Pensions for Preservation

The Need for a P4P Program

State and local governments are spending hundreds of millions of dollars to preserve farmland through purchase of development right (PDR) programs. Such programs identify key farms to be preserved, determine the value of the property as farmland and for development, and purchase the development rights from the landowners for up to 100% of the difference. The development rights are purchased with either a lump-sum payment at closing or specified payments over a defined period of time, and are evidenced by an irrevocable deed of easement that is permanently recorded on the land. The deed of easement prohibits the seller, and any subsequent owner of the farmland, from non-agricultural activities on the land.

While the scenario described above works smoothly for certain farmers, such as those who need cash or those at or near retirement, it does not appeal to the farmers who are farther from retirement and therefore reluctant to sell now. This class of farmers is typically ten to fifteen years from retirement and engaged in active farming. They do not need the cash from a sale now or a stream of payments over the near term. Furthermore, they view the value of their farm and its continued appreciation as their future retirement funding, once they are no longer able to farm the land themselves. Their plans for their farms may be undefined at this time, but probably involve selling all or a portion of the farm for development at some future date.

State and local governments cannot risk losing these farms to developers at some future date; they must offer this class of farmers an attractive alternative that meets the farmers' needs now. Governments might attract such farmers into PDR programs if they offered to acquire development rights in return for enrolling the farmers in a government-funded pension program, such as a **Pension for Preservation (P4P)** trust account.

The goal of a P4P Program in Southern Maryland would be to preserve actively-farmed lands by providing for the farmers' retirements in return for the development rights for their land.

The Tobacco Crop Conversion Program

In 1999, Maryland established the Cigarette Restitution Fund (CRF) in anticipation of receiving its share of tobacco settlement revenue from the Master Settlement Agreement. Since 2000, Maryland has allocated a portion of this settlement revenue to a Tobacco Crop Conversion Program, which is part of the Southern Maryland Regional Strategy Action Plan (the Action Plan). The goal of the Tobacco Crop Conversion Program is to promote *"diverse, market-driven agricultural enterprises, which coupled with agricultural land preservation, will preserve Southern Maryland's environmental resources and rural character while keeping the region's farmland productive and the agricultural economy vibrant."* To assist in the implementation of the conversion program in the five Southern Maryland counties, the Tri-City Council for Southern Maryland (TCC) established the Southern Maryland Agricultural Development Commission (SMADC).

The Tobacco Crop Conversion Program consists of three main components, according to the SMADC:

- *Tobacco Buyout.* The tobacco buyout program is a voluntary buyout program that provides funds to eligible Maryland growers who signed up from 2000 to 2004 for contracts from 2001 to 2015. Growers must agree to give up tobacco production forever but remain in agriculture. Should the land transfer ownership, the land is restricted from tobacco production for 10 years. *Growers are also offered a 10% bonus on their easement value if they choose to sell the easement.* Since its inception, participation in the buyout program has been strong. According to the SMADC, 877 growers, representing 94% of tobacco producers, have taken the buyout as of January 2005. Of the eligible tobacco in 1986, 86% or 7.8 million pounds has been taken out of production.

- *Infrastructure/Agricultural Development Program.* The infrastructure program seeks to foster profitable natural resource-based economic development in Southern Maryland by helping farmers diversify and develop market-driven agricultural enterprises.

- *Agricultural Land Preservation.* This component of the conversion program seeks to provide a bonus incentive to tobacco farmers to place land in preservation, to enhance participation in existing preservation programs, and to assist in the acquisition of land for farmer's markets. According to the SMADC, 1,454 acres had been directly preserved under the program in Southern Maryland in fiscal year 2004. Over three years of the program, 5,763 acres have been preserved. In addition, by leveraging program funds with existing preservation programs, five counties have been able to place over 15,000 additional acres under preservation. Two farmer's markets have been renovated using these funds.

