the Estate Planner

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The conservation easement

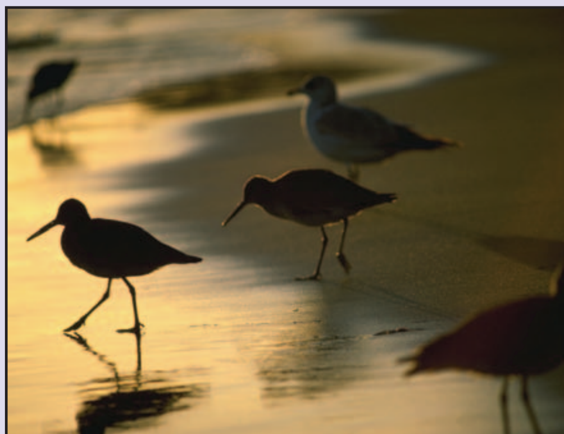
Save the environment while saving taxes

Contrary to what some may believe, estate planning doesn't solely revolve around money. It's also about providing for your loved ones, preserving your business for family and employees, and having a positive impact on your community and future generations. Tax and wealth management strategies are simply tools to help you achieve those goals in the most cost-effective manner.

If one of your objectives is to preserve your land's natural beauty for your family and others, a conservation easement may be worth a look. Not only does a conservation easement restrict most commercial development of your property, but a qualified conservation easement also may yield a healthy crop of tax benefits.

Observing the legislative landscape

During the last several years, Congress has lifted some restrictions on conservation easements and enhanced their tax benefits. Before 2001, for example, estate tax benefits for conservation easements were limited to land located in or within 25 miles of a metropolitan area, national park or wilderness area, or in or within 10 miles of an urban national forest. The 2001 tax act eliminated these distance requirements, extending eligibility to any land located within the United States or a U.S. possession.



Lay the groundwork

A conservation easement is an agreement to *permanently* restrict some or all of the development rights associated with your land. You grant the easement to a conservation organization — a government agency or qualified charity — and record it so it's binding on future owners. The organization monitors the use of the land and enforces the easement.

You and your family continue to own the land and may use it in any way you see fit, so long as it's consistent with the easement's terms. In addition, you may sell the property, give it away or leave it to your family — subject to the easement.

To preserve the easement's tax benefits, select a conservation organization that's either 1) a government entity, or 2) a public charity, such as a land trust, that's committed to protecting the easement's conservation purposes and has the resources to enforce the easement. You also need to obtain a qualified appraisal to establish the value of the land and the easement.

The easement must be granted *exclusively* for one of the following conservation purposes:

- To maintain land for outdoor public recreation or education,
- To protect a relatively natural habitat of fish, wildlife or plants, or
- To preserve open spaces for the public's scenic enjoyment or pursuant to a governmental conservation policy in a way that yields a significant public benefit.

The easement must be carefully drafted to avoid misunderstandings over which uses of the land you're giving up and which you're retaining. Depending on your objectives and the easement's

conservation purpose, you might retain hunting and fishing rights, farming and ranching rights, or timber rights. You may or may not have to grant public access to your land — it depends on the conservation purpose.

Harvest income and estate tax benefits

If you grant a conservation easement during your life, you can take a charitable deduction for the value of the easement for the year you grant it. The easement's value is the difference between the land's value before and after you grant the easement.

But remember that the charitable deduction is limited to 30% of your adjusted gross income (AGI). The excess can be carried forward and deducted during the following five years, but if the easement's value is large relative to your AGI, much of the charitable deduction may go unused. One solution is to grant a conservation easement on a portion of your land, take the charitable deduction during the next six years and then grant an easement on another portion of the land.

A conservation easement also can provide you with estate tax benefits in two ways. First, the easement depresses the land's value, reducing the size of your taxable estate. Second, the tax code allows you to exclude some of the land's value (but not the value of improvements) from your estate by making an irrevocable election with the IRS.

The exclusion is 40% (up to $500,000) of the land's value, but reduced by any deduction allowed for a qualified conservation contribution under Sec. 2055(f) and Sec. 170(h). The 40% figure also is reduced if the easement's value is less than 30% of the land's value without the easement and excluding the value of any retained development right. For example, if the land is valued at $1 million and the easement represents 30% of the land's value, the exclusion would be $400,000, or 40% of $1 million. These estate tax benefits are available even for an easement granted after your death. (But your estate can't claim a charitable deduction.) The easement must be made prior to the election to exclude the value from your estate.

To qualify for the estate tax exclusion, you or a family member must have owned the land for at least three years prior to the decedent's death. Easements for historic land or certified historic structures are ineligible.

Survey the lay of the land

If you're environmentally inclined and own land, a conservation easement can help you achieve two goals: Preserve your land's natural beauty for future generations and save income and estate taxes. But the rules and regulations for conservation easements are complex. Consult with your tax and legal advisors to determine whether your land qualifies and to design an easement that achieves your goals. ∎

There's no place like home

A qualified personal residence trust can be a powerful tax shelter

What if you could transfer your home to your children or other family members at a deeply discounted gift tax value, remove the home's value and any future appreciation from your taxable estate, and continue to live there indefinitely? This may sound too good to be true, but a qualified personal residence trust (QPRT) allows you to accomplish just that.

