LEGAL CREATION & TAX CONSEQUENCES OF CONSERVATION EASEMENTS

Rooted in Land: A Conservation Easements Workshop

Bonnet Springs Park Event Center – Lakeland, Florida

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Objectives – Lessons in Law

- Learn Legal Definition of an “Easement” and “Conservation Easements”
- State Tax Implications – Relief from Ad Valorem Taxation
- Federal Income Tax Implications
- Why Use a Conservation Easement: Opportunities…
  - Protect the Land
  - Investing Proceeds – Commercial Development
  - Pay off Debt
  - Consolidation – Generate Cash and Buy-out Family Members

Introduction to Easements, Generally – a Legal Perspective

Florida Jurisprudence Definitions:

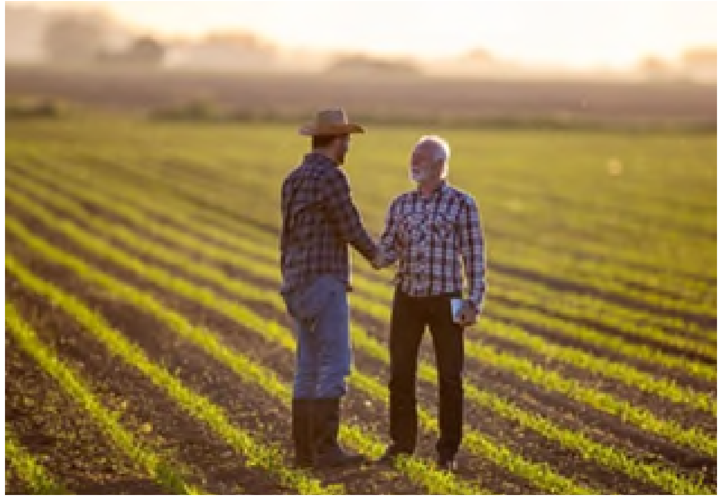
- In general, an easement is a perpetual right or privilege by which one party acquires or is granted the right to use the property of another for a special purpose
- Two categories:
  1. Adjacent Landowners (Rights to Cross Another's Lands)
  2. Third Parties (Utilities, Telecommunications, State/Conservation Groups)

Conservation Easements, Specifically…

Sec. 704.06, Florida Statutes

- A conservation easement is a perpetual right or interest in real property that is appropriate to retaining land or water areas predominantly in their natural, scenic, open, agricultural, or wooded condition
- Preserving areas for habitat, historical significance, agricultural uses
- Prohibiting general development, mining, and/or destruction of the land.

The Transaction…



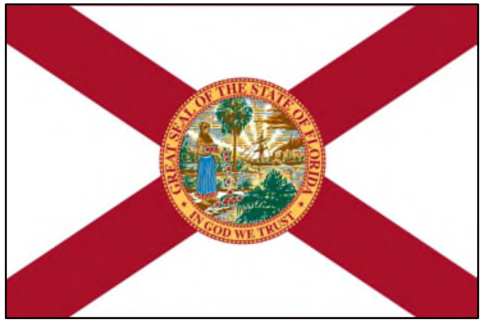
Landowner Gives…

- Written document, identifying:
  - Landowner
  - Recipient of Easement Rights
  - Property
  - Restrictions
  - Reserved Rights
- Documentary Stamp Tax
- Recording Fees

Landowner Receives…

- In some cases… Money
- State Tax Benefits
- Federal Income Tax Implications

Florida
State Property Tax Benefits



General Ag-Exemption…

- 193.461(1), FS – Application/Annual Return Required
- Only lands used primarily for bona fide ag purposes – good faith commercial ag use of the land
- Ag Business Plan Required
- Reduced ad valorem tax bill based on ag-use

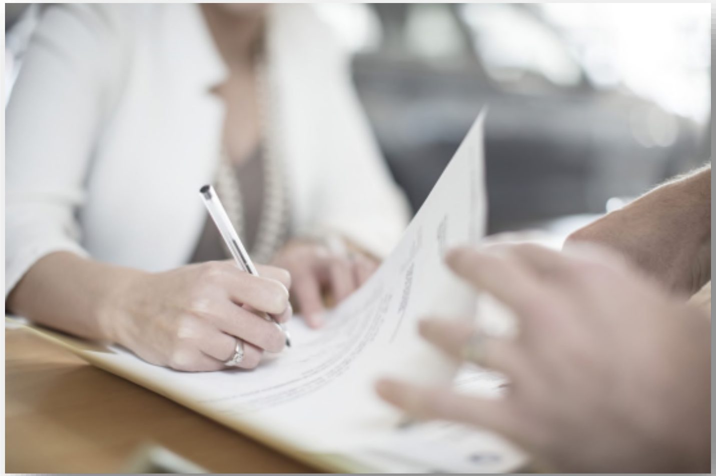
Perpetual Conservation Exemption…

- 196.26, FS – 40+ acre parcels committed to perpetual conservation are totally exempt
- Commercial uses producing income to the extent of 50% of the assessed value
- Buildings on land not exempt unless supporting (“auxiliary to the use of the land for conservation”) may be exempted
- Sub-40 acre parcels can secure exemption if special feature present

