property in the future, and most of that involves pavement.

I have a friend of mine in Virginia who says, "Asphalt is the last crop." Question?

QUESTION:

I would suggest that instead of writing a will and not looking at it for 30 years, that you take a look at it every year and you can change your will at any point. And just as a general estate planning matter, you shouldn't do a will and put it away. Number two, probably, if it's based on public policy it probably also qualifies under at least one of the other conservation purposes test and my general rule in my office is to qualify under as many of the conservation purposes tests as you can and to make that clear in the easement so that if something changes, if your conservation easement is habitat and the bald eagle moves somewhere else, you still have open space and productive ranch land and so forth. So I would say, two points: number one, make the easement broader, and number two, keep checking to make sure it's reasonably current.

Another question. Okay, those are the conservation purposes tests. One more point and that's the mineral interest rule, and I won't tell you what the mineral interest rule said before it was amended because it was too confusing then and it's a little confusing now. The tax rule says that if you don't own all the mineral interests associated with your property, most landowners in the east although not all, own all the mineral interests associated with their property. It's been my experience that most landowners in the west, although not all, don't own all the mineral interests associated with their property. But that varies from state to state and even within state. The rules say, if you don't own all the mineral interests associated with your property, and you want to do a conservation easement on it, you have to be able to establish, and the words in the statute are right here at the end of 5(b), no service mining permitted, (ii) special rule, the last sentence: "shall be met if the probability of surface mining occurring on the property is so remote as to be negligible." You have to be able to establish that the likelihood of surface mining is so remote as to be negligible, and there's really only one way, you get a geologist report.

The geologist report generally comes to the conclusion either there aren't any mineable minerals there on the property, at least there aren't any mineable surface minerals there, or if there are, their extraction would be so expensive it's not economically sound to do that. There is some value there but it would cost way in excess of that to go in and get them out, therefore, so remote as to be negligible. The so expensive example I've heard is in Park City, Utah, United Park City Mines which is one, if not the largest, silver mine in the United States. There is three billion dollars worth of silver in the mine based on current market values but it would cost six billion dollars to get it out, so it's closed. So if the likelihood is so remote as to be negligible, then you're in and you're okay.

That leads to a very, very, very important practice tip if you are going to do a conservation easement, whether you are the landowner or the lawyer or the land trust or an advisor, it doesn't matter what, run the title early. Run the title early. There are a lot of reasons why that's important and one of them is the mineral interest rule, although most landowners who don't own their mineral interests know that. It's important to find out what the state of the title is. There's another rule, and it's in the outline, we'll cover it a little later but I'll mention it while I'm here now. If there is a mortgage on your property, you can't meet the conservation easement tax rules unless the mortgage holder agrees to subordinate to the easement.

Now what does that mean? It doesn't mean the bank has to stand behind anybody for money because the bank would never agree to that. What it means is, the bank has to agree that if the mortgage is ever foreclosed and the property is ever resold , it has to be sold subject to the terms of the conservation easement.

Why would a bank agree to that? Equity, math, very easy. If Aunt Sally has a two million dollar ranch with a $100,000.00 mortgage still on it from when she bought it a long time ago and the conservation easement would lower the value to one million dollars, there is plenty of equity there for the bank and the bank will agree to subordinate. And over the years, there has been very positive experience with banks if the numbers are right.

If on the other hand, Aunt Sally's nephew just bought a two million dollar ranch with a 1.5 million dollar mortgage and he wants to put a conservation easement on it that will lower the value to one million dollars, I don't know any commercial lender anywhere that would agree to subordinate under those circumstances. So run the title early.

We've had a number of unpleasant surprises. In fact, I would go so far in some situations to say, embarrassing surprises but not damaging. Anyone who has dealt with lawyers knows there's a difference between embarrassment and damages. We've had some embarrassing surprises when we've run the title late, but we've been able to fix them so the deal has been able to go ahead. In one situation that we did in the West a few years ago, we ran the title and found out that the fellow who had sold two or three hundred acres to my client some years prior, a year after the sale to my client he'd sold the same two or three hundred acres to someone else. But we were first on the record. It was clear we were the owner of the property but those of you who've dealt with title companies can imagine the title company didn't like that.

And any of you who have dealt with sellers like that can imagine it's not surprising when neither the seller nor his attorney returned our phone calls and that matter may still be getting fixed.

So that's §170(h) and those are the tax rules for conservation easements, and I want to go over the income tax and estate tax benefits just very briefly and then take a little break and then we'll come back and do some more of that. And again, I'm still talking about conservation easement donations.

When you donate a conservation easement, and this is on page six and so forth, this is all also by the way in my *Preserving Family Lands* books, are those for sale here today? How much? Ten dollars each, this is not marketing, this is a public service announcement. Bob mentioned the book, he has an autographed copy which I hope I don't see on eBay at some point but it's a collectors item because most people don't actually ask me to sign these. I wrote this book in 1988 and this is an introduction to conservation easements and the tax issues, and the tax benefits and so forth and again, between this book which is the introduction and book two, which is more on the succession planning issues, partnerships and trusts and corporations and so forth, we've sold more than 100,000 copies of those books and they are a good introduction. One of the reasons we've sold so many is that there is no competition in the field because the bookshelf unfortunately still is very small.

Let me digress for a minute and make an observation. If you live anywhere in the United States and you have a piece of land you want to develop, you'll have absolutely no trouble getting help. Lawyers understand real estate development. The accountants, the appraisers, the lenders, the surveyors, the municipal officials, the land planners, everybody understands real estate development. Two hundred years of real estate development in this country. And there's an industry in the private sector to support real estate development and I'm not saying that's bad or good, I'm saying that's a fact and you can go to these conferences. I've been to an Urban Land Institute Conference, you know in the Dallas Conference Center with 75,000 people and they're all real estate developers attending this conference on how to do subdivisions and hotels and airports and complexes.

But if you have a piece of land that you want to protect, no matter where you live in this country with some exceptions, you have a very, very difficult time finding people who can help you through the process, especially in the private sector. Lawyers, by and large, don't understand this. Accountants don't understand it. Appraisers don't understand it. Government officials don't understand it and some government officials say, "Why would you want to protect that ranch? We should turn it into a subdivision." What I'm suggesting is, there is a need for a whole new industry in the private side to support people who want to do private land protection, voluntary private land protection. That industry will only be a fraction of the size of the real estate development industry, it will never get bigger than that because most people won't be interested in this, but we're still very, very short of qualified help in the private sector to get these projects done.

If you walk into any law office anywhere, where they have a library, and ask to see the books on real estate development, there will be shelves and shelves and shelves of books on real estate development. If you ask to see the books on private land protection, you will either get a very funny look because they don't know of any books on private land protection, or they'll have two or three or four books. This is why it is hard to find a book like this.

Three tax benefits from the donation of a conservation easement:

You get an income tax deduction when you donate a conservation easement. You lower the value of the property, which means that you get some estate tax benefits and you may get property tax relief. Let me talk very quickly about the three and then we'll take a break and come back and talk some more about them.

You get an income tax deduction when you put a conservation easement on your property, and the income tax deduction is equal to the value of the easement. The value of the easement is generally equal to the value before the property, in other words, its unrestricted fair market value. What would Aunt Sally get if she put this ranch on the market and sold it tomorrow? Two million dollars minus the value after. In the situation, I said Aunt Sally does an easement that permits ranching and agriculture and three more forty acre house sites. Let's just say, and I'm just making this number up, that produces a value after the easement of one million dollars. Two million before, one million dollars after. It's one million dollar reduction in value and that's her deduction. Now, Aunt Sally can only take that deduction up to 30 percent of her income for the year. So if Aunt Sally's income for the year is $200,000.00 she can take that deduction up to $60,000.00 of her income, 30 percent of her $200,000.00 income for the yearly gift in five more years.

If Aunt Sally's income for the year is $20,000.00, she can take a deduction of $6,000.00 a year, 30 percent of her $20,000.00 income for the yearly gift in five more years. Obviously, if Aunt Sally doesn't have very much income, the income tax benefits from her gift may be quite small, and I'll come back to that later, but that's something that Aunt Sally needs be aware of. The fact of the matter is, most people who donate conservation easements in this country today can't use all of the income tax deduction. That's in large part because land values have gone up so much and the appreciation is so high that the value of the conservation easement is so large that even someone who is making a lot of money can't use it all up.

The estate tax issue we've covered, the Aunt Sally situation, avoided the forced sale of the property to pay the estate tax and with §2031(c), reduced the tax even further and could property tax relief. This is an important issue because it really varies not just from state to state but even within states.

First of all, it stands to reason that if you lower the value of your property with a conservation easement your property tax should also drop. But that doesn't always happen because that's up to the local assessors and sometimes you might have to fight city hall.

Second, many states have so-called open space, farm land, ranch land, and forest land assessment programs. You commit your property to that use for a period of say ten years and you get a lower property tax by statute. If you've done that, a conservation easement may not result in even a lower property tax because you already might have a lower property tax.

It is important to know that you can do both. You absolutely can have a conservation easement on your property, and you can also have your property in some special assessment program. So by law, you get a lower property tax but the easement also deals with the federal estate tax issues.

A couple of quick observations here on the tax benefits, that is the income tax benefits and the estate tax benefits.

What I recommend to everybody is don't assume anything, and I always say don't assume anything. Don't assume you know what the tax results are going to be. Don't assume you know what the consequences are going to be. When I was writing this book, *Preserving Family Lands: Book I* in 1988, I said, "You know, let's take a look at what happens if mom and pop say, thank you very much, we appreciate all this information, we appreciate you taking the time to come and visit with us, but we're not interested in any of this. We've decided that we want to get the most bucks to the children and we've decided that the way to do that is to put the property on the market and sell it to the highest bidder."