Funding Outlook

According to the Fiscal 2007 Budget Overview for the Cigarette Restitution Fund, prepared by the Department of Legislative Services in March 2006, the Tobacco Crop Conversion Program (referred to in the overview as the Tobacco Transition Program) was to receive an allowance of $11.6 million in fiscal 2007. These funds were to be split as follows: (i) $400,000 for administrative expenses; (ii) $7.65 million for the buyout component; (iii) $1.1 million for the infrastructure component; and (iv) $2.415 million for land preservation. Of the $11.6 million, $7.6 million was to come from CRF special funds, to fund the administrative expenses, the infrastructure component, and the bulk of the buyout component costs. The remaining $4 million was to come from general obligation bonds, to fund the remainder of the buyout expenditures and land preservation.

Looking forward, total funds available in the CRF are expected to increase annually with the addition of annual strategic contribution payments of $28 million starting in 2008. (These payments reflect the states' legal contributions to the settlement.) By fiscal 2010, the annual payments to the CRF are expected to by approximately $180 million. It is unknown at this time if this increase in available funds will result in a higher allocation to the Tobacco Crop Conversion Program.

By 2010, the first of the tobacco buyout contracts will expire, and by 2015, all of the contracts will have expired. If funding allocations to the Tobacco Crop Conversion Program remain at or near historical levels, then funds will start to be freed up from the buyout program for potential use in the land preservation component and specifically to fund a P4P program. As noted below under the discussion of legal and legislative requirements, the Action Plan and specifically the Tobacco Crop Conversion Program may need to be amended to permit this use of funds.

To gain a better understanding of the characteristics of the growers who did participate in the buyout program, the TCC surveyed approximately 800 buyout participants in October 2005. According to the survey results, nearly 50% of respondents were over 60 years old and 30% no longer farmed full-time. With half of the respondents over 60 years old, it is likely that many of the growers who participated in the buyout program are thinking about their retirements. While the land under the buyout contracts cannot be used to grow tobacco anymore, nothing prevents the farmers from selling their land to developers, *unless they sell their easements to the State or county.* For those who did not sell their development rights when they entered the buyout program for the 10% bonus incentive, the risk is high that they are waiting to sell their farms to developers at a future date. *These farmers would be the target market for the P4P program.*

Recommended Maryland Legal Structure for a P4P Program

Given the background described above, a proposed legal structure is described below, along with the steps that would need to be taken by the State, the TCC, and the SMADC to implement such a structure.

- *Amend the Action Plan.* The Southern Maryland Regional Agricultural Action Plan and the Tobacco Crop Conversion Program should be amended to include the P4P program. Once the Action Plan is amended, the Tri-County Council may appropriate funds from the CRF to implement the P4P program. The TCC may also choose to set up a P4P Program Fund to receive any appropriations from the CRF.

- *SMADC to Administer the P4P Program.* The SMADC would administer the P4P program. The administrative responsibilities will include, in conjunction with the farmland preservation programs in the five Southern Maryland counties, identification of those tobacco farmers who wish to sell their development rights in exchange for a government-funded pension and the preparation of a funding agreement to be used between the farmer and the county where the farm is located.

- *County Adopts Resolution for Funding Agreement.* The funding agreement at the county level is authorized by Article 24, §20-102(a), which allows a county to enter into an agreement to purchase development rights. Pursuant to Article 24, § 20-102(b), the county must adopt a resolution to determine the terms of the funding agreement. Under the terms of the resolution and the funding agreement, the county would fund the trust account to provide for the farmer's benefits.

- *Amend Article 24, §20-101 of State Legislation.* At present, as set forth in Article 24, §20-101, Article 24, §20-102 is applicable to two of the five counties in Southern Maryland that would be part of the program (Anne Arundel and Prince George's Counties). In the other

three counties (Calvert County, Charles County and St. Mary's County) Article 24, §20-101 will have to be amended to make Article 24, §20-102 applicable to these counties.

