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A Guide to the Tax Aspects of Conservation Easement Contributions

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WYOMING LAW REVIEW

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A GUIDE TO THE TAX ASPECTS OF CONSERVATION EASEMENT CONTRIBUTIONS

*C. Timothy Lindstrom, Esq.**

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SUMMARY

There are five types of tax benefits available to easement donors and their families, all of which can be enjoyed in combination:

Income Tax Deduction: The gift of a permanent conservation easement to a qualified organization or governmental agency constitutes a charitable contribution and the value of the easement (generally, the difference in the value of the property subject to the easement before and after the easement is put in place) may be deducted from the donor's income for purposes of calculating federal income tax and, in many states, state income tax.

Income Tax Credits: In some states (e.g. Virginia and Colorado), conservation easements generate credits against state income tax liability. Credits are more powerful incentives than deductions because they represent a direct offset against tax due rather than a reduction of the income against which tax is assessed.

Reduction in Taxable Estate: The restrictions imposed by a conservation easement reduce the value of real property in a decedent's estate. This reduction in value results in estate tax savings.

Exclusion from Taxable Estate: Section 2031(c) of the Internal Revenue Code allows the executor of a decedent's estate to exclude 40% of the restricted value of land subject to a qualified conservation easement (i.e., the value of the land after subtracting the value of easement). The maximum amount that may be excluded under this provision is $500,000 per estate.

Reduced Real Estate Tax Assessment: Under the provisions of many state and local laws, land subject to a conservation easement is entitled to a lower real estate tax assessment to reflect the restrictions of the easement. This can result in substantial local real estate tax savings.

A. DESCRIPTION OF A CONSERVATION EASEMENT

Conservation easements are voluntary restrictions on the use of land negotiated by a landowner and a private charitable conservation organization or government agency chosen by the landowner to "hold" the easement. Essentially, holding the easement means having the right to enforce the restrictions imposed by the easement.

The terms of conservation easements are entirely up to the landowner and the prospective easement holder to negotiate. However, the Internal Revenue Code establishes requirements that must be met if the donation of an easement is to qualify for federal tax benefits. Many states also grant tax benefits for easement donations that comply with the federal requirements.

Conservation easements do not generally provide third parties, or the public, with the right to access or use the land that is subject to the conservation easement. Unless the purpose of the easement is the conservation of some feature where public benefit is dependent upon public access, such as preservation of an historic structure, no public access is required to qualify for federal tax benefits.

The protection of farm land, ranch land, timber land, and open space (particularly where such land is under residential or commercial development pressure and where local planning identifies open space preservation as valuable to the community) are typical objectives of conservation easements. In addition, the protection of wetlands, floodplains, important wildlife habitat, scenic views, and historic land areas and structures are also recognized purposes for easements.

Easements that are permanent, donated by the landowner (or conveyed pursuant to a qualified bargain sale), and that conserve publicly significant natural resource values (described in the preceding paragraph), typically qualify for federal and state tax benefits. The amount of the deduction must be determined by an independent appraisal of the value of the easement.

In addition, easements normally permit the continuation of the rural uses being enjoyed by the landowner at the time of the donation of the easement. Land subject to a conservation easement may be freely sold, donated, passed on to heirs and transferred in every normal fashion, so long as it remains subject to the restrictions of the easement. It is also possible to retain some rights to limited residential development (e.g. one dwelling unit per 100 acres), so long as the retention of such rights does not conflict with the conservation purposes of the easement.

To qualify for federal and state tax benefits, easements must be held either by a federal, state, or local government agency, or by a private charitable organization that has the capacity to enforce the terms of the easement. Such an organization does not need to be an environmental organization. A landowners association could qualify, so long as it includes land conservation among its purposes. For example, an association of ranch owners established for the purpose of protecting ranch land and qualifying as a charitable organization under section 501(c)(3) of the Internal Revenue Code would be qualified to hold easements on ranch land if it has the capacity to enforce the easement.

B. REQUIREMENTS FOR INCOME TAX BENEFITS

Section 170(h) of the Internal Revenue Code ("IRC") requires that the contribution of a conservation easement (often referred to in this Guide as an "easement") meet the definition of a "qualified conservation contribution" to be eligible for a federal income tax deduction. The Treasury Regulations ("Regulations") have elaborate provisions governing eligibility.[1] The provisions of IRC § 2031(c) providing federal estate tax benefits also require that an easement comply with IRC § 170(h). An excellent, detailed discussion of the requirements of § 170(h) can also be found in *The Federal Tax Law of Conservation Easements*, by Stephen J. Small, published by the Land Trust Alliance.

It is *extremely* important to recognize that the charitable deduction allowed for the donation of a conservation easement is entirely a "creature of statute." In

[1] Treas. Reg. § 1.170A-14 (as amended in 1999).

other words, the deduction *only* exists as a statutory measure. There is no inherent "right" to a charitable deduction for donating an easement. The deduction is only available if *all* of the statutory requirements for the deduction are met. Failure to do so may result in the permanent restriction of land subject to the defective easement, but no tax benefits. Under some circumstances gift tax may be due for the contribution of an easement that does not meet the requirements of § 170(h).

Further underscoring the importance of compliance with all statutory requirements is the fact that a conservation easement deduction is an exception to the general tax rule that no deduction is allowed for a gift of less than the donor's entire interest in property. Such gifts are called "partial interest" gifts. A conservation easement, being only a partial interest in the donor's interest in the property subject to the easement, is a partial interest.

1. TO QUALIFY FOR A TAX DEDUCTION A CONSERVATION EASEMENT MUST BE A "QUALIFIED CONSERVATION CONTRIBUTION"

Generally, the tax code does not permit a deduction for a gift of less than all of the donor's interest in property. For example, the gift of an apartment building with the retention of a forty-year lease by the donor would not qualify for a charitable deduction.[2]

However, an exception exists for a "qualified conservation contribution." A qualified conservation contribution qualifies for a tax deduction, provided that the following four requirements are met:

> (i) the contribution is of a "qualified real property interest;"
>
> (ii) the contribution is made to a "qualified organization;"
>
> (iii) the contribution is exclusively for "conservation purposes;"
>
> (iv) the conservation purposes of the gift are protected in perpetuity.[3]

These requirements are detailed below.

2. WHAT IS A "QUALIFIED REAL PROPERTY INTEREST?"

A "qualified real property interest" is (i) the donor's entire interest in property other than a "qualified mineral interest," or (ii) a "perpetual conservation restriction."[4]

[2] Treas. Reg. § 1.170A-14(a) (as amended in 1999).

[3] *Id.*

[4] I.R.C. § 170(h)(2)(c) (2004).

a. The "donor's entire interest other than a qualified mineral interest"

The first clause of this definition has been made somewhat more important with the passage of the Pension Protection Act's[5] new tax incentives for the contribution of a "qualified conservation contribution."[6] This is because the new benefits apply to contributions under *both* clauses of the foregoing definition.

A "qualified mineral interest" is the donor's "interest in subsurface oil, gas, or other minerals and the right of access to such minerals."[7]

Example

John Jones owns the Three Rivers Ranch. There are important oil and gas reserves on the ranch that John wants to retain for his grandchildren. However, he wants to give the ranch to a local land trust that he founded years before. John agrees to convey any surface mining rights with the ranch, reserving only the subsurface minerals.

This is a "qualified real property interest." However, is it a "qualified conservation contribution?" In order to fall within that definition the ranch must be conveyed to a "qualified organization;" be "exclusively for conservation purposes;" and the purposes must be protected in perpetuity.

If the land trust has the right to sell the ranch, does that disqualify John's gift as a "qualified conservation contribution" on the grounds that the gift is not exclusively for conservation purposes, which purposes are protected in perpetuity? *Arguably,* because the land trust to which the gift has been made has as its purpose land conservation, and any proceeds from the sale of the ranch would have to be used by the land trust for land conservation, and assuming that the land trust is a corporation with perpetual duration, the requirement has been met.

On the other hand, the definition may require that the ranch be permanently restricted to open space use and agriculture in order to comply with the requirement. There are no rulings or cases providing guidance at this time.

[5] Pension Protection Act, 29 U.S.C. § 1206 (2006).

[6] *See* discussion *infra* Part D.3.

[7] Treas. Reg. § 1.170A-14(b)(1)(i) (as amended in 1999).

b. A perpetual conservation restriction

A "perpetual conservation restriction" is "a restriction granted in perpetuity on the use which may be made of real property—including an easement or other interest in real property that under state law has attributes similar to an easement (e.g. a restrictive covenant or equitable servitude)."[8]

> State law governs the legal enforceability of a real property restriction. Absent statutory authority, a conservation easement is typically considered an "easement in gross" rather than an "easement appurtenant." An "easement in gross" is a mere personal interest in or right to use another's land, without being exercised in connection with the occupancy of the land. It differs from an "easement appurtenant" in that it does not require a dominant tenement. Ordinarily, it is not assignable or inheritable.
>
> ***
>
> "The principal distinction between an easement proper, that is an easement appurtenant, and a right in gross is found in the fact that in the first there is and in the second there is not a dominant tenement." [9] Courts are generally reluctant to enforce easements in gross because it is unclear who should have the right ("standing") to enforce such an easement. Enabling authority in the form of a statute cures this problem of enforceability for conservation easements. The best known statute is the "Uniform Conservation Easement Act" which has been adopted in a majority states. Many other states, including Wyoming, have enacted variations of the Uniform Act.[10]
>
> Again, because a conservation easement is a creature of statute, *compliance with all of the* ***state*** *statutory requirements for creating an easement is essential if the easement is to qualify under federal tax law as a "perpetual conservation restriction."*

[8] Treas. Reg. § 1.170A-14(b)(2) (as amended in 1999).

[9] 28A C.J.S. EASEMENTS § 11 (1996).

[10] WYO. STAT. ANN. § 34-1-201 (2006).

Example

Mary Evers contributes a conservation easement over her farm. The farm is located in a state that has enacted the Uniform Conservation Easement Act. However, the state added two provisions to the Uniform Act. One provision requires that in order to be qualified to hold a conservation easement under the Act an organization must have done business within the state for at least five years. The other provision requires that all conservation easements be reviewed by the local planning commission for compliance with the local comprehensive plan.

Unfortunately, Mary contributes the easement to an organization that has only been doing business in the state for three years. In addition, neither Mary nor the organization submits the easement to the local planning commission for review. Even more unfortunately, Mary's contribution is audited. The IRS points out that the easement is not a perpetual conservation restriction because it fails to comply with the statutory requirements. Mary's deduction is denied. In this case, because the restriction was unenforceable, Mary can start over.

3. The easement must be conveyed to an "eligible donee"

The Regulations require that, in order to be an "eligible donee" of a tax deductible conservation easement, an organization must meet the following requirements:

> (i) the organization must be either a local, state, or federal governmental agency, or a public charity qualified under IRC § 501(c)(3);
>
> (ii) the organization must have a commitment to protect the conservation purposes of the donation (this is typically found in the articles of incorporation or by-laws of a private organization); and
>
> (iii) the organization must have the resources to enforce the restrictions imposed by the easement.[11]

a. What resources are required?

The Regulations expressly state that, in order to meet the resources requirement, a qualified organization *does not* need to set aside a special fund. However,

[11] Treas. Reg. § 1.170A-14(c)(1) (as amended in 1999).

it is unlikely that an organization that has neither staff nor funding available to monitor its easements on a regular basis, or to go to court to defend its easements, is a qualified organization. While this may seem a harsh assessment, when mere discovery in a lawsuit may consume several hundred thousand dollars, it is clear that more than several hundred dollars in the bank is necessary to defend an easement. By the same token, without regular, consistent, comprehensive monitoring of all easements an organization holds, it is impossible to know whether the easement restrictions are being honored. This takes both funding and staffing.[12]

b. Do public agencies automatically have the necessary "commitment to protect the conservation purposes?"

As a practical matter, not necessarily. Organizations seeking public charity status as land trusts now are confronted by several additional questions in the application for IRC § 501(c)(3) status. These questions are intended to determine whether an organization has the required "commitment to protect the conservation purposes." However, because public agencies are not required to comply with § 501(c)(3), no such questions are posed to public agencies and this raises the question of whether all public agencies, simply by virtue of being a public agency, are qualified to hold deductible easements. For example, the author knows of at least one public agency that simply terminated a conservation easement that it held because the landowner whose property was subject to the easement requested the termination.[13] This public agency did not appear to have the "commitment to protect the conservation purposes" required by the tax code.

c. Accreditation

As a result of Congressional concern over the qualifications of some existing land trusts to hold and enforce easements, the Land Trust Alliance ("LTA") has established a voluntary "accreditation" program for land trusts. Whether Congress will mandate such accreditation for all land trusts holding deductible easements is unknown at this time. Essentially, accreditation by the LTA requires adoption and implementation of the LTA's "Standards and Practices."

d. Transfers of easements

Regulation § 1.170A-14(c)(2) *requires* that the conservation easement include the following provisions for any future transfer or termination of the easement:

[12] Form 990 (required to be filed by exempt organizations) requires for 2006 returns that any organization holding conservation easements report how many of its easements have been physically monitored during the preceding tax year and the amount of staff hours and funds it spent in monitoring and enforcing its easements for that year. Form 990, Schedule A, Part III, line 3c, and Instructions.

[13] *See* Hicks v. Dowd, CV-2003-0057 (Wyo. 4th Dist. Ct. 2003), *aff'd*, 2007 WY 74 (Wyo. 2007).

> (i) the easement must prohibit the holder of the easement from transferring it to any organization that is not an "eligible donee" as described above;
>
> (ii) the easement must require that any transferee organization agree in writing to carry out the conservation purposes of the easement;
>
> (iii) the easement must require that, if a later unexpected change in the conditions surrounding the easement property makes impossible or impractical the continued use of the property for conservation purposes, any proceeds received by the easement holder resulting from the later sale or exchange of the easement property must be used in a manner that is consistent with the conservation purposes of the easement.[14]

4. THE EASEMENT MUST ADVANCE A QUALIFIED "CONSERVATION PURPOSE"

Qualified conservation purposes identified by the tax law fall into four categories:

> (i) the preservation of land areas for outdoor recreation by, or the education of, the general public;
>
> (ii) the protection of a significant, relatively natural habitat for fish, wildlife, or plants;
>
> (iii) the preservation of certain open space (including farm land and forest land) pursuant to a "clearly delineated" governmental conservation policy, or for scenic purposes, resulting in a significant public benefit; or
>
> (iv) the preservation of an historically important land area or certified historic structure.[15]

a. The importance of describing the conservation purposes

While it would not seem that the actual language of an easement can alter the quality or characteristics of the land being protected by the easement, the IRS

[14] Treas. Reg. § 1.170A-14(c)(2) (as amended in 1999)

[15] Treas. Reg. § 1.170A-14(d)(1) (as amended in 1999). Note that the IRS has recently begun challenging easements that it claims fail to meet the conservation purposes requirement. *See* Glass v. Comm'r, 124 T.C. No 16 (2005), *aff'd,* 471 F.3d 698 (6th Cir. 2006) (finding that taxpayer's deduction was valid); Turner v. Comm'r*,* 126 T.C. No. 16 (2006) (finding for the IRS).

has made it clear that it expects the easement document to include a thorough description of the conservation purposes of the conservation easement and of how protection of the property advances those purposes. This is best done in several ways:

> (i) the recitals ("whereas clauses") of the easement document should contain an explicit reference to one or more of the conservation purposes identified in the Regulations (preferably in the terms used by the Regulations to avoid confusion);
>
> (ii) the recitals should provide as much detail as reasonably practical describing and elaborating on the characteristics of the land being made subject to the easement that support the conservation purpose(s) of the easement; and
>
> (iii) the characteristics of the property being made subject to the easement should be detailed in the "natural resources inventory" required by the Regulations which should be incorporated into the recitals by reference.[16]

b. Public recreation or education

The Regulations provide that the donation of a "qualified real property interest" for the purpose of preserving land for outdoor recreation or education of the general public is a qualified conservation purpose. [17] The Regulations require that such a donation must provide for (i) substantial and (ii) regular use of the land by the public.[18]

[16] *See* discussion *infra* Part B.13.

[17] *See* discussion *supra* Part B.1.

[18] Treas. Reg. §§ 1.170A-14(d)(2)(i), (ii) (as amended in 1999).

Example 1

The James family owns a private, 80-acre lake. The family contributes a conservation easement over the lake and an access easement from the lake to a nearby public road, for the purpose of preserving the lake for public recreational use. The easement also grants to the public the right to use the lake and access road on alternating weekends throughout the year. The remainder of the weekends the lake is closed to public use, but the easement does not allow any use of the lake by the owners that would diminish the quality of the lake for public outdoor recreation. Such an easement should meet the requirements of the public recreation or education conservation purpose.

The only caveat to this example is that the easement does not allow year-round, 365-day use of the lake by the public. The Regulations do not elaborate on the amount or extent of use other than to say that a donation must allow for "substantial and regular use" by the public. Certainly, full-time access qualifies. Whether use limited to alternating weekends qualifies is not certain. Presumably, access limited to one day per year would be insufficient.

Example 2

The Roths own land that is geothermally active. At the same time each year a spectacular geyser erupts. The rest of the year the geyser is dormant. The Roths put a conservation easement on the area of their land where the geyser is located, and grant an access easement from a local public road for public access to the site. The easement provides that the access and geyser area will be open one day each year when the geyser erupts. The easement further provides that the family will provide an interpretive lecture on the geyser and other geothermal features of the property on that day, and will provide reasonable public notice of the event at least two weeks in advance. This easement should qualify as meeting the public recreational/educational conservation purpose, even though public access is severely restricted, because access is allowed on the one day of the year when something of public significance occurs on the property. Whether such an easement has any measurable economic value for deduction purposes is another question.

c. Preservation of a significant, relatively natural habitat for fish, wildlife, or plants

Habitat protection meeting the following criteria is a recognized conservation purpose:

> (i) the habitat is significant;
>
> (ii) the habitat is *relatively* natural (i.e. some human alteration of the habitat will not preclude it from qualifying under this provision);
>
> (iii) the habitat is for fish, wildlife, or plants.[19]

For this conservation purpose the term "significant" includes:

> (i) habitat for rare, endangered, or threatened species;
>
> (ii) natural areas representing "high quality" examples of a terrestrial or aquatic community (e.g. islands with relatively intact coastal ecosystems); and
>
> (iii) natural areas included in, or contributing to, the ecological viability of public parks or preserves.[20]

The United States Tax Court recently considered a conservation easement whose primary conservation purpose was habitat protection. In the case of *Glass v. Commissioner*, the IRS lost the case and appealed the decision to the United States Sixth Circuit Court of Appeals where the appellate court reaffirmed the Tax Court.[21]

There are at least two things of significance about this case relating to the conservation purposes requirement. The first is the size of the areas protected by the two conservation easements challenged by the IRS. The easement contributed by Mr. and Mrs. Glass in 1992 covered an area 150 feet wide by 120 feet deep, a total of 18,000 square feet. The second easement covered an area 260 feet wide by 120 feet deep, for an additional 31,200 square feet. Each easement was presented as an independent contribution, each meeting, individually, the conservation purpose of protecting a "significant, relatively natural habitat."[22]

Evidence showed that the Glass property was the location of a bald eagle roost (not nest), and that the Lake Huron tansy, an endangered species, grew on the property. The Tax Court and Court of Appeals both ruled that the each of the two conservation easements met the requirements of the habitat protection conservation purpose.[23]

[19] Treas. Reg. § 1.170A-14(d)(3)(i) (as amended in 1999).

[20] Treas. Reg. § 1.170A-14(d)(3)(ii) (as amended in 1999).

[21] Glass v. Comm'r, 124 T.C. No. 16 (2006), *aff'd*, 471 F.3d 698 (6th Cir. 2006).

[22] *Id.*

[23] *Id.*

The second significant aspect of the decision was underscored by that failure of the grantors of the easement to protect more than a small portion of their property. It did not defeat the deductibility of the easements in question.[24]

d. Open space preservation

Easements protecting "open space" (and the Regulations expressly mention farm land and forest land as eligible) qualify if they fit one of two categories:

> (i) easements that preserve open space "for the scenic enjoyment of the general public;" and
>
> (ii) easements that preserve open space pursuant to a "clearly delineated federal, state, or local governmental conservation policy."[25]

1. Scenic Easements

A conservation easement that protects "the scenic character of the local rural or urban landscape" or "a scenic panorama that can be enjoyed from a park, nature preserve, road, water body, trail, or historic structure or land area" generally satisfies the requirements of the scenic enjoyment conservation purpose.[26]

The Regulations provide eight separate factors to be considered in determining whether a view over any given property qualifies as "scenic." However, the Regulations also state:

> "Scenic enjoyment" will be evaluated by considering all pertinent facts and circumstances germane to the contribution. Regional variations in topography, geology, biology, and cultural and economic conditions require flexibility in the application of this test, but do not lessen the burden on the taxpayer to demonstrate the scenic characteristics of a donation under this paragraph.[27]

In other words, you will know a scenic view when you see it.

[24] *Id.* The Court of Appeals actually rejected the IRS's argument that the unrestricted nature of adjoining property owned by others defeated the conservation purposes. However, the fact that less than one-third of the Glass's property was protected by easements, and that one of the easements upheld by the Court comprised less than 4% of the Glass's property, was a significant feature of the case. *Id.*

[25] Treas. Reg. § 1.170A-14(d)(4)(i) (as amended in 1999).

[26] Treas. Reg. § 1.170A-14(d)(4)(ii)(A) (as amended in 1999).

[27] *Id.*

To qualify for the scenic conservation purpose, there needs to be visual (not physical) access over the property, or at least over a significant portion of the property, by the public.[28]

The Regulations provide the following examples of qualified scenic purposes:

> (i) The preservation of a unique natural land formation for the enjoyment of the general public.
>
> (ii) The preservation of woodland along a public highway pursuant to a government program to preserve the appearance of the area so as to maintain the scenic view from the highway. Note that the significance of this view is enhanced by the government program.
>
> (iii) The preservation of a stretch of undeveloped property located between a public highway and the ocean in order to maintain the scenic ocean view from the highway. Note that in this example, the land preserved is not the focus of the view, it merely provides an open foreground to the view itself.[29]

2. Easements pursuant to a "clearly delineated governmental conservation policy"

In order to qualify as an easement that preserves open space pursuant to a clearly delineated governmental conservation policy, a conservation easement must do more than be a "general declaration of conservation goals by a single official or legislative body."[30]

[28] Treas. Reg. § 1.170A-14(d)(4)(ii)(B) (as amended in 1999).

[29] Treas. Reg. § 1.170A-14(d)(4)(iv)(B) (as amended in 1999).

