

CONSERVATION EASEMENTS

California's Natural Heritage Preservation Tax Credit Act of 2000

- There shall be allowed as a **credit** against the “net tax” as defined in Section 17039, an amount **equal to 55 percent of the fair market value of any qualified contribution** made on or after January 1, 2000, and prior to December 31, 2005.
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- Wildlife Conservation Board shall implement the program.
 - Upon approval by the board, a donor may contribute his or her qualified property to a donee and receive a tax credit for a portion of the value of the property. The board shall adopt guidelines or regulations to implement the program.
 - No more than a total of one hundred million dollars (\$100,000,000) in tax credits may be awarded pursuant to this division. Tax credits may be awarded pursuant to this division in the fiscal years 2000-01, 2001-02, 2002-03, 2003-04, and 2004-05.
 - If the credit allowed by this section exceeds the “net tax” the excess may be carried over to reduce the “net tax” in the following year, and the succeeding seven years if necessary, until the credit is exhausted.
 - This credit shall be in lieu of any other credit or deduction, which the taxpayer may otherwise claim pursuant to this part with respect to the property or any interest therein that is contributed.
 - This act is an urgency statute necessary for the immediate preservation of the public peace, health, or safety within the meaning of Article IV of the Constitution and shall go into immediate effect.

Smart Investment Strategies for California's Rural Landowners

A Professional's Introduction to Conservation Easements

... With thanks to National Fish and Wildlife Foundation

Introduction

California agricultural landowners are challenged each day by the unpredictable tests of nature and markets. Fire, drought, floods, pests and market prices are but a few of the obstacles which have for generations threatened the lands, businesses and families of California farmers, timberland owners and ranchers.

In this generation, however, estate taxes are emerging as one of the most monumental threats to the lifestyles and estates of California landowners and their families. When properties are passed down to the next generation, heirs are often forced to turn to their land to pay high estate taxes. When this happens, productive farmlands and ranches are often converted to residential subdivisions. Estate taxes also threaten the public good, as the health and vitality of California's forests, woodlands, watersheds and wildlife habitats depend on natural open spaces found on these privately owned lands. Wildlife habitat is threatened, and watersheds critical to the quality and availability of drinking water are diminished. Disasters from fires and flooding are often another costly result.

One of the best tools available to landowners who desire to protect both their lands from development and their estates from onerous estate taxes is the conservation easement. Used in conjunction with various other estate planning options, conservation easements may have tremendous value to landowners and their families, and for the stewardship of landscapes throughout California.

Simply stated, a conservation easement is an agreement that allows landowners to limit the type and/or amount of development on their property while retaining private ownership of the land. It is a legal document restricting future uses of the land. People grant conservation easements for a variety of reasons, the key one being protection of their property from unwanted development. Conservation easements guarantee smooth transfer of land between generations by reducing (and sometimes eliminating) estate taxes. A donor of land may receive financial and tax advantages while making a long-term quality-of-life difference to the entire community.

This online publication is designed to provide basic information to estate-planning and other financial professionals who may find conservation easements relevant to their clients.

Why are estate taxes a problem for rural landowners?

Estate taxes are often the major problem facing individuals who desire to transfer their assets to their family members. Estate taxes are based on the net assets of the deceased's estate. Typically they are due nine months from the time of death. The taxes are due, in cash, upon the death of an individual and marginal tax rates in 2001 were as high as 60%.

Often, a landowner's most valuable asset is land. Estate tax obligations therefore may force the landowner's heirs into the unwanted sale of the property. When this happens, the heirs may lose their homes and the land that they may have needed to continue the family agricultural business.

While taxes due on an individual estate can be staggering, the problem is not insurmountable. Landowners can employ a number of strategies to preserve land for agricultural use, pass land on to their children, and maintain the family business for years to come.

Estate planning basics for rural landowners

Estate planning is essentially the process of planning for the smooth transfer of assets from one generation to the next. The main problems associated with estate planning involve either taxes or distribution planning. Estates over \$675,000 in 2001 are subject to taxes. All estates, regardless of size, are distributed. In both areas, careful planning is required to achieve optimal results. Please check current tax laws for changes.