- *Requisition of CRF Funds for County Obligations.* The SMADC would assist the counties in creating the trust accounts for the farmers. In accordance with Article 24, §20-102(c), the county's obligations to fund the trust accounts will be a general obligation of the county and will not be subject to annual appropriation by the county. However, the county would expect to requisition funds from the P4P program fund to fund the trust accounts.

- *Enter into Non-Binding Memo of Understanding.* Given that neither the State nor the TCC is under any obligation to allocate funds from the CRF to the P4P program, the State, the TCC, and the five counties would enter into a non-binding Memorandum of Understanding to assure that State funding would be available to the counties to meet its obligations.

- *Convene Meeting of Attorneys.* As discussed above, the only state legislative action required is the amendment to Article 24, §20-101. It should not be necessary to amend the CRF statute, the TCC statue, or Article 24, §20-102 to implement a P4P program. The Assistant Attorneys General who advise the Secretary of Budget and Management and the Tri-County Council, and the County Attorneys for each of the five counties, should be consulted to obtain concurrence with this position. This meeting would also discuss the proposed legal structure and the authority for its implementation.

Section 115 Grantor Trusts

Section 115 of the Internal Revenue Code allows governmental units to create trust for "any essential governmental function" such as paying future employee health benefits, its most commonly considered use. The Maryland Local Government Insurance Trust was created by the Maryland General Assembly in the 1980's as a Section 115 trust. More recently, Section 115 trusts have been identified as likely vehicles for funding Other Post-Employment [health care] Benefits (OPEB) for state and local government retirees to comply with Government Accounting Standards Board (GASB) Statement No. 45.

Operation of a P4P Program

Many operating and tax issues related to Section 115 grantor trusts need further clarification and guidance from a qualified tax and pension professional. Assuming that all of the legal, legislative, and tax issues are resolved, the tax treatment and steps outlined below illustrate the operation of a hypothetical Pension for Preservation program. *The assumed tax treatment and operating steps are subject to change.*

For purposes of this illustration, the tax treatment of withdrawals from a P4P trust is assumed to be as follows:

- When a retiree makes a withdrawal from a P4P account, the tax treatment of the withdrawal would be determined by the characterization of the deposit originally made into the account.

- The withdrawal of principal payments, and investment earnings thereon, that were made into the principal sub-account, would be subject to capital gains tax at the then-prevailing federal and state rates. (The federal rate currently ranges from 0% for those with low adjusted gross income to a maximum of 15 %.) To calculate the capital gains tax, the basis in the development rights sold would be allocated pro rata between the withdrawal and the remaining balance in the principal sub-account. The capital gain would be equal to the withdrawal less the allocated basis.

- If interest payments and investment earnings thereon were withdrawn, they would be subject to income tax at the then prevailing federal and tax rates. However, if bond counsel were to provide an opinion at closing that interest paid into the sub-account were exempt from federal and state income taxes, and if deposits into the account were invested in tax-exempt bond funds, withdrawals from this sub-account would be exempt from income taxes.

- As mentioned above, this differing tax treatment of the two sub-accounts would allow sellers to vary their investment choices. They might invest the principal sub-account in equities for capital appreciation while investing the interest sub-account in fixed-income tax-exempt funds for more predictable growth. Withdrawals from one or both sub-accounts might be determined in any year by the seller's tax bracket and the character of his or her other taxable or tax-exempt income in that year.

Assuming the tax treatment described above, the steps to operate a P4P program would be as follows:

1. Determine Value of Easement
2. Create Grantor Trust
3. Annual Deposits into P4P Trust Account
4. Seller Directs Investment of Funds
5. Seller Determines Withdrawal of Funds

Step 1: Determine Value of Easement. Under a P4P Program, the SMADC would take applications from interested sellers and conduct appraisals on their farms. The SMADC would then follow standard procedures in determining the price of the development rights to be acquired from each landowner. If funds for the P4P Program are limited, the SMADC can rank the sellers based on the discounts sellers are willing to take from appraisals, selecting those farms with prices representing the greatest discounts from appraised values. For those farms accepted into the program, the counties where each of the eligible farms was located would receive at closing an irrevocable deed of easement evidencing development rights.