[30] Treas. Reg. § 1.170A-14(d)(4)(iii)(A) (as amended in 1999).

Example 1

Doris Farm is located in the "A-2" agricultural zoning district of Quantum County. The A-2 zone allows agricultural uses, as well as single-family residential development on two-acre parcels. The zoning ordinance states that the purpose of the A-2 zone is to protect agricultural activity, while allowing flexibility for low-density residential use. The A-2 zone is also identified as implementing the local comprehensive plan's designation of the area around Doris Farm as one having traditionally been a farming area with high-quality agricultural soils that should be preserved for agricultural and low-density residential uses not requiring public utilities. The DEF Land Trust accepts a conservation easement on Doris Farm for the purpose of preserving its open space pursuant to a clearly delineated governmental policy. On audit, the IRS asks if there are more specific policies supporting the preservation of Doris Farm. Unfortunately, the answer is no, and the deduction would probably be denied.

Example 2

Assume the same facts as Example 1, except that in addition to the zoning and comprehensive plan designations, Quantum County also provides a special reduced real property tax assessment for farm land to encourage farmers to keep their land in farming. The cost to local taxpayers for the special reduced assessment on Doris Farm is around $5,000 per year in lost tax revenue. The combination of the planning policies, zoning, and preferential assessment probably collectively constitute a "clearly delineated governmental conservation policy." The Regulations call for a "significant commitment" by the governmental entity that has established the preservation policy to advance the policy, and the special assessment accorded Doris Farm establishes that significant commitment according to Regulation § 1.170A-14(d)(4)(iii)(A). The deduction should be allowed.

Example 3

Again, assume the same facts as Example 1. In addition, assume that Doris Farm is located within a state established "agricultural district" that identifies the land within the district as playing an important role in the state's agricultural economy. The district designation requires a special review of any subdivision application filed with the local government to insure that the division has minimal impact upon the agricultural viability of land within the district. The district also requires a special "agricultural impact assessment" of any publicly funded project proposed for land within the district, such as new schools, roads, utilities, etc. The state-sponsored agricultural district would appear to be a clearly delineated governmental conservation policy to "further a specific, identified conservation project" (Regulation § 1.170A-14(d)(4)(iii)(A)), and the deduction should be allowed.

Example 4

Assume the same facts as Example 1. However, in addition to its A-2 zoning status, assume that Doris Farm hosts a colony of blue-footed ferrets, a recently discovered endangered species. Therefore, preservation of the farm will be (in addition to preservation of a significant wildlife habitat) pursuant to a clearly delineated federal governmental conservation policy in the form of the Endangered Species Act, and a deduction should be allowed.

The foregoing examples attempt to illustrate a rather vague standard that seems to require something more than average zoning classifications, but less than a formal certification program. This is not an area where there have yet been any cases to provide guidance.

The Regulations do offer a sort of "safe harbor" for easements granted under this category of conservation purpose where a duly constituted governmental entity adopts a resolution specifically endorsing protection of a particular property as "worthy of protection for conservation purposes."[31] The problem with this approach is two-fold: First, if you ask for, but don't receive the resolution, is your project dead? Second, if you do receive a resolution, must you then do so on every project pursuant to this category of conservation purpose?

[31] Treas. Reg. § 1.170A-14(d)(4)(iii)(A) (as amended in 1999).

3. Open space easements must yield a "significant public benefit"

The Regulations provide that an easement whose conservation purpose is the protection of "open space" must "yield a significant public benefit."[32] Eleven criteria are listed for the evaluation of public significance. Because of their importance they are included in their entirety here:

> (1) The uniqueness of the property to the area;
>
> (2) The intensity of land development in the vicinity of the property (both existing development and foreseeable trends of development);
>
> (3) The consistency of the proposed open space use with public programs (whether federal, state, or local) for conservation in the region, including programs for outdoor recreation, irrigation or water supply protection, water quality maintenance or enhancement, flood prevention and control, erosion control, shoreline protection, and protection of land areas included in, or related to, a government approved master plan or land management area;
>
> (4) The consistency of the proposed open space use with existing private conservation programs in the area, as evidenced by other land protected by easement or fee ownership by organizations referred to in § 1.170A-14(c)(1) in close proximity to the property;
>
> (5) The likelihood that development of the property would lead to, or contribute to, degradation of the scenic, natural, or historic character of the area;
>
> (6) The opportunity for the general public to use the property or to appreciate its scenic values;
>
> (7) The importance of the property in preserving a local or regional landscape or resource that attracts tourism or commerce to the area;
>
> (8) The likelihood that the donee will acquire equally desirable and valuable substitute property or property rights;
>
> (9) The cost to the donee of enforcing the terms of the conservation restriction;

[32] Treas. Reg. §§ 1.170A-14(d)(4)(i)(A), (B) (as amended in 1999).

(10) The population density in the area of the property; and

(11) The consistency of the proposed open space use with a legislatively mandated program identifying particular parcels of land for future protection.[33]

Example

There are many open space conservation easements that should satisfy these public significance criteria. However, could a conservation easement preserving a farm for farming purposes when the farm is located in a largely vacant region of a plains state, is surrounded by other farmland, and is more than twenty miles from any population center qualify? Evaluating such an easement pursuant to the foregoing criteria suggests that it probably would not.

The farm is not unique; there is neither existing nor foreseeable development in the area; there are unlikely to be any public or private conservation programs in the area with which preservation of the farm is consistent; while development of the farm could lead to degradation of the area, such development is highly unlikely; the remoteness of the farm makes it unlikely that there would be significant public enjoyment of its scenic value; there is virtually no tourism so preserving the land is unlikely to attract tourism or commerce; the cost of enforcement is likely to be marginal (and it is hard to tell whether this is a positive or negative factor under the Regulations); local population density is low; and there are unlikely to be any legislatively mandated protection programs including the farm.

Even if preservation of such a farm met one of the conservation purposes, it is unlikely that the easement would have any value economically, as it is likely that the highest and best use of the property is as a farm.

4. Prevention of intrusion or future development

To qualify for a deduction, an easement may not permit "a degree of intrusion or future development that would interfere with the essential scenic quality of the land or with the governmental conservation policy" that otherwise qualifies it as serving the conservation purpose of preserving open space.[34]

[33] Treas. Reg. § 1.170A-14(d)(4)(iv)(A) (as amended in 1999).

[34] Treas. Reg. § 1.170A-14(d)(4)(v) (as amended in 1999).

This requirement addresses a misconception that some landowners have: "I should get a tax deduction because my conservation easement has reduced the development potential of my land by 50%; that is a huge loss in value." If the reserved development potential would interfere with the characteristics of the land that cause it to meet the open space requirements, even if there is a huge loss in value due to the restrictions, no deduction under this category of conservation purpose is allowed.

Example 1

Joe Doaks recently purchased Lost Oaks Farm, which consists of 200 acres of highly scenic pasture and woodland along a heavily traveled state road. Doaks puts a conservation easement on the farm reducing development potential from the 50 home sites (and lots) permitted (and feasible) under local zoning, to five home sites. However, the home sites are located squarely within the view of the property enjoyed by the traveling public. A deduction would likely be denied here because the reserved development permits "a degree of intrusion that would interfere" with the scenic quality of the property.

Note that the degree of intrusion is not qualified; i.e., the Regulations do not provide that the degree of intrusion must be significant, or substantial; it is sufficient merely that it "interfere."

Example 2

Assume the same facts as in Example 1, except that Doaks reserves 15 home sites, but restricts their location, and all other improvements on the property, to a portion of the property that is screened from the public view by the woodland and a hill. The easement prohibits removal of the trees, or re-contouring of the land. A deduction should be allowed here, assuming that the reserved uses don't impair other significant conservation interests.

Example 3

Assume that the Doaks easement only reserves one home site, to be determined by Doaks in his discretion, in the future. A deduction is unlikely because Doaks could choose to locate the home site squarely in the middle of the view-shed.

Example 4

Assume that the Doaks easement reserves ten home sites, the location of which is to be determined in the future, but subject to the prior approval of the land trust to which the easement has been granted. Approval is to be conditioned on location of the home sites and related improvements, in a manner consistent with the conservation purposes of the easement and the protection of other significant conservation interests. A deduction should be allowed because the land trust's control over the future location of the sites insures that the future sites will not be located so as to interfere with the view, or other significant conservation interests.

e. Historic preservation

Conservation easements providing for the preservation of an "historically important land area or a certified historic structure" satisfy the conservation purposes requirements.[35]

1. Historic land areas

An historically important land area includes:

> (A) An independently significant land area including any related historic resources (for example, an archaeological site or a Civil War battlefield with related monuments, bridges, cannons, or houses) that meets the National Register Criteria for Evaluation in 36 CFR 60.4 (Pub.L. 89-665, 80 Stat. 915);
>
> (B) Any land area within a registered historic district including any buildings on the land area that can reasonably be considered as contributing to the significance of the district; and
>
> (C) Any land area (including related historic resources) adjacent to a property listed individually in the National Register of

[35] Treas. Reg. § 1.170A-14(d)(5) (as amended in 1999).

> Historic Places (but not within a registered historic district) in a case where the physical or environmental features of the land area contribute to the historic or cultural integrity of the property.[36]

The United States Tax Court recently provided comments on the requirements for land to qualify under the historic preservation provisions.[37] In *Turner*, the court found that the mere proximity of land to an important historic structure did not make that land historically significant if nothing of historic significance occurred there; nor did it qualify as protecting an historic structure if the easement did not apply to any historic structures.[38]

2. Historically significant structures

In 2006, as part of the Pension Protection Act, Congress amended IRC § 170(h) to substantially tighten the requirements for conservation easements that protect historic structures. Paragraph (B), quoted below from the new law, is entirely new; paragraph (C) is a revision of existing law:

> **(B) Special rules with respect to buildings in registered historic districts.**—In the case of any contribution of a qualified real property interest which is a restriction with respect to the exterior of a building described in subparagraph (C)(ii), such contribution shall not be considered to be exclusively for conservation purposes unless—
>
> (i) such interest—
>
> (I) includes a restriction which preserves the entire exterior of the building (including the front, sides, rear, and height of the building), and
>
> (II) prohibits any change in the exterior of the building which is inconsistent with the historical character of such exterior,
>
> (ii) the donor and donee enter into a written agreement certifying, under penalty of perjury, that the donee—

[36] Treas. Reg. §§ 1.170A-14(d)(5)(ii)(A)-(C) (as amended in 1999).

[37] Turner v. Comm'r, 126 T.C. No. 16 (2006).

[38] *Id.* The court did not specifically consider the provisions of subparagraph (C) cited above, although it was clear that the court did not believe that there was anything about the physical or environmental features of the land in question that contributed to the historic structures on the adjoining land. *Id.*

> > (I) is a qualified organization (as defined in paragraph (3)) with a purpose of environmental protection, land conservation, open space preservation, or historic preservation, and
>
> > (II) has the resources to manage and enforce the restriction and a commitment to do so, and
>
> (iii) in the case of any contribution made in a taxable year beginning after the date of the enactment of this subparagraph, the taxpayer includes with the taxpayer's return for the taxable year of the contribution—
>
> > (I) a qualified appraisal (within the meaning of subsection (f)(11)(E)) of the qualified property interest,
>
> > (II) photographs of the entire exterior of the building, and
>
> > (III) a description of all restrictions on the development of the building.
>
> **(C) Certified historic structure.**—For purposes of subparagraph (A)(iv), the term "certified historic structure" means—
>
> (i) any building, structure, or land area which is listed in the National Register, or
>
> (ii) any building which is located in a registered historic district (as defined in section 47(c)(3)(B)) and is certified by the Secretary of the Interior to the Secretary as being of historic significance to the district.

A building, structure, or land area satisfies the preceding sentence if it satisfies such sentence either at the time of the transfer or on the due date (including extensions) for filing the transferor's return under this chapter for the taxable year in which the transfer is made.[39]

In addition, Congress added a requirement for the payment of $500 with the filing of any tax return claiming a deduction in excess of $10,000 for conservation easements contributed to protect historically significant structures, as provided in IRC § 170(h)(4)(B).[40]

[39] I.R.C. §§ 170(h)(4)(B), (C) (2004).

[40] Pension Protection Act, 29 U.S.C. § 1206 (2006); I.R.C. § 170(f)(13) (2004).

5. THE CONSERVATION PURPOSES OF THE DONATION MUST BE PROTECTED IN PERPETUITY

To be eligible for an income tax deduction the "conservation purposes" advanced by the easement must be protected in perpetuity.[41]

Practically speaking, this means that the grantor of a conservation easement must permanently relinquish the right to terminate or modify the easement without the consent of the holder of the easement and that the easement must be binding upon future owners.[42]

Many people wonder if they can provide in their easement that the easement terminates if the tax benefits are denied for some reason, or if the tax benefits turn out to be less than anticipated. Of course the answer is that they cannot make such a provision because it violates the requirement that the easement be granted in perpetuity.

The Regulations do make an exception for potential remote events over which the parties have no control. The Regulations give the example of a state statutory requirement that all restrictions on the use of land be re-recorded every thirty years to remain valid (sometimes called a "Marketability of Title" statute).[43]

a. The "Rule Against Perpetuities" and perpetual conservation easements

Many states have either statutory or constitutional requirements regarding the "vesting" of property held in trust for others. These requirements are typically called the "Rule Against Perpetuities." The rule, again typically, requires that any property held in trust vest outright in a beneficiary, free of trust, within a stipulated period of time. "Vesting" in this sense, means "becomes owned outright," i.e., free of trust. Occasionally, it is argued that the requirement that a conservation easement be perpetual violates the rule. However, because a conservation easement "vests" immediately in the holder of the easement once the easement is conveyed, the rule does not apply.

Of course, this does not address the more fundamental question of whether it is appropriate for an easement donor to dictate to, in theory, all future generations, how his or her land is to be used. Such a question goes to the heart of our system of private property in which many land use decisions with long-lasting effects,

[41] Treas. Reg. § 1.170A-14(a) (as amended in 1999).

[42] *See* discussion *infra* Part B.5.

[43] Treas. Reg. § 1.170A-14(g)(3) (as amended in 1999). It should be noted that such statutes may, in fact, cause easements to terminate unless affirmative action is taken to re-record the easement within the statutory time-frame. *Id.*

e.g., the development of subdivisions, shopping malls, and amusement parks, are delegated to individual owners, and should be considered in that context.

b. Conservation easement amendments and "Excess Benefit Transactions"

In spite of the requirement that a conservation easement be perpetual to be deductible, easements are inherently contracts and, like any contract, can be amended if all of the parties to the contract agree. While there have been arguments made that conservation easements should be considered to be governed by the "charitable trust" doctrine, which would substantially limit the powers of the parties to amend them, that doctrine has not been generally applied to date. In addition, the Uniform Conservation Easement Act provides that "a conservation easement may be created, conveyed, recorded, assigned, released, modified, terminated, or otherwise altered or affected in the same manner as other easements."[44]

However, the fact that easements are contracts does not mean that they can be freely terminated, or even amended, by land trusts. This is because to be an "eligible donee" to hold conservation easements, a land trust must be a public charity qualified as such under IRC § 501(c)(3), and "have the commitment to protect the conservation purposes of the donation."[45] An organization that allows easement terminations or amendments in a manner that is inconsistent with the conservation purposes of the easement fails to qualify as an "eligible donee" because it demonstrably lacks "the commitment to protect the conservation purposes of the donation."[46]

Public charity status under federal tax law also imposes substantial limitations on the actions of land trusts; in particular, land trusts are prohibited by tax law from participating in "excess benefit" transactions.[47] An excess benefit transaction is one in which a public charity, or other tax-exempt organization, directly or indirectly, provides an economic benefit to any "disqualified person" in excess of the value provided by that person to the organization in exchange for the benefit.[48] A disqualified person is any person who, for a period of five years *preceding* the transaction, was in a position to exercise substantial influence over the organization, including family members of such a person.[49] Excess benefit transactions violate the requirement that "no part of the net earnings of [a public charity] inures to the benefit of any private shareholder or individual."[50]

[44] U.C.E.A. § 2 (1981).

[45] *See* discussion *supra* Part B.3.b; Treas. Reg. § 1.170A-14(c)(1) (as amended in 1999).

[46] Treas. Reg. § 1.170A-14(c)(1) (as amended in 1999).

[47] I.R.C. §§ 501(c)(3), 4958(c)(1) (2004).

[48] *Id.*

[49] I.R.C. § 4958(f)(1).

[50] I.R.C. §§ 4958(a), (c) (2004).

An additional limitation on land trusts' ability to amend or terminate conservation easements derives from the requirement that public charities be "organized and operated exclusively" for charitable purposes.[51] Organizations are allowed tax-exempt status only if they engage "primarily" in activities that accomplish one or more exempt purposes, i.e., if more than an "insubstantial part of [an exempt organization's] activities [are] not in furtherance of an exempt purpose."[52] Note that the prohibition against excess benefit transactions (private inurement) and the requirement that an exempt organization be operated exclusively for exempt purposes are separate.[53]

Violation of these rules can result in the imposition of stiff fines ("excise taxes") on the parties to the transaction, including land trust staff, and even the revocation of a land trust's charitable status. Therefore, such rules impose an important constraint on a land trust's ability to amend or terminate an easement.

[51] *Id.*

[52] Treas. Reg. § 1.501(c)(3)-1(c) (as amended in 1990); *see* Airlie Found. v. United States, No. 93-5254, 1995 U.S. App. LEXIS 10681 (D.C. Cir. Apr. 24, 1995) (serving as an example of an organization that lost its exempt status for failure to serve exclusively public interests).

[53] United Cancer Council, Inc. v. Comm'r, 109 TC 326, (1997), *rev'd*, 165 F. 3d 1173 (7th Cir., 1999).

Example

Mrs. McCreedy donated a conservation easement on her farm in 1995. At that time she reserved three home sites, one for herself, and one for each of her two grandchildren. In 2000, her daughter had a third child. Mrs. McCreedy now wants to amend her easement to allow a fourth home site so that each of her grandchildren can have a house. From a contract law standpoint, if Mrs. McCreedy and the land trust both agree to amend the easement to allow the fourth home site, they can do it. However, such an amendment would violate the requirement that the land trust be operated "exclusively" for charitable purposes.

Mrs. McCreedy points out that she owns another farm about five miles down the road which consists of several hundred acres and which is not protected. She asks if she puts that farm under easement can the land trust agree to amend the existing easement to allow the fourth home site. She also owns fifty acres of prime timber that is a nesting ground for a bald eagle, that is not protected, and that adjoins the original easement.

Every land trust should have an amendment policy. However, at a minimum, to avoid the occurrence of an "excess benefit transaction" in responding to Mrs. McCreedy's request, the *net financial results* to Mrs. McCreedy of any amendment must be, at a minimum, neutral. To insure this, the land trust needs to arrange for an appraisal of the affects of an amendment, which must include an offset, either in the form of the protection of the farm down the road, or the adjoining 50-acre timber parcel, or both. The land trust should arrange for this appraisal, and should be reimbursed by Mrs. McCreedy for this cost, and any other costs incurred in undertaking the amendment.

This leaves the question of whether an amendment should be granted in any case, and if so, what the proper offset might be from a conservation standpoint. From a tax law standpoint it is clear that the results of the amendment must be financially neutral to Mrs. McCreedy. However, if there is no conservation offset (suppose Mrs. McCreedy simply makes an offsetting cash payment to the land trust), does this affect that status of the land trust as a "qualified organization," because it lacks the required "commitment to protect the conservation purposes of the donation" as required by Regulations § 1.170A-14(c)? It might.

Note that "amending" an existing easement to include additional property typically requires a formal conveyance of a new easement (even if it is on the same terms as the existing easement) over the additional acreage, not just an amendment of the existing easement, e.g., by changing the description of the property subject to the easement.

c. Judicial modifications/termination

The tax law contemplates that a conservation easement may be terminated by a court in the event that, "due to changed circumstances," the use of the property for the conservation purposes has become "impractical or impossible."[54]

Courts typically have the authority to terminate, or modify ("reform"), trusts where the original intent of the grantor of the trust can no longer be accomplished with the trust property.[55] This authority is necessary because trusts may last long after they were originally established, and many changes not contemplated in the trust document may occur that defeat the purpose of the trust. Conservation easements are similar to trusts in this respect, and the authority of courts to terminate and reform trusts is believed to extend to conservation easements as well.

The power of a court to terminate a conservation easement on the grounds that it can no longer achieve its original purpose, and the power of courts to modify easements for the same reason, is an exception to the tax rule that conservation easements must be permanent.

Example 1

Mr. Jax contributed a conservation easement on twenty-five acres on the outskirts of Tucson in 1980. At the time of the contribution, the acreage was the site of a magnificent group of saguaro cacti, each believed to be over two hundred years old. In 1995, a freak windstorm obliterated the stand of saguaros. At that time the land was owned by Mr. Jax's son, who went to court and sought to have the easement modified to allow public use of the property as a park, so that he could sell the parcel to the City of Tucson. The action was brought because the holder of the conservation easement did not believe it could allow the amendment because it would confer a substantial financial benefit on the landowner in violation of the holder's charitable status (i.e., it might constitute an excess benefit transaction.)

Whether the land trust's position was right or not, the court, considering all of the facts, agreed that the original purpose of the easement could no longer be accomplished and allowed the easement to be modified to allow use of the property as a public park. The court felt that use of the property as a public park at least advanced the original easement donor's intent to provide a public benefit with the land. Note that a portion of the sale's proceeds would be required to be paid to the easement holder.

[54] Treas. Reg. § 1.170A-14(g)(5)(ii) (as amended in 1999).

[55] *See generally*, GEORGE BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 433 (3d ed. 1951).

Example 2

Assume the same facts as the first example, except that the property is now surrounded by intense commercial and industrial development. The landowner petitions the court to terminate the easement on the grounds that there is no longer any public purpose that can be served by preservation of the 25 acres. The court considers requiring that the land be used for a public park, but recognizes that it is too remote from residential development and that the surrounding uses make it highly unlikely that anyone from the public would choose to use such a park. The court agrees to termination of the easement on the grounds that there is no longer any public purpose to be achieved by keeping the land open. The owner sells it to the adjoining textile mill, which promptly turns it into much needed parking lot. The owner receives $3 million for the land.

Under a provision of the easement required by the Regulations, the owner will be required to share the payment received for the land with the land trust.

According to the terms of the charitable trust doctrine, the court, had it applied that doctrine, could also have required that the proceeds of the sale go to some public purpose. How this would intersect with the regulatory requirement that the proceeds of the sale be shared with the land trust, is an unknown.