So I went through the numbers and again, this is all in Chapter seven in Book I, entitled *Cash Sale Compared to Good Planning*. I looked at what happened if mom and pop sold the property, if they paid capital gains tax on what they got, if they put what was left in the bank, if they died, and if they paid estate tax on what was in the bank and the kids were left with this much dollar value. Then I compared that with the other situation, if mom and pop put a conservation easement on the property, and if they enjoyed the income tax savings from the conservation easement. Let's say they reserved four lots to sell after their death. They die and the estate tax is lower because the value of the property is lower. It turns out that in this situation the kids are left with almost exactly the same amount of dollar value including the property because mom and pop had done the planning. So the point is, don't just assume that the kids are going to do better if you sell the property. Don't assume that's necessarily true.

When I redid this book in 1992, the second edition of this book, I ran those same numbers again. They sell, they pay the tax, and the kids are left with a certain amount of money. Or they put a conservation easement on it and so forth and they found that if mom and pop did the conservation easement and did the tax planning right, even though the tax rates had changed a little bit between 1988 and 1992, that the kids were still almost in exactly the same dollar position . Then 1998 rolls around and I redid this book in 1998. This is the third edition and it was after the 1997 Tax Act passed that included Section 2031(c). I found that with the benefits of Section 2031(c) available that the kids were now in a better financial position. There is now more after tax worth dollars, value available for the kids, if mom and pop do the tax planning, pay attention to the tax planning, use a conservation easement, and take advantage of Section 2031(c).

Now, I'm going to talk about §2031(c) again a little bit later if we have time, I've covered the fundamentals but there is one more observation I want to make about it and that is for a married couple that owns land. If they do the planning correctly, each spouses estate can take advantage of Section 2031(c). That means there's a savings in the estate of the first spouse to die, and a savings in the estate of the second spouse to die. So the moral of the story there is run the numbers, don't assume anything.

I am sure that there are landowners in this room today, and I guarantee you that there are landowners not too far from here, who don't like to be told what to do with their real estate. My friends, my message to you and my message to them is very simple. If you don't do the planning for your real estate Uncle Sam may tell your heirs what to do with that real estate and they aren't going to like that message.

Now I was asked a question during the break. How do you deal with someone who is older and not well and is in denial, and doesn't like to deal with issues like estate planning and taxes and value and so forth? One of my answers is that doing nothing is a choice, but doing nothing has consequences. If you do nothing under the heading of letting the kids do what they want, but you don't pay attention to the tax issues, the kids aren't going to have any choices. The property is going to have to be sold and the kids aren't going to have any options.

QUESTION:

That's exactly the right question and it depends upon the family's assets. It depends on the value of the assets and it depends upon other assets. There are insurance people in the financial products industry who will tell you that you can solve all of your estate tax problems if you buy enough life insurance. If you start from that proposition, it's true. You could solve all of your estate tax problems if you buy enough life insurance to cover the estate tax so assets don't have to be sold at all. Insurance may be an option and lifetime giving may be an option. There are a lot of different ways to deal with it and I'm just focusing on the easement. The fact of the matter is, if you don't do the planning that's a mistake and if there's one message that I have this morning for everybody, landowner or not, it is to do the planning and pay attention. I'm suggesting one possible tool in the toolbox. If you like it, great! If you don't like it, that's okay. But don't just say, "We're not going to do anything and we didn't like what we heard."

There are a couple of things that you can do for someone who is not well, who is elderly, and is not really interested in listening and not interested paying attention. Number one, it is possible to put a conservation easement in the will if people want that. Number two, it is possible to rely on post mortem conservation easements under Section 2031(c) if the family wants that, but that's a very difficult planning option. If Aunt Sally owns that ranch and she wants it protected by including a conservation easement in her will, you need her signature on the deed. After her death it gets a lot more complicated.

A law student who spent some time in this field did a paper and concluded that in every single state it is possible under state law to do post mortem conservation easements. However, it is not as simple as doing it during a life time. There's one thing that you can do at the last minute for someone who is dying, who understands and wants to do this, and it's too late to do anything else. You can just get a codicil to the will that says, "I authorize but do not direct my executor to donate a post mortem conservation easement under Section 2031(c)," or even just a post mortem conservation easement, "I authorize but do not direct my executor to donate a post mortem conservation easement." That by itself will make a lot of the state law issues go away just by having that language in the will. So that's an answer again to one of the questions I received.

QUESTION:

If it's owned in an entity and the decedent owns 30 percent or more of that entity, you can do a post mortem conservation easement and you can be eligible for the §2031(c) benefits. In fact, there's another larger outline with a lot of citations here, as I mentioned earlier for advisors who want to go to that trouble. There is a letter ruling cited in that outline that we got for a western rancher under §2031(c). It was a ranch that was held in a corporation in Wyoming and to make a long story short, the facts were right, but the IRS blessed what we wanted to do. If you want to read more of that look at all of the examples in my longer outline that deal with things like that. It can work as long as the decedent had a 30 percent or more interest.

One more observation about easements and land trusts and donee organizations and so forth. I know every state is different and the experience is different everywhere, but I want to share with you the Colorado experience as a frame of reference. There's a lot of land trust activity in Colorado. But at the beginning of the last decade a lot of ranchers in Colorado didn't know the land trust people well and the ranching community was starting to think seriously about conservation easements for this reason. Some of the board members of the Colorado Cattlemen's Association had come to the conclusion that maintaining those large ranches, keeping that ranching and agriculture base, was fundamental and critical to the way of life in Colorado and to the socioeconomic fabric of Colorado. It wasn't an estate tax issue. It wasn't conservation issue. It wasn't a tax issue. So much of the way of life in Colorado was tied up with those big ranches that the Cattlemen's Association started to think about starting its own land trust. And they did. To make a long story short, they started their own land trust to deal with ranchers who weren't interested in dealing, for example, with the Nature Conservancy. They have a very active track record of protecting ranches in Colorado.

The point isn't starting your own land trust. I especially wouldn't say that with the sponsors here this morning. The point is that there was an attitude among the ranching community in that state and that was that we need to keep these ranches intact to preserve and protect a way of life. It was a much larger issue than any individual planning issue. I just wanted to share that one.

Okay, in the outline there is one observation at the top of page seven. One of the fellows at dinner last night said, "I hear a lot a people saying if I donate a conservation easement, I'm going to have alternative minimum tax consequences." This is not the program for the alternative minimum tax. In fact, I've never really found a good program for the alternative minimum tax. But to make a long story short, and I've spent a lot of time with the spreadsheets and I've looked at the numbers, and as a general rule, donating a conservation easement is not going to hurt. It is not going to trigger alternative minimum tax issues and it is not going to put you in a worse position than you would have been in if you hadn't done it. In fact, in every single situation that I've seen, it puts you in a better after tax position than if you hadn't done it. The only way to find that out for sure, absolutely, clearly for sure, is to run the numbers. Get access to a professional or be a professional who can look at the tax software and see how the numbers turn out.

QUESTION:

A corporation can donate a conservation easement, whether it's mom and pop in a ranch corporation or whether it's Georgia Pacific Corporation. All of the rules of Section §170(h) are the same that we went over a little bit earlier. The difference is, when a corporation donates an easement it can take a deduction up to 10 percent of the corporation's taxable income as opposed to the 30 percent for an individual. That's the corporate rule. Whether repeal of the alternative minimum tax for corporations will have any affect on conservation easement giving, I would suspect it will be minimal and it's generally not an issue.

QUESTION:

There has been a lot of talk about how complicated the alternative minimum tax is and it's possible that it will be changed for individuals, but I don't think it's going to be repealed for individuals. It's a backstop for people who have a lot of deductions and who end up paying what the government thinks is too little tax. That's a political issue that I'm not going to get into. It's a very complicated tax provision in the corporate and in the individual area, and it would be nice if they could simplify it but I don't think one way or another it has much affect on what we're talking about here.

There's one other myth about conservation easements that I want to point out this morning. I hear so many people say, "I hear if you donate a conservation easement, you are going to get audited."

There's three myths that are the most common myths:

(1) You have to let the public on if you put a conservation easement on your property, and as we said before, that's just not true.

(2) Well, you've got to worry about the alternative minimum tax, and that's almost always not true.

(3) You are going to get audited.

I will just share with you some observations that I made. Last year in June I spoke to 400 lawyers in Fort Worth, Texas, and then I spoke to 400 lawyers in Palm Beach, Florida. These are state bar conferences and these aren't lawyers who make a living doing conservation easements, but they are tax real estate lawyers and they know pretty much what is going on in their law firms. I asked both groups, "How many of you know of conservation easement audits that are occurring right now?" Not one hand came up in either group in Texas or in Florida. Just about a month ago, at the very beginning of October, I was talking to a national conference of land trusts in Maryland. There were 1,600 people there, and I asked the same question in a couple of the workshops, "How many of you know of conservation easement audits that are going on?" Usually at that land trust conference five, six, seven, eight, ten hands come up out of 500 people and that's not bad. This year not one single hand came up. Now I know of two conservation easement audits that are going on because our office is involved in two of them. But the fact of the matter is, there is absolutely no relationship between claiming a conservation easement deduction and being audited. If you file a tax return you might get audited. If you deduct a conservation easement you might get audited, but there's no relationship between the two and we'll talk a little bit more about that in a minute.