Step 2: Create Grantor Trust. Rather than receiving cash at closing, a seller in the P4P program would be enrolled in an individual retirement account that would pay the seller for the development rights after an initial period of time of his or her choosing, subject to federal law and regulation. To accomplish this, the SMADC would assist the county in setting up a grantor trust pursuant to Section 115 of the Internal Revenue Code. The grantor trust, or P4P trust account, would be established with a low- or no-load mutual fund company (such as Vanguard) that offered a variety of equity and fixed-income investment alternatives. The P4P trust account

would consist of two sub-accounts, one for the interest component and one for the principal component.

Step 3: Annual Deposits into P4P Trust Account. After creation of the P4P trust account and under the terms of a funding agreement between the county and the farmer, the county would make equal annual deposits into the account over a specified term such as 20 years. (As discussed under the recommended legal structure, the county would requisition CRF funds to meet its P4P obligations.) The term would be based on the period over which the counties normally amortize their general obligation bonds, assuming the final maturity is within the funding term of the tobacco restitution funds. Payments into the account would be deposited into the two sub-accounts to facilitate tax calculations: (1) the interest required to amortize tax-exempt bonds, whose principal amount equaled the purchase price, over the same period and (2) principal.

Step 4: Seller Directs Investment of Funds. Sellers would direct the investment of funds on deposit in their P4P trust accounts, as they would for any self-directed individual retirement account. Depending on the tax treatment of the two sub-accounts (see discussion below), differing tax treatments of the interest and principal accounts would allow sellers to vary their investment choices.

Step 5: Seller Determines Withdrawal of Funds. When a seller was ready to retire, he or she would begin to draw on the retirement accounts, with withdrawals determined by the financial need of the retiree. Sellers might be governed by the requirements of IRAs, which mandate minimum withdrawals (based on life expectancy of the recipient) from the account annually after the retiree has reached the age of 70.

Analysis of a P4P Trust Account

Assume that a hypothetical farmer, currently age 60, sells the easement on his or her farm to the county in Southern Maryland for $1 million, in exchange for participation in a P4P program. The assumed basis in the easement is $100,000. The following six schedules illustrate how a P4P trust account would work for this hypothetical farmer.

Schedule 1: County Contributions into the P4P Trust Account
Schedule 2: Potential Investment Returns on Trust Account with No Withdrawals
Schedule 3: Balance in Interest Account with Minimum Withdrawals
Schedule 4: Balance in Principal Account with Minimum Withdrawals
Schedule 5: Balance in Interest Account with Level Withdrawals
Schedule 6: Balance in Principal Account with Level Withdrawals

Schedule 1: County Contributions into the P4P Trust Account. The schedule shows the calculation of the annual contributions which would be made by the county into the trust account, split between the principal and interest portions. The total annual payment averages to be $73,000 and approximate the payments that would be required to amortize a $1 million bond issuance.

Schedule 2: Potential Investment Returns on Trust Accounts with No Withdrawals. This schedule shows the potential returns on investment for the principal sub-account and the interest sub-

account. For the principal sub-account, the annual contributions of principal from the county in the account are assumed to be invested in mutual funds appreciating at an annual pre-tax rate of 7.5%. As noted previously, the farmer would direct the investment of these funds. Assuming no withdrawals, 20 years of principal contributions would appreciate to 4.4 million by Year 30.

For the interest sub-account, the annual contributions of interest from the county, considered to be tax-exempt, are assumed to be invested by the farmer in tax exempt bond mutual funds with an average rate of return of 4%. Assuming no withdrawals, the 20 years of interest contributions would grow to nearly $1.2 million by year 30. Together with the principal account, the P4P trust account would be worth nearly $5.6 million by Year 30.