FEDERAL TAX IMPLICATIONS…

Creating a Conservation Easement by Sale

An easement can be created by the sale of the easement to another party.



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Charitable Creation of an Easement

- This is the granting of an easement for no consideration in return.
- A landowner permits another to enforce restrictions on the landowner’s property.
- If properly structured, a charitable easement can provide income and estate tax benefits.

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Tax Consequences of the Sale of a Conservation Easement

Income Tax

- The sale of an easement is a "realization event" that may result in the recognition of gain or loss.
- If the landowner's use is substantially reduced, then the sale of the easement is treated as a sale of the property.
- If the landowner's use is not substantially reduced, then the sale of the easement is considered recovery of basis.
- Even if gain is realized, tax deferral opportunities exists to avoid gain recognition.
  - I.R.C. Section 1031
  - I.R.C. Section 1033

Tax Consequences of the Sale of a Conservation Easement

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Example No. 1:

No Gain; Recovery of Basis

- Landowner has a 1,000 acre ranch recently purchased for a cost of $6,000 per acre.
- The State purchases a conservation easement from the landowner, allowing him to continue grazing cattle on the land for a price of $3,000 per acre.

The easement over 1,000 acres is <u>not</u> considered a sale. The landowner does <u>not</u> recognize a gain, but the basis of his property is reduced by $3,000 per acre from $6,000,000 to $3,000,000.

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Tax Consequences of the Sale of a Conservation Easement

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Example No. 2:

Capital Gain & Like-Kind Exchange

- Same facts as in Example No. 1, except the landowner purchased the ranch 45 years ago for $500 per acre.
- The landowner's gain will be $2,500 per acre. At the current capital gains rate of 20% and Net Investment Tax of 3.8%, he will owe $595 per acre income tax or a total of $595,000 (595 x 1,000 acres).

The landowner could defer taxes on the gain by engaging in a like-kind exchange under Section 1031, investing the proceeds in another property.

Tax Consequences of the Sale of a Conservation Easement

Estate & Gift Tax

- Estate and gift taxes are based upon the fair market value of the property.
- If an interest in the property, or an entity owning the property, is transferred during life, the fair market value for gift tax purposes will be discounted as a result of the restrictions resulting from the easement.
- If the landowner dies owning an interest in the property, or in an entity owning the property, the fair market value of the property will be discounted for estate tax purposes as a result of the restrictions resulting from the easement.

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Tax Consequences of a Charitable Easement

Income Tax

I.R.C. Section 170(f)(3) provides generally that no charitable contribution deduction is allowed for a transfer to a charitable organization of less than the taxpayer's entire interest in property unless the transfer is of a "Qualified Conservation Contribution."

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Tax Consequences of a Charitable Easement (cont.)

Qualified Conservation Contribution

- A contribution of a “qualified real property interest”
- To a “qualified organization”
- Exclusively for “conservation purposes”

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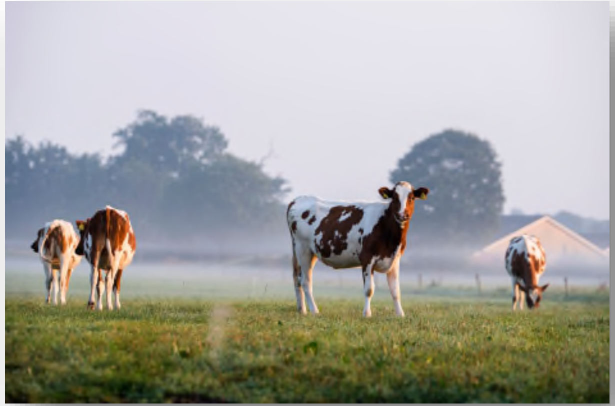
Tax Consequences of a Charitable Easement (cont.)

- A qualified real property interest is defined as:
  - The entire interest of the property other than certain mineral interests;
  - A remainder interest in the property; or
  - A perpetual restriction on the use of the property.



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Tax Consequences of a Charitable Easement (cont.)