Okay, page seven of the outline and again, we've covered a lot of this material by going through the statute so we don't have to spend too much time on this. Page seven, eight, nine, and so forth talk about the Section §170(h) and the tests and the statute. At the bottom of page eight, B3, there's that's that practice tip I gave you before. Run the title early to make certain that you know that you have good title, that there is no mortgage that you're not aware of, or so you know the status of the mineral rights.

I want to talk a little about how you reserve additional building rights under a conservation easement, and it's limited development and the reference there is six, about a third of way down page nine: numerous approaches for reserve rights, including reserved residential development rights. Let me tell you what we're talking about here.

Let's say Aunt Sally has 500 acres and let's say that Aunt Sally wants to reserve three more ten acre house sites on 500 acres. There's a range of ways that she can do that under the conservation easement. At one end of the spectrum, she can get the house site surveyed, she can get whatever zoning approval she might need, and she can include that in the easement and be done with it. That's clear and it's specific and there is no mistake about it. But she doesn't have to do that. Very few people actually go to those lengths but you could do it that way. At the other end of the spectrum, Aunt Sally could say I reserve the right to have three more house lots on my property subject to approval of the locations by the land trust, and that's okay. A lot of landowners like to do it that way. They have a good relationship with the land trust, they don't anticipate any problems. But some landowners say, "We know the people who are running it now. These rights might not be exercised for five or ten or fifteen years and we don't want the discretion of the land trust to rule whether or not we get to put houses in particular locations on the property." You can't just say, "I want three more house sites on my property and not somehow limit that."

So again, at one end of the spectrum, survey them out and another end of the spectrum, they're subject to site approval by the donee organization. But most of the time we find some middle ground. If the landowner wants, for example, to do three more house sites maybe we'll find three or four or five or six locations on the property where those house sites would be acceptable, not visible from the highway, over the ridge, not in a wildlife corridor, not in the middle of prime ranch land and we'll work those out with the donee organization as we go through the conservation easement process. We generally have more possible locations than we have houses to build, just to preserve some flexibility. So the easement will say, we can put up the three house sites in any of the limited building areas identified on this exhibit, and maybe we'll have five or six possible areas, but then we also add in a lot of cases. We can have house sites in any of the limited building areas that we've identified without any further approval, because we've already agreed on that. If we want to put a house outside of those areas, then we need approval of the donee organization and that's kind of a backstop.

QUESTION:

Yes, when you put land under conservation easement you only give up the development rights that you give up. You can sell the property to anyone you want subject to the restrictions. You can give it to your children subject to the restrictions, or you can sell it to your children subject to the restriction. You can leave it to charity and give it away subject to the restrictions. This is an interesting question though because I've been in situations where families have said, and usually it's smaller properties than 1,000 acres, "We reserve the right to have three more house lots on the property with the idea in mind that the three kids will each take one of the house lots. But the family also includes a right of first refusal if any of those house lots is ever sold out of the family." So that if all three move in and one decides to go somewhere else the others have the opportunity to control, to some extent, who gets that other house lot.

Easements can be very, very creative and very, very flexible. A lot of people say it's a restriction and it ties your hands. It certainly is a restriction and certainly it needs to be somewhat restrictive to meet the tax code rules, but we've done conservation easements that have said, "We reserve the right to have up to three more lots on the property, each lot not to exceed 100 acres or a 1,000 acres," depending upon the size of the property. So if the owners in the future want to sell off a ten acre lot, or a fifty acre lot, or a one hundred acre lot, or a five hundred acre lot, they reserve the flexibility to do that and it's important to identify generally where the building can go in the future. But you don't need to identify the lots lines with specificity at all. We've done this on ranch easements before, you can put a house here, you can put a house here, and you can put a house here, and you can convey out tracts not to exceed 1,000 acres each so you can draw the lot lines on the property anyway you want to. So there's a lot of flexibility that can be built into the process if you think about it. The important issue is that the conservation purposes that prompted the gift in the first place continue to be protected, and you have a lot of room to experiment within that.

Valuation

I talked a little bit about the valuation rule. There is a case, and it's not cited in this short outline, but it's a case I like to talk about. It's called the Stotler Case and it was a case that was decided by the tax court. Some California residents purchased a piece of property in Monterey County, California and they put a conservation easement on it. They said the property was worth $1 million before the easement, and it was worth $100,000 after the easement, a 90 percent drop in value. The appraisal didn't say a 90 percent drop in value. The appraisal said $1 million before, and $100,000 after. They went to tax court and the IRS said it was worth $450,000 before and $45,000 after. So it was a $400,000 drop in value but interestingly enough, also a 90 percent drop in value. The tax court decided with the landowners, $1million before and $100,000 after, for a 90 percent drop in value. The moral of that story is that a conservation easement where there is very heavy development pressure, can result in an enormous and very significant drop in value. Now it isn't always 90 percent. I've seen easements that are 20 percent, easements that are 50 percent, and easements that are 90 percent.

How can you tell ahead of time? Let me give you an example using some east coast properties that I'm familiar with, but it illustrates the point. These two properties were both in South Carolina. I don't know how many of you are familiar with the Charleston area or Myrtle Beach and all that area along the coast. I was doing a lot of work in that area about seven or eight years ago, and so the values were current then and the values may be different now. One property was a plantation covered with pine trees in South Carolina they call it Pahn, 35 minutes from the Myrtle Beach Airport. It was surrounded by golf courses, condos, resorts and other development and that land was worth $10,000 an acre if it was worth a penny an acre. If the landowner put a conservation easement on that property and limited it to forestry, the property might have been worth six hundred, seven hundred, eight hundred dollars an acre afterwards for forestry use. Now you can think of the same analogy in an agriculture in a ranching setting: high development pressure, $10,000 an acre, afterwards limited to ranching and agriculture use, whatever that number is, three, four, five, six seven, eight, nine hundred dollars an acre less or more depending. So a conservation easement on that particular property would have had an enormous reduction in value, $10,000 an acre before to $800 an acre after is more than a 90 percent reduction. If you went down the coast about one-half hour or 45 minutes, south of Myrtle Beach and south of Georgetown, and still an hour north of Charleston, South Carolina, seven or eight years ago there wasn't much development pressure in that area. I had a client that had a property that looked exactly like the first property, flat, covered with pine trees. But because the development pressure was so much less that might have only been worth $1,200 an acre before the easement and seven, eight hundred dollars an acre afterwards. So you can see the drop in value was significantly less. So the answer is that it usually depends on development pressure and that's a big generalization to make, but that's more or less how it works.

QUESTION:

If values go up should you give now or give later? One of the first answers to that might be that it depends on how big your income is, because at some point the deductions are so big you can't use all of them. So if you can't use all of it you might as well take a smaller deduction now instead of a bigger deduction later. Number two, even though we think the tax code and the income tax area is going to stay the same, at least in this regard for as far as the eye can see, you never know. My recommendation to people is, do your planning and get your work done sooner rather than later. We have the certainty of knowing exactly what the rules are, but those are generalizations and it's a personal valuation.

QUESTION:

Once an easement is on a piece of property, whatever its value, it is still determined by an appraisal at that point in time. So the before value, the development pressure value to a significant extent is irrelevant. It doesn't matter, it doesn't matter whether it's worth $100,000 an acre or it's worth $1,000 an acre. The issue is, what is it worth restricted? Now the fact of the matter is, over time land values go up, and over time, even restricted land continues to go up. We had some data in Massachusetts some years ago that showed that even that restricted land went up in value, it didn't go up as fast as unrestricted land, but it did continued to go up in value and that's one of the reasons. One of the questions I get a lot is, Aunt Sally puts a conservation easement on her land, she reduces the value to one million dollars, and she lives for fifteen more years. At the end of fifteen more years it's back up to two million dollars again, and she has an estate tax problem all over again. The answer to that question is the example I gave earlier. If Aunt Sally is paying attention to estate planning, she puts a conservation easement on her property, she deeds it into a family partnership or a limited liability company, and she starts giving interest to her three daughters every year and maybe to their spouses, and maybe to their children and maybe to trusts for the benefit of their children. So that after ten years Aunt Sally only has 30-40 percent left, and all the rest of the value has been taken out of her estate down to the next generation. That's really the Book II part, that's the succession planning part.

QUESTION:

Each year your property tax is assessed, each of the value of your assets changes and it's always a moving target.

QUESTION:

Not the value of the easement but the value of the restricted property changes. Once you make the donation, that easement value is fixed at that point in time, and if you claim an income tax deduction based on the donation that year, and the market triples the following year or it crashes the following year, you made that donation and that number is still the number that you use. That is a good one to lead me to the next part of the outline, substantiation, there at the bottom of page nine.

Substantiation

The best defense against a bad experience with the Internal Revenue Service is a really good appraisal and it certainly does not pay to be penny-wise and pound foolish when you are claiming a deduction for donating a conservation easement. If you read all of the tax cases on conservation easement appraisals, you will find that the ones where the landowner has a really good appraiser who understands conservation easements, who understands the local market, and who understands real estate values, the landowner wins in the end. The IRS is at an extreme disadvantage in these cases. The IRS sends in an engineer, sometimes from outside the area who doesn't understand the market. The engineer goes to the registry, writes up a report and it's meaningless. I can tell you as a former IRS employee, it's embarrassing for me to look at some of these cases and look at some of the positions the IRS has advanced because they just don't do a thorough job.