6. EXISTING MORTGAGES MUST BE SUBORDINATED TO THE EASEMENT

Existing mortgages must be subordinated to the conservation easement in order for the easement to be deductible.[56] Although this may appear a difficult requirement to meet, where landowners have sufficient equity in the property being placed under easement, it is rarely a problem.

Note that the Regulations do not specify when the subordination must occur. Best practice is for the mortgage holder to join in the easement deed. In any event, it seems likely that the subordination must be completed by the date of filing of the tax return on which the easement donation is first deducted.

It could be a grave mistake to record a conservation easement without the commitment of the mortgage holder to subordinate because if the mortgage holder fails to subordinate, the grantor of the easement may find his or her land permanently restricted by an easement that is not deductible.

[56] Treas. Reg. § 1.170A-14(g)(2) (as amended in 1999).

7. Uses inconsistent with conservation values must be prohibited

Generally, a deduction will be denied if the donor has retained rights to the use of land that would permit the destruction of significant conservation values, *even if those values are not specifically identified for protection in the easement*.[57]

The Regulations give an example of an easement, the purpose of which was to support a government flood control program. [58] The easement permitted the unrestricted use of pesticides that could destroy a naturally occurring ecosystem on the property. The example states that such an easement would violate the requirement that it prohibit the destruction of other significant conservation values, and it would not be deductible.

However, where uses inconsistent with "significant conservation values" are necessary for the specific conservation purposes of the easement, the reservation of the rights to such uses in the easement will not preclude deductibility.[59]

A deduction for an easement, the purpose of which is the preservation of scenic open space, or open space pursuant to a clearly delineated governmental conservation policy, will be denied if the landowner retains rights to use land that would interfere with the essential scenic qualities of the land or with the governmental policy to be furthered by the easement.[60]

The requirement that a conservation easement prohibit "inconsistent uses" is an important one that is currently drawing IRS attention. It is also a requirement that is not always easy to meet. It is important to remember that the easement must not only protect the values that are identified in the easement for protection, but *any other significant conservation values*, whether or not identified in the easement.[61]

It is also important to note a provision of the Regulations repeatedly cited by the Sixth Circuit Court of Appeals in its affirmation of the Tax Court ruling in the *Glass* case.[62] This provision states, referring to the prohibition against inconsistent use:

[57] Treas. Reg. § 1.170A-14(e)(2) (as amended in 1999).

[58] *Id.*

[59] Treas. Reg. § 1.170A-14(e)(3) (as amended in 1999).

[60] *See* Treas. Reg. § 1.170A-14(d)(4)(v) (as amended in 1999).

[61] Treas. Reg. § 1.170A-14(e)(2) (as amended in 1999).

[62] *See* discussion *supra* Part B.4.d.2.

> However, this requirement is not intended to prohibit uses of the property, such as selective timber harvesting or selective farming if, under the circumstances, those uses do not impair significant conservation interests.[63]

Example 1

Mr. Green buys 600 acres along a heavily traveled public road in a small, western, resort town known for its spectacular scenery. He reserves the right to construct two houses on the property, one for himself, and one for his guests. The houses are required to be set back from the road by nearly a third of a mile. However, the property consists exclusively of open pasture land. The houses, likely to be substantial, will be visible from the road. Also, any screening established around the houses will be out of keeping with the rest of the property, which is completely open. The purpose of the easement is protection of the scenic view across the property.

This example raises the question of whether or not an easement has to be "perfect" to be deductible. Without the easement, the property could have been, and likely would have been, developed into forty large-lot home sites. With the easement in place, the development of the property is limited to two home sites. Nevertheless, the easement allows a use that will interrupt the current unsullied view across this expansive pasture.

I believe that this use is "inconsistent" with the conservation purpose of the easement to protect the scenic view over the pasture. Should it be deductible? Yes. There is no question that limiting the use of the property to two, rather than forty, home sites goes a very long way to protecting the view and provides a significant public benefit. Could the IRS argue that merely reserving two home sites violates the requirements of the Regulations? Yes. Would it win this case in court? It is doubtful that a court would apply so restrictive a standard. But we do not know for sure.

[63] Treas. Reg. § 1.170A-14(e)(2) (as amended in 1999).

Example 2

Assume the same facts as Example One, except that there is a small creek that runs through the property which is a spawning ground for cutthroat trout, an important and dwindling game species. The easement allows *no* development of the property, but does allow continued ranching on the property. The right to ranch reserved in the easement is very general, and the easement says nothing about protection of the creek or the cutthroat trout.

This easement is probably not deductible, even though its purpose was protection of a scenic view, not wildlife habitat; even though it eliminates all development potential on the ranch; and even though the value of the easement is appraised at $40 million. The reason? The easement allows ranching in a manner that could harm the creek and the cutthroat trout. This example, and the result, is very similar to the example found in Regulation § 1.170A-14(e)(2).

Example 3

Bill Gallo contributes a conservation easement over an historic vineyard. The easement permits no development and preserves the open space represented by the property, which has been specifically identified by the local county supervisors by resolution, and in the comprehensive plan, as a clearly delineated local government conservation policy. However, the continued use of the property as a vineyard requires use of harsh pesticides that may endanger the purple-topped grouse biter, a small endangered insect. Although this reserved use is inconsistent with protection of the biter, pesticide use is crucial to the maintenance of the vineyard, which is the goal of the clearly delineated governmental conservation policy and the principal conservation purpose of the easement. Pursuant to the exception to the inconsistent use prohibition found in Regulations § 1.170A-14(e)(3), described above, this easement should be deductible.

"Carving out" the inconsistent use

If the "inconsistent use" is limited physically to a specific area, it may be possible to carve that area out of the easement so that the inconsistent use does not taint the deductibility of the easement.[64]

One of the arguments made by the IRS in the *Glass*[65] case was that the easement did not accomplish a publicly significant conservation purpose because the donor did not protect his entire property, but only a very small portion. The Sixth Circuit Court of Appeals rejected this argument (albeit in terms of neighboring property owners) as follows:

> The Commissioner also argues that the Tax Court erred by not considering the building rights of neighboring property owners. This argument similarly fails. There is no statutory or regulatory provision requiring consideration of neighboring property owners' building rights when determining whether a conservation easement is a "qualified conservation contribution." Congress likely recognized the common sense truth that Taxpayers/ Donors cannot realistically limit building on property outside of their control. Adoption of the Commissioner's position would unnecessarily preclude conservation donations permitted under the Tax Code.[66]

Remember that in the *Glass* case one of the easements challenged by the IRS, and upheld as deductible by the courts, only protected 18,000 square feet out of a total of eleven acres (less than four percent of the total acreage of the property) owned by the donor. The other easement protected 31,200 square feet of the eleven acres.[67]

Given the language, the ruling, the circumstances of the *Glass* case, and the complete lack of any provision to the contrary in the tax law, carving an area out of an easement on which to undertake uses that might have been "inconsistent uses" appears to be a reasonable strategy.

One note of caution in using this approach: if the donor decides to put a nondeductible restriction of some sort on the "carved out" portion of his property, the restriction itself must conform with all of the requirements of IRC § 170(h)

[64] *See* discussion *supra* Part B.10.

[65] Glass v. C.I.R., 471 F.3d 698 (6th Cir. 2006).

[66] *Id.* at 711-12.

[67] *Id.* at 703, 705.

(except that the restriction need not meet the conservation purposes test)[68] or the contribution of the non-deductible restriction may be subject to federal gift tax.[69]

Note, too, that gift tax is imposed on any gift made by an individual, unless that gift is specifically exempt. IRC § 2522(d) exempts qualified conservation contributions from the gift tax; however, in order to qualify the gift must meet the requirements of IRC § 170(h). However, for gift tax purposes the easement need not meet the "conservation purposes" requirements of IRC § 170(h)(4)(A).

8. PUBLIC ACCESS IS NOT REQUIRED FOR MOST "OPEN SPACE" EASEMENTS

Easements to preserve open space pursuant to a governmental conservation policy normally are not required to provide public access in order to be deductible.[70]

Only when the purpose of the easement requires public access for there to be a public benefit is access required. Examples of easements requiring public access include scenic easements (scenic qualities must be publicly visible)[71] and historic easements (the public must have at least visual access to the historic area or structure).[72]

9. "REMOTE AND FUTURE EVENTS"

The Regulations do not deny a deduction in cases where some "remote, future event" that is "so remote as to be negligible" may cause a termination of the easement, notwithstanding the requirement of perpetuity.[73] The example given in the Regulations is of termination of an easement by operation of what is known as a "marketability of title" statute. Such statutes require that interests in land that do not involve physical possession ("inchoate interests") must be re-recorded periodically to remain in force.[74] A conservation easement constitutes such an inchoate interest, and may automatically terminate in the event that the easement is not re-recorded within the specified period of time.

[68] *See* I.R.C. § 2522(d) (2004).

[69] I.R.C. § 2522(d) (2004); *see also* discussion *infra* Part D.2.

[70] Treas. Reg. § 1.170A-14(d)(4)(iii)(C) (as amended in 1999).

[71] Treas. Reg. § 1.170A-14(d)(4)(ii)(B) (as amended in 1999).

[72] Treas. Reg. § 1.170A-14(d)(5)(iv) (as amended in 1999).

[73] Treas. Reg. § 1.170A-14(g)(3) (as amended in 1999).

[74] *See* WYO. STAT. ANN. § 34-10-101 (LexisNexis 2007).

Unfortunately, the example given does not very well reflect the Regulatory requirement that circumstances triggering termination be "so remote as to be negligible."[75] Termination under a marketability statute is not "so remote as to be negligible" but is instead a completely predictable event that will occur at a specific time if the land trust does not re-record the easement prior to that time.

As noted previously, perhaps the most important lesson from this example is to alert land trusts that there are statutes in a number of states that can cause termination of conservation easements if the land trust does not re-record its easements within the statutory period.

10. NO DEDUCTION IS ALLOWED WHERE SURFACE MINING RIGHTS ARE RETAINED

An easement that reserves the right to recover a "qualified mineral interest" by any surface mining method is not deductible.[76] A "qualified mineral interest" is "the owner's interest in subsurface oil, gas, or other minerals and the right of access to such minerals."[77]

Provided that the easement prohibits surface mining, an exception to the no-deduction rule exists where mineral interests have been severed from the surface rights and are not owned by the grantor of the easement, *and* the probability of surface mining such minerals is "so remote as to be negligible."[78] A letter from a qualified geologist that the probability of surface mining on such property "is so remote as to be negligible" provides evidence (not necessarily conclusive) that this condition has been satisfied, in case of an audit.

Note that a right reserved in an easement to remove gravel from a riverbed on the protected property for use in maintaining roads on the property and for use in construction of a permitted structure on the property was considered by the United States Court of Claims to be a reserved surface mining right defeating a $19 million tax deduction.[79]

"Split Estate" issues

The problem of the "split estate," i.e., where mineral rights and surface rights are separately owned, is a major one in the western states, where minerals were typically retained by the U.S. government when the land was homesteaded. Where minerals have been retained by the government, or otherwise separated from the ownership of the surface, a conservation easement cannot control the

[75] Treas. Reg. § 1.170A-14(g)(3) (as amended in 1999).

[76] Treas. Reg. § 1.170A-14(g)(4)(i) (as amended in 1999).

[77] Treas. Reg. § 1.170A-14(b)(1)(i) (as amended in 1999).

[78] Treas. Reg. § 1.170A-14(g)(4)(ii) (as amended in 1999).

[79] *See* Great Northern Nekoosa Corp. v. United States, 38 Fed. Cl. 645 (1997).

manner in which such minerals are removed from the property unless the owner of the minerals joins in the easement, or unless the easement preceded separation of the minerals from the ownership of the surface.

While it is difficult to make a deductible contribution of a conservation easement in split estate situations, the definition of "qualified conservation contribution" allows a deduction for the charitable gift of the donor's entire interest in property, other than a "qualified mineral interest." The Regulations expressly allow a deduction for such a contribution.[80] According to the Regulations, "a qualified mineral interest is the donor's interest in subsurface oil, gas, or other minerals and the right of access to such minerals."[81] These provisions of the Regulations offer some planning opportunities for the conservation of land in which *subsurface* mineral interests are owned separately from the surface.[82]

Example 1

Susan Jones wants to protect her ranch. She places a conservation easement over the ranch that reserves her right to remove gravel from a small creek for maintenance of ranch roads, a use that has been part of the ranch operation for over 100 years. The IRS audits the easement and denies the deduction based upon the *Nekoosa* decision described above. However, the ranch is located in Wyoming, and Wyoming law does not consider gravel a "mineral." Because the definition of the term "mineral" has been left by the Regulations to state law, Susan is able to retain her deduction. Had state law been different, the IRS might have been successful in denying the entire deduction.

[80] Treas. Reg. § 1.170A-14(b)(1) (as amended in 1999).

[81] Treas. Reg. § 1.170A-14(b)(1)(i) (as amended in 1999).

[82] Pension Protection Act, 29 U.S.C. § 1206 (2006). Note that such a contribution of a fee interest with reservation of a qualified mineral interest is eligible for the tax benefits made available by the Pension Protection Act. *Id.*

Example 2

Suppose that Wyoming law were different and that gravel was considered a mineral. Susan insists that she cannot economically operate the ranch if she has to purchase gravel to maintain the ranch's many miles of roads.

A solution *may* be to carve out from the easement property the area from which Susan obtains gravel. Provided that the easement over the remaining land constitutes a deductible conservation easement under IRC § 170(h), there is no *known* basis upon which the IRS can challenge the deductibility of the easement on the grounds that the gravel area was excluded. The IRS can only look at what is protected by the easement and the easement itself. It cannot look outside of the protected area and say "you should have preserved this as well."

Susan (or the land trust) may wish to put a non-deductible easement, or restriction, on the gravel area just to insure that some future owner cannot turn it into a cement factory. As noted previously, if Susan contributes a non-deductible easement over the gravel pit, she needs to make sure that the contribution is not subject to the gift tax.

11. Reservation of other mining or mineral extraction rights

No deduction will be allowed for any easement reserving the right to recover any qualified mineral interest by any method that is inconsistent with the conservation purposes of the easement.[83] This tracks the provisions of the "inconsistent use" rule.

However, a deduction will not be denied if the easement retains the right to engage in a form of mining (*but not surface mining*) that meets the following three criteria:

(i) the mining will have only a limited impact on the property;

(ii) the mining will have only a localized impact on the property; *and*

(iii) the mining will not be irremediably destructive of significant conservation interests.[84]

[83] Treas. Reg. § 1.170A-14(g)(4) (as amended in 1999).

[84] Treas. Reg. § 1.170A-14(g)(4)(i) (as amended in 1999).

Of course, the principal problem with mineral interests is not where the landowner granting the easement owns the minerals, but is the case of the split estate where the mineral rights have been separated from the surface rights. When mineral rights have been separated from the surface, assuming that commercially recoverable mineral deposits exist on the property, the requirements of the tax law cannot be met by inserting controls over extraction in the easement. Such provisions cannot bind persons who obtained (or retained) title to the minerals prior to the conveyance of the conservation easement. To do that, the mineral owner would have to subordinate his or her interest in the minerals to the provisions of the easement.

While the Regulations do provide two examples of easements in which the reservation of the right to extract minerals in an easement did not preclude a deduction, the examples are not particularly helpful.[85] The following examples are more specific, but have not been tested:

Example 1

Sam Murdo operates a ranch on 2,000 acres that was homesteaded by his grandfather in 1880. Sam's grandfather was a shrewd man and made sure that he obtained the mineral rights with the property.

Sam approaches the local land trust about the contribution of a conservation easement. Sam is willing to prohibit surface mining on the ranch. However, he wants to retain the right to explore for and extract the subsurface oil and gas reserves that are there. He agrees to an easement that 1) requires him to space the wells on 160-acre parcels; 2) strictly limits the land disturbed for each drilling and operations pad to no more than five acres; 3) requires the location of the pads to be reviewed by the land trust to insure that no significant habitat or scenic view is disrupted; 4) limits the roads accessing the pads to locations and designs agreeable to the land trust; 5) requires that all pipelines leading from the wells be located underground; 6) requires reclamation of any disturbed land to the condition of the surrounding undisturbed land; and 7) requires complete reclamation of the property at the completion of mineral extraction activities.

This easement should meet the requirements of the Regulations that the impact of exploration and extraction have no more than a limited, localized, impact not irremediably destructive of conservation values.

[85] Treas. Reg. § 1.170A-14(g)(4)(iii) (as amended in 1999).

Example 2

Assume the same facts as Example 1 above, except that Sam's grandfather failed in his efforts to obtain mineral rights to the ranch. The land trust explains to Sam the complication resulting from the separated mineral interest. Sam obtains a report on the minerals on the ranch from a qualified geologist. The report indicates that there are no surface minerals having any commercial value on the ranch; however, there are valuable and recoverable subsurface oil and gas reserves. Of course, these reserves are owned by the federal government, not Sam.

Sam proposes to make a "qualified conservation contribution" to the land trust in the form of a gift of the *fee interest* in his ranch. Such a gift will meet the requirements of the Regulations for a gift of the fee, in which the donor reserves a "qualified mineral interest." Sam retains a life estate in the ranch, so that he and his family can continue to enjoy the ranch during his lifetime. Sam could convey the ranch to his children (and grandchildren) as tenants in common prior to making the contribution to the land trust. This *might* allow Sam, his children, and grandchildren to all reserve life estates in the property and still qualify the gift under another exception to the prohibition against deducting gifts of partial interests, i.e., the exception for the gift of a personal residence or farm in which the grantor retains a life estate. *See* Treas. Reg. §§ 25.2522(c)(2)(ii) and (iii).

Note that if Sam reserved a right to lease the property for some period of years the gift would not qualify for a deduction, because retention of a lease constitutes the retention of a partial interest, which is not one of the exceptions to the prohibition against deducting partial interest gifts. On the other hand, if Sam were trusting, he could make the gift of the ranch with no strings attached and later negotiate a lease-back from the land trust. The issue for the land trust would be whether a lease-back on terms acceptable to Sam would constitute an "excess benefit" transaction.

12. AN INVENTORY OF NATURAL RESOURCES IS REQUIRED

If the donor retains any rights to use the property subject to the easement (e.g., farming, limited residential use, recreational use) a written "natural resource inventory" must be prepared and made available to the donor and the prospective holder of the easement *prior to the conveyance of the easement*.[86] The Regulations provide a list of suggested matters to be covered in the inventory.[87]

[86] Treas. Reg. § 1.170A-14(g)(5)(i) (as amended in 1999).

[87] *See* Treas. Reg. §§ 1.170A-14(g)(5)(i)(A)-(D) (as amended in 1999).

This inventory is critical to the ability of the holder of the easement to monitor and enforce the easement because it provides a starting point from which to measure change on the protected property over time. It should go without saying that knowing where the inventory is at all times is important; for that reason, some land trusts actually record the inventory with the easement, making it a matter of public record.

13. Notice requirements

The easement must require that the donor/landowner notify the easement holder prior to exercising any rights reserved in the easement if such exercise might impair the conservation interests.[88] This requirement is occasionally objected to by easement donors, who feel it is intrusive. However, to be safe, a conservation easement should expressly provide something along the following lines:

> The Grantor shall notify the Grantee prior to undertaking any use of the property that may impair the conservation interests protected by this Easement.

14. Monitoring of the property must be provided for

The easement must require that the easement holder have the right to enter the property at reasonable times to inspect the property for compliance with the terms of the easement.[89] Note that while providing for notice to the landowner prior to monitoring as a courtesy is typical, monitoring may not be conditioned upon landowner consent or it will defeat the requirement of the Regulations.

15. Enforcement terms required

The easement must provide the easement holder with the right to enforce the terms of the easement, including the right to require restoration of the property subject to the easement to the condition that existed *on the date of the conveyance of the easement*.[90]

The emphasized language is contrary to the provisions of many easements, which provide that restoration must be to the condition existing prior to the violation. Such a provision is not in compliance with the requirements of the Regulations.[91] An exception for changes in the property that are consistent with the terms of the easement is probably not in violation of this requirement.

[88] Treas. Reg. § 1.170A-14(g)(5)(ii) (as amended in 1999).

[89] *Id.*

[90] *Id.*

[91] *Id.*

Example

Sol Green donates a conservation easement over 200 acres, one-third of which is forested. The easement reserves the right to timber the forested portion of the property, subject to a plan for timber management that has been approved by the land trust. Sol timbers about twenty acres of the property consistent with the approved plan. The following year he sends in a bulldozer to clear debris. This clearing is in violation of the easement because it is contrary to the timber management plan that requires leaving debris to provide habitat.

The Regulations would require restoration of the improperly cleared area to the condition on the date of conveyance of the easement: i.e., fully forested with mature trees. Obviously, this is not possible. Also, removal of the trees was not a violation of the easement because it was done according to the approved plan. A restoration provision requiring restoration to the condition existing on the date of the easement conveyance "except for changes made that are consistent with the terms of the easement" would allow the property to remain in its timbered state, while requiring replacement of the removed debris, or the addition of comparable cover for wildlife.

16. EXTINGUISHMENT (TERMINATION) OF AN EASEMENT

The possibility that an easement may be extinguished will not defeat deductibility if:

a) the termination was by court order;

b) the termination was due to changed circumstances making continued use of the property for the conservation purposes impractical or impossible; *and*

c) the holder of the easement is required to use its share of any proceeds resulting from the termination of an easement in a manner that is consistent with the conservation purposes of the easement.[92]

Concerns about easement termination, other than by court order, are growing in the face of the occurrence of several easement terminations, or modifications amounting to termination, in recent years. Such cases are still extremely rare. However, they have started a debate nationally about application of the "chari-

[92] *Id.*

table trust doctrine" to conservation easements. Essentially, application of this doctrine would require judicial oversight of most all easement terminations *or* modifications. To date, this doctrine has not been applied generally, and some questions have been raised about the appropriateness of applying the doctrine at all.

Regardless of this debate, the Regulations do not contemplate that an easement may be terminated other than by judicial action in a manner more or less consistent with the charitable trust doctrine.[93] Absent application of the charitable trust doctrine, as a matter of common law, easements are contracts that can be modified by the parties regardless of provisions in an easement to the contrary.[94] However, it is important to keep in mind that easements cannot be modified or terminated with impunity because of the restrictions imposed by federal tax law on the ability of public charities to engage in "excess benefit transactions."[95]

17. DIVISION OF SALES PROCEEDS IN THE EVENT OF TERMINATION

The Regulations require that an easement must provide for a division of sales proceeds resulting from the termination of an easement in whole, or in part.[96] The Regulations require that a conservation easement contain the following provisions:

> a) that the easement holder's interest in the easement is a vested property interest;
>
> b) that the fair market value of the holder's interest is at least equal to the proportionate value that the easement, at the time of the donation, bears to the value of the unrestricted property as a whole at the time of the donation;
>
> c) that this proportionate value of the easement will remain constant; and
>
> d) that in the event that the easement is extinguished, the proceeds of any sale, exchange, or involuntary conversion of the property that was subject to the easement will be divided between the landowner and the easement holder on the basis of that proportionate value.[97]

[93] *See* Treas. Reg. § 1.170A-14(g)(6)(i) (as amended in 1999).