Typically, when you transfer property to a trust for the benefit of family members but retain an interest in the trust, gift tax is assessed on the property's full market value. But the tax code provides an exception for QPRTs. The value of a home you transfer to a QPRT is its fair market value minus the present value of your retained interest (computed using the federal Sec. 7520 rate).

QPRT basics

A QPRT is an irrevocable trust to which you transfer your primary residence or a vacation home, reserving the right to occupy the home for a specified term. If you transfer a vacation home, it must be a personal residence, meaning you use it more than 14 days a year or more than 10% of the total number of days it's rented out, whichever is greater.

At the term's end, the home is transferred to your children or other beneficiaries, either outright or in trust. But that doesn't mean you have to move out. You can continue living in the home after the term ends, but to preserve the QPRT's tax benefits you must pay the trust beneficiaries fair market rent.

The trust's term can be as long or as short as you'd like. A longer term reduces the gift's size, enhancing your tax benefits. But to tap a QPRT's tax-saving power, you must survive the term. If you die during the term, the home's fair market value will be included in your estate as if the QPRT had never existed. So, in selecting a term, strike a balance between maximizing tax benefits and minimizing mortality risk.

Because a QPRT is a grantor trust, you remain responsible for mortgage payments, real estate taxes, insurance and other expenses during the trust term. You're also entitled to deduct mortgage

Why QPRTs still make sense in today's low interest rate environment

Qualified personal residence trusts (QPRTs) are most effective when interest rates are high. But even with today's low interest rates, this strategy can reduce a home's value for gift tax purposes by 50% or more. Consider this example:

Grace, age 55, owns a vacation home worth $2 million. She transfers the home to a QPRT, retaining the right to use it for 15 years. At the term's end, the home passes to Grace's daughter, Lucy. If the Sec. 7520 rate is 5%, the value of Grace's retained interest is about $1,234,000 and the value of the gift is $766,000. Assuming that Grace hasn't used up her $1 million lifetime gift tax exemption, she can transfer the home to the QPRT tax-free.

By transferring the home now rather than later, Grace also removes it from her estate and shelters any future appreciation in value from estate taxes. Suppose, for example, that the home is worth $4 million at the end of the trust term and that Grace dies shortly thereafter. By using a QPRT, Grace will have avoided close to $2 million in estate taxes (assuming a 45% marginal estate tax rate) and will have used only $766,000 of her estate tax exemption.

interest and real estate taxes on your individual income tax return.

Technical requirements

QPRT regulations contain a number of technical requirements. For example, the trust instrument must:

- Prohibit the trust from holding any assets other than the personal residence and certain cash and insurance policies, such as homeowner's insurance and cash for maintaining the home,
- Provide for mandatory distributions of any trust income — for example, a vacation home's rental income — to the grantor at least annually during the trust term, and
- Exclude the trust from making distributions to anyone other than the grantor during the trust term.

Because a QPRT is a grantor trust, you remain responsible for mortgage payments, real estate taxes, insurance and other expenses during the trust term.

The regulations also state that QPRT status is lost if the home ceases to be used as a personal residence or is sold (unless the trustee uses the proceeds to purchase a new personal residence within two years).

Planning considerations

A QPRT is an effective technique for transferring wealth at reduced gift and estate tax values. But there are issues to consider before adopting this strategy, such as:

Mortality risk. As noted above, you'll lose a QPRT's benefits if you don't survive the trust term, so it's important to select the term carefully. If you're concerned about surviving the term and your spouse has a longer life expectancy, consider transferring the home's title to your spouse. Then he or she can set up a QPRT.

Capital gains. Your children or other beneficiaries will inherit your tax basis in the home. If the home's value has appreciated significantly, your children may be hit with a high capital gains tax bill should they decide to sell the home. Weigh this potential cost against the gift and estate tax savings, especially in light of the fact that your children would otherwise be entitled to a step-up in basis to the value of the home when you die.

Potential GST tax trap. The generation-skipping transfer (GST) tax is a separate tax on transfers to grandchildren or other persons more than one generation below you. The GST tax is imposed at the highest marginal estate tax rate *in addition* to gift or estate taxes. To avoid GST tax on QPRTs benefiting grandchildren, you need to allocate a portion or all of your $1.5 million GST tax exemption to cover transfers in trust that will (or may) benefit them. This can be risky, however. Under the tax code, your GST exemption allocation isn't effective until the QPRT term's end. But by that time the home's value may have appreciated significantly, and your exemption may not be sufficient to shelter it from GST tax. To avoid this risk, consider limiting QPRT beneficiaries to children or other nonskip persons and using other assets to benefit grandchildren.

Mortgaged property. Ideally, you'll pay off the mortgage before you transfer a home to a QPRT. Transferring the property subject to the mortgage to the QPRT reduces the size of the initial gift.