It used to be that the court cut the baby in half. If the landowner said, "My easement is worth $500,000," and the IRS said it was worth $100,000, the tax court would say, " Okay, we'll split the difference at $300,000." But they don't do that anymore. They look at both appraisals and if you have a really good appraisal you are going to win. So you need the best possible local or regional appraiser to do the appraisal. If there isn't someone who is a really good local or regional appraiser who understands conservation easements and has done this work before, then my recommendation is to get the best possible local appraiser that you can for the local market data and understanding, and to bring in from outside the area a review appraiser who has done this work. There are other easement appraisers in the West who have done this work that I would trust with the job of review appraiser, and there are outside the West too, but it's very, very important to have a really good appraisal.

One observation on page ten. I don't know if there are any real estate developers in the room and that's okay if there are, or people who might want to become real estate developers, but a question comes up a lot as the word of conservation easements gets out more and more. People begin to think, hmm, sounds like an easy way to get an income tax deduction. More and more real estate developers think, "maybe I can help my bottom line by using a conservation easement on my project." It's very, very, very difficult for a real estate developer to get a meaningful conservation easement deduction, and there are two principal reasons why.

Conservation Easements, Conditions of Development Approval, and Public Benefit

The first one is the so-called quid pro quo rule. The real estate developer stands up before the regulators and says, "If you let me put houses on 50 percent of my property, I will dedicate the other 50 percent to open space." And that's great and that's how things happen in this country, but that's not a charitable contribution, that's a quid pro quo. If you give me this, I will give you that.

Similarly, if the regulators say, "You can put houses on 60 percent of your property but we want the other 40 percent dedicated to open space permanently," that also is not a charitable contribution, that's an extraction.

That's a condition of approval and most of the time when real estate developers start to think about conservation easements, they are already in that situation. They are in a situation where a project has been approved, there is a requirement of open space in it and the developer thinks, "Gee, if this property has to stay open maybe I'll put a conservation easement on it and take a deduction." The conservation easement might work but it's not a charitable gift. A lot of developers also think, "I'll put a conservation easement on wetlands because I can't build there anyway and I'll take a deduction for that." Well, a conservation easement might work, it might protect wetlands but what's the value? If you can't build on the wetlands there's no give up of value, so there's no deduction. So that quid pro quo is the first issue that hurts real estate developers.

The second one is the conservation purposes test. Remember I said the tax code starts from the proposition that first you have to protect something with some significant conservation value. A lot of developers will say, "Well, you know, we're going to do a subdivision and we're going to do house lots around a twenty acre or a forty acre park in the middle." That park might not be a bad idea but if the only people who can get to the park are people who buy lots in the subdivision, then that's not really a public benefit, that's really private and it's really associated with the development.

So short answer to the question, most of the time real estate developers can't get a meaningful deduction for doing any conservation easement. Sometimes they can. I have said to developers, "If you have a genuine open space component to your deal and you don't need it to get your deal approved, and we start the planning early enough and set it up early enough, you have a shot at it." I've done two big easement donations for real estate developers. I did one in Colorado where the development team came in to me first, they had a 3,000 acre ranch. They said, "Essentially what we want to do is we want to put 25 or 40 acre house lots on the eastern third of the ranch and we want to leave the western two-thirds open." Now, as a matter of law in Colorado, if you've got 40 acres you can get a house lot on it and you don't need the other 2,000 acres to get approval. So that was a project where a conservation easement absolutely would work. Now, they knew that by having 2,000 acres of open space the houses would sell quicker and they would be worth more, but the fact of the matter is, there was a genuine give up of value there.

And we did another one on the east coast. A developer that had a big, big resort development on the east coast. They also owned a small island that was fully permitted for development, and they gave up most of those development rights with a conservation easement. I think maybe one of the reasons they donated the easement was they were afraid that the island might blow away in a hurricane at some point and be worth less than it was worth when they put the easement on it. But be that as it may, I will just share with you the comment. That easement went to Ducks Unlimited. There are some national groups that take conservation easements like Ducks Unlimited, the Rocky Mountain Elk Foundation, and other organizations like that. This easement went to Ducks Unlimited, and the Ducks Unlimited biologist went out to that ocean barrier island, which was a small island and his comment after his field trip was, "The ecology of that island is as fragile as a beehive hairdo in a windstorm."

Holding Period Issues

If you buy an asset and you give that asset to charity before you have owned it for a year, you can get a deduction but the deduction is limited to what you paid for it, it's cost or basis, not what you might claim the full value is. Here's the situation. Someone comes in and says, "I'm going to buy Aunt Sally's ranch and I've got her in a moment in a weakness and I'm going to pay her $1.5 million for it, but it's really worth $2 million." If that person turned around and donated the ranch, let's not talk about an easement but gave the ranch to the land trust before he or she had owned it for a year, even if you could get a bullet proof appraisal that said it was worth $2 million or $2.5 million, the deduction would be limited to the cost because you haven't held it for a year. That's one rule.

Corporate Gifts

There are a lot of western ranches and there are a lot of southern plantations that are owned by corporations and in that case, a couple of things important to remember.

Number one is that the deduction for donating a conservation easement or any other charitable deduction is limited to 10 percent of a corporations taxable income. So the income tax deduction benefit may not be that great. But let's say Aunt Sally has her ranch in a corporation and let's say she's owns all the stock, just to keep it really simple. Even though there may not be much of an income tax benefit, and Aunt Sally puts a conservation easement on the ranch, she lowers the value of the ranch to one million dollars, and she also lowers the value of her stock to one million dollars because the assets in the corporation are worth less than they were before. So there is still some estate tax benefit.

Restricted Gifts

The last one is on the bottom of page ten, number four, restricted gifts. I did get a question about this during the break and this is a very, very important tax planning point that tax lawyers call a trap for the unwary, because it can hurt people with good intentions.

Let's say Aunt Sally says, "I love this community and I really want to give something back. I'm going to give the County my ranch, but they can only use it as park land and open space forever." This is not a conservation easement gift. This is a fee gift of the real estate. Aunt Sally includes in the deed language that it can only be used as a park forever. What the IRS has said in that situation is that if you make a restricted gift, the deduction is not the full fair market value of the gift, it's the restricted value of the gift. So, if Aunt Sally wants to give away her ranch, and most of the time Aunt Sally doesn't want to give away her ranch, but if she does want to give away her ranch and she wants it used as open space and park land forever, the way to make sure she gets the tax benefits and also to make sure that it stays protected, is first to put a conservation easement on it. The give that easement to one organization and then give the restricted ranch to another organization. That way if the organization that holds the ranch decides it wants to sell it someday, it can sell it but it can only sell it subject to the terms of the restriction.

There have been a lot of horror stories, and someone mentioned one to me during the break, of well-intentioned people who have made gifts of open space to non-profits or government agencies based on a handshake, or on a wish or on a prayer, or on agreement. This can only be used as park land, and if it's not restricted the owner is free to sell it unrestricted at any point, and the restricted gift rule can hurt. There was a situation in a very expensive Massachusetts community where the landowner gave two house lots in town to the conservation commission of the town. He donated the two house lots and he had language in each of the deeds of the two house lots that said, "This can only be used as park land." The IRS audited that and they said, "No, your deduction is not $100,000. The value of the house lot, your deduction, is $500 a house lot because that's all it's worth as park land." So you need to make sure you do that right. Easement to one organization and then the restricted land to another organization.

QUESTION: Would that balance? Would that carry forward so you can use it more or less as a credit? Would that be based on the depreciating value of the property over those five years? Or....

No.

QUESTION: ...or over the value of the property as of the first?

As of the date of the gift, in every case. Once you make that gift regardless of what happens to the value of the property in the future, that fixes it. You know that real estate values usually go up, but in fact they haven't always gone up and we've had situations where we've made donations and property values have stalled or gone down. But you fix that donation when you make it.

I've been talking about donated easements and I want to talk about sold easements or selling easements or selling development rights or selling preservation rights or whatever it is you call them.

D. Other Incentives and Issues Potentially Helpful for Landowners

Bargain Sale

Here's a couple of observations: The first observation is this. You can sell development rights either at their full appraised market value, or for less than for their full appraised market value. If the County comes in, or the land trust comes in, or the State comes in and says, "Aunt Sally, your conservation easement is worth $1 million. We'll give you $500,000 for it." Okay, and let's say Aunt Sally agrees and she says I'm going to sell you a $500,000 easement for $1 million. That's called a bargain sale because he sold her asset at a bargain. She sold it for less than its worth. Two things happen on Aunt Sally's return. The first thing that happens is she pays tax on the $500,000 check that she received, and the second thing that happens is that she gets a charitable deduction for the $500,000 of value that she's given up. I'm going to come back to that in a minute.

Now, if the County says, "Aunt Sally, I'll give you $500,000 for your easement," and Aunt Sally say's, "Nope, not a penny less than a million. It's value is a million and I don't want to take a penny less than a million." They agree and they write her a check for $1 million. Aunt Sally sells her easement for fair market value. Now pay attention. Technically, as a tax matter, if Aunt Sally sells her easement at full fair market value, all the rules of Section §170(h) that we went over earlier are irrelevant! Section §170(h) is only relevant if Aunt Sally claims a deduction, whether she gives the easement away in the first place, or whether she sells it for less than its fair market value. §170(h) is relevant where there's a deduction.

If Aunt Sally and the County agree that her easement is worth $1 million, technically Aunt Sally could report a restriction on her property that says, "I won't ever put anymore houses on my property." Aunt Sally signs it and the County signs it. It gets recorded and they are done. The IRS doesn't care if Aunt Sally doesn't take a deduction, the IRS doesn't care what that document says. It's good practice to say everything you are supposed to say. It's probably not a good idea to have a restriction that says, "I will never want to put anymore houses on my property." What about a shopping mall? What about an industrial park? What about taking some action that would destroy the habitat or the agricultural soils? But the IRS doesn't care. The IRS does care if there's going to be a deduction and that leads me to the important observation here about the sale of development rights.

