JohnHancock
LIFE INSURANCE

Restoring Economic Value in Land Conservation

LIFE INSURANCE TO THE RESCUE

Individuals who have wealth in landholdings are often approached by land developers who make enticing offers to buy their land. In many instances the land has been passed down through generations and these landowners may be concerned about preserving the property for future generations and protecting it from being irresponsibly developed. At the same time the landowners may be concerned about maximizing their wealth or equalizing inheritance among their children. These competing goals can paralyze the planning process resulting in adverse tax and non-tax consequences.

Life insurance can be an economical tool in the wealth transfer plan of a preservation-oriented landowner. It can help a landowner to feel comfortable preserving and restricting the use of the land because the policy replaces the economic value lost when a conservation easement is placed on the property. In this way, life insurance can help to maintain the economic value of the land and can potentially provide heirs with the liquidity needed to equalize inheritance or pay estate taxes.

PLANNING OPPORTUNITY

Land preservation is necessary in order to safeguard our country's fragile ecosystems and critical community watersheds, to protect stunning views and wildlife habitats, and to promote sustainable agriculture and forestry. The development of land across the country has reached critical mass and there now exist tax incentives at the federal, state and local levels to encourage more preservation of land. In fact, attractive federal tax benefits are currently available. Therefore, tremendous opportunities exist for financial service professionals and landowners alike to work together with land conservation experts to achieve the benefits of conserving land.

OPTIONS AVAILABLE TO A LANDOWNER

SELLING TO A LAND DEVELOPER

Although there are a number of options available to protect property from unappealing development, often a landowner is approached by land developers who make unsupported or unrealistic bids to develop the land. In many instances the purchase price the developer offers is significantly above the appraised value of the land. Although in many cases a down payment is part of the developer's contract, the total purchase price typically includes contingencies on the balance due based on the potential number of units to be sold at a given price point, subjecting the land sale to risk and delaying the landowners' receipt of the sale proceeds. In addition, income and capital gain taxes may apply when the property is sold. Furthermore, if the property to be developed is adjacent to other property owned by the landowner, the value of the other property may be diminished by the development of the adjacent land.

SELLING TO A LAND TRUST

Alternatively, the landowner can sell the land for its appraised value to a local, regional or state conservation group, many of which are land trusts. Many land trusts qualify as federally recognized public charities under IRC §501(c)(3). Although a charitable land trust may stipulate that the landowner can continue to use the land for a specified term of years following the land sale, the term will eventually end and the land will ultimately not be available to heirs. Nonetheless, the land trust preserves the land based on stated conservation objectives.

DONATING A CONSERVATION EASEMENT TO A LAND TRUST

The landowner may place a conservation easement on the property to keep it from being developed. A conservation easement is an agreement in which **the landowner continues to own and generate income from the land but agrees to limit or restrict how the land can be used.**[1] The easement must last forever, as outlined in IRC §170(h)(5)(A) in order for tax benefits discussed below to apply. Essentially, the landowner is making a charitable donation of the right to enforce the restriction to a conservation organization, like a land trust. The easement can be designed to meet the specific objectives of the landowner and can cover all or a portion of the property. The land trust is typically the holder of the easement and a "steward of the land" responsible for monitoring the property to ensure compliance with the terms of the easement.

QUALIFIED LAND APPRAISAL

The appraisal of the land must be completed by a qualified appraiser trained to value conservation easements in the detail required to meet IRS standards outlined in Treasury Regulations 1.178A-13(c). An IRS form 8283, signed by the appraiser and the donee organization, is filed with the donor's income tax return for the year of the gift.

TAX BENEFITS

Although the placement of an easement on the property diminishes the economic value of the land due to limitations placed on its potential uses, there are tax benefits to the landowner when an easement is donated to a 501(c)(3)[2] conservation organization like a land trust. These tax benefits are available only if the land meets specific conservation qualities outlined in IRC §170(h). Briefly, the land that is restricted must qualify as useful for one or more of the following purposes in order for the tax benefits to apply:

- To provide public recreation or education.
- To preserve a significant natural habitat.
- To provide open space for scenic enjoyment.
- To provide open space for local government policy.
- To preserve historic value.
- To promote sustainable agriculture or forestry.

Aside from reducing the value of the landowner's taxable estate by the value of the easement, a conservation easement may provide a charitable income tax deduction from federal and/or state income taxes, in addition to a potential income tax credit and tax credit exchange pools that may be available in some states. Moreover, certain states require that local property taxes be reduced to reflect the value of the restriction, as well. Therefore, depending on the state, it may be possible for a preservation-oriented landowner to reap significant tax savings from the placement of a conservation restriction on his or her property.