- The contribution must be for a conservation purpose.
  - The preservation of land for outdoor recreation by, or the education of, the general public;
  - The protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem;
  - The preservation of open space including farmland and forest land or the preservation for the scenic enjoyment of the general public or pursuant to a federal, state, or local governmental conservation policy; or
  - The preservation of a historically important land area or certified historic structure.
  - A contribution will not be treated as exclusively for conservation purposes unless the conservation purpose is protected in perpetuity.

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Income Tax Benefits of a Charitable Contribution

Contribution of a Capital Asset

- Deduction is equal to the FMV of the contribution, not its adjusted basis.

Deductions for contributions of capital assets are limited to:

- 30% of an individual taxpayer’s income (5-year carryforward)
- 10% of a corporation’s income

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Income Tax Benefits of a Charitable Contribution (cont.)

Qualified Conservation Contributions have enhanced deductions

- Deduction is 50% of an individual taxpayer’s income
- 15 year carryforward period
- Special rules for “qualified farmers or ranchers”
  - Deduction is 100% (individuals and corporations)
  - Must retain the right to use the property for agriculture or livestock production

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Income Tax Consequences of Gift of an Easement

Comprehensive Example

- Farmer donates to the SFWMD an easement for the perpetual right to store water on a 100-acre section of a 4,000-acre ranch abutting the Kissimmee River. The appraised value of the easement is $400,000.
- Basis of all 4,000 acres is $4 million or $1,000/acre
- FMV of all 4,000 acres is $16 million or $4,000/acre

Income Tax Consequences of Gift of an Easement (cont.)

The easement is considered a gift of a Qualified Conservation Contribution.

- Charitable deduction of $400,000.
- Limited to 100% of income with a 15-year carryforward.

Farmer's basis of the property is reduced by $100,000 to $3,900,000.

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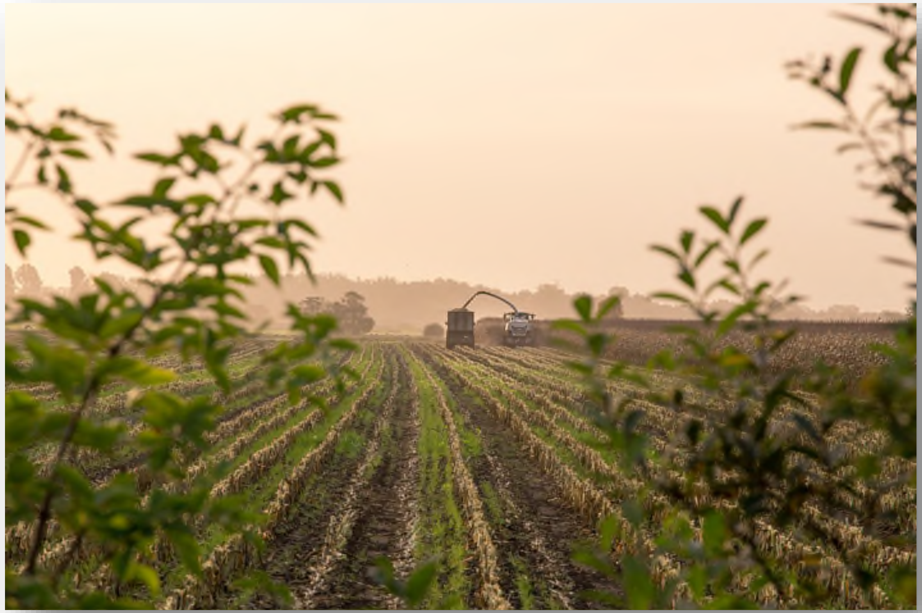
Ad Valorem Tax Consequences of Gift of an Easement

The 100-acre easement is exempt from ad valorem tax.



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Estate Tax

Qualified Conservation Easement

- Piggybacks off of §170 definition of "qualified conservation contribution"
  - A gift of a "Qualified real property interest" to a "Qualified organization" exclusively for "conservation purposes."
  - Does not apply to historically important land structures and certified historic structures
  - Must prohibit more than de minimus commercial recreational activity
  - Must be owned by decedent or family for 3 years prior to death