If you sell development rights at less than fair market value and plan to claim a deduction for the value that you give up, that document has to meet all of the requirements of Section §170(h). It has to be the same exact document that you would use if you donated it, and that's where those rules come back into play again. Technically, §170(h) is irrelevant if you sell for full market value but if you plan to claim a deduction, it's very, very relevant.

Now, why is this an issue? It's an issue because in some purchase of development rights programs that I'm familiar with around the country, the document that is used by the purchasing agency might have some weaknesses in it, or some points in it, or be missing some of the language in it that the IRS would require for a deduction. The agency doesn't know that and the landowner doesn't know that, and I'll give you one example. It's a technical example, but bear with me. In New Jersey, they have a purchase of development rights program on farm land, and the State will buy your development rights to protect farm land. The State's goal is to keep agricultural activities going in the State of New Jersey. But what the document says is, "If you ever want to put more structures on this property that are used for agricultural purposes, you can."

Now what does that mean? To me, it means that someday Aunt Sally's farm could be covered with greenhouses. It could be covered with riding rings and stables and barns and windmills and greenhouses and slaughterhouses, and so forth. Now that might be okay for agricultural purposes, but it doesn't protect the open space. This statute that we've been talking about this morning is talking about open space and the argument in New Jersey is, there is no limitation in the State document about how much you can pave the property, how many structures you can put on the property and arguably, you could do such damage to the agricultural soil and the open space and the scenic property that you could blow the deduction.

And there's an argument in New Jersey between the conservation groups and the State, and the conservation groups are saying, "No, no, no, no, the purposes of the federal tax statute is to protect open space." And the State says, "No, the purpose of our program is to protect agricultural activities and we don't care if the whole thing is paved over as long its dedicated to agriculture." So again, that's a technical example but be mindful of the fact that if you sell development rights and want to claim a deduction you have to be very, very certain what that document says.

You know, sometimes I think it's hard to stand up here and talk for two and half or three hours but then I realize it's harder to sit there and listen, because at least I know what I'm going to say and I understand myself most of the time.

An important observation/question I got during the break and let me tell you, there is an appendix in *Preserving Family Lands: Book I*, on this issue so if you don't get the particulars, it's in here. Remember I said very early on that when you donate a conservation easement you can take a deduction up to 30 percent of your income for the year with a five year carry forward. There is an election that you can make under the tax code and you just follow a statement with your tax return. That allows you to take a deduction up to 50 percent of your income for the year. But if you do that you can only deduct the cost or basis of the asset that you give away rather than the full fair market value. Now in most situations, there will be bigger tax savings if you deduct the full fair market value up to 30 percent of your income, but not all. And so it's very important in any individual situation to take a look, have your tax return prepared, or if you are a tax return preparer, take a look and see which is the better option for the person who made that donation because it's free, no cost or obligation. You can do it if you want to, it just has to work for you that's all.

QUESTION:

If your cost is higher than the value, you still need an appraisal to determine the value of the gift. But in that case, all of the value would be basis. If your current fair market value is less than what you paid for it and you put an easement on it, then all of the value of that easement would be basis so you wouldn't lose anything by choosing to deduct only basis. So that's a perfect example again where running the numbers would show you that it's probably in your interest to make that election. Good question.

Testament Gift

I want to cover a little bit of §2031 again and I want to cover the succession planning stuff at the very end of the outline. Two more things before we get to that. On page eleven of the outline on C, see testamentary gift. I mentioned this at the very beginning, I cannot emphasize it too strongly. You can include a conservation easement in your will just like any other charitable gift. In fact, let me share with you a very sad story, it was a great story from the perspective of getting the planning done, but it was a very sad story.

Oh, five or six years ago I was visited by a couple of young men from Chattanooga, Tennessee, they called and we'd exchanged a few phone calls. This is a true story. Their father was a very successful businessman and had done all of the planning for his very successful business. All the sophisticated planning, notebooks and notebooks and binders were all done, but he had never done any planning for the land he loved up on the mountain. He developed a very aggressive form of cancer and was due for a bone marrow transplant at the end of February of this particular year. The family started contacting me in mid-January and they said, "You know, we think we got to get something done here for father." I think they said, "Twenty percent of the people who have this surgery don't survive it and we're not going to tell him that we think he's going to die, but we're going to tell him to get started on a conservation easement for the property he loves and cares about so much. Then maybe we'll get him to put it in his will and then we'll at least be covered by the time he goes into surgery." And I said, "Okay, that's all a good plan but we need to know about this sooner rather than later because there's not a lot of time to do the planning."

So they came up and they visited with me and they called the following week. This was around 21,22,23 or 24 of January, something like that, and they called and said, "Okay, go ahead, get started with the project." Then they called the next day and they said, "He took a turn for the worst, we almost lost him last night, they moved up the surgery to February 4th. Can you get the work done by February 4th?" And this is like the 28th of January and I said, "Yeah, I don't think we can wait that long because the news was bad. To make a long story short, I was working with Chattanooga counsel that had represented the family and its business interests and so forth for a long time and we got a new will done and we got a conservation easement done and added to the will and we had been in touch with the donee organization. In fact, the donee organization said, "There's no way that we can ever finish this easement in the world to our satisfaction in the time frame that you are talking about." And we said, "True with us too, but we need to understand, we're going to put it in the will and we're going to have language in there that says we agree to, you know, fix it and get it all done and get it recorded and get it done right."

We got the documents out on a Saturday afternoon, they were sent by courier from Chattanooga to the Mayo Clinic in Jacksonville, Florida, and then I dropped out of the loop at that point. Sunday morning one of the son's called me, nine o'clock Sunday morning and he burst into tears and I said, "Tell me what's happened," and he said, "Well," he said, "Dad made it through the night but they are telling us he won't survive the day." And I said, "Well, I have to ask the lawyers question I said, "What happened to the documents?" He said, "They got signed last night, they got to the hospital, we had four and a counsel, we had witnesses and notaries and Dad's competent and he's thinking clearly, he's just going to die today." So the documents got signed Saturday night in a hospital and he died on Sunday, but it worked, it worked.

There was a conservation easement in his will, also in his will he set up a private foundation with the four children as trustees of the private foundation to hold the most environmentally important core piece of his property that had a phenomenal gorge and waterfall in it, absolutely spectacular!

inaccessible unless you know where you are going and know how to get there. The rest of the story is the two son's lived in Chattanooga and worked with the family business, the other two kids lived elsewhere and they were new to this business at that point, they were new to the land business and new to the conservation business. The idea was to set up the private foundation and have Dad leave to it under his will, a big chunk of the property, with the idea that they would spend a couple of years getting to know the land trusts and the conservation groups and the agencies and so forth in the area, and if they wanted to then they would subsequently gift. The foundation would give that property to some other organization and go out of business or they would stay in business and continue to own it and run it. And they turned out to love it and they stayed in business and one of the guys actually left the family business and has gone to work for the Trust For Public Land which is one of the national land conservation groups and he's their project director in Chattanooga now.

So, you can have a conservation easement in a will and it works. Don't rely on it obviously, if you can get it done earlier than that, it's better, but it's a planning technique that's available. That was before post mortem easements were included in the law but frankly, even if post mortem easements were included in the law, we would have done it the same way because it's easier to get it done in the will with one signature.

Special Use Valuation for Farmland and Ranchland

Two observations at the top of page twelve. One of them is on Section §2032(A) of the tax code. Section §2032 as the lawyers call it, Section §2032(A), capital A which is a special state valuation for farm land, ranch land, and forest land. Essentially, what §2032(A) says is that if you die owning farm land you can have it valued for estate tax purposes at farm land value rather than for development potential value if you meet all of the requirements of §2032(A). They are technical and they are lengthy and they are particular and they are difficult to meet. This is a very rough generalization, but one out of every ten times that families look at §2032(A) it works beautifully and the other nine times it doesn't work for whatever particular reasons might be there. I would just recommend it's because it's something that people need to think about and be aware of.

State Court Cases

There's a cryptic reference but here's the observation. What I've been talking about so far when I've been talking about court cases is generally the tax court. For example, when the IRS argues about how much your easement is worth, you go to tax court. In many, many states around the country, enforceability of conservation easements has been challenged in state court. And the good news is that in almost all of those cases, the easements have been upheld and they've been found to be enforceable. There was one peculiar case in Washington State that people say isn't worth very much. There's a recent case in Maryland where an easement was held to be unenforceable and that's on appeal. But there's at least a dozen cases in a number of other states where easements have been upheld and are enforceable.

One case that I'd like to talk about because it has an interesting fact pattern is in Massachusetts, and it's the Bennett case. Massachusetts has an agricultural protection program and they buy development rights on farm land. The prior landowner to the Bennett's, sold to the Commonwealth of Massachusetts, the development rights on farm land. Then the family that sold the development rights sold the farm to new owners, Mr. and Mrs. Bennett subject to that recorded conservation easement. Under the terms of the conservation easement, the landowner whoever it was, could put one more house on the property subject to approval of the location for the house by the Commissioner of Food and Agriculture, which is the holder of the easement. So the Bennett's said, "We want to put a house up there on the hill," and they went to the commissioner and the commissioner said, "Nope, you can't put a house up there on the hill, you can put a house there or there or there or there but you can't put a house up there on the hill."