[94] *See* discussion *supra* Part B.5.

[95] *See* discussion *supra* Part B.6.

[96] Treas. Reg. § 1.170A-14(g)(6)(ii) (as amended in 1999).

[97] *Id.*

Example

If River Ranch is worth $1,000,000 in its unrestricted state and $300,000 as restricted by a easement, the proportionate value of the unrestricted property represented by the easement is 70% ($700,000/$1,000,000). If the Ranch is subsequently condemned for public use as the site of a new school and the proceeds of the condemnation are $2,000,000, the proceeds must be divided and distributed $1,400,000 (70% x $2,000,000) to the easement holder and $600,000 (30% x $2,000,000) to the owner of the Ranch. Note that these values do not include improvements because it is assumed, in this example, that improvements are not restricted by the easement and are not, therefore, included in its value.

C. INCOME TAX BENEFITS

There are significant income tax benefits associated with the contribution of conservation easements provided that the easement document complies with all of the requirements of IRC § 170(h) and the accompanying Regulations (beginning at § 1.170A-14).

1. THE VALUE OF THE EASEMENT IS DEDUCTIBLE

The value of a conservation easement that complies with the requirements of IRC § 170(h) may be deducted from the donor's income for purposes of calculating federal income tax. The value of the easement for purposes of the deduction is typically the difference in the value of the easement property before the contribution and after the contribution.[98]

Example

Mr. Jones contributes an easement on land that is valued at $1,000,000 before the contribution. After the contribution the land is valued at $300,000. The value of the easement is $700,000 ($1,000,000 – $300,000), which is the difference in the before and after easement value.

2. CALCULATING THE MAXIMUM TAX BENEFIT

The *maximum* possible federal income tax benefit (i.e., tax savings resulting from a deduction) from any easement contribution is calculated by multiplying

[98] *See* discussion *infra* Part C.5; Treas. Reg. § 1.170A-14(h)(3)(ii) (as amended in 1999).

the value of the easement by the top federal tax rate. Many states with an income tax provide a deduction for easement contributions as well. In such cases, adding the applicable top federal and state tax rates together and multiplying the value of the easement by these combined rates provides the *maximum* possible combined federal and state income tax benefit of any easement contribution.

As of January 2007, the top federal income tax rate for individuals was 35% and the federal income tax rates for "C" corporations (i.e., corporations taxed as separate entities) ranged from 15% to 39%, but not incrementally. "S" corporations, and other entities such as limited liability companies and partnerships, pass both income and deductions through to their owners, which income is then taxed at the owner's individual tax rate.[99]

Example 1

If Mr. Jones, in the example on the preceding page, earned sufficient income that the entire $700,000 represented by the easement deduction was taxed at the current top federal rate of 35%, the value of his deduction would be $245,000 (35% x $700,000).

If Mr. Jones resides in a state with a 6% income tax that allows a deduction for the contribution of a conservation easement, he would enjoy an additional state income tax benefit of $42,000 (6% x $700,000).

Some states, in addition to allowing a charitable deduction for the contribution of a conservation easement, allow a credit against state tax due for easement contributions. For example, Virginia allows a tax credit equal to 40% of the value of any conservation easement donated by a Virginia taxpayer over land in Virginia (providing that the easement qualifies as a qualified conservation contribution under IRC § 170(h)).[100] State tax credit programs are few and can vary significantly from state to state.[101]

[99] *See* discussion *infra* Part C.13.b.

[100] *See* VA. CODE ANN. § 58.1-512 (2007).

[101] *See* discussion *infra* Part C.13.c (discussing the federal tax treatment of state tax credits for easements).

Example 2

Mr. Jones (the donor of the $300,000 easement in the previous examples) is a Virginia resident with a Virginia tax liability of $200,000. Virginia allows a state tax credit of 40% of the value of a qualified conservation easement, subject to certain other limitations. In addition to his federal and state charitable deductions, he can take a credit against his Virginia tax liability of $120,000 (40% x $300,000). This credit reduces his Virginia tax liability to $80,000.

3. THE AMOUNT OF THE FEDERAL DEDUCTION IS SUBJECT TO AN ANNUAL LIMITATION

Note that the following discussion of annual limitations is divided into "old law" and "new law." This is because in August, 2006, as part of the "Pension Protection Act of 2006," more generous limitations on charitable deductions for easement contributions were enacted by Congress.[102] However, because *the new law will only apply to easements donated in 2006 and 2007,* readers need to know both the old and new law. Whether the *new law* will be extended is not known at this time, although efforts are currently underway to make the *new law* permanent.

Old Law

Under the *old law*, when an individual made a contribution of "long-term capital gain" property (i.e., a capital asset held more than one year, for example, a conservation easement on land owned for more than one year by the donor), the federal income tax deduction for that donation was limited to 30% of the donor's "contribution base."[103] "Contribution base" is adjusted gross income without regard to the amount of the contribution and without regard to any "net operating loss carry-back."[104]

Under the *old law*, if the easement contribution were made in the first year of ownership, the deduction was allowed up to 50% of the donor's contribution base because the gift was considered a gift of "ordinary income property."[105] However,

[102] Pension Protection Act, 29 U.S.C. § 1206 (2006); IRC § 170(b)(1)(E) (2004).

[103] Treas. Reg. § 1.170A-8(e) (as amended in 1972).

[104] Treas. Reg. § 1.170A-8(d)(1) (as amended in 1972).

[105] I.R.C. § 170(e)(2) (2004); Treas. Reg. § 1.170A-8(b) (as amended in 1972).

a deduction for ordinary income property cannot exceed the donor's basis in the easement (this continues to be true under the *new law*).[106] Note that "basis in the easement" *is not* necessarily basis in the property subject to the easement.[107]

After the first year of ownership, an individual donor may *elect* to limit the amount of the deduction to his or her basis in the easement gift and thereby qualify for the 50% limitation rather than the 30% limitation.[108] This election is no longer needed under the *new law*.

In any event, the aggregate amount of *all* of a donor's charitable deductions (e.g. easement contributions and other contributions such as cash, securities, etc.) made during a tax year is limited to 50% of the donor's contribution base (including conservation easement deductions that are limited to 30% of the donor's contribution base). Thus, if the donor has made contributions for which charitable deductions are available in addition to the conservation easement gift, the value of the other contributions may reduce the amount of the deduction that may be taken for the easement contribution.

Note: "C" corporations are limited to deducting no more than 10% of their "taxable income" for charitable contributions, regardless of the length of time the property that is contributed has been owned by the corporation.[109] *This rule is **not** changed by the new law **unless** more than 50% of the corporation's income is from "the business of farming" and the stock of the corporation is not publicly traded.*[110]

Example 1 (Old Law)

Mr. Jones' easement is worth $700,000. He has owned the property that is subject to his easement contribution for five years. Therefore, the contribution is considered the contribution of long-term capital gain property subjecting him to the 30% limitation. Mr. Jones' income is $250,000 annually; therefore, he may only deduct $75,000 (30% x $250,000) of his easement contribution each year, even though the value of the easement is $700,000.

[106] I.R.C. § 170(e)(1) (2004).

[107] *See* discussion *infra* Part C.5.

[108] See Treas. Reg. § 1.170A-8(d)(2) (as amended in 1972).

[109] I.R.C. § 170(b)(2) (2004).

[110] *See* discussion *infra* Part C.3.

Example 2 (Old Law)

If Mr. Jones made other charitable gifts amounting to $100,000 during the year in which he donates the conservation easement, he may only deduct $25,000 of his easement gift because his total deduction for charitable gifts is limited to 50% of his contribution base ((50% x $250,000) – $100,000 = $25,000). However, as described below, Mr. Jones may "carry forward" the unused portion of his deduction to future tax years.

Note that under the *old law* it did not matter which charitable contributions were completely deductible in the year of the contribution and which had to be carried forward. This is not the case under the *new law*.

Example 3 (Old Law)

Mr. Jones contributes his easement six months after he purchases the property. Thus, the property is treated as "ordinary income property," and the deduction may be used up to 50% of his contribution base. In this case, he may deduct $125,000 (50% x $250,000) of the value of the easement and carry the unused balance of the contribution forward. However, Mr. Jones's deduction cannot exceed his basis in the easement.

New Law

The *new law* changes the annual limitation to 50% for all easement contributions, regardless of the length of time the land subject to the easement has been owned by the donor. In other words, the 30% limitation no longer applies to easements contributed on land owned for more than one year.[111]

In addition, if the easement were contributed by a "qualified farmer or rancher," the contribution may be taken against 100% of the donor's contribution base. A qualified farmer or rancher is someone (including a corporation, the stock of which is not "readily tradable on an established securities market"[112]) more than 50% of whose income comes from the "business of farming."[113]

[111] I.R.C. § 170(b)(1)(E)(i) (2004).

[112] I.R.C. § 170(b)(2)(B)(i)(I) (2004). While it is clear that this new provision applies to "corporations," a limited liability company, in most cases, is treated as a partnership for federal tax purposes. While there is no guidance on this point yet, it seems likely that the greater than 50% of income from farming requirement, in the case of LLCs, must be met at the member level, not the entity level. *Id.*

[113] I.R.C. § 170(b)(1)(E)(iv) (2004).

IRC § 170(b)(1)(E)(v) provides that the definition of "farming" under the *new law* is the definition currently found in IRC § 2032A(e)(5), which is as follows:

> (A) cultivating the soil or raising or harvesting any agricultural or horticultural commodity (including the raising, shearing, feeding, caring for, training, and management of animals) on a farm;
>
> (B) handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than one-half of the commodity so treated; and
>
> (C) the planting, cultivating, caring for, cutting of trees, or the preparation (other than milling) of trees for market.[114]

The definition of "farm" for purposes of the foregoing is found in IRC § 2032A(e)(4):

> The term 'farm' includes stock, dairy, poultry, fruit, furbearing animal, and truck farms, plantations, ranches, nurseries, ranges, greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities, and orchards and woodlands.[115]

In order for the 100% limit to apply, the conservation easement must insure that the land that is subject to easement remains "available" for agriculture. This is not a requirement that the easement mandate that the land be actively used for agriculture.[116] This requirement does not apply to 50% limit deductions.

Note that under the *new law* if the more than 50% of income from the business of farming requirement is met in the year of the easement contribution, it does not appear to matter what source the income is from in the carry-forward years; the 100% limit will continue to apply.

[114] I.R.C. § 2032A(e)(5) (2004).

[115] I.R.C. § 2032A(e)(4) (2004).

[116] I.R.C. § 170(b)(1)(E)(iv)(II) (2004).

Example 1

Mr. Jones' easement is worth $700,000. He has owned the property that is subject to his easement contribution for five years. Although this is considered the contribution of long-term capital gain property subjecting him to the 30% limitation under the *old law*, under the *new law* the limitation is increased to 50%. Mr. Jones' income is $250,000 annually. Thus he may deduct $125,000 of his easement contribution (50% x $250,000), allowing him to deduct the entire value of the easement within a five-year period.

Example 2

Sam Evans is a rancher. He has a large ranch that he runs with his family through a family-owned corporation, the Lazy J LLC. Lazy J is a limited liability company (taxed like a partnership, not as a separate entity). Lazy J's adjusted gross income in 2007 is $1,000,000, which it passes through to its members in proportion to their ownership in the company (unless the "operating agreement" for the company provides for a different distribution). Of this income, $550,000 is from the "business of farming" and the rest is from investments. Sam Evans owns 80% of the company and, therefore, is entitled to $800,000 of the Lazy J's income, which comes to him 55% as farm income and 45% as investment income, the same as the percentage of income to the company. This constitutes Sam's sole source of income.

The Lazy J contributes a conservation easement in 2007 valued at $10 million. As a limited liability company, Lazy J passes the entire amount of this deduction through to its members. Therefore, Sam is entitled to an $8 million charitable contribution deduction. Because more than 50% of Sam's income is from the business of farming, the *new law* allows him to take this deduction against his entire $800,000 income annually until the deduction is used up. Under the *new law* Sam may spread this deduction over a total of sixteen years. In this case he will use-up the deduction in ten years, assuming his income does not change.

Example 3

XYZ Corporation is a "C" corporation, i.e., it is taxed separately from its shareholders, unlike an "S" corporation or limited liability company. XYZ's stock is not publicly traded and is wholly owned by a small group of farmers who have used the corporation to acquire and hold certain real property that they use for hay production for their various individual farming operations. All of XYZ's income is from the sale of its agricultural products. XYZ contributes a conservation easement that preserves the real property it owns for agricultural use and as scenic open space. The easement is valued at $1 million. XYZ's taxable income is $50,000 per year. Under the *old law* XYZ was only allowed to use a conservation easement deduction up to 10% of its *taxable* income. Under the *new law* XYZ is allowed to use the deduction up to 100% of its taxable income. As noted below, XYZ will be able to carry the unused portion of the deduction forward for fifteen years. Assuming that its income remains the same, this allows XYZ to use $800,000 (16 x $50,000) of the deduction.

4. Unused portions of the deduction may be used in future years

The law governing the number of years that unused portions of a conservation easement deduction may be "carried forward" has also changed for easements donated in 2006 and 2007.[117] Again, discussion will be divided into the *old law* and the *new law*.[118]

Old Law

Under the *old law* any unused portion of an easement deduction could be "carried forward" for five years after the year of the contribution (allowing a maximum of six years within which the deduction could have been utilized), or until the amount of the deduction has been used up, whichever came first.[119]

New Law

The new law increases the carry forward period from five years to fifteen years, or until the amount of the deduction has been used up, whichever comes first.[120]

[117] *See* discussion *supra* Part C.3.

[118] *See* discussion *supra* Part C.3.

[119] Treas. Reg. § 170A-10(c)(1)(ii) (as amended in 1975).

[120] I.R.C. § 170(b)(1)(E)(ii) (2004).

Note that it appears that the *new law* also applies to contributions of the fee interest in real property, provided that the donor reserves a "qualified mineral interest" in the property contributed.[121] The contribution of the fee *including* mineral rights will not qualify. This unusual outcome is due to the incorporation by the new law of the definition of "qualified conservation contribution" as defined in IRC § 170(h)(1).

Note also that, because the *new law* provides a fifteen-year carry-forward period for conservation easement contributions, a donor with a conservation easement contribution, and other contributions subject to the five-year carry-forward period, should give priority to writing off the five-year carry-forward deductions over the conservation easement deduction.

Example 1

Assume that John Wells donates a conservation easement valued at $900,000. Assume also that his annual contribution base is $140,000. This would allow Wells to use up to $70,000 per year of this $900,000 deduction. Over the six-year period during which he could use the deduction under the *old law*, he could only deduct $420,000 (6 x $70,000). However, under the new law, and assuming no change in his contribution base, Wells can deduct the entire amount of the $900,000 contribution because he has fifteen years to carry the deduction forward and only needs thirteen ($900,000/$70,000).

[121] I.R.C. § 170(b)(1)(E)(i) (2004). By incorporating the definition of "qualified conservation contribution" from I.R.C. § 170(h)(1) (2004). *Id.*

Example 2

Assume, under the *new law*, that in 2007 Sam Wells' easement contribution is worth $1,000,000, and that he has other contributions amounting to $500,000. Also assume that his annual contribution base is $250,000. The maximum amount that Sam may deduct from his income in 2007 is $125,000 (50% x $250,000). Sam assumes that his contribution base will remain approximately $250,000 for the foreseeable future. He calculates that he has six years (including the year of the contribution) to use up his $500,000 deduction and sixteen (including the year of the contribution) to use up his $1,000,000 easement contribution.

Therefore, Sam claims $90,000 of his five-year carry-forward deductions and allocates the remaining $35,000 of his allowed annual deduction ((50% x $250,000) – $90,000) to the fifteen-year carry-forward deduction. Thus, at the end of the sixth year he has completely deducted the five-year carry-forward deduction and has used $250,000 of his fifteen-year carry-forward deduction, leaving $750,000 of the fifteen-year carry-forward deduction remaining. He has an additional ten years to use up this $750,000 balance, which (assuming he has no other charitable deductions) he can do over a period of six years ($750,000/$125,000).

Although there are no regulations providing guidance as to exactly how to differentiate between five-year and fifteen-year carry-forward deductions in claiming the deductions, Example 2 makes it clear that there is an advantage to giving priority to the deduction of five-year carry-forward deductions over fifteen-year carry-forward deductions.[122]

5. "PHASING" EASEMENT DONATIONS TO EXTEND INCOME TAX BENEFITS

As noted above, deductions for easement contributions under the *old law* were limited to either 30% or 50% of the donor's contribution base depending upon the length of time the donor had owned the property prior to the contribution, and under the *new law*, to 50% of the donor's contribution base, regardless of holding period. These limitations prevent some easement donors from deducting the full value of their easement gift (although the fifteen-year carry-forward period allowed under the *new law* should dramatically reduce this problem). This problem can be addressed by "phasing" easement gifts.

[122] *See* discussion *supra* Part C.4.

Example

Mrs. Blue donates a conservation easement over her 1,000-acre ranch. The value of the easement is $6,000,000. Mrs. Blue's average annual income is $500,000. The maximum deduction that Mrs. Blue can realize, assuming she is subject to the 50% annual limitation and that her income does not change, is $4,000,000 (50% x $500,000 x 16).

However, Mrs. Blue could increase the amount of the deduction she can use by protecting her ranch in two phases, using two separate easements donated at different times. For example, the first easement could cover 500 acres of her ranch. Assume that the value of that easement is $2,500,000 (taking into account the increase in the value of the unrestricted portion of the ranch due to the conservation easement).

Over a ten-year period Mrs. Blue will be able to fully deduct this gift (50% x $500,000 x 10 = $2,500,000). Once this gift has been fully deducted Mrs. Blue donates a second easement over the remaining 500 acres of the ranch. The second easement is worth $5,000,000 (considering appreciation). By the time of this gift, Mrs. Blue's average annual income has increased to $700,000. Over the fifteen years beginning with the second easement donation Mrs. Blue will be able to fully deduct this $5,000,000 gift (50% x $700,000 x 15 = $5,250,000).

Mrs. Blue could have phased her easement gifts differently by donating an easement over the entire ranch that eliminated only half of the development potential that she ultimately intended to eliminate. The second easement would eliminate the balance of the development potential. In any case, each easement must *independently* meet the standards of IRC § 170(h), including the generation of a significant public benefit. A reservation of such potential may raise "inconsistent use" issues.[123]

In a phased conservation plan, such as Mrs. Blue's, the donor should include a provision in her will directing her executor to contribute an additional conservation easement that completes protection of the property. A full draft of the intended easement should be incorporated into the will to avoid uncertainty. Such a conveyance will not qualify for any income tax benefits, but will qualify for full estate tax benefits, which may be significant.

[123] *See* discussion *supra* Part B.6.

6. THE LIMITATION TO "BASIS"

Another important limitation on the amount that may be deducted for the contribution of a conservation easement is the limitation to basis for easements contributed on property owned for one year or less by the donor.[124] This limitation *has not* been changed by the Pension Protection Act.

The limitation to basis limits the deduction to the donor's *basis in the easement*, not basis in the property subject to the easement, which is different. This limitation is an important consideration in timing an easement contribution.

The basis in the easement is a function of two factors: (1) the amount the donor paid for the property subject to the easement (basis in the property), and (2) the percentage of the *appraised* "before easement value" that is represented by the easement. The donor's basis in the property is multiplied by the appraised "before easement value" percentage to determine the donor's basis in the easement.

Where the appraised value of the property prior to the easement is the same as, less than, or only slightly more than, the donor's basis in the property, the limitation to basis will not make a significant difference in the amount of the deduction. However, where the appraiser determines that the "before easement" value of the property is substantially more than what the donor paid for the property, the limitation to basis can make a significant difference in the amount of the deduction.

Example

Assume that Mr. Blue's basis in the property he places under easement is $250,000 (which was the purchase price). He donates a conservation easement on the property six months later. The appraiser determines that the property before the easement is in place is actually worth $500,000, and that the restricted value of the property after the easement is in place is $250,000. Thus, the percentage of before easement value of the property represented by the easement is 50% ($250,000/$500,000). Although the value of the easement as determined by the appraisal is $250,000 ($500,000 – $250,000), Mr. Blue's basis in the easement is only $125,000 (50% x $250,000), therefore, his deduction is limited to $125,000. Had Blue waited for 366 days or more after his purchase of the property to contribute the easement, he would have been entitled to deduct the entire amount.

[124] I.R.C. § 170(e)(1) (2004); Treas. Reg. § 1.170A-4(a)(1) (as amended in 1994).

7. LIMITATION OF ITEMIZED DEDUCTIONS

For individuals whose adjusted gross income in 2006 exceeded the "threshold" level of $150,500 ($72,250 for married taxpayers filing separately), the amount of most itemized deductions, including charitable deductions for conservation easement gifts, must be reduced. The reduction required is 3% of the amount by which the taxpayer's income exceeds the threshold, or 80% of the total amount of itemized deductions, whichever is *less*.[125] This limitation is being phased out over the next several years.[126]

Example

Mrs. Blue (from previous example) earns $500,000 annually, jointly with her husband, which they report on a joint income tax return. In the year of the donation of her $2,000,000 conservation easement (2006) the Blues are allowed a deduction for the easement contribution in the amount of $250,000 due to the 50% limitation ($500,000 x 50%). The phase-out rule requires the Blues to reduce the amount of this deduction by the lesser of 3% of their income over the "threshold" amount (in 2006 $150,500 for individuals filing joint returns) or 80% of the total of their itemized deductions. Assume that the Blues have itemized deductions (including the deduction for the easement) totaling $200,000; 3% of their income over $150,500 amounts to $10,485 ($500,000 – $150,500 x 3%); 80% of the Blues' total itemized deductions amounts, to $160,000 ($200,000 x 80%). Therefore, the Blues must reduce the total of their itemized deductions by $10,485, which is the lesser of the two alternatives. However, under the phase-out of this limitation, the limitation is reduced by one-third for the tax years 2006 and 2007. This reduces the limitation to $6,920.10 (.66 x $10,485).