The 2001 Economic Growth and Tax Relief Reconciliation Act, effective in 2002, increased the amount that individuals can pass tax-free and lowered the top marginal tax rate. While the new legislation calls for the repeal of the estate tax in 2010, the legislation has a "sunset" provision and therefore in 2011 the estate tax rates current under legislation prevailing in 2001 will be again effective! (see the accompanying table for tax exemption amounts and marginal rates.)

While the general subject of estate planning is far beyond the scope of this brochure, suffice it to say that there are a variety of tools which may be employed, such as: Distribution strategies; wills and living trusts; gifting to family; special use and other valuation discounts; business continuity planning; life insurance; charitable gifting; liquidity planning; and tax payment extensions.

When can conservation easements help?

If the goals of a landowner include passing on land to family members, reducing estate taxes, and/or preserving the character and uses of the land, an agricultural or conservation easement may be a useful tool. A conservation easement can reduce the taxable value of the land and/or restrict its use in perpetuity (to an extent agreed to by the landowner). Any property that contains significant conservation or historic resources can be protected by a conservation easement.

What is a conservation easement?

A conservation easement is a legal agreement by which a property owner voluntarily restricts the activities, such as residential or commercial development, that may take place on the land. This is done to protect the agricultural or forestry uses of the land. Every easement is a unique agreement between the landowner and a qualified conservation organization. The easement sets forth the limitations the owner has chosen to apply to particular parcels. Conservation easements are permanent and binding on all future owners.

A landowner may either donate or sell the conservation easement to the conservation organization. Donated conservation easements can qualify for an income tax deduction. Not every easement that restricts the future uses of property will qualify for a tax deduction as a charitable gift. The tax law requires that it be "for conservation purposes."

A conservation easement donation can be in various forms. For example, it may be a current donation or a bequest; it may be associated with a leaseback agreement or a retained life estate.

Sales of conservation easements may also be of various types. For example, they may be sold at market value or less than market value, or sold on a cash basis or an installment sale.

Conservation easements are tailored to the needs of the donor. Conservation easements typically restrict some or all of the land's development potential in order to protect the land's significant resources. Very often, the conservation easement can reserve the right for heirs to build their own residences on designated parcels.

A conservation easement can provide for public access for trail use or nature study purposes, which may enhance the value of the conservation easement, but this is not required. However, the conservation easement does not give the public any rights unless the donor decides to include such rights in the easement.

Only the specific use rights that the donor chooses to transfer are removed from the property value. One can still own, build upon, sell, lease, mortgage, farm, ranch, log or otherwise use your property consistent with the terms of the conservation easement. A conservation easement can be used to control the number, location, and design of parcels and buildings, thus assuring that a quality development plan is maintained in perpetuity. Used in this manner, an easement may be able to enhance the value of the property over time.

How to determine the value of a conservation easement

The value of a conservation easement is typically derived by comparing the appraised value of the land before and after the existence of the easement. The difference between the two appraisals is the value of the easement. The more restrictive the easement, generally, the greater its value.

For example, assume that the fair market value of a property, without a conservation easement, is \$5 million to a developer who would subdivide the land and sell home sites or completed homes. If the property were subject to a conservation easement that prohibited residential construction, the value might drop to \$2 million. The value of the conservation easement would then be \$3 million. That is the amount from which income tax deductions (if applicable) and estate tax deductions would be based.

Financial benefits of a conservation easement

Conservation easements can reduce **estate taxes**. The Federal estate tax is levied on the value of the property retained in the estate. Therefore, reducing the value of property with restrictions may lower, and in some cases, eliminate Federal estate taxes.

Conservation easements can reduce **income taxes**. Charitable gifts of land or conservation easements made during a donor's lifetime can generate income tax deductions, subject to the normal limitations.

Conservation easements can reduce **property taxes**. Property tax assessments are usually based on the land's market value, which reflects the property's development potential. Therefore, reducing the development potential can reduce the assessed value of property.

In California, the Natural Heritage Preservation Tax Credit Act of 2000 now offers a **state income tax credit** equal to 55% of the value of the easement for properties approved by the Wildlife Conservation Board. The program is designed to promote habitat conservation for native species of plants and animals, for agricultural lands, for water rights, and/or for parks and open space.