Well the Bennett's sued the commissioner and they took the commissioner to court and they said, "There's two claims we have in court. The first one is that the easement is not enforceable, and the second one is that if it's enforceable the commissioner abused his discretion by denying us the ability to put a house up on the hill." And here's what the court said. "As far as the first claim that the easement was not enforceable," the court put this in much more judicial language than this but what the court said was, "Now give us a break. You bought this property subject to a recorded restriction, it's in English, it's clear, and it's not ambiguous. So don't come whining to us now that it's not enforceable." A very, very strong public policy statement.

As for the second claim that the commissioner abused his discretion by denying the ability to put a house up there, the court said, "In fact, in order to put a house up on the hill the Bennett's would have had to pave over one mile of prime farm land, and since the purpose of this program is to protect agricultural soils the commissioner absolutely did not abuse his discretion by denying you the ability to do that." So that's the Bennett case and that's an example of the state court cases.

E. Estate Tax Treatment of Certain Land Subject to a "Qualified Conservation Easement"

This is Section 2031 and we covered most of the material that I want to cover and I just want to make maybe one or two quick observations.

The first one is on page twelve, under B, limitations. Remember, we go back to Aunt Sally again here, $1 million, minus 40 percent or $400,000, which leaves $600,000 subject to tax. The first limitation that is important is that under the exclusion, you can only further reduce the value of property by $500,000. That's capped at $500,000. So if Sally's farm had been worth $5 million before the easement and $2 million after the easement, 40 percent of $2 million is $800,000. But she couldn't have taken another $800,000 reduction because the statute caps it at $500,000. That's usually not a big issue but it's an important issue and once again, if both spouse's do this correctly, then each spouse's estate can be eligible for §2031(c). Now one math example and I know there have been a lot of math examples and it's late in the morning, if not late in the day, but bear with me just to illustrate the difference between planning and not planning.

Aunt Sally and Uncle Bob have a ranch worth $2 million and $2 million in other assets, so they have a $4 million estate. Uncle Bob dies and he leaves the ranch to Aunt Sally. So the first example is no planning at all. Uncle Bob dies, he leaves everything to Aunt Sally. Aunt Sally dies, she leaves everything to the kids. There is $1.65 million in estate tax. Remember that number, $1.65 million.

Instead, compare that with when Aunt Sally and Uncle Bob do the planning. They put a conservation easement on the ranch and they divide up the ranch so they each own half of it, so each estate can take advantage of the §2031 exclusion. To make a long story short, after both spouse's die, the total estate tax, if they do the planning, is $332,000. So by putting a $1 million easement on the ranch they saved $1.3 million in estate tax and for those of you who remember what I said at the beginning of the program, the story and the tax magazine where the author said, "No, there's no other charitable giving opportunity that has the same tax benefits as conservation easements," that's one of the things that we are talking about. You get an income tax deduction and you save $1.3 million in taxes! That's not a deduction. That's not some fictional number. That's $1.3 million less that the heirs owe the federal government and that's worth paying attention to.

F. Succession Planning Issues

Let's wrap up with a discussion about succession planning.

Here's the issue. Aunt Sally and Uncle Bob put a conservation easement on the ranch and they want to do even better. They can do even better than the example I just gave you. They set up a family partnership and they put the ranch into the partnership and they start giving partnership interests. So they set up an L.L.C., a limited liability company, and they start giving L.L.C. interests to the children. The question comes up, what kind of entity do we use? Do we use a corporation, a partnership, a trust, an L.L.C.? Very quickly, here's what I want you to remember. Never, never, never, never put family land in a corporation. Never put family land in a corporation!

Why? Because when the corporation sells the land there is one tax to pay. When the money comes out to the shareholders there's another tax to pay. There's two levels of tax. So if you have the opportunity to do the planning right from the beginning, if you have a clean slate, don't use a corporation for no other reason than the double tax reason. There may be other reasons but that's enough.

If you put land into a partnership or a limited liability company and when I say partnership for the next few minutes, I mean partnership or limited liability company, there is one tax to pay. They are single tax entities. When a partnership sells an asset the partners pay tax, that's the end of it. So you can get all of the management succession planning control, voting, non-voting, all those issues you can deal with in a partnership or an L.L.C. with only one tax instead of worrying about a corporation with two taxes.

A "Subchapter S Corporation" is a type of corporation, it's not as desirable as a partnership and it's better than a regular corporation but for reasons too complicated to go into at the end of this three and a half hour program, trust me on this. If you have to start at the beginning, go with a partnership or an L.L.C. If you want more on that, read *Preserving Family Lands: Book II*, that goes into these different entities.

Trust, what about a trust? People say to me, "Well can't we use a trust? Can't we just put the property into family trust and be done with it?" The question isn't, "Can we use a trust?" The question is, "Does the family understand and does the advisor understand what that legal and tax consequences are of using that trust?" Some trusts are taxed like corporations, two taxes. Some trusts are taxed like partnerships, one tax. Some trusts are taxed as if they didn't exist at all. So a trust may work but it's important to understand what kind of trust you are getting into.

G. Conclusion

The last comment in this regard is, what about mom and pop who say, "Why do we need a lawyer? Why do we need an L.L.C. or a partnership? Why can't we just give the kids undivided interests each year, just deed the kids undivided interests of 5 percent, 2 percent, 10 percent on the property?"

Dealing with tenants in common, dealing with co-owners, is one of the most difficult planning situations that you can be up against because all of the co-owners need to agree. If there are four owners, co-owners of a piece of property and three want to sell and one doesn't, nothing happens. If there are four co-owners and three want to put a conservation easement on it and one doesn't, nothing happens. And any co-owner at any point in time can ask to be cashed out, can file a petition suit to divide the property up, can file a suit to try and force the sale of the property and planning for co-owners in undivided interests can be very, very complicated and very, very difficult and there's no magic answer to that.

The answer to that is that every landowner has to do the planning that's right for his or her own family and if you don't do anything, if you don't do anything at all, you won't get anywhere. If you do the planning and if you ask the questions and find out what the answers are that are right for you and your family, you will help keep this part of the country a beautiful place to live and to visit.
Thank you very much.

QUESTION: (inaudible) and the State Trust Land is dedicated by law to give maximum value for educational applications and the state has fastidiously refused to participate in this process of the formulation of the Sonoran Desert Conservation Plan. In particularly, the State Trust Land Department has been completely uncooperative and so there is absolutely no coordination between this plan and what the state's intention is with this State Trust Land checkerboards all the areas within the jurisdiction of the Sonoran Desert Conservation Plan. As an attorney who deals with these land issues, is there any prospect that, should the Sonoran Desert Conservation Plan come into affect, that we could have some legal prevailing interest by which we can tell the state to dedicate some part of that land towards conservation easements or uses? Can the state itself dedicate conservation easements, not necessarily for tax advantages but in order to ensure the integrity of that land in perpetuity?

That's a tough question in part because it deals with state law and local politics issues and so forth. But I think my best answer to the question is education, education, education and more education. In some parts of the country, conservation easements are fairly well understood and fairly well accepted tools and a lot of the myths that people have don't exist anymore by and large, although again, that's a generalization. In some parts of the country, they are still new, they are still different and people aren't familiar with them.

People don't understand them and I know from my experience here in this part of the country that there's an enormous amount of education that's still needed about the economic benefits of conservation easements. Not just the aesthetic and habitat and scenic and other benefits but the economic benefits of conservation easements, the fact that keeping land in ranching and agricultural use puts less of a strain on municipal services and puts less of a strain on municipal budgets. Don't quote me on these numbers exactly but the American Farm Land Trust has done studies around the country that show that for every dollar of farm land, you need thirty-two cents in municipal services whereas for every dollar of subdivision you need a dollar forty in municipal services. Those aren't necessarily the precise numbers, but that's the point.

I think, it's certainly my impression, that even though some people in Arizona have known about conservation easements for quite awhile, a lot of people don't, and I think it's just a question of continuing to educate the public and elected officials about those benefits.

The elected officials aren't going to change their mind about something, no matter what it is, the elected officials aren't going to change their mind about it unless they hear from a lot of people suggesting that it's a good opportunity to think. So, there's no magic answer except education. I can tell you this. I can tell you that a decade ago, half of the state's in this country had conservation easement statutes, enabling legislation and half didn't. And I can tell you that this year, Pennsylvania, in the last six weeks became the 49th state to pass a conservation easement enabling statute. Somebody told me last week that Wyoming which was the only holdout has just passed a conservation easement statute there. The point is, the legislator's in Wyoming didn't just change their minds and say, "Well okay, it's probably a good idea to do it now." It took years of education dispelling the myths and convincing public officials that in the right case, these work. They are not right for everyone but in the right case they work.

I like to quote Abraham Lincoln who said, "If this is the sort of thing, you'll like this sort of thing."

QUESTION: Can the state dedicate conservation easements at all?

I'm not sure. A lot of jurisdictions can't give away property interests without going through, or even sell property without jumping through enormous hoops. So there might be restrictions on that, but there may also be ways to amend the law if a state agency gives a conservation easement to another state agency and the value of the state coffers aren't reduced at all. That's a possibility. You know, we just made that up, but yes.

QUESTION:

There are instances around the country where non-profits and government agencies, although I'm not sure state agencies, have donated conservation easements as a show of good faith and to make sure that nothing ever happens to that particular property. They are few and far between but they are just starting to happen and again and it's an educational process. I mean I remember the speech I gave in front of the Colorado Cattlemen's Association long before they started their land trust part. They were not interested in listening to a tax lawyer from Boston, but now they have a land trust that has a lot of easements on cattle ranches around the state.