8. THE ALTERNATIVE MINIMUM TAX (AMT)

The AMT does *not* apply to conservation easement donations. Charitable contributions of conservation easements are not considered "tax preference items." The tax code provision treating gifts of appreciated property as tax preference items[127] was repealed for gifts of appreciated property, including conservation easements, effective December 31, 1992.[128]

[125] I.R.C. § 68 (2004).

[126] I.R.C. § 68(f) (2004).

[127] I.R.C. § 57(a)(5)(C)(iv) (2004).

[128] P.L. 103-66 (1993).

9. The extent of the tax deduction depends upon the value of the easement

One of the most critical and frequently challenged aspects of easement deductions is the valuation of the easement. Easements resulting in reductions in fair market value have been judicially recognized ranging from 16% to over 90%.

a. The "Before and After" valuation method

In the before and after approach to valuing an easement, the property subject to the easement is valued before the easement is in place and after the easement is in place. The difference represents the value of the easement contribution for deduction purposes.[129] An experienced appraiser can estimate the value of a potential donation by knowing the terms of the proposed easement and assuming it is in place. Such pre-donation estimates can be a valuable tool for prospective donors.

The before and after value method typically relies upon the "comparable sales method" to determine the value of the property both before and after an easement is in place. This method requires the appraiser to determine the value of the easement property by looking at what comparable properties are selling for. A comparable property is one having comparable zoning, physical access, proximity to services, physical characteristics and size to the easement property. It is possible to adjust the sales of other properties that are not comparable to make them so. This is typically done using a "paired sales analysis" in which previously sold properties having comparable characteristics except for the one that is the subject of the analysis (e.g., great views) can be compared to determine effect on the value of the one characteristic not held in common.

[129] Treas. Reg. § 1.170A-14(h)(3) (as amended in 1999); Rev. Rul. 73-339, 1973-2 C.B. 68; *see also*, Thayer v. Comm'r, T.C. Memo 1977-370.

Example

Haley Sears donates a conservation easement on a 500-acre farm just outside of Expensive, Pennsylvania. Land with comparable zoning, physical access, proximity to services, and physical characteristics is, at the time of the easement contribution, selling for approximately $50,000 per acre. The property has exceptional views over a large public reservoir and park. A "paired sales analysis" has determined that having such a view increases property value by about 10%. Therefore, the appraiser can estimate the "before" value of the property at $55,000 ($50,000 x 110%) per acre. However, the comparable sales are all of parcels smaller than the Sears' parcel, averaging only 50 acres each. The appraiser is required to discount the Sears' parcel to reflect this difference (smaller parcels generally having a higher per-acre value than larger ones) and applies a 30% discount. Thus, the final "before" value of the subject property is determined to be $38,500 (($50,000 x 110%) x 70%) per acre, or $19,250,000 ($38,500 x 500).

Determining the "after" easement value also depends upon the use of comparable sales. It happens that in the Expensive region, there have been a number of properties sold subject to conservation easements similar to the one contributed by Sears. These properties have sold for an average of $2,500 per acre; essentially their value for agricultural use. (No paired sales analysis was necessary in determining the value of the property as restricted by the easement.) Thus the value of the Sears' property, after the easement is in place, is $1,250,000 (500 x $2,500).

The difference between $19,250,000 (the before value) and $1,250,000 (the after value) is the value of the easement: $18,000,000.

b. Factors required to be considered in the "Before and After" method

The Regulations provide that, if the before and after valuation method is used, the fair market value of the property before contribution of the conservation restriction must take into account *all* of the following factors:

> (i) The current use of the property.
>
> (ii) An objective assessment of how immediate or remote the likelihood is that the property, absent the restriction, would in fact be developed.

> (iii) Any effect on the value of the property resulting from zoning, conservation, or historic preservation laws that already restrict the property.[130]

c. The "Development Method" of determining the "before value"

Appraisers will occasionally use what is known as the "development method" or "build-out" method, to determine the "highest and best use" value of property before the easement is in place. While this method is not prohibited by tax law, it lends itself to abuse because of the significant number of assumptions upon which it depends. Essentially, the method determines what the value of the property would be if it were fully developed into residential lots, rather than in its actual state.

In order to use the development method to determine the highest and best use value, an appraiser is required to consider the following factors:

> (i) *Legally permissible uses.* The appraiser *may not* consider uses that are not allowed by current zoning and subdivision regulations applicable to the property. The appraiser *must* consider restrictions imposed by law (e.g., the Endangered Species Act, federal wetlands regulations, etc.) or by private restrictions, such as restrictive covenants.
>
> (ii) *Physically possible uses.* The appraiser must take into account physical characteristics of property that limit its development potential. For example, an appraiser cannot assume that land on a 75% sandy slope is developable.
>
> (iii) *Financially feasible (and marketable) uses.* The appraiser must take into account the actual costs of development and sales, as well as the rate at which the local market will absorb any lots that may be developed. The appraiser must discount the projected selling price of lots to reflect such costs and absorption time.[131]

d. The "Comparable Sales" valuation method

Although the before and after method is recognized by the IRS when there are no comparable sales of easements, the comparable sales method is preferred, using actual easement sales (e.g., a "purchase of development rights" program) as comparables. However, the Regulations recognize that in many cases there will

[130] Treas. Reg. § 1.170A-14(h)(3)(ii) (as amended in 1999).

[131] *See* THE DICTIONARY OF REAL ESTATE APPRAISAL 135 (Appraisal Inst., 4th ed. 2002).

not be a "substantial record" of comparable easement sales and in such cases the IRS will accept valuations based upon the before and after method.[132]

Example

Assume the same facts as the previous example regarding Haley Sears, except that there have been, pursuant to the Cheap County (within which Expensive lies) open space program, a number of conservation easement purchases. The current value being paid for a conservation easement comparable to the one contributed by Sears is $10,000 per acre. This value, while considerably lower than the value reflected in the before and after analysis, is preferred by the IRS because it represents actual easement sales, not speculation. Assuming that there is nothing significant differentiating the easement donated by Sears and the easements being purchased in the area (e.g., none of the other easements have been sold as "bargain sales"), the value of Sears' easement is $5,000,000 ($10,000 x 500 acres). It will be difficult, although not impossible, for Sears to overcome this valuation with the before and after method.

e. The value of the deduction must be substantiated

Any claim for a charitable contribution deduction exceeding $5,000 must be supported by a "qualified appraisal"[133] and conducted by a "qualified appraiser."[134] The Pension Protection Act revises the definition of "qualified appraisal and appraiser."[135]

Form 8283, "Noncash Charitable Contributions," must accompany any return claiming an easement deduction. The gift must be acknowledged by the donee organization. The organization is required to state whether the donor has received any goods or services in exchange for the gift.[136]

The law now requires that a person contributing a conservation easement valued in excess of $500,000 *must file the complete appraisal*, not just the summary Form 8283, with his or her return.[137]

[132] Treas. Reg. § 1.170A-14(h)(3)(i) (as amended in 1999).

[133] Treas. Reg. § 1.170A-13(c)(2) (as amended in 1996).

[134] Treas. Reg. § 1.170A-13(c)(3) (as amended in 1996); *see* Treas. Reg. § 1.170A-13(c)(5) (as amended in 1996) (defining a "qualified appraiser").

[135] I.R.C. § 170(f)(11)(E) (2004). *See also* IRS Notice 2006-96 (providing for "interim guidance" on the implementation of the new law. These changes are not yet reflected in the Regulations).

[136] Treas. Reg. § 1.170A-13(f) (as amended in 1996).

[137] I.R.C. § 170(f)(11)(D) (2004).

In order to address certain "oversights" in the valuation process, Form 8283 now requires the donor of the easement to attach a statement to the form that does the following:

> —Identifies the conservation purposes furthered by the easement;
>
> —Shows the value of the property subject to the easement both before and after the easement contribution;
>
> —States whether the contribution was made to obtain a permit or other governmental approval, and whether the contribution was required by a contract; and
>
> —States whether the donor or any related person has any interest in other property near the easement property and, if so, describes that interest.

Substantiating appraisals are complex and typically costly. They must be conducted no earlier than 60 days prior to the conveyance, and no later than the due date for the tax return on which the deduction is first claimed.[138]

Regardless of when the appraisal is made, it must reflect the value of the easement *on the date of the conveyance*.[139]

f. Entire contiguous property rule

The Regulations provide that if a conservation easement covers only a portion of contiguous property (whether one or more parcels) owned by the easement donor, the value of the easement is the difference in the value of the *entire contiguous property* before and after the easement; not just that portion subject to the easement.[140]

[138] Treas. Reg. § 1.170A-13(c)(3)(A) (as amended in 1996).

[139] Treas. Reg. § 1.170A-13(c)(3)(ii)(I) (as amended in 1996).

[140] Treas. Reg. § 1.170A-14(h)(3)(i) (as amended in 1999).

Example

Sonny Jacobs owns a 500-acre farm in western Pennsylvania. He decides to contribute a conservation easement over the eastern 250 acres. Local zoning allows Sonny to divide and develop houses on the remaining acreage at a density of one unit per five acres. The unrestricted portion of the property overlooks the eastern 250 acres, which includes a river and a series of springs and wetlands. There are four potential home sites on the eastern portion of the property under local zoning regulations.

The appraiser values the eastern 250 acres at $4,000 per acre before the easement (a total of $1,000,000) and at $500 per acre after the easement ($125,000). Sonny is pleased with this $875,000 deduction ($1,000,000 – $125,000) as it will help him offset the proceeds from development of the unrestricted balance of the property.

The IRS audits Sonny's return and denies all but $125,000 of his claimed deduction. The IRS appraiser, following the contiguous parcel rule, values Sonny's *entire* 500-acre farm before and after the easement. He finds that the western 250 acres of the farm is worth $6,000 an acre before the easement ($1,500,000) and the eastern portion $4,000 ($1,000,000). However, after the easement he finds that the western portion is worth $9,000 an acre ($2,250,000) because of protection of the eastern portion over which the western portion looks. The IRS agrees that the eastern portion after the easement is only worth $500 per acre. The net result, according to the IRS, is that the entire 500-acre property is worth $2,375,000, after the easement. Thus the easement is only worth $125,000 ($2,500,000 – $2,375,000).

The IRS also imposes a severe penalty on Sonny and Sonny's appraiser because the appraisal "grossly overvalued" the easement. In fact, the appraisal overvalued the easement by 700%, far more than the 150% over-valuation that triggers the penalty. See the penalty provisions of IRC § 6662(e)(1)(A), which were recently amended by the Pension Protection Act of 2006.

g. "Enhancement" may reduce the deduction

Enhancement is closely related (and sometimes confused with) the "contiguous parcel rule" described above. Enhancement occurs when a landowner donates an easement that has the effect of increasing the value of separate unrestricted land owned by the donor or a "related person," whether or not the unrestricted land is contiguous to the conservation easement.[141]

[141] Treas. Reg. §1.170A-14(h)(3)(i) (as amended in 1999).

A "related person" with respect to an individual donor is that person's siblings, spouse, ancestors, and lineal descendents. The term also includes relations between partnerships, corporations, and other title-holding entities.[142]

Note that if the separate land is contiguous to the easement property, and is owned by the grantor, the contiguous parcel rule applies, not the enhancement rule. If the unrestricted property is not contiguous, or if it is contiguous but under separate ownership from the easement property, the enhancement rule applies.

The net result of applying either the contiguous parcel rule or the enhancement rule should be the same in terms of the ultimate value of the easement; however, the appraisal methodology is different. In the case of the contiguous parcel rule the increase in value, if any, resulting to the unrestricted portion is simply a part of the before and after analysis. However, in the case of enhancement, the appraiser is required to determine the value of the unrestricted "enhanced" parcel before and after the easement as a separate calculation—subtracting the increase in the value of the unrestricted parcel from the value of the easement determined in a separate before and after analysis of the easement property.

Example

The land Mr. Jones placed under easement is just a quarter of a mile from 200 acres that overlooks the easement property. Mr. Jones' sister owns the 200 acres. The easement reduces the value of the easement property by $300,000, but the 200 acres increases in value by $100,000 because the view from this property will be permanently protected by the easement. This $100,000 "enhancement" must be subtracted from the $300,000 value of the easement. Therefore, Mr. Jones's deduction will be reduced to $200,000.

There is an additional distinction between the contiguous parcel rule and the enhancement rule: When adjusting the basis in the property subject to the easement to reflect the easement contribution, enhancement is not taken into account.[143] Because the enhancement occurs to a parcel distinct from the parcel subject to the easement, it does not affect the value of the easement parcel, and, therefore, it does not affect the basis of the easement parcel.

[142] I.R.C. §§ 267(b), 707(b) (2004) (as amended in 1999).

[143] *See* discussion *infra* Part C.13.a.

h. Financial benefits received must be subtracted from the deduction

The amount of an easement deduction must be reduced by any cash payment or other economic benefit received, or reasonably expected, by the donor or any "related person" as a result of the donation of the easement.[144]

Example 1

Mr. Blue agrees with the ABC Land Trust that he will contribute an easement over his land if ABC will acquire and protect a parcel of land adjoining Mr. Blue's land. ABC agrees to do this. The acquisition by ABC enhances the value of Mr. Blue's land by $150,000. The value of Mr. Blue's easement is $400,000. ABC is required to notify Mr. Blue that, in exchange for his easement contribution to ABC, he has received $150,000 in "goods and services" from ABC, thereby reducing the amount of Mr. Blue's deduction to $250,000 ($400,000 – $150,000).

Example 2

Ms. Brown agrees with the XYZ Land Trust to sell a conservation easement to XYZ on land that she owns adjoining one of XYZ's most important holdings. The agreed price for the easement is $50,000. An appraisal of the easement shows that its value is $150,000. Ms. Brown is allowed a deduction of $100,000 ($150,000 – $50,000) for this qualified "bargain sale." (See IRC § 1011(b) for provisions regarding bargain sales.)

Example 3

Mr. Green contributes a conservation easement to the UVW Land Trust. The Land Trust agrees to pay Mr. Green's costs incurred in the transaction, which include obtaining legal counsel, an appraisal, a survey, and preparation of the natural resources inventory. The costs amount to $5,000. The Land Trust is required to notify Mr. Green that, in exchange for his easement contribution, he has received $5,000 in "goods and services." Mr. Green must reduce his deduction by the $5,000 amount. However, Mr. Green may be able to deduct most of the $5,000 he paid in order to make the gift and substantiate his deduction.

[144] Treas. Reg. §1.170A-14(h)(3)(i) (as amended in 1999).

10. "DONATIVE INTENT" IS REQUIRED

In order for the grant of a conservation easement to be deductible as a charitable contribution the grantor of the easement must *intend* the grant to be a charitable contribution.[145] The intent to make a charitable contribution is known as "donative intent."

The requirement for donative intent should not be confused with the requirement that any financial or economic benefit received in exchange for a conservation easement be subtracted from the value of the easement deduction.[146] In the cases to which this economic benefit rule applies, the grantor of the easement *intends* that the excess of the value of the easement over the benefit received be a charitable contribution. However, where the grant of the easement is required by some regulatory or contractual arrangement, the fact that the conveyance of the easement was *required* generally negates the possibility of donative intent.

The requirement for donative intent precludes deductions for the conveyance of conservation easements in a number of circumstances, e.g., "*quid pro quo*"[147] situations where the donor obtains a governmental permit in exchange for the contribution of an easement, or where an easement is contributed to discharge a contractual obligation. A few of the more common circumstances precluding donative intent are outlined below.

a. Cluster development projects

A growing number of localities allow a landowner increased residential density, or simply the right to cluster permitted residential density, in exchange for the grant of a conservation easement on that portion of the property from which the clustered density has been derived. Because the grant of the easement is a requirement of local regulation there is no donative intent.[148]

[145] United States v. American Bar Endowment, 477 U.S. 105 (1986); Rev. Rul. 67-246, 1967-2 C.B. 104.

[146] *See* discussion *infra* Part C.10.

[147] Meaning "something for something."

[148] *See* I.R.S. Tech. Adv. Mem. 92-39-002 (June 17, 1992). Technical Advice Memoranda are not supposed to be used or cited as precedent. I.R.C. § 6110(j)(3) (2004).

Example

Elmer Fuddie owns 50 acres in Cracker County. Cracker County allows Elmer up to one house for every five acres that he owns, in his case ten houses and ten lots. However, if Elmer clusters all of his development on ten acres he will be allowed to double his density to twenty houses. In exchange for the increased density, Elmer is required to put a conservation easement on forty acres insuring that it can never be developed.

Elmer hires an appraiser who determines that the value of the fifty acres before he agreed to the cluster and the easement was $1,000,000, and that after the agreement and easement the property was worth only $750,000. Elmer claims a tax deduction of $250,000 for the easement.

The IRS agrees that the easement is worth $250,000. However, the IRS disallows the deduction on the grounds that the easement was not the result of any charitable intent; it was given pursuant to Cracker County regulations requiring the easement in order to obtain the increased density. This is a "*quid pro quo*" transaction.

Note that it doesn't matter that Elmer gave more than he got in this exchange. The fact that the easement was mandated by governmental regulations precludes any "donative intent."

An Alternative: Had Elmer put the easement in place prior to seeking cluster approval from Cracker County, the deduction might have held up because the easement would have been contributed independently from any county approval. There are several additional issues raised by this alternative. First, was the easement written to allow the acreage subject to the easement to be used for purposes of density calculation for development outside of the easement? If so, the appraisal would be required to reflect this retained value. Second, would Cracker County allow the "transfer" of density from the easement land to unrestricted land? Generally, because conservation easements held by private organizations are entirely private contracts, localities do not have the authority to enforce them (which is, in effect, what the county would be doing if it denied Elmer the right to transfer density from the easement property).

b. Reciprocal easements

Where one landowner agrees to grant a conservation easement over his land if his neighbor does the same, and if the agreement is legally enforceable, the contractual obligation to grant the easement precludes donative intent. Performance of a contractual obligation owed to a private individual does not constitute a charitable gift.

Example 1

The Blacks and the Whites own adjoining farms. For years each of them has considered contributing a conservation easement. The only thing keeping them from going forward with the contribution is the fear that once the easement is in place the other family will develop its land to take advantage of their neighbor's land protection. Finally, Black and White agree with each other that if one donates an easement the other will follow suit. They sign an agreement to that effect and contribute their respective easements.

Because the easements were granted pursuant to the agreement between them, no deduction is allowed. This is because Black and White were discharging a legal obligation by conveying their easements, not making a charitable contribution.

Example 2

There is another way to accomplish what Black and White want that probably (there are no rulings on this plan) preserves their deductions. Where a land trust seeks to obtain conservation easements from several landowners within a region to advance a conservation goal that could not be met with the piecemeal contribution of easements, the land trust may agree to escrow easements until it has received enough easements to accomplish its goal. Such an arrangement does not preclude donative intent. Note that, until the easements are put to record, no deductible gift has been made. Note also that it will be important for the land trust in such a case to have a legitimate conservation justification for the plan.

For example, it turns out that the Black and White farms comprise an historic Civil War battlefield. Events of considerable national significance happened on both farms. The local land trust has been approached by the Black family to protect its farm. However, being purists, the land trust's board members say that they really aren't interested in protecting just a portion of the battlefield; they want both farms.

For fear that the Blacks will change their mind while the land trust is working on the Whites, the land trust asks the Blacks to put their easement in escrow (essentially in trust) with an independent third party (the "escrow agent"); typically the escrow agent would be an attorney or title company. The easement would be held by the escrow agent according to a contract that provides that the easement will be held in escrow until the land trust has obtained an easement from the White family. When the White easement has been obtained, the escrow agent releases the Black's easement to the land trust, which then puts both easements to record.

However, the escrow agreement further provides that in the event that the land trust is unsuccessful in obtaining a satisfactory easement from the Whites within one year of deposit of the Black's easement into the escrow, the escrow will terminate and the Black's easement will be returned to the Blacks.

Within six months of deposit of the Black's easement in escrow, the land trust has a satisfactory easement from the Whites in hand. It records both easements and both Black and White get a tax deduction. Because the escrow agreement ran to the benefit of the land trust, which is a tax-exempt organization, conveying the easement pursuant to the terms of that contract should not affect the deductibility of the easement contribution.

This is because, as a general proposition, complying with an enforceable pledge to make a charitable contribution, where the pledge is made directly to a charity, does not preclude "donative intent." The pledge and the performance of the pledge, having been made out of charitable motives and without any expectation of receiving, or right to receive, any economic benefit in exchange, are acts done with donative intent.

c. "Conservation Buyer" transactions

Occasionally, a landowner decides to offer his land for sale but only to a buyer who will place a conservation easement on the property after closing. Where the sales contract imposes an obligation on the buyer to convey the easement after closing, the grant of the easement constitutes the performance of a contractual obligation to a private individual, not a charitable contribution. This is true even though the buyer receives no compensation for the easement grant.

A variation of the foregoing is where the seller grants an option to a land trust to acquire a conservation easement on his land, and the land is sold subject to the option. In such a situation, the option is a feature of the title to the property and is a binding part of the private contract between the buyer and the seller. Furthermore, the buyer, who is obligated to honor the option, did not grant the option, and any charitable intention that may have been part of the option grant cannot be attributed to the buyer. For this reason, conveyance of the easement pursuant to the option is the discharge of a private contractual obligation, not a charitable contribution.

Until recently it was believed that there would be a different outcome if the prospective buyer himself granted an option to a land trust, exercisable by the land trust *if* the buyer completed the purchase. Similarly, it was believed that a binding pledge to a land trust by the prospective buyer prior to closing, to contribute an easement after closing, would not preclude a deduction for the easement donation. In both cases it was believed that the option, or the pledge, being made directly to a public charity by the person who would make the contribution and claim the deduction, would not preclude a deduction for the easement donation pursuant to the option or pledge.

However, as discussed immediately below, IRS Notice 2004-41 raises questions about *any easement granted in connection with the purchase of real property*.[149]

Form 8283 now requires a statement from the easement donor as to whether the donor has contributed the easement to obtain a governmental approval, or as part of a contractual arrangement.[150]

d. IRS Notice 2004-41 and "Conservation Buyer" transactions

In July, 2004, the IRS published Notice 2004-41, which is highly critical of certain types of conservation buyer transactions.[151] The notice states in part: "Some taxpayers are claiming inappropriate charitable contribution deductions under § 170 for cash payments *or easement transfers to charitable organizations in connection with the taxpayers' purchases of real property*."[152]

The notice specifically criticized transactions in which a land trust as the seller of property obtains a combination of (1) payment for the property (which is sold subject to a retained conservation easement), based upon the value of the property as restricted by the easement, and (2) a cash contribution from the buyer.[153] The buyer then claims an income tax deduction for the cash contribution. The intent behind the requirement for the cash contribution is to allow the land trust to recover, between the sales price and the contribution, what it originally paid for the property. The notice said that, in such cases, it would treat both payments

[149] I.R.S. Notice 2004-41, 2004-1 C.B. 31. The notice states, "Some taxpayers are claiming *inappropriate* charitable contribution deductions under § 170 for cash payments *or easement transfers to charitable organizations in connection with the taxpayers' purchases of real property*." *Id.* (emphasis added). The problem is created by the general criticism of all such transactions (as underscored) as "inappropriate" with no further clarification of exactly what types of "*easement transfers to charitable organizations in connection with the taxpayers' purchases of real property" are "inappropriate.*" *Id.* (emphasis added).

