Extinguishment of Easements: Division of Proceeds Clauses

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Estate Planning: Proposed Estate Freeze Rule Changes

The estate planner’s dream is to find some way to pass family lands from parents to children free of estate taxes, notwithstanding retention by the parents of the right to enjoy the property during their lives. Many years ago it was possible for parents to do just that by giving to their children the so-called remainder interest in the property. Since the parents’ interests in the land expired at their death, they were not subject to estate tax on the land. Congress shut down the remainder gift technique in 1932, but ingenious estate planners subsequently solved the problem by causing the children to pay their parents the fair market value of the remainder interest determined at the time of the transfer. No gift was involved, assuming a correct appraisal, but more important, the value of the appreciated land escaped estate tax in the parents’ estate. This transaction became known as an “estate freeze.”

In 1987 and again in 1988 Congress passed legislation that closed this perceived loophole. The rules they enacted are extraordinarily complex and ambiguous, leading many, if not most, estate planners to abandon the technique except in instances that involve family residences.

In March of this year, the House Ways and Means Committee Chairman, Dan Rostenkowski (D-Ill.), introduced legislation that would, if passed, revoke the 1987 and 1988 legislative efforts retroactively. His draft legislation proposes a new approach to the problem. Under his approach, a sale of a remainder interest by parents to children could, if properly structured, eliminate estate tax in the parents’ estates notwithstanding the continued enjoyment of the property by the parents during their lives. However, under the terms of the proposed legislation, it appears that the price payable by the children for the remainder interest may be an artificial price substantially higher than the price payable under Treasury tables and the law in effect before 1987. Owners of personal residences are excepted from the proposed rules and therefore may sell remainder interests to their children under the favorable pre-1987 rules.

Thus, under Rostenkowski’s proposal, it appears that a rancher will be able to sell to his children a remainder interest in the ranch house (a personal residence) according to the pre-1987 rules. The rancher may also sell the remainder interest in the grazing lands, but under the new rules a taxable gift will occur if the price paid for the remainder interest is less than a prescribed, artificial amount. Any element of gift would produce adverse estate tax consequences on the parents’ deaths.—Kingsbury Browne

Extinguishment of Easements: “Division of Proceeds” Clauses

Ten years ago, when legislation creating “qualified conservation contributions” was in anxious gestation, the hostility of the Treasury Department to the very notion of tax deductibility for easement transfers was patent. Why should there be a tax expenditure subsidy for an alleged gift that left the donor with the same quantum of access and enjoyment? Although the legislation was ultimately enacted in spite of that rather fundamental objection, the heart of the Treasury has never much warmed to the conservation easement. Nowhere was that more apparent than in the process leading to the promulgation of regulations under Section 170(h).

Consider, for example, the requirement of Section 1.170A-14(g)(6)(ii), which requires, as a precondition to the allowance of a deduction, that the document conveying the easement must provide for a constant proportionate value. That is to say, should a change in conditions dictate the extinguishment of the easement and the sale of the subject property, the land trust donee must be entitled to such percentage of the sale proceeds as corresponds to the original proportionate value of the easement.

To illustrate, suppose that Sven Perquisten owns a 360-acre tract of northern Wisconsin hardwood forest, an important remnant of the natural habitat of the snub-tailed whistling shrew. Sven’s donation of an easement, suitably protective of the shrew’s habitat, will reduce the value of his property from $150,000 to $90,000; i.e., by 40%. Under the cited regulation, the deed must provide that the donee, Bags Groove Land Trust, must reap 40% of any eventual sale proceeds. Thus, should there come a day when the whistles of the snub-tailed shrew are heard no more in the Perquisten woods, and the land trust sensibly agrees to join Sven in a sale of the property for $250,000, it would appear that the Bags Groove coffers would be fattened by $100,000.

We say “appear” most deliberately. For although there is no arguing that the clause requiring such a proportionate division of proceeds must be included in the original easement document, the stipulations of that provision may have little or nothing to do with the ultimate division of proceeds (unless, as is most unlikely, the shrew departs and the property is sold within the...
three-year statute of limitations applicable to Sven’s charitable donation).