QUESTION: In reference to both points, the Arizona Constitution has (inaudible) before the State Trust Funds can do anything like that because the Constitution does spell out that all the State Trust Lands must be sold to the highest bidder (inaudible)

Yes. Unless they don't sell them.

AUDIENCE: Well, that's never a problem.

I'll just wind up. This is the last story. When I visited Bob Sharp in that valley, I guess he said in 1993, I remember I told him the story earlier, I had dinner one evening with Larry Robbins who was then in his early 80's and had a big ranch down there. As you can imagine, there were people at that dinner table who thought Barry Goldwater was a Communist and people in the land preservation business and so forth. And I remember part way through dinner a fairly heated argument ensued about some political issue and Larry turned to me after about ten minutes and he said, "I notice you haven't said anything for the last few minutes." I said, "That's right." He said, "Good for you."

Thank you very much.

PRESERVING FAMILY LANDS

TAX AND ESTATE TAX PLANNING WORKSHOP

by

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Sponsored by

Arizona Open Land Trust
Pima County

Arizona Historical Society Auditorium
Tucson, Arizona
October 27, 2001

PRESERVING FAMILY LANDS

TAX AND ESTATE TAX PLANNING WORKSHOP

by

Stephen J. Small, Esq.

I. PLANNING FOR THE LANDOWNER

A. Historically, goal of estate planning has been to put the client's affairs in order.

B. Beyond that, biggest problem: how to get the family's <u>business</u> through the estate tax, intact, and into the hands of the next generation.

1. Example: valuable family business – what happens when clients visit advisor.

2. Example: valuable family land – what happens when clients visit advisor.

3. Landowners are asking for the same planning attention and creative energy by professionals as business owners are receiving – and landowners <u>are not getting it</u>!!

4. Understanding <u>the process</u>: how do you get the family to agree??

5. What are some of the things the attorney needs to know about to be able to help the family reach agreement (this is not intended to be an all-inclusive list):

See, generally, Small, <u>The Federal Tax Law of Conservation Easements</u> (Land Trust Alliance, 1986), for annotated commentary on the Income Tax Regulations on easement donations and for a discussion of some of the tax considerations associated with easement donations. See also <u>Preserving Family Lands (Book I)</u>, third edition, Landowner Planning Center, 1998; <u>Preserving Family Lands: Book II – More Planning Strategies for the Future</u>, Landowner Planning Center, 1997.

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a. The estate and gift tax rules, especially with respect to transfers that are not subject to transfer tax

b. Conservation and preservation easements, including qualification under the tax rules, valuation, donee organization rules, all related issues

c. The income tax deduction limitation rules, including the substantiation requirements

d. The new estate tax rules for certain land subject to conservation easements

e. Bargain sales

f. Tax-free swaps of real estate and interests in real estate

g. Certain estate tax valuation rules

h. Generation-skipping tax rules

i. Choice of entity issues:

   i. How is a corporation taxed? Who has decision-making authority? What if more than one person wants decision-making authority?

   ii. How is a partnership taxed? Who has decision-making authority? What if more than one person wants decision-making authority?

   iii. How is an S corporation taxed? Who has decision-making authority? What if more than one person wants decision-making authority?

   iv. What are the restrictions on eligibility for shareholders of an S corporation?

   v. What is a "Limited Liability Company"? Will you be one of the first in your state to use one?

   vi. What is a "family trust"? How is a trust governed? Taxed?

   vii. What are the potential planning problems for tenants in common (undivided interests)?

j. Valuation discounts

k. So-called private foundations and other non-public and non-private tax-exempt entities, including, for example, charitable trusts and "supporting organizations"

l. Charitable remainder trusts and related vehicles

m. Taxation of life insurance

n. Hazardous waste liability issues

o. Water rights law

p. Mineral rights law

q. State law, real estate law, land use controls, zoning, state and local taxation of real estate

r. Community property law

II. <u>WHAT DOES THIS YEAR'S TAX BILL MEAN FOR PRIVATE LAND CONSERVATION</u>??

A. Understand the rules

B. Understand: <u>the rules mean uncertainty</u>

C. What does the uncertainty mean? <u>You must work harder</u>!!

III. <u>FEDERAL ESTATE AND GIFT TAX "PRIMER"</u>

A. Introduction to concepts; most people <u>never ever</u> had to worry about this before.

B. General rule (old rule): all transfers of wealth are subject to gift tax or estate tax

C. Exceptions

1. $10,000/$20,000 (exclusion; see §2503(b))

2. Between spouses (not subject to tax; see §2523)

3. Charitable (not subject to tax; see §2522)

4. So-called "$600,000 exclusion" (now $675,000) may apply, increasing ("old" law) by gradual steps to $1,000,000 (see §2505)

5. New §2031(c) (see later in this outline)

D. New rules (Congress and the President did not repeal the estate tax)

1. $675,000 goes to $1,000,000 on January 1, 2002.

2. That goes to $1,500,000 on January 1, 2004.

3. That goes to $2,000,000 on January 1, 2006.

4. That goes to $3,500,000 on January 1, 2009.

5. Beginning January 1, 2010, there is NO ESTATE TAX… for one year.

6. If Congress takes no further action, on January 1, 2011, the estate tax comes back and the "exclusion" goes back to $1,000,000!! Ridiculous? Impossible? A bill of goods? True!!!

7. Estate tax <u>rates</u> drop.

8. Gift tax "credit" goes to $1,000,000 in 2002 and is not scheduled to change.

9. In 2010 complex "carryover basis" rules go into effect.

IV. <u>DONATION OF A CONSERVATION EASEMENT: AN OVERVIEW</u>

A. General discussion; must be perpetual; see definition.

B. <u>Remember, you still own your property if you donate an easement</u>.

C. Public access is generally <u>not</u> a requirement.

D. Flexibility: each property owner is unique, each piece of land is unique, and each easement must be unique.

1. When you think about a conservation easement, you have to think about how it relates to <u>a particular piece of property</u>.

2. For each piece of land, consider income-producing uses, compatible with the protection of the conservation values of the property.

3. Cuts across social, geographic, economic, and political lines

4. Landowners <u>don't like to be told what to do with their real estate</u>

E. Estate tax benefits: <u>lower the value of the property</u>; avoid the forced sale of the property to pay estate taxes.

1. Run the numbers!! Don't assume anything!! See Chapter 7 of <u>Preserving Family Lands</u>, "Cash Sale Compared to Good Planning."

2. <u>Give up value</u> but <u>gain control</u>

3. <u>Keep value in return</u>

F. Income tax deduction

1. Valuation of conservation easements: generally (though not always) using the "before and after" test.

2. Limitation on benefits from a gift of <u>property</u> to charity: generally deductible up to 30% of adjusted gross income ("AGI"). Five-year carryforward. (A gift of cash is deductible up to 50% of AGI.) Possible election to take deduction up to 50% of AGI, <u>without deducting any appreciation</u>.

3. Example: John and Mary have adjusted gross income of $100,000. They give land with a value of $100,000 to charity. They can deduct $30,000 of the gift (30% times $100,000) in the first year, with a five-year carryforward of the $70,000 that's left. Any undeducted "value" remaining after six years disappears into thin air.

4. No alternative minimum tax rule, although the alternative minimum tax <u>may</u> still be relevant.

5. Most easements <u>not</u> driven by income tax benefits.

6. Run the numbers!!

G. Lower property tax

1. Up to local assessors (or state statute), not federal tax law

2. State and local considerations; state statutory issues. Various states have enacted legislation or are considering legislation that would lower the property tax assessment on property subject to conservation easements.

3. Watch out for "revenue base" mentality.

4. <u>Special use assessment considerations and misconceptions</u>

H. Do the <u>economic analysis</u>

V. <u>"QUALIFIED CONSERVATION CONTRIBUTIONS" UNDER §170(h) OF THE INTERNAL REVENUE CODE OF 1986, AS AMENDED, AND THE REGULATIONS THEREUNDER (THE "CODE")</u>

A. What donations qualify for deduction

1. "Qualified real property interest"

a. Easement (the regulations say, "an easement or other interest in real property that under state law has attributes similar to an easement")

b. Remainder interest in real property

c. Donation of a fee interest with reservation by donor of subsurface mineral rights

2. Donated to a "qualified conservation organization"

a. Charitable organization or governmental unit

b. Generally must be in the conservation or historic preservation field

c. <u>Not</u> a "private foundation"

3. "For conservation purposes"

a. Public outdoor recreation and education; must be for the "substantial and regular use of the general public or the community."

b. Protection of a significant habitat or ecosystem, including "buffer zones."

c. Preservation of historic property, generally requiring classification as a National Register property by the National Park Service but also including "historically important land areas" of independent significance (such as an archaeological site or Civil War battlefield).

d. Preservation of open space, either

i. Pursuant to a clearly delineated governmental policy and will yield a significant public benefit, or

ii. For the scenic enjoyment of the general public and will yield a significant public benefit.

e. Note that the average value per acre of farmland in the U.S. was roughly \$100 in 1960 and \$800 in 1996.

B. Other requirements

1. Enforceable in perpetuity.

2. Donors should be advised that an easement gift is not deductible (because it is not enforceable in perpetuity) until the easement is recorded.