[150] *See* discussion *supra* Part C.9.e.

[151] I.R.S. Notice 2004-41, 2004-1 C.B. 31.

[152] *Id.*

[153] *Id.*

(i.e., the payment of the purchase price *and* the cash contribution) as payment for the property and deny the purchaser any charitable deduction for the cash contribution.[154]

Example 1

The Blue Land Trust buys Blue Acre Farm for $2 million. It later sells Blue Acre Farm, retaining a conservation easement. The value of Blue Acre Farm as restricted by the retained easement, according to a qualified appraisal, is $1 million. The buyer pays $1 million for Blue Acre Farm, and makes a cash contribution to the Blue Land Trust of $1 million. The Blue Land Trust has now recovered the entire $2 million that it paid for Blue Acre Farm. However, IRS Notice 2004-41 says that the buyer *may not* claim a charitable contribution deduction for the $1 million cash contribution. The IRS will, instead, treat the entire $2 million paid as payment for the property.

Example 2

Assume that the buyer in Example 1, instead of making a separate cash contribution of $1 million to the Blue Land Trust, simply pays the Land Trust $2 million for the property, the value of which has already been established to be $1 million by a qualified appraisal. The Land Trust formally acknowledges to the buyer that the buyer has "overpaid" for the property by $1 million, which both the buyer and Land Trust acknowledge was intended as a charitable contribution. The buyer successfully claims a $1 million deduction for the charitable contribution to the Blue Land Trust represented by his overpayment for the land.

According (unofficially) to an IRS representative, the buyer in Example 2 is entitled to a charitable deduction for the $1 million overpayment. The crucial difference, according to the IRS representative, is that in Example 2 the structure of the transaction provides the IRS with information that allows it to evaluate whether the overpayment is based upon a valid easement and easement valuation.[155] In Example 1, the IRS has no way of knowing that the cash contribution is connected with the acquisition of property or a conservation easement and has no way of knowing whether the buyer is claiming more of a deduction than is appropriate (e.g. the buyer could pay the land trust $500,000 for the restricted property that is really worth $1 million, and make a cash contribution of

[154] *Id.*

[155] *See* discussion *supra* Part C.11.

$1.5 million for which the buyer claims a deduction, thereby converting $500,000 of what should have been a non-deductible payment into a claimed charitable deduction).[156]

Few land trusts have the resources to acquire land and resell it as a conservation tool. More frequently land trusts try to match conservation-worthy land with conservation-minded buyers willing to commit to protect the land if they acquire it. Unfortunately, the notice's rather vague and generalized condemnation of all easement conveyances made in connection with the acquisition of real property has cast doubt on such transactions as well. As a result, enforceable commitments made by prospective buyers to protect land once the land is acquired may result in the denial of any deduction for an easement contribution made pursuant to the commitment.

The new Form 990, required to be filed by tax exempt organizations, now requires land trusts to disclose whether they have had any transactions "described in" Notice 2004-41.[157]

11. The contribution of a conservation easement reduces the donor's basis in the easement property

The donor of a conservation easement is required to reduce his or her basis in the property subject to the easement (basis is, essentially, what was paid for the property)[158] to reflect the value of the contributed easement. This reduction in value must reflect the proportion of the unrestricted fair market value of the land on the date of the donation, represented by the value of the easement.[159]

Example

Mr. Brown contributes an easement on his land. Before the easement was imposed, the land was valued at $1,000,000. After the easement the land was valued at $700,000. Therefore, the value of the easement is $300,000 ($1,000,000 – $700,000). Mr. Brown's basis in his land was $100,000 before the contribution. The easement represents 30% of the unrestricted value of the land when the contribution was made. Therefore, Mr. Brown's adjusted basis after the easement contribution will be $70,000 ($100,000 – (30% x $100,000)).

[156] *See* discussion *supra* Part C.11.

[157] Form 990, Schedule A, Part III, line 3c.

[158] *See* discussion *supra* Part C.5.

[159] Treas. Reg. § 1.170A-14(h)(3)(iii) (as amended in 1999).

As noted previously,[160] the basis adjustment does not reflect "enhancement" of adjoining unrestricted land.[161]

12. Treatment of easement contributions by real estate developers

Tax deductions for easement contributions by real estate developers may be limited to the developer's basis in the property subject to the easement donation. This is because a deduction for contributions of "ordinary income property" (e.g. lots held for sale by a developer) must be reduced by the amount of gain that would not have been considered long-term gain had the property been sold on the day of the contribution.[162] Because the sale of ordinary income property generates ordinary income rather than capital gain ("long-term gain") this rule essentially limits the deduction to the developer's basis in the easement.[163]

"Ordinary income property" includes property "held by the donor primarily for sale to customers in the 'ordinary course of his trade or business.'"[164] It is possible for a dealer in real estate to hold property primarily as investment property (a capital asset) and not for sale to customers ("inventory"). The contribution of a conservation easement on investment property will not be limited to basis.

[160] *See* discussion *supra* Part C.13.

[161] *See* discussion *supra* Part C.13; *see also* Treas. Reg. § 1.170A-14(h)(4) (as amended in 1999).

[162] Treas. Reg. § 1.170A-4(a)(1) (as amended in 1994).

[163] *See* discussion *supra* Part C.5.

[164] Treas. Reg. § 1.170A-4(b)(1) (as amended in 1994).

Example

Jack Hoyle is a real estate developer. He has developed 50 lots for sale, but has identified 100 acres of the development property for "open space" protection and it has never been offered for sale. On his books Jack carries the 50 lots as "inventory" and the 100 acres as a capital asset.

Five years later after having sold 40 lots, Jack decides to start a new project and wrap this one up. He agrees with a local land trust to donate a conservation easement on the remaining 10 lots plus the 100 acres. His basis *in the easement* on the 10 lots is $100,000 and his deduction cannot exceed that amount for this part of his contribution, even though the easement on the 10 lots is appraised at $2,000,000. The easement on the 100 acres is appraised at $5,000,000.

Jack will be allowed to deduct $100,000 for the donation of the easement on the lots. This is because his deduction relates to the contribution of ordinary income property. He will be allowed to deduct the full $5,000,000 on the 100 acres because this property was clearly not held for "sale to customers in the ordinary course of his trade or business" and is treated as a capital asset held for investment.

13. CORPORATIONS, PARTNERSHIPS, LIMITED LIABILITY COMPANIES, AND TRUSTS

The amount that may be deducted for the contribution of a conservation easement by an artificial entity may be different from the amount that an individual may deduct for the same contribution. The following is a very limited description of the rules governing limitations on deductions associated with corporations, partnerships, limited liability companies, and trusts. This is a very complex area of tax law and no one should proceed in this area without the assistance of tax counsel having a comprehensive understanding of these rules, which extend considerably beyond what is described in this article.

a. Corporations

There are two types of corporations for purposes of taxation: C-corporations ("C-corps") and S-corporations ("S-corps"). A C-corp is a corporation the income of which is taxed at the corporate level, not the shareholder level. As noted above,[165] a C-corp's deduction for the contribution of a conservation easement is limited to no more than 10% of its "taxable income." The Pension Protection Act

[165] *See* discussion *supra* Part C.3.

created an exception from the 10% limit for a C-corp more than 50% of whose income is from the "business of farming."[166]

The income of an S-corp is taxed at the shareholder level, not the corporate level. Income and deductions of an S-corp are passed through to the shareholders in proportion to their ownership interest in the corporation. In addition, the amount of the corporation's deductions that an individual shareholder is allowed to claim is limited by the shareholder's basis in his or her stock in the corporation. The shareholder's basis is a function of what the shareholder paid for the stock, and subsequent adjustments to reflect items of income and loss (including deductions) allocated to the shareholder. In general, a shareholder may not deduct more than his or her basis in the stock of the S-corp, plus the amount of any debt owed by the S-corp to the shareholder.[167]

Example

The Blinkers Corporation, an S-corp, makes a contribution of a conservation easement on land that it has owned for more than one year. The value of the easement is $1,000,000. The corporation's basis in the property subject to the easement is $500,000. Jerry Doaks owns 75% of the stock of Blinkers Corporation, for which he paid $375,000. Over the years he has taken losses, and other deductions, amounting to $250,000, the result of which is a downward adjustment in his basis in the stock of the corporation to $125,000. Under the law prior to the Pension Protection Act of 2006, Jerry could only deduct $125,000 in connection with the corporation's gift of the easement. This is because Jerry's basis in the Blinkers Corporation stock was only $125,000.

However, the Pension Protection Act (supposedly) changed the law to allow S-corp shareholders to deduct their pro rata share of the value of a contribution of property (including conservation easements) made by the corporation without regard to their stock basis. In other words, under the new law, Jerry may (possibly, depending upon one's reading of the *new law*) deduct $750,000 in connection with the corporation's easement contribution. Of course, Jerry's basis in his stock would be reduced to zero as a result.

A careful reading of the 2006 Pension Protection Act provisions regarding charitable contributions by an S-corp suggests that the only change made by the act was to change the amount by which S-corp shareholders are required to

[166] *See* discussion *supra* Part C.2.

[167] I.R.C. § 1366(d)(1); Treas. Reg. § 1.1366-2(a)(1) (as amended in 1999).

adjust their stock basis to reflect a charitable contribution by the corporation of property.[168] The old rule required a shareholder to reduce his or her stock basis by the shareholder's pro-rata share of the value of the gift. The new rule limits the basis adjustment to the shareholder's pro rata share of the corporation's adjusted basis in the property that was contributed.[169] This rule reduces the amount that the shareholder must recognize as gain in the event of a future sale of stock in the corporation.

However, the examples provided by the Joint Committee on Taxation accompanying its explanation of the new law suggest that the law eliminates the limitation to the stock basis rule, as reflected in the preceding example.[170] Nevertheless, on close reading, the new law seems at odds with the example.[171]

This new tax benefit expires December 31, 2007, unless extended by Congress prior to that date.[172]

b. Limited liability companies and partnerships

Limited liability companies ("LLCs") are entities with some attributes of a corporation (e.g. protection from corporate liabilities for members), but they are taxed like a partnership.[173] Partnerships do not provide any protection from partnership liabilities for partners, although limited partnerships may provide some protection where partnership liability may be limited to a "general partner."

Both LLCs and partnerships pass deductions through to their members/partners in proportion to the members'/partners' ownership interest.[174] Partnerships and LLCs allow the members/partners to allocate interests in the entity in a manner other than equal shares, provided that the interests have "economic substance." For example, one member may have contributed more money to an LLC, or accepted liability for an LLC debt, and may be entitled to a larger ownership interest to reflect such additional investment in the LLC. IRC § 704 and Regulation § 1.704-1 cover the determination of a partner's "distributive share" of a partnership.

[168] Pension Protection Act, 29 U.S.C. § 1203 (2006); I.R.C. § 1367 (2004).

[169] I.R.C. § 1367(a)(2) (2004).

[170] STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 109TH CONGRESS Title XII.A.3 (Comm. Print 2007).

[171] As of the date of this writing (March 2007), the IRS had agreed to provide clarification of this provision of the Pension Protection Act of 2006, but has not indicated when it will do so.

[172] I.R.C. § 1367(a)(2) (2004).

[173] *See* IRS Pub. 1066, revised July 2003, pp. 1-16.

[174] *See* I.R.C. § 702(a)(4) (2004); *see also* Treas. Reg. § 1.702-1(a)(4) (as amended in 2005); Treas. Reg. § 1.703-1(a)(2)(iv) (as amended in 1995).

Example 1

The Blue Lake Limited Liability Company owns a 500-acre farm that includes a 100-acre lake. There are ten members of the LLC. John Jay, the original owner of the property, set up the LLC and originally was the sole member. Over the years he has given membership interests in the LLC to his five children and their four spouses. Each "family" member has received a membership interest in the LLC amounting to a 5% interest. Thus John owns 55% of the membership of the LLC and each of his children and their spouses own 5%.

The Blue Lake LLC donates a conservation easement on the farm. The easement is valued at $2 million. Therefore, John is entitled to a deduction of $1.1 million ($2,000,000 x 55%), and each of the other members in the LLC are entitled to deduct $100,000 ($2,000,000 x 5%). The same results would occur if the farm had been owned by a family partnership.

Example 2

The Scam LLC owns a 5,000-acre ranch in northern Montana. Scam's sole member is Jim Scam. Scam LLC paid $500,000 for the ranch in 1985. Jim does not want to sell the ranch, but he does want to get some money for a portion of his interest in the LLC. Therefore, Jim offers to sell a 49% interest in the LLC for $1 million to Jonas Schuyler, who had a bang-up year on the stock market and, accordingly, has ordinary income of $10 million for the year. Jim convinces Jonas that for $1 million, Jonas can obtain a $5 million tax deduction that will save him $2.2 million in federal and California income taxes (combined top rates of 44%). This is because Scam LLC plans to contribute a conservation easement to a local land trust and the estimated value of the easement is $10.2 million (of which, as a 49% owner, Jonas will be entitled to $5 million). Jim also requires that Jonas grant an option to Jim to reacquire the 49% interest within two years for $90,000. Taking into account the net loss in membership value resulting from the restrictions imposed by the easement, if the option is exercised Jonas will still net $1,290,000 ($2,200,000 – $990,000).

The only problem with this scenario is whether or not Jonas' 49% interest, for which he paid $1 million in an LLC worth at least $10 million, has any economic substance. Even given the discount for a minority interest, and the obligation to resell the stock, it is likely that 49% is far too big a percentage for the $1 million payment. It is also likely Jonas would have a great deal of difficulty explaining a rationale for such a deal other than tax avoidance.

c. Trusts (other than charitable remainder trusts)

Other than "charitable remainder trusts" qualified under IRC § 664, which are not governed by the rules described below, there are three types of trusts, and each type is treated differently for taxation purposes.[175] "Grantor trusts"[176] are trusts in which the person creating the trust (the "grantor") retains certain rights or interests in the trust. Most typically, the grantor of a grantor trust retains the right to amend or terminate the trust at will. People often create grantor trusts to avoid probate. Grantor trusts are ignored for all purposes of taxation, including federal income and estate taxes.[177]

Therefore, if a grantor trust makes a charitable contribution of a conservation easement on land owned by the trust, the tax deduction passes through the trust directly to the persons who are deemed to be the owners of the trust as though they themselves had made the contribution.

The income and deductions generated by a grantor trust are taxed entirely to the owner of the trust. The owner of the trust is the person who has a power, exercisable solely by himself or herself, to appropriate the income or principal of the trust to his or her personal use.[178] It is possible for more than two persons to be treated as owners of a grantor trust.[179]

[175] "Simple trusts" are required to distribute all income currently, the taxation of which is governed by I.R.C. § 651. "Complex trusts" may accumulate income, the taxation of which is governed by I.R.C. § 661. "Grantor trusts" are ignored for purposes of taxation. I.R.C. §§ 267(b), 707(b) (2004) (as amended in 1999).

[176] *See generally* I.R.C. § 2702 (2004); Treas. Reg. § 25.2702-5 (as amended in 1997).

> Grantor trusts include personal residence trusts, and qualified personal residence trusts ("QPRTs"). Most conservation easements will not pertain to residence trusts because the tax law strictly limits the amount of land that may be included in such trusts. However, it does not appear that the conveyance of a conservation easement by such a trust would violate the requirements of the tax code.

Treas. Reg. § 25.2702-5 (as amended in 1997). *See also* I.R.S. Priv. Ltr. Rul. 1999-16-030 (Jan. 22,1999). There are several private letter rulings that confirm that the fact that a residence is subject to a conservation easement will not preclude placement of that property into a residence trust. *Id.*

[177] *See* I.R.C. § 671 (2004); Treas. Reg. § 1.671-1 (as amended in 1980); Treas. Reg. § 1.671-3(a)(1) (as amended in 1969).

[178] *See* I.R.C. § 677 (2004); Treas. Reg. § 1.677(a)-(1) (as amended in 1996).

[179] I.R.C. § 678; Treas. Reg. § 1.678(a)-1 (1960).

Example

Jon creates a trust and conveys his farm to the trust. In the trust instrument Jon retains the full right to revoke the trust, or amend the trust. The trust is, therefore, a grantor trust. Jon is the sole trustee and sole beneficiary of the trust until his death. As sole trustee, Jon makes a charitable contribution of a conservation easement to the JY Land Trust. The value of the easement is $500,000. Jon, as the 100% owner of the trust, is entitled to a deduction for $500,000, as though the trust did not exist.

Note that even if Jon were not the trustee and sole beneficiary, but held the right to amend or revoke the trust, he would still be deemed the owner of the trust.

Trusts other than grantor trusts are classified by federal tax law either as "simple trusts"or "complex trusts." Simple trusts (1) are required to distribute all of their income annually, (2) can make no charitable contributions, and (3) do not distribute any of the trust principal during the tax year.[180] A trust that is not a simple trust is a complex trust.[181] Complex trusts are allowed to accumulate income.

Neither simple nor complex trusts pass deductions through to the beneficiaries of the trust. Income and deductions are determined and taxed at the trust level. However, "distributable net income" paid to beneficiaries is taxable to the beneficiaries and is deductible to the trust. Complex trusts are allowed a deduction against trust income for payments out of the income of the trust directed by the trust instrument to be paid for charitable purposes.[182]

However, if the trust instrument does not expressly authorize payment of trust income for charitable purposes, no deduction under IRC § 642(c) is allowed.[183] *More importantly for contributions of conservation easements*, no deduction is allowed for the contribution of a conservation easement regardless of whether the trust instrument authorizes such a contribution. This is because federal tax law allows no deduction for a payment out of the "corpus" of a trust, as deductions are limited to amounts paid from income only and conservation easements are con-

[180] Treas. Reg. § 1.651(a)-(1).

[181] I.R.C. § 661 (2004).

[182] I.R.C. § 642(c) (2004).

[183] *See* Rev. Rul. 2004-5, 2004-1 C.B. (Jan. 20, 2004).

sidered part of corpus, not income. [184] Thus, *other than grantor trusts, trusts are not allowed a deduction for the charitable contribution of a conservation easement*.[185]

Example

Under the terms of the Poodle Trust, the trustee is permitted to accumulate income and is authorized to make charitable contributions of cash and property to public charities recognized under IRC § 501(c)(3). The trustee of the trust makes a $200,000 contribution to the local Episcopal Church for a new building and contributes a conservation easement over a farm owned by the trust. The conservation easement is valued at $1 million. The Poodle Trust has income of $400,000 during the year of these contributions. The trustee also makes a distribution to the beneficiaries of the trust in the amount of $200,000.

The Poodle Trust is permitted a deduction against the trust's $400,000 of income in the amount of $200,000 for the contribution to the church. The trust is also allowed a deduction of $200,000 for the distribution to the beneficiaries. Thus, the trust has no income tax liability for the year. The beneficiaries have collective taxable income from the trust of $200,000. However, no deduction is allowed for the contribution of the conservation easement to the trust, because the contribution was made out of the principal, not the income, of the trust. Furthermore, no charitable contribution for the value of the easement passes through to the beneficiaries of the trust. Thus, the value of the deduction for the easement contribution is lost.

14. FEDERAL TAX TREATMENT OF STATE TAX CREDITS FOR EASEMENT CONTRIBUTIONS

A number of states provide credits against state income tax for easement contributions. As noted earlier, tax credits are much more powerful incentives for easement contributions than income tax deductions because they directly offset tax liability, whereas deductions only indirectly offset tax liability by reducing the income against which tax is imposed. The following discussion is not intended to describe the various state credit programs, but to summarize how tax credits are treated under federal tax law. It must be emphasized that there are a number of unknowns in this area and neither Congress nor the IRS has provided answers to all of the outstanding questions.

[184] *See* Goldsby v. C.I.R., 92 T.C.M. (CCH) 529 (2006); Rev. Rul. 2003-123, 2003-2 C.B. 1200.

[185] In some cases, distribution of land from a trust and conveyance of a conservation easement thereafter may be a solution. In others, (particularly where distribution is not practical, or where there may be unborn beneficiaries) sale of land out of the trust, i.e., replacement of the value of the land, will be necessary.

Some states allow tax credits to be transferred from the original easement donor to other taxpayers. The tax treatment of credits in the hands of the original recipient of the credit and in the hands of the transferee of the credit is different. Therefore, the following discussion is divided into tax treatment for the original recipient and tax treatment for the credit transferee.

a. Treatment of the original credit recipient

1. The credit is not taxable if used against the original recipient's tax liability.

The IRS recently stated that, to the extent that a conservation easement tax credit is used to offset the original recipient's state tax liability, it is not taxable.[186] However, the recipient's federal itemized deduction allowed under IRC § 164 for the payment of state taxes will be reduced to the extent that state income tax liability is offset by use of the credit.[187]

Example

Jordan contributes a conservation easement on land in Virginia. Jordan is a Virginia taxpayer and his easement contribution makes him eligible for a Virginia income tax credit equal to 40% of the value of the easement. The value of the easement was $250,000; therefore Jordan is entitled to a credit against his Virginia income tax of $100,000 ($250,000 x 40%). Jordan's Virginia income tax liability for 2006 is $200,000 (Virginia's top rate is 5.75% and Jordan's 2006 income was approximately $3,500,000). Jordan files his Virginia income tax return in 2007 and uses the tax credit to "pay" $100,000 of his $200,000 liability. He sends along a check for $100,000 to cover the balance. When Jordan files his federal return for 2007 and itemizes his deductions, he can only claim a deduction of $100,000 for his 2006 Virginia income tax payment because he "paid" $100,000 of his $200,000 tax liability with the credit.

2. Proceeds from the sale of a tax credit are taxable.

The IRS has stated that the proceeds from the sale of a tax credit, by the original recipient to another taxpayer, are taxable under IRC § 1001.[188] The IRS

[186] I.R.S. AM 2007-002 (Jan. 11, 2007).