But what of the sanctity of contract? Hasn’t the landowner made a binding commitment to give Bags Groove a 40% slice? Of course he has, and the Bags Groove board may be perfectly content to withhold its acquiescence in the disposition (despite the obvious fiscal temptations to convert a completely unproductive easement to cash), until Sven provides escrow instructions that honor the original deal. It may, in fact, hold out for a greater-than-40% share. Conversely, if Sven is in no hurry to peddle the shrew-less woodlands, Bags Groove may find it in its best interests to stimulate Sven’s disposition tendencies by agreeing to take something less than 40%.

Once we realize that the parties are always free to go back to the table and renegotiate, we see the regulations’ attempt to dictate a permanent division of proceeds for what it truly is: a psychological gambit designed to focus the prospective easement donor’s attention on the possible loss of substantial future appreciation.

We do not mean to suggest that Sven and the Bags Groove representatives are somehow misrepresenting their present intentions by including the division-of-proceeds language required by the regulations. Assuming a solid appraisal, the recited 40% entitlement is a fair initial share. But times and expectations change, and surely no one at the IRS or Treasury had any illusions, when the easement regulations were constructed, about the ability of the tax authorities to dictate the fiscal relativities forever after. The fact of the matter is that once the last shrew has relinquished its tenancy, one of our two co-owners is certain to be more anxious than the other to put the property on the block. When that day comes, the Bags Groove board should properly consider the easement’s dictates on the division of sale proceeds to be no more than an opening bid.—William T. Hutton

Preserving Family Lands by Gifts of Undivided Interests

Resort to gifts and sales of undivided interests to divide the benefits of use and burdens of maintenance between the donor and a charitable donee is a promising, if somewhat under utilized, conservation technique.

As a hypothetical example, Mollie Brown owns an estate on Chesapeake Bay comprised of a house, swimming pool, caretaker’s cottage, and gymnasium. Important to the conservation community is the estate’s 200 acres of marshland, undeveloped upland, and sandy beach, with recreational, educational, and ecological values to nearby Chesapeake College. Mollie has a dozen grandchildren, and family use concentrates in the months of July and August. But maintenance costs and real estate taxes have escalated in recent years, and Mollie questions the wisdom of continuing to maintain the estate in order to provide summer vacations for her grandchildren. Furthermore, prospective estate taxes attributable to the property will more than consume her liquid assets, and very likely make it impossible for her beneficiaries to retain the property.

Chesapeake Stewards, a local land trust, devises the following solution. Mollie gives Chesapeake Stewards a conservation easement over the property in order to prevent future development. She then separately conveys an undivided interest in the restricted property to Chesapeake College, executing a concurrent use agreement under which she reserves the use of the property to her family for each July and August. Maintenance costs and real estate taxes are also apportioned between Mollie and the college according to the relative values of their separate interests.

Under the suggested plan, Mollie has made two separate charitable donations. The first consists of the conservation easement, and is measured according to the familiar “before and after” standard of Reg. 170A-14(h)(3). In an area like Chesapeake Bay, subject to substantial development pressure, that easement may well reduce the value of the property by an amount substantially in excess of 50%.

The second donation, to Chesapeake College, consists of an “undivided portion” of Mollie’s entire remaining interest in the property. One might be tempted to conclude that the second step of the plan divests Mollie of five-sixths of the estate’s remaining value, since she retains only two months’ use. It is highly unlikely, however, that the IRS would agree that the deduction should be measured according to a chronological fraction, since the retained summer months are undoubtedly the most desirable. (A published ruling on this situation, Revenue Ruling 75-420, 1975-2 C.B. 78, sanctions the basic approach suggested here, but provides no suggestion whatsoever that the amount of the contribution is determined by chronological apportionment.) The Service would likely assert that the relative values of the donated and retained undivided interests are to be determined according to their respective fair rental values.

On the conservation assumptions that the easement reduces the value of the estate by 50%, and that the subsequent conveyance of a ten months’ possessor interest to Chesapeake College reduces Mollie’s remaining interest by 50%, the end results are indeed salutary. Mollie is entitled to income tax deductions for the con-