Charitable Income Tax Deduction. A federal income tax deduction may be available only if the easement is designed to last forever.[3] The value of the income tax deduction is based on the value of the easement which is calculated to be the difference between the appraised value[4] of the land with and without the restriction. The amount of the deduction that can be taken by the landowner in any given year is limited based on adjusted gross income (AGI). Under current law, the amount of the deduction is limited to 30% of AGI[5] with a 5-year carryforward.[6] Moreover, a charitable contribution of qualifying conservation easement is not a preference item in the calculation of the Alternative Minimum Tax (AMT).

State Charitable Income Tax Deduction. Many states allow a landowner to take a charitable income tax deduction from state income taxes as well.

State Income Tax Credit. A number of states have created tax incentive programs that entice landowners to conserve property. California, Connecticut, Colorado, Delaware, Maryland, Mississippi, New Mexico, North Carolina, South Carolina and Virginia currently offer tax credits. Most of these states cap the amount of the credit that can be used in any given year as well as the number of years in which the credit can be carried over. For example, New Mexico allows a carryover of the unused credit for 20 years while North Carolina allows for a five-year carryover period.[7] On the other hand, although South Carolina limits how much of a credit can be taken annually on a landowner's tax return, the state has no cap on the number of years a credit can be carried over. A few states require that the carryover in subsequent years be consecutive.

Estate Tax Exclusion. Since the restricted property continues to be owned by the landowner, it will be included in the taxable estate at death. However, IRC §2031(c) allows the landowner to exclude 40% of the value of the land from the taxable estate.[8] The maximum amount of this exclusion is $500,000. However, the value of the land must be reduced by 30% due to the restriction for this tax benefit to apply. Furthermore, a postmortem easement may qualify for the estate tax exclusion if the decedent owned the land at least three years before death and either the decedent or a family member granted the easement. However, no federal income tax charitable deduction, as discussed above, is available with a postmortem restriction.[9]

It is important to note that whether or not a conservation easement is placed on the land, under IRC §2032A the value of land on which an income-producing farm or ranch is operating and run by a decedent's family may be further discounted for estate tax purposes to its agricultural value (or current-use value), rather than its highest and best-use value. The maximum reduction in value under IRC §2032A special valuation discount is currently $1,000,000. The farm or ranch must continue to operate for at least ten years. Failure to continue the farming or ranching use of the property can result in a recapture of the estate taxes saved.[10]

EFFECTS OF A CONSERVATION EASEMENT

Clearly, the tax code encourages land conservation. Consequently, placing an easement on land can be an extremely tax-efficient planning strategy when all the tax benefits connected with the easement are taken into account. Therefore, a proper analysis must take into account the net tax effects of the easement on the landowner's entire estate.

WHAT ARE CHARITABLE LAND TRUSTS?

To help landowners protect property from unnecessary development, non-profit charitable land trusts were first formed in the late 19th century. Today more than 1500 land trusts operate across the country in almost every state. The Northeast region of the country has the most land trusts, numbering over 560.

Land trusts are closely tied to the communities they protect and are involved in conserving land for its historic, scenic, and recreational values as well as preserving the land's natural features and resources. These land trusts are organized at the local, regional and state level, and receive their funding primarily from charitable contributions and sometimes from federal and state initiatives. These organizations preserve land by purchasing it, accepting donations of the land or funds to purchase the land, or accepting a donation of a conservation easement. In some instances, they actually purchase the easements. Often, land trusts work collaboratively with the local conservation organizations to preserve properties that have significant conservation qualities.

HOW DOES LIFE INSURANCE HELP?

Insurance advisors can offer expertise in insurance planning to help members of a local land trust organization understand how life insurance may help to replace the reduced value of the land when an easement is placed on it. Insurance advisors can also illustrate to both the landowner and the conservation organization how the life insurance policy premiums may potentially be funded using the combined tax savings generated from the easement, where applicable. To determine the amount of conservation activity in your marketplace, the following table illustrates the approximate number of local and regional land trusts by state:

NUMBER OF LAND TRUSTS PER STATE									
Alabama	7	Georgia	24	Maryland	58	New Jersey	43	South Dakota	2
Alaska	7	Hawaii	14	Massachusetts	161	New Mexico	10	Tennessee	21
Arizona	21	Idaho	12	Michigan	44	New York	90	Texas	32
Arkansas	2	Illinois	35	Minnesota	5	North Carolina	32	Utah	6
California	198	Indiana	27	Mississippi	6	Ohio	44	Vermont	35
Colorado	38	Iowa	8	Missouri	19	Oklahoma	3	Virginia	32
Connecticut	128	Kansas	7	Montana	15	Oregon	20	Washington	36
Delaware	5	Kentucky	10	Nebraska	5	Pennsylvania	95	West Virginia	8
DC	4	Louisiana	4	Nevada	5	Rhode Island	47	Wisconsin	54
Florida	36	Maine	85	New Hampshire	35	South Carolina	24	Wyoming	5

* North Dakota does not have any Land Trusts established. Data taken from the 2005 National Land Trust Alliance Census Report. See www.LTA.org to find a listing of land trust organizations by locality.