[187] *Id.*

[188] *Id.*

has also ruled that *a state tax credit is not a capital asset* within the meaning of IRC § 1221, and therefore the sale of a credit results in ordinary income, regardless of how long the seller has held the credit.[189]

Example

Assume that Jordan, in the preceding example, sold his credit rather than using it against his Virginia income tax liability. He received $75,000 in 2007 for the credit (a 25% discount, which is not uncommon). Jordan had held the credit for two years prior to the sale. Jordan is required to report the $75,000 as income on his 2007 return, and pay tax at the ordinary rate (assume 35% in Jordan's case) resulting in a tax on the credit sale of $26,250 ($75,000 x 35%).

3. Does the receipt of a tax credit affect the federal deduction for the contribution of the easement?

The answer to this question is not yet known. The IRS has been considering whether receipt of a tax credit constitutes a "*quid pro quo*" that precludes the required "donative intent."[190] To date the IRS has issued no advice on this point. There are three obvious alternative answers to this question (and possibly more that are less obvious): (1) the credit is a payment for the easement that precludes donative intent and no deduction is permitted, (2) the conveyance of an easement resulting in receipt of a tax credit is treated as a "bargain sale" and the amount of the credit must be subtracted from the value of the easement to determine the amount of the deduction, or (3) the credit has no effect on the amount of the easement deduction.

It would seem *unlikely and illogical* that the IRS would rule that the receipt of a credit precludes any deduction for the easement at all if the value of the easement exceeds the amount of the credit. Whether, or when, the IRS will issue any additional comments on the question of donative intent and state income tax credits is unknown at this time.

b. Treatment of transferees of credits

1. Credit transferees may deduct state taxes paid with credits.

Use of a tax credit to pay state income tax by someone who acquired the credit from the original recipient of the credit results in a deduction under IRC § 164(a)

[189] I.R.S. CCA 200211042 (Mar. 15, 2002).

[190] *See* discussion *supra* Part C.10; I.R.S. CCA 200238041 (Sept. 20, 2002) (providing a discussion of donative intent.).

for payment of state income tax.[191] Note that this is different than treatment of use of a credit by the original recipient, which use reduces the deduction allowed under IRC § 164(a).[192]

2. Taxable gain (or loss) may result from use of a credit by a transferee.

The IRS has ruled that the transferee of a state income tax credit has acquired property with a basis equal to the purchase price of the credit.[193] This ruling also states that use of the credit may result in gain or loss under IRC § 1001.[194] However, the IRS has not said whether gain on the sale or use of a credit by a transferee would be taxed as ordinary income or capital gain.

Example

Susie Q purchased Jordan's $100,000 Virginia income tax credit. She paid Jordan $75,000 for the credit. She used the credit to offset her 2006 Virginia income tax liability of $100,000. Her basis in the credit, which is treated as property, is $75,000. When Susie uses the $100,000 credit she will be considered to have paid her state taxes with property in which she has a basis of $75,000. She will be entitled to deduct the state taxes paid in this fashion under IRC § 164(a), but will have to report as income the $25,000 by which the value of the credit exceeds what she paid for it.

15. Tax treatment of expenses incurred in contributing a conservation easement

A frequent question is what expenses of making an easement contribution are deductible. Typical expenses include the following: legal fees, appraisal fees, surveyor's fees, recording fees, costs incurred for preparation of the natural resources inventory, and payments to land trusts to cover future stewardship expenses.

Arguably, an individual may deduct expenses incurred "in connection with the determination, collection, or refund of any tax."[195] This deduction includes most expenses likely to be incurred such as legal fees (insofar as these fees are incurred to insure that the easement is in compliance with federal or state tax requirements); appraisal fees (because the appraisal is a tax code requirement);

[191] I.R.S. AM 2007-002 (Jan. 11, 2007); I.R.S. CCA 200445046 (Nov. 5, 2004); I.R.S. CCA 200126005 (Jun. 29, 2001).

[192] *See* discussion *supra* Part C.14.b.

[193] I.R.S. AM 2007-002 (Jan. 11, 2007).

[194] *Id.*

[195] I.R.C. § 212(3) (2004).

surveyor's fees (because a survey may be necessary to insure that the easement is enforceable, which is a tax code requirement); recording fees (tax law requires that easements be recorded to be deductible); and costs incurred in preparation of a natural resources inventory (the inventory is a requirement of tax law).[196] In other words, these expenses are all expenses incurred "in connection with the determination . . . of . . . tax."[197]

However, while *voluntary* contributions made to a land trust to assist the land trust in monitoring and enforcing its easements are deductible under IRC § 170, if the payment is *required* it no longer qualifies as a charitable contribution because there is no "donative intent."[198] Furthermore, because a payment made to provide for the monitoring or enforcement of conservation easements is not a payment made "in connection with the determination . . . of . . . tax," and because such a payment does not qualify under any other tax code provision as deductible, it is unlikely that such payments are deductible.

D. ESTATE AND GIFT TAX BENEFITS

A decedent's estate that receives land from a decedent that is subject to a conservation easement from the decedent may qualify for two specific estate tax benefits. In addition to these tax benefits, a conservation easement controls the future use of property in the hands of a decedent's heirs, or other successors in title, more effectively than any other technique available. For these reasons, conservation easements compliment and increase the power of many estate planning techniques. More importantly, the substantial estate tax benefits associated with conservation easements are important tools for estate planning.

1. A NOTE ON THE FUTURE OF THE FEDERAL ESTATE TAX

In 2001, Congress repealed the federal estate tax effective in 2010.[199] Between 2001 and 2010 the estate tax is phased out in stages. In 2011, the entire estate tax, as constituted in 2001, is automatically reinstated. What will, in fact, happen to the estate tax in 2011 is hard to predict. It is unlikely that Congress will allow full reinstatement, but it is also unlikely that Congress will make the repeal permanent. The Republican-controlled Congress tried and failed in 2006 to make the repeal of the estate tax permanent.[200] It appears even less likely that permanent repeal will occur with the Democrat-controlled Congress elected in November of 2006.

[196] Treas. Reg. § 1.170A-14(g)(5)(i) (as amended in 1999).

[197] I.R.C. § 212(3) (2004).

[198] *See* discussion *supra* Part C.10.

[199] Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No.107-16 (2001).

[200] Permanent Estate Tax Relief Act of 2006, H.R. 5638, 109th Cong. (2006) (passed the U.S. House of Representatives 269 to 156, died in the U.S. Senate.)

The two principal components of the estate tax are the value of estate assets that are exempt from the tax (the "exemption amount" for purposes of this discussion, to distinguish it from the § 2031(c) 40% "exclusion") and the top rate of the tax. These components will be changing over the next five years as follows:

- In 2007 and 2008, the exemption amount is $2 million; the tax on assets over $2 million is 45%.

- In 2009, the exemption amount increases to $3.5 million; the tax on assets over $3.5 million remains 45%.

- In 2010, the estate tax is fully repealed.

- In 2011, the estate tax is reinstated and the exemption amount drops to $1 million; the top rate of tax is increased to 55%.

All of the examples that follow are based upon the 2007 and 2008 exemption amount and tax rates.

2. THE REDUCTION IN ESTATE VALUE AND THE ESTATE AND GIFT TAX DEDUCTIONS

a. The restrictions of a conservation easement reduce the value of the taxable estate

A conservation easement on real property included in a decedent's estate reduces the value of that property for estate tax purposes. This "reduction" in value is applicable regardless of whether the easement was sold or contributed. The value of real property subject to a conservation easement will be determined at the same time as other estate assets: the decedent's death, or on the alternate valuation date (the date six months after the death of the decedent) if the executor elects the alternate date.[201]

[201] I.R.C. § 2032(a) (2004).

Example 1

Mrs. Smith owns, at her death, land worth $4,000,000 *without* considering the effect of a conservation easement that Mrs. Smith contributed prior to her death. On the date of Mrs. Smith's death, the land had a value, taking into account the restrictions imposed by the easement, of $2,000,000. Thus, the easement reduced the size of Mrs. Smith's taxable estate by $2,000,000. Because the other assets in Mrs. Smith's estate were substantial enough that the entire $2,000,000 in land value removed by the easement would have been taxed at the top estate tax rate of 45%, the estate tax savings due to the easement are $900,000 (45% x $2,000,000).

Example 2

Mr. Blue sold a conservation easement in 2000 for $550,000. The easement reduced the value of the land subject to the easement by $1,000,000. Mr. Blue is entitled to a "bargain sale" deduction for the difference between what he received for the easement and what it was worth: $450,000 ($1,000,000 – $550,000).

Mr. Blue dies in 2007. At his death the value of his land is $2,500,000, taking into account the restrictions of the easement. If the land were unrestricted the value in 2007 would have been $5 million. Therefore, the easement has reduced Mr. Blue's taxable estate by $2,500,000, generating estate tax savings of $1,125,000 (45% x $2,500,000). However, Mr. Blue invested the $467,500 (net of taxes) he was paid for the easement in stocks that had a value at the date of his death of $1,000,000. The estate tax on this value will be $450,000 (45% x $1,000,000).

Taking into account the tax savings due to the restrictions imposed by the conservation easement, and the tax on the stocks purchased with the proceeds of sale of the conservation easement, the net estate tax savings for Mr. Blue's estate is $675,000 ($1,125,000 – $450,000).

b. The effect of restrictions other than qualified conservation easements

Generally, restrictions on real property (e.g. options, restrictions on use, the right to acquire or use property for less than fair market value) *cannot* be taken into account by an estate in valuing the property for estate tax purposes.[202]

[202] Treas. Reg. § 25.2703-1 (1992).

However, "qualified easements" pursuant to IRC § 170(h) made during a decedent's lifetime are exempt from this provision[203] and are also deductible for gift tax purposes.[204] In addition, easements qualified under IRC § 170(h) conveyed by the terms of a decedent's will are qualified for estate tax deductions[205] (but without regard to the conservation purposes requirements of IRC § 170(h)(4)(A)).[206]

It is also possible for restrictions that do not comply with the requirements of IRC § 170(h) to be recognized for estate valuation purposes, provided that all of the following requirements are met:

> a) the restrictions are the result of a "bona fide business arrangement;"
>
> b) the restrictions are not a device to transfer the property to family members for less than adequate consideration; and
>
> c) the terms of the restriction are comparable to similar arrangements entered into by persons in an arm's length transaction.[207]

Example

Mr. Brinkman sells a "scenic easement" over Greenacre to his neighbor, the owner of Brownacre. The easement is not perpetual, and expires after 50 years. The easement is, in effect, a restrictive covenant benefiting Mr. Brinkman's neighbor and any future owners of Brownacre during that period. The scenic easement prohibits construction over an area of some 200 acres within view of Brownacre. It also reduces the value of Greenacre by 25%.

Although this scenic easement does not qualify as a "qualified conservation contribution" within the meaning of IRC § 170(h), it does meet the three requirements of IRC § 2703 described above. Therefore, when Mr. Brinkman dies, his executor is allowed to take into account the effect of the scenic easement on the value of Greenacre.

[203] Treas. Reg. § 25.2703-1(b)(4) (1992).

[204] I.R.C. § 2522(d) (2004).

[205] I.R.C. § 2055(f) (2004).

[206] *See* discussion *infra* Part D.3.

[207] Treas. Reg. §§ 25.2703-1(b)(1), (2) (1992).

c. Estate and gift tax deductions for conservation easements

Generally, gifts made during a person's lifetime are subject to the federal gift tax. However, IRC § 2522(d) allows a deduction for contributions of conservation easements that meet the requirements of IRC § 170(h), with one exception discussed below.

Contributions of conservation easements made by a decedent's will are deductible from the decedent's estate. The amount of the deduction is equal to the value of the easement, as determined in the same manner as for an income tax deduction.[208]

Both the gift tax deduction and estate tax deduction for conservation easements allow the deductions *regardless* of whether the easement meets the "conservation purposes" requirement imposed by IRC § 170(h)(4)(A) for federal income tax deductions.[209] Presumably, if a conservation easement is not required to meet the conservation purposes test, it is not subject to the prohibition on the retention of rights that are inconsistent with conservation purposes, although this is only logical speculation.[210]

According to the official 1986 explanation of the gift and estate tax easement deductions, the reason for exempting gifts and bequests of conservation easements from the conservation purposes test was to avoid a situation in which a decedent makes an irrevocable bequest of a valuable property interest but, because the easement failed to meet a technical standard of the tax code, that property interest is still taxed in the decedent's estate at full value even though it is permanently restricted.[211]

It is also possible that a conservation easement that fails to meet the conservation purposes test might constitute a restriction on the use of real property that a decedent's executor could take into account in valuing such property for estate tax purposes.[212]

[208] *See* discussion *supra* Part C.5.

[209] *See* discussion *supra* Part B.4.

[210] *See* discussion *supra* Part B.8.

[211] See Tax Protection Act of 1986, Pub. L. No. 99-514, 1986. (Regulations have not been promulgated nor cases decided under this provision to give further guidance).

[212] See I.R.C. § 2703 (2004); *See* discussion *infra* Part D.3

Example

Mr. Brown, a farmer, has a very large estate because of the value of his farm land, but he has only a small income. An income tax deduction is not going to do him much good. However, his children love the farm and don't want it to be sold out of the family, nor does Mr. Brown. Because of the uncertainty of his financial situation Mr. Brown does not want to restrict his ability to sell the farm for top dollar while he is living. (Mrs. Brown left many years earlier, thoroughly disgusted with farming.) Therefore, Mr. Brown provides in his will for the contribution of a conservation easement on the farm (including with the will a complete draft of the instrument so that his executor doesn't have to guess what should go into the easement).

The executor values the farm land on the date of Mr. Brown's death at $4,000,000 before the easement, and at $2,000,000 after the easement. The executor is able to deduct the $2,000,000 value of the easement under IRC § 2055(f). This saves Mr. Brown's children $900,000 in estate taxes because the entire $2,000,000 would have been subject to the 45% marginal rate (the top rate in 2007). Due to the $2,000,000 estate tax exemption in 2007, and the exclusion available under IRC § 2031(c) (discussed below), the easement entirely eliminates the estate tax on Mr. Brown's estate.

Note: Under the terms of § 2031(c)(9), even if Mr. Brown had not made a provision in his will for the easement, his heirs could have directed the executor to donate a "post-mortem" easement that would have given the estate the same tax benefits as the testamentary easement.

3. THE 40% EXCLUSION

In addition to recognizing the reduction in the value of real property resulting from the restrictions of a conservation easement, federal tax law allows 40% of the *easement-restricted* value of land (but not improvements) subject to a "qualified conservation easement" to be excluded from a decedent's estate.[213] To date no regulations or cases concerning the 40% exclusion are available to provide guidance.

The exclusion does not apply to all "*qualified conservation contributions*" as do the deductions under IRC §§ 170(h) and 2055(f), but only to "*qualified conservation easements*."[214] The differences between qualified conservation contributions and qualified conservation easements are that the term "qualified

[213] I.R.C. § 2031(c)(1)(A) (2004).

[214] I.R.C. § 2031(c)(1)(A) (2004); I.R.C. §2031(c)(8)(B) (2004)

conservation easement" does not include certain types of contributions that are included within the meaning of "qualified conservation contribution."[215] Also, a qualified conservation easement must meet requirements that a qualified conservation contribution does not: (1) the easement must apply to land held by the decedent or member of the decedent's family for at least a three-year period immediately preceding the decedent's death; (2) the easement contribution must have been made by the decedent or a member of the decedent's family (as defined in the law); (3) the conservation purposes of the easement cannot be limited to historic preservation; and (4) the easement can allow no more than a "*de minimis* commercial recreational use."[216] These requirements are discussed in more detail below.

Note that the phrase "qualified conservation easement" when used hereafter refers to qualified conservation easements as defined in the preceding paragraph. Note also that the § 2031(c) "exclusion" should not be confused with the "exemption amount." The § 2031(c) exclusion is allowed *in addition* to the exemption amount.

a. Extent of the exclusion

IRC § 2031(c) provides that a decedent's executor *may elect* to exclude 40% of the value of land subject to a qualified conservation easement.[217] In other words, the exclusion applies to the value of the land *taking into account* the restrictions of the easement. Values are determined as of the date of the decedent's death, or six months thereafter if the executor elects the "alternate valuation date."[218]

Example

Before he died, Mr. Brown contributed a conservation easement on his farm reducing the value of the farm from $3,000,000 to $1,000,000. The value of the farm on the date of Mr. Brown's death remained at $1,000,000, taking into account the restrictions of the easement. Mr. Brown's executor elects to exclude 40% of the restricted value of the farm (the $1,000,000) from his estate under IRC § 2031(c). Therefore, $400,000 (40% x $1,000,000) may be excluded. Thus, the easement has reduced the taxable value of the land in Mr. Jones' estate by $2,400,000: $2,000,000 from the initial reduction in value and $400,000 due to the exclusion.

[215] *See* discussion *supra* Part B.1.

[216] I.R.C. § 2031(c)(8)(B) (2004).

[217] I.R.C. §§ 2031(c)(1), (6) (2004).

[218] I.R.C. §§ 2031(c)(1), (2) (2004).

b. The easement must meet the requirements of IRC § 170(h) to qualify for the exclusion

The easement must meet the requirements of IRC § 170(h),[219] *including* the conservation purposes test.[220] Therefore, while it is possible for a conservation easement that does not meet the conservation purposes test of IRC § 170(h)(4)(A) to be deductible for estate and gift tax purposes, and for permanent restrictions on the use of property to reduce the value of that property for estate tax purposes under IRC § 2703, such restrictions or easements *will not* qualify for the § 2031(c) exclusion because they do not comply with IRC § 170(h).[221]

c. The exclusion applies to land only

The exclusion applies only to the value of land, not to improvements on the land.[222] This limitation does not apply to tax benefits under other provisions of the tax code.

Example

Mrs. White died owning a 200-acre farm subject to a qualified conservation easement. The easement allows only agricultural use of the land and imposes architectural standards on the house, a certified historic structure. Without the easement the land would be worth $1 million and the house and outbuildings $350,000. Taking the easement into account, the land is valued at $750,000 and the house and outbuildings at $300,000 for estate tax purposes. Mrs. White's executor elects the § 2031(c) exclusion. As a result the executor can exclude $300,000 of the restricted value of the land (40% x $750,000). The exclusion does not apply to the house and outbuildings. Thus, for estate tax purposes, the conservation easement results in a total reduction in the value of Mrs. White's farm of $600,000. This is due to a reduction of $250,000 in the value of the farm land; a reduction of $50,000 in the value of the structures; and the exclusion of $300,000 in the value of the farm land as restricted by the easement. These reductions save Mrs. White's heirs $270,000 in federal estate tax ($600,000 x 45%), assuming that all of the value removed by the easement would have been subject to tax.

[219] *See* discussion *supra* Part B.1.

[220] I.R.C. § 2031(c)(8)(B) (2004).

[221] I.R.C. § 2031(c)(8)(B) (2004) (defining a "qualified conservation easement" as a "qualified conservation contribution as defined in section 170(h)(1)").

[222] I.R.C. § 2031(c)(1)(A) (2004).

d. *The exclusion does not apply to the gift tax*

Federal law taxes gifts made during an individual's lifetime as well as transfers at death. The gift tax closely tracks the federal estate tax. The § 2031(c) exclusion does not apply to the gift tax imposed on lifetime gifts of conservation easement property.[223] For this reason estate-planning strategies based upon lifetime transfers of property should carefully evaluate the effect of making a lifetime gift of easement-protected land that is subject to a conservation easement. A lifetime gift of land that is subject to a conservation easement, and that otherwise qualifies for the § 2031(c) exclusion, will waste the exclusion. However, there may be other overriding reasons to make lifetime transfers of such land.

Example

Mr. Smith donates a conservation easement on 100 acres. The value of the land as restricted by the easement is $200,000. Before he dies, Mr. Smith gives the land to his son. This gift is subject to the full federal gift tax on a $200,000 gift (which could be as much as $90,000) *and none* of the value of the land can be excluded under § 2031(c).

If Mr. Smith had transferred the land to his son by will, only $120,000 of the value of the land would have been subject to tax. This is because the exclusion would reduce the taxable value by $80,000 (40% x $200,000). Assuming that both the lifetime gift and the bequest would have been taxed at 45% (the maximum estate *and* gift tax rate in 2007), transferring the land by a lifetime gift rather than by will would cost Mr. Smith $36,000 (45% x $80,000) in gift tax over and above what the estate tax would have been had the transfer been made at death.

e. *The exclusion does not apply to easements whose sole conservation purpose is historic preservation*

The § 2031(c) exclusion does not apply if the *sole* conservation purpose of the easement is the preservation of the historic character of the land (historic structures, being improvements rather than land, are not eligible for the exclusion either).[224] However, the fact that land is historic does not disqualify an easement over it for the exclusion if there is also a bona fide conservation purpose for the easement other than historic preservation.

[223] There is no gift tax provision corresponding to I.R.C. § 2031(c) (2004).

[224] I.R.C. § 2031(c)(8)(B) (2004).

Example

Sally owns an historic 18th Century New England farm. The land is identified in the local comprehensive plan and zoning ordinance as prime agricultural land and is accorded a special reduced real estate tax assessment because of its agricultural value. Sally donates a conservation easement protecting the historic *and* agricultural characteristics of the farm. When she dies, her executor may elect to exclude 40% of the value of the land making up the farm after taking the value of the easement into account. Even though the easement has an historic purpose, it also has the purpose of the preservation of open space pursuant to "a clearly delineated governmental conservation policy" (i.e. farmland preservation).

If the sole purpose of the easement and the only significant characteristic of the farm were its historical significance the exclusion would not be available, although the other easement tax benefits would still be available. However, assuming that the easement complies with IRC § 170(h), the easement would qualify for an income tax deduction. In addition, such an easement would reduce the value of Sally's property for estate tax purposes.

f. The exclusion is available for the estates of decedents dying after 12/31/97

Example

Mary donated a conservation easement in 1980 that meets all of the requirements of § 2031(c). She died December 1, 2000. Because she died after December 31, 1997, Mary's estate is eligible to elect use of the exclusion.

g. Three-year holding period required

The decedent, or a member of the decedent's family, must have owned the land that is subject to the easement for at least three years immediately preceding the decedent's death in order to be eligible for the exclusion.[225] For purposes of this provision the term "member of the decedent's family" is defined as follows:

a) an ancestor of the decedent;

b) the spouse of the decedent;

[225] I.R.C. § 2031(c)(8)(A)(ii) (2004).

c) a lineal descendent of the decedent, or of the decedent's spouse, or of a parent of the decedent; and

d) the spouse of any such lineal descendent.[226]

Example

Joel's father gave him 200 acres. His father owned the land for two years before he made the gift to Joel. Joel promptly donated a conservation easement on the land. He died two years after donating the easement. This land will qualify for the exclusion because the total period of time that Joel and a member of his family owned the land immediately preceding Joel's death was four years.

h. The exclusion is limited to $500,000 per estate

Example

James owns land subject to a qualified conservation easement. The value of the land, as restricted by the easement, is $2,000,000. James dies in 2004. Forty percent of the value of the restricted land is $800,000 (40% x $2,000,000). However, the maximum amount that may be excluded by James' estate under § 2031(c) is $500,000, thus James' executor may only exclude $500,000.