3. <u>Run the title early: mortgage; mineral interests</u>

4. In the case of the donation of an easement on property subject to a mortgage, <u>no deduction will be allowed</u> unless the mortgagee subordinates its rights in the property to the right of the qualified

organization to enforce the conservation purposes of the gift in perpetuity.

a. Note what this requirement means. It does not mean the mortgagee can't recover the full amount of the <u>cash due</u> in the event of a foreclosure. It means that in the event of a foreclosure and a subsequent resale of the property, the easement <u>must remain in effect</u> as a recorded restriction on what can be done with the property.

b. New territory for lenders.

5. Public access is generally <u>not</u> a condition of the gift.

6. Numerous approaches for reserved rights, including reserved residential development rights and potential charitable and/or commercial activities.

7. Valuation

a. Long-standing rule: value of an easement equals the fair market value of the unencumbered property (before the easement) minus the fair market value of the encumbered property.

b. If the easement covers a portion of the <u>contiguous</u> property owned by the donor <u>and the donor's family</u>, the value of the easement is equal to the value of the <u>entire contiguous portion</u> before the easement minus the value of <u>the entire contiguous portion</u> after the easement.

8. Substantiation

a. A taxpayer who claims a value in excess of $5,000 for a charitable gift <u>must</u> have a "qualified appraisal" supporting the claimed value.

b. The taxpayer must file with his or her tax return IRS Form 8283, "Noncash Charitable Contributions."

c. Form 8283 requires an acknowledgment by the donee organization. If the donee organization disposes of the property within two years, the organization must file with the IRS Form 8282, "Donee Information Return," and must provide the taxpayer with a copy.

d. A "qualified appraisal" must include, among other things, a description of the property, the method of valuation used to determine the fair market value of the property, certain information about the appraiser, and a description of the fee arrangement between the donor and the appraiser.

e. The "qualified appraisal" must be done by a "qualified appraiser."

f. The appraisal cannot be completed more than sixty days prior to the date of the gift. The appraisal must be completed no later than the due date (including extensions) for the federal tax return for the year in which the gift was made.

g. <u>Failure to comply with the appraisal requirements will mean that the deduction will not be allowed</u>.

C. Other federal tax issues

1. Harry Investor

a. Harry proposes donating to the town a conservation easement if the town approves his application for a new subdivision.

b. <u>Quid pro quo</u> trap: Harry's "deal" is not a gift, and no deduction is allowable. This not just "conservation" law, it is part of the underlying law of charitable contributions.

c. <u>If</u> Harry can get by the <u>quid pro quo</u> hurdle, it is still arguable (though not at all certain) that his deduction will be limited to his "basis" (or cost) of the donated property.

2. Holding period issues.

3. Deductibility of corporate gifts limited to 10% of corporation's taxable income, with 5-year carryforward of the balance.

4. "Restricted" gifts: a potential trap. See Rev. Rul. 85-99, 1985-2 C.B. 83.

VI. OTHER TAX INCENTIVES AND ISSUES POTENTIALLY HELPFUL FOR LANDOWNERS -- A VERY BRIEF OVERVIEW

A. Bargain sale

1. John and Mary paid $200,000 for their scenic property, and it is now worth $800,000.

2. They "just want to get their money out," so they sell it to a tax-exempt conservation organization for $200,000.

3. Surprising tax results:

   a. Basis is allocated between the "sale" portion and the "gift" portion.

   b. The amount realized ($200,000) is 25% of the fair market value ($800,000); 25% of the basis is allocated to the "sale" portion and 75% of the basis is allocated to the "gift" portion.

   c. Gain is $150,000 ($200,000 minus $50,000 allocated basis); gift is $600,000.

B. Gift of a remainder interest

1. After life estate or term of years

2. Valuation of gift depends on actuarial tables based on interest rates that may now be redetermined monthly.

C. Testamentary gift (by will)

1. Estate tax deduction allowed for a testamentary gift of an easement.

2. Almost no law on easement donations by wills.

3. Recommendation: for the highest level of certainty, to the extent possible the actual language of the deed of easement should be incorporated into the will.

4. Examples of when this may be useful; a very underrated planning tool.

D. Special use valuation for farmland and ranchland (§2032A)

1. Grossly misunderstood (ask the family's attorney for estate tax projections).

2. This Code section is fraught with traps and landowners must pay very careful attention to all of the requirements

3. Run the numbers!!

E. Tax-free swaps of real estate and interests in real estate

F. State court cases

VII. ESTATE TAX TREATMENT OF CERTAIN LAND SUBJECT TO A "QUALIFIED CONSERVATION EASEMENT" (§2031(c))

A. Background

1. 1990 bill: land subject to a conservation easement shall be exempt from estate tax.

2. 1997 law (effective for decedents dying beginning in 1998): if you die owning land subject to a conservation easement, and if you meet the geographic, holding period, and activity limitations, up to 40% of the land value can be excluded from the gross estate.

3. Message to landowners and the professional planning community: this is a very important new tax code provision. There are questions about how it works but there is a lot that we do know about how it works.

B. Limitations

1. Exclusion was capped at $100,000 in 1998, increasing by $100,000 each year up to $500,000 in 2002 and thereafter.

   a) If the planning is done correctly, the estates of both spouses can be eligible for the §2031(c) exclusion.

   b) The §2031(c) exclusion may be combined with other estate tax provisions that can benefit land-based businesses.

2. Easement must have been donated and must have met the

requirements of §170(h), although easements solely to protect historic assets are not eligible.

3. Land must have been owned by the decedent or a member of the decedent's family for at least three years prior to the decedent's death.

   a) The easement must have been donated by the decedent or a member of the decedent's family (or by the executor of the decedent's estate or a trustee of a trust holding the subject property).

   b) Mr. Able donates a conservation easement in 1998 and dies in 2003. He leaves his land to his daughter Sally. His estate is eligible for the §2031(c) exclusion. Sally dies in 2028. She leaves the land to her daughter. Sally's estate is eligible for the §2031(c) exclusion. Etc.

4. The easement must prohibit all but "de minimis" commercial recreational use of the land.

   a) Much remains to be learned about this rule. What about a dude ranch? A summer camp? A wilderness resort?

   b) The conference committee report notes that "de minimis commercial recreational activity that is consistent with the conservation purpose, such as the granting of hunting and fishing licenses, will not cause the property to fail under this provision."

5. "Retained development rights" can be extinguished after the death of the decedent.

6. An amount of land value equal to the amount of any mortgage on the property will not be eligible for the exclusion.

7. To the extent of the exclusion land will receive a "carryover basis," rather than a "stepped-up basis" at the decedent's death.

8. The 40% exclusion will be reduced by two percentage points for each percentage point by which the easement fails to reduce the value of the property by at least 30%. The 30% determination is made as of the date of the donation.

9. The exclusion may apply when land is owned by a family

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

a) This can provide an important "second look" for the family that uses a land-owning limited partnership (for example) as a vehicle in an extensive lifetime giving program. When the 30% ownership threshold is reached the family can reassess whether to stop gifting and retain eligibility for §2031(c) or to continue gifting without reliance on the exclusion. <u>In this connection, note that the exclusion provided by §2031(c) does not apply to the gift tax</u>.

b) One can assume a calculation methodology similar to that in <u>Estate of Hoover</u>, 69 F.3d 1044 (10th Cir. 1995), that is, fair market value of the easement-restricted property, minus appropriate discounts, minus the full exclusion amount (as opposed to a pro-rated portion of the exclusion amount).

10. It is understood that new §2031(c), as included in the Taxpayer Relief Act, was intended to allow a "post-mortem" easement donation that was deductible under §2055(f) <u>and</u> made the estate eligible for the §2031(c) exclusion.

a) It is now clear this is how the statute works. See Section 6007(g), a technical amendment to the Internal Revenue Service Restructuring and Reform Act of 1998, adding new §2031(c)(9).

b) Example: Mr. Able owns land worth $2,000,000. He dies in 2003 without having donated an easement during his lifetime or by will. His estate donates a conservation easement that lowers the value of his land to $1,000,000. The land is valued in his estate at $2,000,000; the estate is entitled to a $1,000,000 deduction under §2055(f). His executor elects to take advantage of the §2031(c) exclusion; 40% of the $1,000,000 remaining land value is excluded from Mr. Able's estate; $600,000 of land value is subject to estate tax.

c) The post-mortem easement must be recorded (and the election made) by the due date, including extensions, for the estate tax return (§2031(c)(6)).

d) In many situations this will be a critical and important post-mortem tool but because of the complexity and uncertainty of post-mortem planning issues (see below) landowners and their advisors should not plan to rely on this provision in the post-mortem period.

C. General Observations

1. Every single easement must now take into account the rules of §2031(c) as part of the planning process.

2. Every single family lands planning situation must now take into account the rules of §2031(c).

3. Every single recorded easement should be reviewed with §2031(c) eligibility in mind if the land is still owned by the same family that donated the easement.

4. Planning immediately after the death of many landowners will now become more complex, difficult, expensive, possibly highly beneficial, and absolutely necessary; see below.

D. Post-Mortem §2031(c) Planning Checklist

1. Have an accurate appraisal of the subject property, the value of structures, the value of any reserved development rights, and the value of an easement

2. Understand and resolve any state law issues

3. Understand and resolve any family issues

4. Reach agreement with the easement holder or donee

5. Run all the numbers

6. Perhaps record an easement or an "Agreement to Extinguish" or an easement amendment

7. Have a final qualified appraisal in hand

8. File the §2031(c) election

VIII. **"SUCCESSION PLANNING" ISSUES**

A. Corporations

B. Partnerships and Limited Liability Companies

C. S Corporations

D. Trusts ("killer trust" story)

E. Undivided interests

IX. **CONCLUSION**