



## INCOME, ESTATE, AND PROPERTY TAX IMPLICATIONS OF A CONSERVATION EASEMENT TRANSACTION

### Income Tax Implications of a Donated Conservation Easement

#### Assumptions – Tom Landowner

Adjusted Gross Income (AGI):	\$100,000
Value of the Property Unencumbered:	\$1,000,000
Value of the Encumbered Property:	\$500,000
Amount of the Charitable Donation:	\$500,000

Former Tax Law (30% of AGI with 5-year carryover period):

Tom could deduct \$30,000 in the year of the donation plus carry over any remainder for up to 5 years—assuming the same AGI each year, he could deduct a total of \$180,000; \$320,000 of the donation would be unused.

Enhanced Tax Incentives (2013) Non-Farmer/Non-Rancher (50% of AGI with 15-year carryover period):

If Tom is not a farmer, he could deduct \$50,000 in the year of the donation plus carry over any remaining amount for up to 15 years—assuming the same AGI each year, he could deduct entire \$500,000 donation amount by carryover year 9, well within the 15-year carryover period.

Enhanced Tax Incentives (2013) Farmer/Rancher (100% of AGI with 15-year carryover period):

If Tom is a farmer (i.e., more than 50% of his income in the year of the donation is derived from farming activities), he could deduct \$100,000 in the year of the donation plus utilize the 15-year carryover period—assuming the same AGI each year, he could deduct the entire \$500,000 donation amount by carryover year 4.

Combined Income, Estate, and Property Tax Benefits of a Conservation Easement Donation

Assumed Income Tax Rate (40% – combined fed/state rate): Assuming Tom can deduct the entire \$500,000, he will save \$200,000 in federal/state income taxes.

Assumed Estate Tax Rate (40% – max. 2013 rate): Although the conservation easement is not a deduction for estate tax purposes, Tom’s estate will be reduced by \$500,000 by virtue of the conservation easement conveyed during his lifetime. He will therefore save another \$200,000 in estate taxes. (Note that a conservation easement conveyed through one’s will does entitle the decedent to an estate tax deduction.)

Section 2031(c) “Bonus” Exclusion: An additional exclusion is allowed to the estate of a decedent whose property is protected by a conservation easement (so long as the conservation easement does not allow commercial recreation). This exclusionary bonus is limited to the lesser of 40% of the value of the easement-protected property or \$500,000. Here, the post-easement property is worth \$500,000, and therefore Tom will be able to exclude another \$200,000 from his gross estate, which, at the 40% estate tax rate, saves him another \$80,000 in estate taxes.

Total easement gift:	\$500,000
Total income/estate tax benefits:	\$480,000

Michigan P.A. 446 (no uncapping of property subject to conservation easement): As of 2006, Michigan law provides that property (but not buildings) subject to a conservation easement is not subject to “uncapping” upon the transfer of the property during one’s life or at death. In other words, the property’s value for property tax purposes will remain at the taxable value in effect at the time of the easement conveyance and will be subject only to increases of the lesser of 5% or the consumer price index rather than “popping up” to the state equalized value upon transfer. This could provide enormous additional tax savings depending on the difference between the taxable and state equalized values applicable to one’s property.

## Tax Implications of a Bargain Sale (Part Sale/Part Donation) of a Conservation Easement

### Slightly Different Assumptions:

Adjusted Gross Income:	\$100,000
Value of the Property Unencumbered:	\$1,000,000
Value of the Encumbered Property:	\$500,000
Fair Market Value of the CE:	\$500,000
Sale Price of the Conservation Easement:	\$375,000 (75% of FMV)
Amount of the Charitable Donation:	\$125,000

### Income Tax Implications

Assuming the property has a cost basis of \$75,000, Tom would typically recognize \$300,000 in capital gains, which, at the current capital gain rate of 15%, would cost Tom \$45,000 in capital gain tax on the sale. That year, Tom would also have to pay \$40,000 in ordinary income tax on his \$100,000 income. However, Tom has a \$125,000 charitable contribution deduction to offset some of that tax liability. In the first year (2013), Tom could deduct all \$125,000 (up to 50% of AGI), resulting in tax savings of \$40,000 of ordinary income tax and \$3,750 of capital gain tax, for a total income tax savings of \$43,750.

### Estate Tax Implications

The property is now worth \$500,000, but unlike in the outright donation example, Tom received \$375,000 in cash, some of which will presumably end up in his taxable estate. Still, at the 40% estate tax rate, the \$125,000 of reduced estate value saves \$50,000 in estate taxes. In addition, the estate now has some liquidity to allow Tom to pass the farm on to one or more heirs while providing cash to other heirs who may not be interested in participating in the farm operation. When combined with the \$80,000 Section 2031(c) bonus exclusion discussed above, the conservation easement transaction renders a \$130,000 estate tax benefit.

All told, the combined income and estate tax benefits of the conservation easement in this example are \$173,750.

Implications of Electing Alternate Valuation for Farmland (IRC § 2032A) – Section 2032A allows farmland to be valued as farmland (rather than at its “highest and best use”) for estate tax purposes.

#### Requirements to make the election

- The farm estate must be made up of real property used in farming that has a fair market value of at least 25% of the total value of the adjusted estate.
- The farm assets, both real and personal, must make up at least 50% of the estate.
- The farm real property must have been owned by the decedent (or a family member) for five of the previous eight years.
- For five of the preceding eight years, the qualifying real property must have been farmed or materially participated in by the decedent or a member of the family.
- The real property qualifying for special land-use valuation must pass to a qualifying heir (usually a family member).
- The executor (personal representative) must file an election for alternate valuation under 2032A with an agreement signed by each person having an interest in the property consenting to the liability for any estate tax recapture that may occur later.

#### Possibility of Recapture

- One of the heirs must continue to farm, or be materially engaged in the farming operation, for another 10 years to ensure that any estate tax reduction is not recaptured.
- If the qualifying farmland is taken out of production or sold to a non-family member during that 10-year period, there is a recapture of any estate tax reduction that previously was allowed. This includes the sale of a conservation easement during that 10-year period (although efforts are being made to exclude sales of conservation easements from triggering recapture).
- The Section 2032A special land-use valuation essentially creates a tax lien against the farm in favor of the United States. A negative aspect of this election is that it makes the qualifying heirs personally liable for the payment of the additional estate tax if a recapture event occurs.