Schedule 3: Balance in Interest Account with Minimum Withdrawals. The assumption for the P4P trust account is that the farmer, starting at age 70, would be required to take minimum distributions from the account, as required by the IRS for Individual Retirement Accounts. Assuming the hypothetical farmer turns 70 in Year 10, Schedule 3 shows the minimum withdrawals by the farmer from the tax-exempt interest sub-account of the P4P trust account. To minimize the tax impact to the farmer, initial withdrawals are made from this account from Years 10 through 20. As mentioned above, the contributions of interest made into the account by the county are assumed to be tax-exempt. In addition, if this interest is then invested in tax-exempt bond funds at the farmer's discretion, then the withdrawal of investment earnings should also be tax-exempt. By Year 20, the interest sub-account has been depleted, after a total of $685,572 in tax-exempt withdrawals.

Schedule 4: Balance in Principal Account with Minimum Withdrawals. This schedule shows the balance in the principal sub-account. Once the interest sub-account has been depleted in Year 20, the withdrawals start in the principal sub-account. Until this point, the contributions by the county into the principal sub-account have continued to appreciate. The county's contributions into both the interest and principal sub-accounts conclude at the end of Year 20.

Unlike the tax-exempt withdrawals from the interest sub-account, the withdrawals from the principal sub-account are assumed to be subject to capital gains taxes. As withdrawals from the principal sub-account begin, the $100,000 basis of the easement is allocated on a pro rata basis based on the amount of the withdrawal and the remaining balance in the sub-account. Capital gains taxes are then paid on the difference between the withdrawal and the basis, as the maximum federal rate of 15%. Between the interest and principal sub-accounts, total after-tax withdrawals from Year 10 through Year 30 are $2,034,652. By Year 30, after these minimum withdrawals have been made from the interest and principal accounts, there is $2,196,805 remaining in the principal sub-account.

Schedule 5: Balance in the Interest Account with Level Withdrawals. Schedule 5 shows the impact on the interest sub-account if the farmer chose to take the maximum annual level withdrawal from Year 10 through Year 30, instead of minimum withdrawals. For the first few years, all of the $137,000 annual withdrawal is from the interest sub-account, to minimize the tax impact on the farmer. In Year 13, only $100,538 is available for withdrawal from the interest sub-account, as the account is depleted (until the county makes its next contribution of interest.) In Years 14 through 20, only the annual interest contribution from the county plus investment earning is withdrawn from the interest sub-account. The rest of the level $137,000 withdrawal in Years 13 through 20 is from the principal sub-account.

Schedule 6: Balance in the Principal Account with Level Withdrawals. Schedule 6 shows the level withdrawals from principal sub-account beginning in Year 13, when the interest sub-account has been nearly depleted (except for the annual interest contributions). From Years 21 through 30, the full $137,000 annual withdrawal comes from the principal sub-account. As shown in Schedule 4, capital gains taxes are paid on the difference between the withdrawals from the principal sub-account and the allocated basis. From Year 10 through Year 30, $2,548,664 in after-tax dollars is withdrawn from the interest and principal sub-accounts. The balance remaining in the principal sub-account is $39,817.

Outstanding Tax and Pension Issues

Before a P4P program can be offered to farmers, several critical issues related to the establishment, structure, and operation of the trust accounts need to be analyzed and resolved by a qualified tax and pension advisor. These issues include the following:

- *Creation of the Section 115 Trusts.* A review of federal and state laws and regulations would be required to confirm the legal basis for the creation of a Section 115 trust to fund retirement benefits. State legislation and a private letter ruling from the Internal Revenue Service might be required.

- *Ownership.* If the development rights were owned jointly, by a Sub-Chapter C or S corporation, by a partnership or a trust, counsel would need to determine how such sellers were entitled to payments from one or more P4P trust accounts.