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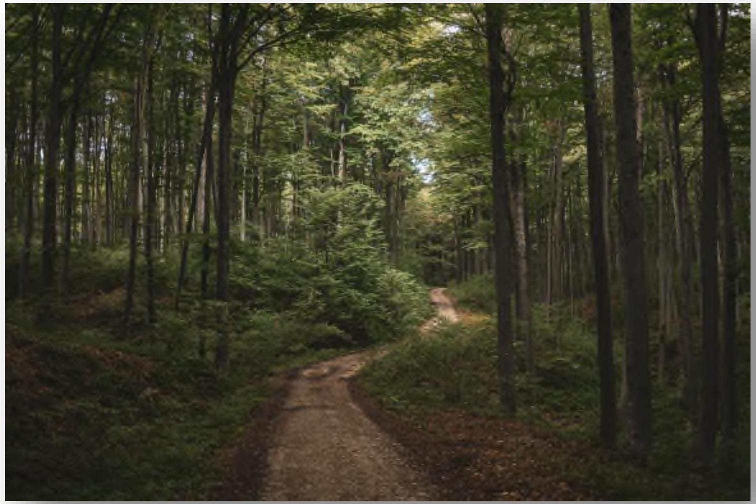
Estate Tax

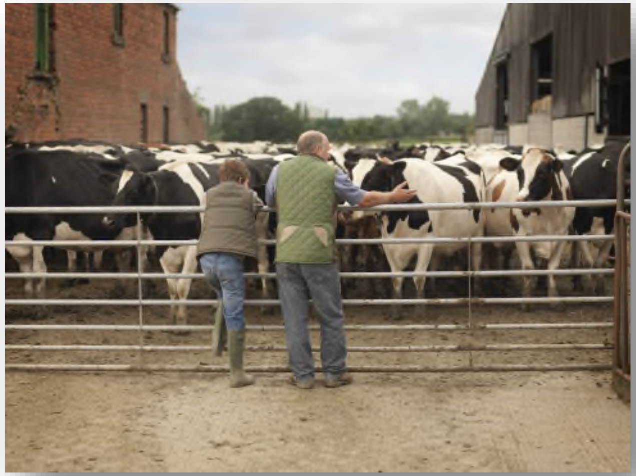
- Value of gifted/inherited property reduced by impact of any Qualified conservation easement.
- Donation does not incur gift or estate date due to deduction.



Estate Tax

Exclusion for Qualified Conservation Easements

- Up to 40% of the FMV of the remaining land value on the date of the decedent's death
- $500,000 limit



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Estate Tax

Exclusion for Qualified Conservation Easements

- Election must by made on return
- Easement can be granted after death
- Reduction in benefits of easement if:
  - Property is “debt-financed property”
  - Development rights are retained
- Special use valuation § 2032A available

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Bargain Sale of a Conservation Easement

- A bargain sale is a sale of a conservation easement for less than its fair market value (FMV).
- A bargain sale is treated as a sale to the extent of the sales price, and as a charitable contribution to the extent the fair market value of the easement exceeds the sales price.
- The landowner's basis will need to be allocated between the sale portion and the charitable contribution portion.

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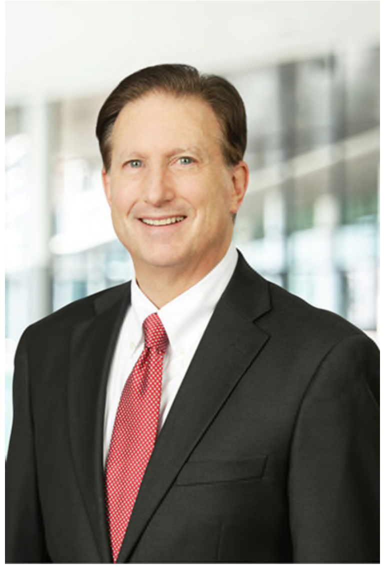
Bargain Sale of a Conservation Easement (cont.)

Example

Landowner sells a conservation easement, having a value of $600,000, to the State for $400,000. To the extent the $400,000 received by the landowner exceeds the basis allocated to the sale, the landowner will have taxable gain.

The landowner will also have a charitable contribution of $200,000 subject to the charitable contribution limitations discussed above.

Let’s Connect!



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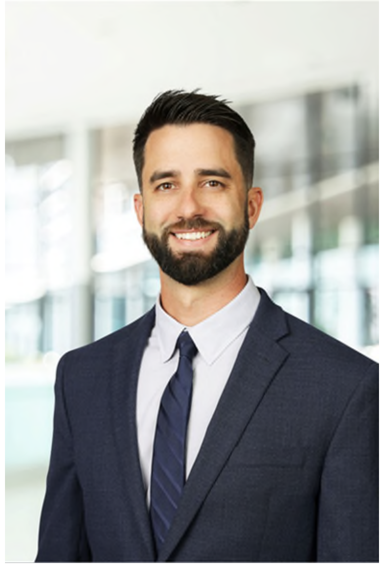

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