Case study

Scenario #1

Total Taxable Estate Value: \$7,000,000
Tom dies first in 2001
Virginia dies in 2002
\$1,000,000 sheltered at Virginia's death

Estate Taxes due: \$ 2,955,000

Resources to pay the tax

The land (\$5,000,000)
The cash (\$1,000,000)
The life insurance (\$1,000,000)
but, there is not enough cash !

Result:

Forced sale of land ?
Or, what ?

Scenario #2

Jantzen's draft Bypass Trust

Total Taxable Estate Value: \$7,000,000
Tom dies first in 2001
Virginia dies in 2002
\$675,000 sheltered at Tom's death
\$1,000,000 sheltered at Virginia's death

Estate Taxes due: \$ 2,617,500

Resources to pay the tax

The cash
The life insurance

Result:

Taxes Saved: \$ 337,500
But there is not enough cash !
Will there be a fire sale of the land ?

CASE STUDY

FACTS

Tom and Virginia Jantzen
Both age 65

Owners of Rolling Oaks Farms since 1970
Current Value: \$5,000,000
They want to protect it from development

Other Assets:

\$1,000,000 cash
\$1,000,000 life insurance policy

Total Estate Value: \$7,000,000

Estate Planning
Simple Wills

Scenario #3

Jantzen's draft Bypass Trust
Jantzen's use life insurance trust

Total Taxable Estate Value: \$6,000,000
Tom dies first in 2001
Virginia dies in 2002
\$675,000 sheltered at Tom's death
\$1,000,000 sheltered at Virginia's death

Estate Taxes due: \$ 2,117,500

Resources to pay the tax

The cash
The life insurance

Result:

Taxes Saved: \$ 837,500
But there *still* is not enough cash !
Will there be a fire sale of the land ?

Scenario #4

Jantzen's draft Bypass Trust
Jantzen's use life insurance trust
Jantzen's put conservation easement on land
They donate the easement & get tax deduction
Reduces value of land to \$2,500,000

Total Taxable Estate Value: \$3,500,000
Tom dies first in 2001
Virginia dies in 2002
\$675,000 sheltered at Tom's death
\$1,000,000 sheltered at Virginia's death

Estate Taxes due: \$ 852,250

Resources to pay the tax

The cash, or
The life insurance
and, there is MUCH more than enough

Result:

The land is saved
Cash Left: \$ 1,147,750
Taxes Saved: \$ 2,102,750
Possible income tax savings: \$1,125,000 !!

To see the estate planning horsepower of the conservation easement, consider the case study presented in **Boxes 1-4**. Here, the clients have a sizeable estate and desire to pass all their land in a preserved state to future generations.

?? Box 1 identifies the salient facts of the client's situation with a \$7 million estate.

?? Box 2 indicates that taxes due on this estate, without planning, would be about \$3.0 million.

?? Box 3 indicates that the taxes would decline about \$837,000 through the use of traditional techniques, such as a bypass trust and a life insurance trust.

?? Box 4 then indicates that taxes could decline an additional \$1.3 million with a use of a conservation easement! And that the family would additionally receive potentially as much as \$1.1 million in traditional tax deductions from this charitable gift!

?? In California, the Natural Heritage Preservation Tax Credit Act of 2000 could increase even more the tax benefits of the above example using the conservation easement. Consider this example:

Value of Easement	\$2,500,000
State Tax Credit	\$1,375,000
Federal Income Tax Savings	\$1,125,000
Federal Estate Tax Savings	\$1,250,000
Total Tax Savings	\$3,750,000
Net Cost of Donation	(\$1,250,000)

Yes – in this example the donor's "cost" of the conservation easement is negative; that is, the donor and the heirs receive more economic value in tax savings than the dollar value of the easement given away!

Advanced planning options with conservation easements

Conservation Easements may be sold to not-for-profit conservation organizations for less than fair market value. This is termed a **bargain sale** and results in a charitable gift for the bargain element and the seller's capital gain tax liability is reduced in proportion to the bargain element. The seller may also benefit from reduced selling costs because of the elimination of fees associated with a commercial sale. The term bargain sale also refers to transactions in which mortgaged property is transferred (donated) to charity; the owner is assumed to have received consideration in an amount equal to the debt in such instances.