- *Tax Treatment of Trust Account Withdrawals.* Counsel and an actuary would need to determine (1) whether withdrawals from the principal sub-account were subject to capital gains tax, when such taxes were due and how such capital gains were calculated; (2) whether withdrawals of deposits to the interest sub-account were exempt from federal and state income taxes, and whether interest from investing sub-account deposits in tax-exempt mutual funds was also tax-exempt and (3) when withdrawals from the sub-accounts were required under federal law, in what amounts and from which sub-accounts.

- *Control over Investment of Trust Fund and Withdrawals.* Counsel would need to determine if the farmer is able to direct the investment of funds in the trust account, as they would be able to do for a self-directed retirement account. In addition, counsel would need to determine if the seller can decide on the timing of their withdrawals from the trust account. (The hypothetical illustration below assumes that the seller has such rights.)

- *Charitable Deductions.* If landowners sold development rights for principal payments into the P4P trust account that were less in aggregate than appraised value at closing, counsel would need to determine if the seller were entitled to a charitable deduction under Section 170(h) of the Internal Revenue Code.

- *Inheritance.* Counsel would need to determine how heirs would inherit P4P trust accounts and the estate, capital gains, and income tax implications.

Education of Farmers on the P4P Option

Once the legal, legislative, and tax issues are resolved, the primary objective will be to identify and educate potential farmers on the benefits of a P4P Program, as well as educating the counties in Southern Maryland as to the benefits of their participation. The growers who participated in the tobacco buyout program but did not sell their easements would be the starting target market, particularly those who are more than 10 years from retirement. In marketing a P4P program, the TCC and the SMADC can stress the following benefits to farmers and Southern Maryland:

Benefits to Farmers

- *Provides Retirement Funding Now.* While many farmers may be reluctant to decouple themselves from the real estate market, there are benefits to locking in their retirement funding now. The future sale of a farm to provide for retirement is more ambiguous and less certain than receiving funds now that can be invested over 10 to 15 years, at the farmer's discretion, for their future use.

- *Invest Funds Tax-Free.* By selling their land now for a P4P, a farmer is able to invest the proceeds tax-free, until they are ready to make withdrawals. At the time of a withdrawal, the portion of a withdrawal from the interest sub-account that is attributable to the original deposit would be tax-free. The withdrawal from the interest sub-account that is attributable to investment earnings may also be tax-free if invested in tax-exempt funds.

- *Defers Drawdown of Funds.* Unlike a sale transaction now for cash or installment payments, a P4P allows the farmer to defer drawdown of the proceeds until they either need the money or are forced by IRS regulations to begin minimum drawdowns.

Benefits to Southern Maryland

- *Preserves Land Now.* A P4P program will allow Southern Maryland to offer an alternative to those farmers who may not otherwise be willing to sell their development rights now. Leaving these farms left unpreserved increases the risk that they will be sold off to developers in the future.

- *Leverages Available Funds.* As would be the case with the funding of a sinking fund account or the payment of interest on an installment purchase agreement, the funding of a P4P trust account would require annual payments by the county where the farm is located. The installment nature of the program would allow the SMADC to further leverage its available funds to preserve more farmland.

- *Larger Discount to Appraised Value Possible.* Because the seller is able to invest the proceeds of the easement sale now, over the next 10 to 15 years, some sale prices may represent a discount to appraised value. The tax benefits available to the sellers under a P4P program should be a factor in determining how much of a discount is agreed upon by the seller.

- *Payments Similar to Bond Financing.* From a county's perspective, the funding of a P4P trust account is similar to funding the purchase of land through the issuance of bonds. The annual payments made by the county into the P4P sub-accounts would be approximate to the interest and principal payments required on a bond issue for the same amount as the purchase price of an easement.

Contact Evergreen Conservation Finance for information on how a P4P program could provide a means for farmland preservation programs to buy agricultural conservation easements from working farmers:

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