Then, each time you make a mortgage payment, it's considered an additional gift that must be valued for gift tax purposes. A less cumbersome approach is for you to remain personally liable on the mortgage, as opposed to transferring the liability to the QPRT. That way, the home's gift tax value can be determined without regard to the mortgage.

Nothing to lose

Although a QPRT's benefits will be erased if you don't survive the term, you generally will be no worse off than if you hadn't created the QPRT in the first place. So while there's nothing to lose by attempting this strategy, there's a lot to gain if it's successful. ▪

IRS ruling clarifies intentionally defective grantor trust usage

For many years, people have reaped the benefits of intentionally defective grantor trusts (IDGTs). But questions lingered about many tax issues related to this technique. Although most estate planning experts felt confident about the popular technique, IRS Revenue Ruling 2004-64 clears up some of these issues. The ruling also provides valuable guidance on drafting trust documents to ensure they accomplish your objectives.

The definition

You create an IDGT by setting up a grantor trust to which you transfer assets for your children or other beneficiaries. The transfer creates a taxable gift, but the assets and any future appreciation in their value are removed from your estate.

You make the trust "intentionally defective" by reserving certain powers over or interests in the trust that cause you, the grantor, to be treated as the owner of the trust assets for income tax purposes without causing them to be includable in your taxable estate. You pay the income tax on any trust income even though you don't have rights to the income.

Because the trust itself doesn't pay taxes, in effect the assets grow tax-free, maximizing the wealth that passes to your beneficiaries. Plus, your income tax payments further reduce your taxable estate without tapping your lifetime gift tax exemption or annual gift tax exclusion.

A potential downside to a grantor trust is that your tax obligation may become a financial burden if the trust's earnings grow larger than expected. To avoid this problem, many IDGTs permit the trustee to reimburse you for all or part of the income taxes attributable to the trust's income.

The uncertainty

Despite the IDGT's popularity, lingering uncertainty about its tax consequences cast a shadow of doubt over the technique. Unanswered questions included:

- Is the grantor's income tax payment a taxable gift to beneficiaries?
- If the trust reimburses the grantor for income taxes paid, does that constitute a taxable gift from the beneficiaries back to the grantor?
- Is the right to reimbursement a retained interest that causes the assets to be brought back into the grantor's estate under Internal Revenue Code Sec. 2036? (This section provides that a grantor who retains rights to the income from transferred assets is taxed as the asset's owner for estate tax purposes.)

The IRS answered these questions in Revenue Ruling 2004-64.

The clarification

The IRS ruling details three hypothetical situations to illustrate the tax treatment of the grantor's payment of income taxes and various tax reimbursement provisions. For each situation, the ruling assumes the grantor has created a grantor trust with an independent trustee:

No reimbursement. The grantor pays income taxes on the trust's income from his or her own funds, and neither state law nor the trust instrument requires or permits the trust to reimburse the grantor. The grantor is legally obligated to pay the taxes, so the payments aren't considered taxable gifts. And, because the grantor can't use the trust assets to satisfy the tax liability, none of the assets are included in his or her estate under Sec. 2036.

Mandatory reimbursement. The trust (or applicable state law) *requires* the trustee to distribute income or principal to cover the grantor's tax liability. Though the distributions aren't considered taxable gifts from the beneficiaries to the grantor, the right to reimbursement causes trust assets to be included in the grantor's estate under Sec. 2036.

Discretionary reimbursement. The trust (or applicable state law) gives the trustee the discretion to reimburse the grantor. The trustee's exercise of that *discretion* will not, by itself, cause the trust assets to be included in the grantor's estate under Sec. 2036. But the IRS cautions that estate tax may be triggered by additional facts, such as an express or implied understanding between the grantor and trustee regarding the trustee's exercise of discretion, the grantor's retained power to remove the trustee and name him- or herself as successor trustee, or a state or local law that subjects the trust assets to the claims of the grantor's creditors. To be safe, it may be best not to give the trustee discretionary reimbursement powers.

The result

Revenue Ruling 2004-64 is good news, as it lays to rest the concerns over the legitimacy of the grantor's payment of income taxes on IDGT income. If your estate plan includes an IDGT, review your trust documents and applicable law to make sure the trust doesn't create any unintended estate tax consequences.

Estate planning red flag

Owning real estate in multiple states

Avoiding probate is an important estate planning goal, especially if you own real estate in more than one state. Unless you've transferred your property to a living trust (also referred to as a revocable, inter vivos or declaration of trust), your estate may be subject to probate in each state where you own real estate.

Probate is a court-supervised administration of your estate. The court inventories your assets, resolves creditor issues and oversees the distribution of your estate in accordance with your will. Probate has many disadvantages, including the loss of privacy (proceedings are a matter of public record), added costs and delays.

The main probate proceeding takes place in your home state, but ancillary probate proceedings must be opened in each other state where you own real estate. This adds more cost and time to the process. Your personal representative or executor will need to hire a probate lawyer in each state, file certified copies of the main probate proceedings in the other states' courts and comply with other administrative requirements.

Probate is required only for property you own in your name. Avoid multiple probate proceedings by making sure all of your real estate is owned by your living trust.

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