In the correct circumstances, and with a proper financial design to the transaction, a bargain sale may be just as profitable as a sale at fair market value! See the example in **Box 5**.

Another excellent planning option is that of combining a **conservation easement with a gift of a remainder interest with a retained life estate**.

A gift of a remainder interest with a retained life estate is similar to a charitable remainder trust. The difference is that it utilizes land. The donor may use/occupy the property for a period of time, including the remainder of one's life. The owner has the property transferred to charity at the end of that period. The tax advantages are like those involving the use of a charitable remainder trust.

Scenario #5

New Goals:

- Bequeath land to one child
- Treat the other 3 children fairly

Jantzen's draft Bypass Trust
 Jantzen's use life insurance trust
 Jantzen's put conservation easement on land
They donate the easement & get tax deduction
Reduces value of land to \$2,500,000

Estate Taxes due: \$ 852,250

Resources to pay the tax
 The cash, or
 The life insurance

Result:

The land is saved
 Estate left: \$ 3,647,750
 Cash Left: \$ 1,147,750
 Possible income tax savings: \$1,125,000 !!

But - are there enough assets to treat all fairly?
 One child gets the land
 The others divide the remaining cash

Scenario #6

New Goals:

- Bequeath land to one child
- Treat the other 3 children fairly

Jantzen's draft Bypass Trust
 Jantzen's use life insurance trust
 Jantzen's put conservation easement on land
They donate the easement & get tax deduction
Reduces value of land to \$2,500,000

Use income tax savings for additional life insurance

Estate Taxes due: \$ 852,250

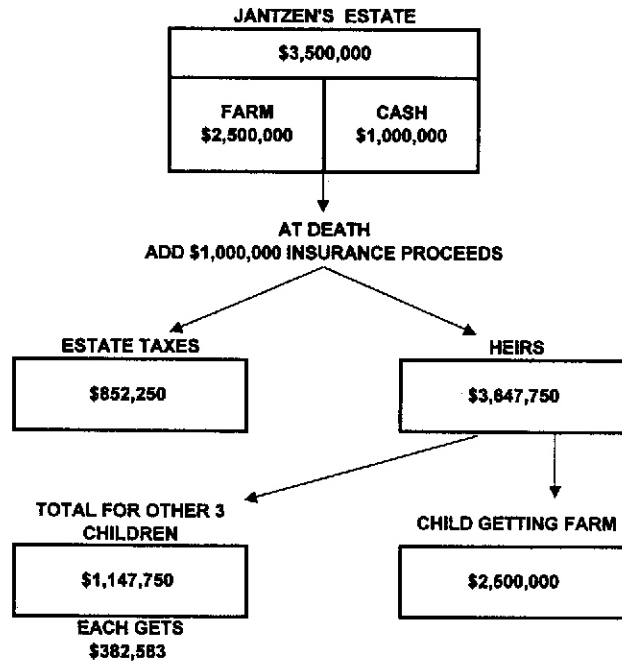
Resources to pay the tax
 Cash = \$1,000,000
 Old insurance = \$1,000,000
 New Insurance = \$6,000,000

Result:

The land is saved
 Estate left: \$ 9,647,750
 Cash Left: \$ 5,147,750
 Possible income tax savings: \$1,125,000 !!

Now - are there enough assets to treat all fairly?
 Yes - more than enough!

ESTATE EQUALIZATION ISSUE



To maximize the tax benefits in this scenario, the gift of a conservation easement should be made before making the remainder gift of property. In this way, the full value of the easement at the current time would be recognized as a tax-deductible charitable gift, rather than the present value of the easement at the donor's actuarial death (as is the method of calculating the present value of a future charitable gift in the case of charitable remainder trusts and gifts of remainder interests with retained life estates).

The last example of an attractive design using a conservation easement is the standard **wealth replacement trust** concept. For those clients that feel uncomfortable with the idea of reducing the dollar value of the estate transferred to their heirs, donors can simply use the current tax deduction associated with the conservation easement to fund a life insurance contract to replace an appropriate amount of wealth, or to even create more after tax wealth, than would be the case without the conservation easement.