BENEFITS

- The landowner continues to own the land and may sell or transfer the land at any time.
- The life insurance policy replaces the economic value lost to a conservation restriction.
- The life insurance policy allows a landowner and conservation group to compete with land developers.
- The life insurance policy provides a landowner with the flexibility needed to make future planning decisions.
- The life insurance policy provides the children with the flexibility needed to make estate planning decisions at the death of the landowner parents.
- The children may be able to leverage the potential tax savings with life insurance.

CONSIDERATIONS

- Although it is a tax-deductible expense, the cost of a land appraisal may be high, typically in the range of $1,000 to $5,000, but sometimes higher.
- The landowner must have sufficient annual income to benefit from tax savings and the value of the deduction and credits that may be available may not be fully utilized over the carryover period.

CASE STUDY

The following is a case sample that illustrates how life insurance can be used to replace the economic value donated to a qualifying conservation organization when an easement is placed on qualifying land. This example demonstrates how the combined tax savings generated from the easement may potentially fund the life insurance policy.

Taylor Henderson, age 62, of California, has a parcel of land appraised at $10,000,000 by a qualified appraiser. If he donates the right to enforce the restriction under the conservation easement to a qualified land trust, the appraiser has determined that the easement will reduce the value of his property to $7,000,000, a 30% reduction.

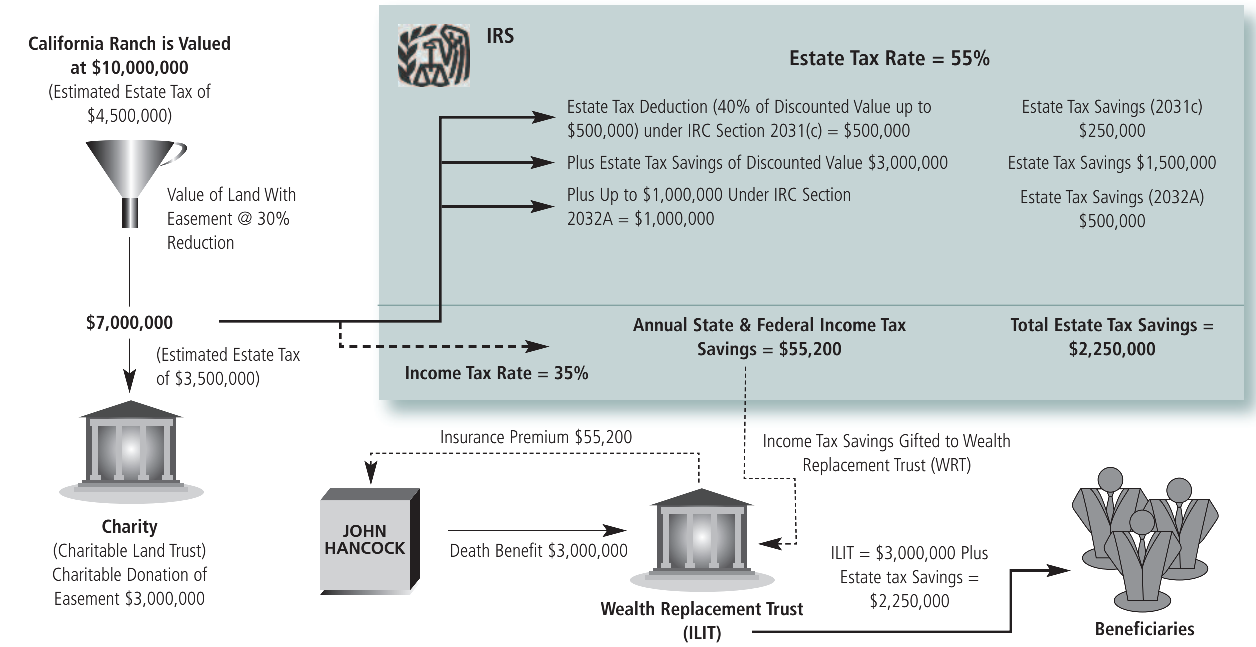
Taylor has a ranching operation and an adjusted gross income (AGI) of $300,000. He is in the 35% federal income tax bracket and pays a state income tax rate of 7.9%. California has a tax incentive program[11] in which Taylor can claim 55% of the value of the easement as a credit against the state income taxes due. Any unused credit amount can be carried over the next 7 years. Effectively, Taylor can eliminate state income taxes altogether. Moreover, since Taylor has an estate worth over $25,000,000 including the land, he may be able to lower his estate tax if he places a qualified conservation easement on the land. The potential tax savings translate as follows:

CASE STUDY (continued)

FEDERAL & STATE INCOME TAX SAVINGS								
Yr.	Fair Market Value of Land	Value of Land with Easement @30.00% Reduction	Federal Charitable Income Tax Deduction	AGI Limitation (30% of AGI)	Federal Income Tax Savings	Potential State Income Tax Savings	Total Annual State & Federal Tax Savings From Easement	Total Cumulative Tax Savings
1	$10,000,000	$7,000,000	$3,000,000	$90,000	$31,500	$23,700	$55,200	$55,200
2			$2,910,000	$90,000	$31,500	$23,700	$55,200	$110,400
3			$2,820,000	$90,000	$31,500	$23,700	$55,200	$165,600
4			$2,730,000	$90,000	$31,500	$23,700	$55,200	$220,800
5			$2,640,000	$90,000	$31,500	$23,700	$55,200	$276,000
6			$2,550,000	$90,000	$0	$23,700	$55,200	$331,200
7			$2,460,000	$0	$0	$23,700	$23,700	$354,900

The following flowchart illustrates how this works. The data shown is taken from a hypothetical calculation and may not be used to project or predict actual planning results. Please consult your tax and legal advisors regarding your particular situation.

How Does it Work?



This is a supplemental illustration. The life insurance values are based on a hypothetical product illustration for a female age 60 and male age 70, both Preferred Non Smoker status, for a John Hancock Protection SUL-G 10 policy with a guaranteed death benefit of $3,000,000 to age 102 of youngest insured and a guaranteed annual insurance premium of $55,200 for 5 years. Guarantees are based on the claims-paying ability of the insurer and the payment of the required annual premiums and no withdrawals and/or loans taken from the policy during lifetime.

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1. The easement is sometimes referred to as a restriction.
2. See IRC §501(c)(3) regarding types of charitable organizations.
3. The conservation restriction should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including generation skipping transfer tax). Failure to do so could result in adverse tax treatment. See PLR 200836014 for an example of a favorable ruling on a qualified conservation contribution of a conservation easement. A Private Letter Ruling (PLR) is merely an IRS interpretation of law and is only binding upon the taxpayer to whom it is issued.
4. If the value of the donation is expected to exceed $5,000, a qualified and independent real estate appraiser must perform the appraisal. The recipient of the gift, such as the land trust, cannot perform the appraisal.
5. Alternatively, a 50% of AGI limitation applies if the value of the deduction is reduced by the property's appreciation.
6. See IRC §170 for specific rules regarding charitable deductions as well as the differences between types of charities.
7. See "Conservation Tax Credit by State Comparison" created by the Land Trust Alliance.
8. Subsequent generations may be eligible for the 40% exclusion if the land remains within the family of the original owner. The exclusion under Section 2031(c) is not indexed for inflation. The family may receive a step up in basis to the extent of the value included in the taxable estate (after all reductions and exclusions have been taken). Land excluded from estate tax under this provision will receive a carryover basis rather than a stepped-up basis, following the landowner's death.
9. See Section 6007(g) of the IRS Reform Act (H.R. 2676) regarding postmortem easements. For the estate tax benefits of a postmortem restriction to apply, the easement deed must preclude all but a minimum use for commercial recreational activity. Certain development rights must be specifically accounted for in the tax calculation. And, a historic preservation easement does not qualify for the estate tax exclusion or the postmortem easement. Land excluded from estate tax through this provision has a carryover basis.
10. See IRC §2032A. Consult the tax code for the current special valuation discount under Section 2032A. In 2010, the special valuation discount under 2032A is $1,000,000, after indexing for inflation.
11. In California, a dollar for dollar state credit is available against state income taxes due annually, up to 55% of the fair market value of the restricted property. The amount of the credit that is not used in any given year can be carried over for the succeeded 7 years up to the value of the restricted property and provided income has been generated.

Insurance policies and/or associated riders and features may not be available in all states.

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