Common Client Questions and Answers about Conservation Easements

If I donate or sell a conservation easement, do I still own and control my property?

Yes. Only the specific use rights that you choose to transfer are removed from your property value. You can still own, build upon, sell, lease, mortgage, farm, ranch, log or otherwise use your property consistent with the terms of the conservation easement.

Does a conservation easement also restrict my heirs?

Yes. The restrictions are in perpetuity and those restrictions that you voluntarily put in place will guide you and all future owners of the land, including your children.

Does a conservation easement require me to allow public access to my land?

No. The conservation easement does not give the public any rights to your land unless you decide to include such rights in the easement.

To whom is a conservation easement given?

A conservation easement can be given either to a qualified non-profit organization or to a public body such as a town, a county, or a state agency. The recipient of the easement, or **conservancy**, must accept it in writing and agree to enforce the terms of the conservation easement to assure that future owners of the property abide by it.

May I donate a conservation easement and still develop my land?

Yes. A conservation easement may be used to control the number, location, and design of parcels and buildings, thus assuring that a quality development plan is maintained in perpetuity. Used in this manner, an easement may be able to enhance the value of each lot created.

How long does an easement last and who upholds it in the future?

To be eligible for a Federal income tax deduction, the easement must be "perpetual," that is, it must last forever. The conservancy monitors the property, generally once a year, to assure that the easement is not being violated. If the easement has been breached, the conservancy will take whatever steps are necessary to uphold the terms of the easement, including legal action. Because of this obligation, the conservancy asks all easement donors to make a financial contribution to the conservancy's endowment fund. This fund ensures long-term monitoring and enforcement of every easement the conservancy receives.

Who owns the conservation easement?

To qualify for a tax deduction, the easement must be donated to a unit of government or a qualifying conservation or historic preservation organization. A conservancy qualifies as a Federally recognized public charity under Internal Revenue Code Section 501 (c)(3). Landowners retain full rights to control and manage their property within the limits of the easement. Landowners continue to bear all costs and

Estate and Gift Tax Rates
and Unified Credit Exemption Amount

Calendar year	Estate and GST Tax deathtime transfer exemption	Gift Tax transfer exemption	Highest estate and gift tax rates
2002	\$1 million	\$1 million	50%
2003	\$1 million	\$1 million	49%
2004	\$1.5 million	\$1 million	48%
2005	\$1.5 million	\$1 million	47%
2006	\$2 million	\$1 million	46%
2007	\$2 million	\$1 million	45%
2008	\$2 million	\$1 million	45%
2009	\$3.5 million	\$1 million	45%
2010	N/A (taxes repealed)	\$1 million	top individual income tax rate under the bill (gift tax only)
2011	\$1 million	\$1 million	55%

liabilities related to ownership and maintenance of the property. The conservancy monitors the property to ensure compliance with the easement's terms, but it has no other management responsibilities and exercises no direct control over other activities on the land.

Does the easement have to cover all of the landowner's property?

No, some easements only cover a portion of the landowner's property. Again, it depends on the landowner's wishes. For example, if someone owns 80 acres, of which 35 acres are wetlands, the landowner may decide to restrict development only on the 35 acres. The remaining 45 acres would not be covered or affected by the easement.

Note: Landowners are encouraged to work with their financial advisors, attorneys and accountants to make beneficial succession plans. Ultimately, this effort will be the greatest gift to their families and to their communities.

The California Oak Foundation works with landowners, ranchers, farmers, community members, conservation organizations, and others to conserve oak woodlands, prevent losses of plant and animal biodiversity, protect the state's critical watersheds and wildlife habitat, and to plan responsibly for land use at the state, regional and local levels. COF continues to build partnerships, enable community leaders, educate children and adults, and garner financial support in order to conserve oak woodlands in the face of the ever-increasing pressures of costly urbanization in rural areas.

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The National Fish and Wildlife Foundation is a nonprofit organization dedicated to the conservation of fish, wildlife, and plants, and the habitats on which they depend. Since its founding in 1984, the Foundation has conferred over 2,800 grants for conservation projects. The Foundation's work is local, regional, national, and international in scope.

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