The exclusion is limited to $500,000 *per estate*.[227] The limitation was phased in beginning in 1998, in $100,000 increments. The $500,000 limit applies to the estates of decedent's dying after December 31, 2001.[228]

i. The benefits of the exclusion may be multiplied

Because the $500,000 limitation on the exclusion applies *per estate*, not per easement,[229] one conservation easement can generate multiple exclusions.

[226] I.R.C. § 2032A(e)(2) (2004).

[227] I.R.C. § 2031(c)(1) (2004).

[228] I.R.C. § 2031(c)(3) (2004).

[229] I.R.C. § 2031(c)(1) (2004).

Example 1

Mr. Green and his wife own land as "tenants in common" with each entitled to a 50% share in the land. In a tenancy in common, the interest of the first decedent does not automatically pass to the surviving tenant, as is the case with joint tenancies and tenancies by the entirety. The will of each of the Greens provides that each share of land goes directly to their children rather than to the surviving spouse. The Greens put extensive easements on the land reducing the value of the land overall from $6,500,000 to $2,500,000. Accordingly, the 50% share of the land owned by each of the Greens, as restricted by the easement, is worth $1,250,000. The exclusion available to each of the Greens' estates would be $500,000 (40% x $1,250,000 = $500,000). Therefore, by dividing the ownership of the land and keeping it separate, the Greens have been able to reduce the aggregate value of their two estates by $1,000,000 by qualifying each estate to use the exclusion up to the $500,000 limit.

A commonly used alternative to passing land directly to the children would be for the Greens to have bequeathed their share of the land to a "by-pass trust" that allows the surviving spouse to use the land but not to control it. Upon the death of the surviving spouse, the by-pass trust distributes the land directly to the Greens' children or to other beneficiaries.

Example 2

Four brothers own a ranch inherited from their parents as equal tenants in common. They donate a qualified conservation easement on the ranch. The value of the ranch before the easement was $20,000,000; after the easement the ranch was worth $10,000,000. The brothers all die in a blizzard in 2007. Their executors each elect to take advantage of the 40% exclusion. Each estate receives the decedent brother's 25% interest in the ranch, worth $2,500,000 (25% x $10,000,000), taking into account the restrictions of the easement. The value of the exclusion available to each estate prior to the $500,000 limitation is $1,000,000 (40% x $2,500,000). Each estate may elect to exclude up to $500,000 of its share of the ranch. Therefore, the total value of the ranch that may be excluded is $2,000,000 (4 x $500,000). In this manner one conservation easement qualified for *four* separate exclusions of $500,000 each.

The net effect of the conservation easement in this example was to reduce the taxable value of the ranch by $12,000,000. This is the combination of the initial reduction in value due to the restrictions of the conservation easement ($20,000,000 – $10,000,000 = $10,000,000) and the exclusion of $500,000 available to each brother's estate (4 x $500,000 = $2,000,000). Assuming that this value would have been taxed at the 45% federal estate tax rate, total estate tax savings between the four estates would amount to $5,400,000 (45% x $12,000,000 = $5,400,000). Due to the $2 million exemption from estate tax available in 2007, none of the brothers' estates would be taxable.

Note: If the brothers had held their interests in the ranch as partners in a partnership, as members in a limited liability company, or as stockholders in a corporation, the result would not have been the same. Because each brother would have owned less than 30% of the partnership, limited liability company, or corporation, their estates would not have been eligible for the exclusion. IRC § 2031(c)(10) allows the exclusion for partnership, corporation, and trust interests held by a decedent, *but only* if the decedent owned at least 30% of such entity.

j. The exclusion may be used in conjunction with other tax benefits for easements

The exclusion, the reduction in value of a decedent's estate due to the existence of a conservation easement, and the income tax deduction attributable to the original contribution of the easement, may all be used in connection with the same easement contribution.

Example

Mr. Jones' land is valued at $1,000,000 and his easement reduces that value to $700,000. Mr. Jones is entitled to a $300,000 income tax deduction. His estate can report the value of the easement restricted land as $700,000, rather than $1,000,000, and the executor can elect to exclude $280,000 of the remaining value under § 2031(c) (40% x $700,000). In this manner, the easement removes $580,000 ($300,000 + $280,000) from the taxable value of the estate, in addition to generating state and federal income tax deductions.

Assume that Mr. Jones' income is taxed at the top 2007 federal rate of 35%, a state rate of 6%, and that the assets in his estate are taxed at the rate of 45%. Given these assumptions, donation of an easement valued at $300,000 would save Mr. Jones and his estate a total of $384,000 in state and federal taxes. These savings are made up of income tax savings of $123,000 ((35% + 6%) x $300,000); estate tax savings of $135,000 due to the reduction in the value of the estate resulting from the conservation easement (45% x $300,000); and additional estate tax savings of $126,000 due to the § 2031(c) exclusion (40% x $700,000 x 45%).

In addition, the exclusion may be layered on top of the unified estate and gift tax credit (the "exemption amount" and the tax benefits available under the special valuation rules of IRC § 2032A for qualified family farms).[230]

k. The exclusion may be passed from one generation to the next

The benefit of the exclusion is available to each succeeding generation of landowners so long as the land remains in the family of the donor.[231] Once the land passes outside of the family, the exclusion is no longer available unless the new owner donates another easement on the land that independently qualifies under IRC § 2031(c).[232] If such a contribution can be made, the exclusion will be revived for the estate of the new donor and his heirs, so long as the land remains in his family.

[230] I.R.C. §2032A (2004). Care needs to be taken using conservation easements in connection with I.R.C. §2032A so that the easement does not reduce the value of the farm below the 50% of estate assets threshold. *Id.*

[231] I.R.C. § 2031(c)(8)(C) (2004).

[232] I.R.C. § 2031(c)(8)(A)(ii) (2004).

Example 1

Mr. Jones donates a conservation easement on his land that qualifies under § 2031(c). When Mr. Jones dies, the property passes to his son John. John marries and passes his land to his wife Sarah at his death. Sarah has a daughter by a subsequent marriage (John died young), Julie. Julie inherits the land at Sarah's death, marries, and has children who ultimately become beneficiaries of the land. Mr. Jones' estate is eligible for the exclusion, as are the estates of John, Sarah, Julie, and Julie's children, if the land is included in their estates at their deaths.

In addition, the reduction in value due to the restrictions imposed by the easement will be available to future generations in the family of the donor. However, unlike the exclusion, the reduction in value attributable to the restrictions of the easement remains available to owners outside of the family of the original donor in the event that the land is transferred outside of the family.

Example 2

Mr. Green donates an easement on his land that qualifies under § 2031(c). The easement reduces the development potential on Mr. Green's land from 100 houses to 10 and generates a significant public conservation benefit. When Mr. Green dies, the land passes to his son Alfred. Alfred sells the land to his neighbor Mrs. Brown. Mrs. Brown dies leaving the land to her daughter Melissa. Melissa donates a second conservation easement that eliminates all remaining 10 house sites so that the land cannot be developed at all. The easement donated by Melissa is a qualified conservation easement. Melissa passes the land on to her daughter Joan, and it is included in Joan's estate at her death.

Mr. Green's estate is eligible for the exclusion. Alfred's estate does not contain the property so no exclusion is available, and the proceeds of sale that remain in his estate at his death will be fully taxable. Mrs. Brown's estate is not eligible for the exclusion because neither she nor any members of her family donated the easement. However, due to the new easement donated by Melissa, Melissa's estate is eligible for the exclusion, as is Joan's estate.

l. The exclusion must be "elected"

In order to take advantage of the exclusion, a decedent's executor or trustee must make an *affirmative* election to use the exclusion before the date on which the estate tax return for the decedent is due, including extensions.[233] The election is made on Schedule U ("Qualified Conservation Easement Exclusion") of Form 706, which is the federal estate tax return. Federal law requires estate tax returns to be filed within nine months of a decedent's death.[234]

Extensions of up to six months are available; however, they are not automatic.[235] Under the current law, failure to elect the exclusion does not preclude subsequent generations from electing the exclusion. Schedule U provides that an executor is deemed to have made this election by filing Schedule U and excluding the value of land subject to a conservation easement from the estate.

Note that an executor would probably not choose to elect the exclusion if the estate is not otherwise subject to estate tax (e.g., because the total value of the estate is less than the $2 million exemption amount). This is because, to the extent of the exclusion, land passing through a decedent's estate is denied a "stepped-up" basis.[236]

m. The easement must reduce land value by at least 30% to qualify for the full exclusion

The 40% exclusion is reduced if the conservation easement fails to reduce the value of the land that is subject to it by at least 30%. The statute provides that the 40% exclusion is to be reduced by two percentage points for each one percentage point that the easement fails to reduce the value of the restricted land by 30%.[237] The purpose of this provision is to prevent landowners from donating minimal easements in order to take advantage of the exclusion.

The values for determining compliance with the 30% requirement are the values of the land and easement *at the time of the original contribution* of the easement.[238] To determine compliance with this standard the executor must obtain information about the value of the easement, and the value of the land as restricted by the easement, at the time of the original contribution. However, if the estate qualifies for the exclusion, the exclusion is applied to the restricted value of land under the easement *as of the date of the decedent's death* (or the alternate valuation date, if selected).

[233] I.R.C. §§ 2031(c)(1), (6) (2004).

[234] I.R.C. § 6075(a) (2004).

[235] I.R.C. § 6081(a) (2004).

[236] *See* discussion *infra* Part D.16.

[237] I.R.C. § 2031(c)(2) (2004).

[238] *Id.*

Example

Mrs. Johnson's land was valued at $1,250,000 before she contributed her easement and $1,000,000 after she contributed her easement. The value of the easement was $250,000 ($1,250,000 – $1,000,000). Therefore the easement reduced the value of the unrestricted land by 20% ($250,000/$1,250,000). Twenty percent is ten percentage points less than the 30% reduction in value required by § 2031(c). To determine the amount by which the 40% exclusion must be reduced, Mrs. Johnson's executor must subtract two percentage points from the 40% exclusion for every one percentage point by which the easement falls short of the 30% requirement, in this case 20% (2 x 10%). Therefore, the executor may only exclude 20% of the restricted value of the land.

However, by the time of Mrs. Johnson's death, the value of the land as restricted by the easement has appreciated to $2,500,000. Twenty percent of this value is $500,000 (20% x $2,500,000). $500,000 is the maximum amount that can be excluded under § 2031(c) in any event. Therefore, due to the appreciation in the value of the restricted land, the 30% threshold requirement does not penalize the estate at all. Had the value of the land subject to the easement not appreciated between the date of the easement donation and the date of Mrs. Johnson's death, the amount that could have been excluded would have been limited to $200,000 (20% x $1,000,000).

n. Retained development rights are not eligible for the exclusion

Any "development rights" retained in the conservation easement are not eligible for the exclusion.[239] However, if those people with an interest in the decedent's land after the decedent's death agree before the due date for the estate tax return (including any extension), to terminate some or all such retained rights the exclusion will apply as though the terminated rights never existed. Those with an interest in the land have two years after the decedent's death to put their agreement into effect (presumably by recording an amendment to the original easement or recording a supplemental easement).[240]

Development rights for purposes of this provision are defined in the law as any right to use the land for a commercial purpose "not subordinate to and directly supportive of the use of such land as a farm for farming purposes."[241]

[239] I.R.C. §§ 2031(c)(2), (c)(5)(D) (2004).

[240] I.R.C. §§ 2031(c)(5)(A), (B) (2004).

[241] I.R.C. § 2032A(e)(5) (2004) (The definition of "farm for farming purposes" is provided in I.R.C. § 2032A(e)(5)); *see* discussion *supra* Part C.3.

Rights to maintain a residence for the owner's use, as well as normal farming, ranching, and forestry practices should not be considered retained development rights.[242] Retained rights to sell land for development, or to establish houses for sale or rent, probably would be considered retained development rights.[243]

Many conservation easements retain the right for the grantor to use an existing residence, or to construct a residence for use by the grantor. While there are no regulations, cases, or rulings to the knowledge of the author on this point, it would seem that such a retained right is not a "retained development right" because a right reserved by the grantor to personally use a residence does not constitute a "commercial purpose."

Example

An easement otherwise meeting the requirements of IRC § 2031(c) reserves the right to develop and sell five home sites, each worth $50,000. The land is valued at $2,000,000 before the easement and $1,000,000 after the easement (including the value of the retained home sites). Before calculating the exclusion, the executor must subtract the value of the retained development rights from the restricted value of the land ($1,000,000 – (5 x $50,000) = $750,000). The exclusion is then applied to the adjusted value of $750,000. The value that can be excluded from the decedent's estate is therefore $300,000 (40% x $750,000).

If all of the people with an interest in the decedent's land agree to terminate these retained development rights, the exclusion will increase to $400,000 (40% x $1,000,000). If the value excluded were subject to the 2007 45% federal estate tax rate, terminating these rights would save the heirs an additional $45,000 (45% x $100,000) in estate taxes.

It is also possible for people having a legal interest in the decedent's land to take advantage of the "post-mortem" easement provisions of IRC § 2031(c)(9)[244] and eliminate the retained development rights by donating a new easement before the estate tax return is due.[245] This would qualify the termination of the retained

[242] I.R.C. § 2031(c)(5)(D) (2004). This is because the definition of "development right" in IRC § 2031(c)(5)(D) excludes uses that are subordinate to, and directly supportive of, the use of the land as a farm for farming purposes. A farm house for the farmer and housing for farm employees, as well as barns, sheds, etc. used in the farming operation, are a necessary element of a farm or ranch. *Id.*

[243] *Id.*

[244] *See* discussion *supra* Part D.20.

[245] I.R.C. § 2031(c)(9) (2004) (allowing post-mortem easement contributions to qualify for the § 2031(c) exclusion and the I.R.C. § 2055(f) deduction, provided that the easement is a "qualified conservation easement" as defined in I.R.C. § 2031(c)(8)(B)).

rights for both an expanded exclusion as well as an estate tax deduction under IRC § 2055(f).[246] These benefits would be in addition to the reduction in value already attributable to the restrictions of the easement donated by the decedent during his lifetime.

o. Commercial recreational uses must be prohibited

Any easement in which the right is retained to use the land subject to the easement for more than "*de minimis*" commercial recreational purposes is not a qualified conservation easement and is disqualified for the § 2031(c) exclusion.[247]

The official explanation of this provision given by the Joint Committee on Taxation includes a statement that rights retained in an easement to grant hunting or fishing licenses on land subject to the easement is within the exemption for *de minimis* uses and does not disqualify the easement for the exclusion.[248]

No other official clarification of this provision has been given. From a drafting standpoint, until more information about the meaning of this provision is made available, easement donors intending to qualify for the § 2031(c) exclusion should include language in their easements expressly prohibiting "any commercial recreational use, except those uses considered *de minimis* according to the provisions of § 2031(c)(8)(B) of the Internal Revenue Code." An equally effective alternative is a blanket prohibition in the easement against any "commercial recreational" activity or any "commercial activity."

Existing conservation easements that do not include such prohibitions should be re-examined and possibly amended. The staff of the Joint Committee on Taxation has verbally taken the position that a prohibition against all but *de minimis* commercial recreational uses may be supplied by a decedent's executor or trustee in a "post-mortem" amendment to an existing easement. [249] If the easement donor is unable to amend the easement, such a post-mortem correction may be the only alternative. However, because of the cumbersome process involved in granting a post-mortem easement, including the uncertainty of state law and of obtaining consent from all beneficiaries in a timely fashion, amendment of the easement by the original grantor is a far more reliable approach to compliance with this requirement of § 2031(c).

[246] I.R.C. § 2031(c)(9) (2004).

[247] I.R.C. § 2031(c)(8)(B) (2004).

[248] *See* STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 109TH CONGRESS Title XII.A.3 (Comm. Print 2007).

[249] *See* discussion *supra* Part D.3.t.

p. The exclusion imposes a carryover basis

To the extent of the § 2031(c) exclusion, land received from a decedent has a "carryover basis" in the hands of heirs rather than a "stepped-up basis."[250] Basis is, essentially, what the owner paid for the land, plus amounts paid for improvements. The significance of basis is that when property is sold the seller pays tax on the difference between the property's basis and the sale value of the property.

Example

Mr. Smith's estate includes land subject to a conservation easement. The restricted value of the land, as valued by the executor, is $750,000. Mr. Smith's basis in the land is $5,000. The exclusion allowed is $300,000 ($750,000 x 40%). The carryover basis rule requires that 40% of Mr. Smith's $5,000 basis be carried over to the heirs, along with the stepped-up basis on that portion of the value of the land not subject to the exclusion. Thus, $2,000 ($5,000 x 40%) must be carried over to the heirs. That portion of the value of the land that was not subject to the exclusion ($750,000 – $300,000 = $450,000) will receive a stepped-up basis. The total adjusted basis for the land is therefore $452,000 ($2,000 + $450,000).

The effect of the carryover basis rule, given 2007 income and estate tax rates, is that while Mr. Smith's estate saves $135,000 in estate taxes (45% x $300,000), the heirs are exposed to increased income tax liability on the sale of Mr. Smith's easement property of $44,700 (($750,000 – $452,000) x 15%).

Carryover basis refers to passing on a decedent's basis in his property to his heirs. Normally, land passing from a decedent to his heirs receives a stepped-up basis.[251] This means that the decedent's basis in the property is replaced with a new basis reflecting the fair market value of the property when the decedent died. The stepped-up basis substantially reduces or eliminates income tax on sales of property received from a decedent's estate by heirs.

Improvements are not eligible for the exclusion. Therefore, improvements will continue to receive a stepped-up basis, regardless of whether or not the exclusion is elected.

[250] I.R.C. § 1014(a)(4) (2004).

[251] I.R.C. § 1014(a)(1) (2004).

q. Geographic limitations on the exclusion

When originally enacted, the provisions of § 2031(c) applied only to land in or within a twenty-five mile radius of a Metropolitan Statistical Area (MSA), national park and/or national wilderness area.[252] This requirement has been eliminated.[253] The current provision only requires that land, to be eligible under § 2031(c), be located within the United States or any U.S. possession.[254]

r. Debt-financed property

If a landowner incurred debt to purchase land with respect to which the § 2031(c) exclusion is elected, any amount of that debt that remains unpaid when the landowner dies must be subtracted from the value of the land before calculating the exclusion.[255] However, the debt is deductible under another provision of the federal estate tax code.[256]

Example

If land subsequent to easement has a restricted value of $700,000, and it is subject to a $300,000 mortgage when the decedent dies, the exclusion can only be applied to $400,000 ($700,000 – $300,000). The exclusion amount in this case would be $160,000 (40% x $400,000).

s. Property owned by partnerships, corporations, and trusts

If the decedent's interest in land eligible for the exclusion is held indirectly through a partnership, corporation, or trust, his or her estate may still enjoy the benefit of the exclusion to the extent of the decedent's ownership interest in such an entity. However, the decedent must own at least a 30% interest in the entity in order for his estate to be able to take advantage of the exclusion.[257]

Although the statute does not speak of limited liability companies, it is likely that such entities will qualify for similar treatment because they have both the attributes of a corporation and a partnership, both of which are eligible for the exclusion.

[252] I.R.C. § 2031(c)(8)(i) (2004).

[253] The Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No.107-16 (2001).

[254] I.R.C. § 2031(c)(8)(i) (2004).

[255] I.R.C. § 2031(c)(4) (2004).

[256] I.R.C. § 2053(a)(4) (2004).

[257] I.R.C. § 2031(c)(10) (2004).

Example

Mrs. Sanders, a widow, placed the family farm into a family corporation in order to facilitate the transfer of interests in the farm to her four children. She donated a conservation easement on the farm before transferring it to the corporation. At the date of her death the farm's land was worth $4,000,000, taking into consideration the restrictions imposed by the conservation easement. The other assets in the corporation were worth $1,000,000 (farm improvements and equipment). Mrs. Sanders owned 35% of the stock of the corporation when she died.

Mrs. Sanders' executor may elect to exclude 40% of the value of her stock attributable to the farm's land from her estate because she owned over 30% of the stock in the corporation at her death. If we assume that the portion of the stock value attributable to the land value is $1,400,000 (35% x $4,000,000—remember that the exclusion applies to the value of land only, not improvements), then the executor may exclude $500,000 of that value from the estate. Note that 40% of Mrs. Sanders' share of the land is $560,000; however, because of the limitation on the amount of the exclusion her estate can only exclude $500,000.

If Mrs. Sanders' interest in the corporation had been 29% or less, her estate would not have been eligible for any of the § 2031(c) exclusion. Note that we are assuming that the corporation will qualify for the exclusion, even though neither it, nor any member of its "family," contributed the easement or owned the easement for the requisite 3-year period immediately preceding the contribution. This may not be a safe assumption. To be completely safe, it might be prudent to defer contribution of the easement until after conveyance of the land to the corporation and until the corporation has held the land for at least three years.

t. Easements donated after the decedent's death ("post-mortem" easements)

The 40% exclusion is available for easements donated by a decedent's executor or trustee *after* the decedent's death—even though the decedent failed to donate an easement before his death.[258] The grant of a post-mortem conservation easement must be completed prior to the due date for the estate tax return (nine months after the date of the decedent's death), plus any extension granted for filing the return.[259]

[258] I.R.C. § 2031(c)(8)(A)(iii) (2004); I.R.C. § 2031(c)(8)(C) (2004); I.R.C. §2031(c)(9) (2004).

[259] I.R.C. § 2031(c)(9) (2004).

A post-mortem easement will qualify for both the exclusion *and* an estate tax deduction under IRC § 2055(f), *provided* that no income tax deduction is taken in connection with the conveyance of the easement.[260] This provision makes available an important "retroactive" estate planning technique.[261]

Example

Sam and Susie had tried for years to get their aging father to put a conservation easement on his farm. The old man never seemed to get around to it and died without having donated the easement. At the time of his death, the farm's land was valued at $1,000,000. Sam and Susie, being the only persons with any legal claim to the land, directed their father's executor to donate an easement on the farm, and the donation was completed within 9 months of their father's death. The easement reduced the value of the land by $400,000, thereby generating a $400,000 estate tax deduction under IRC § 2055(f). The value of the farm's land, taking the restrictions of the easement into account, was $600,000. Therefore, the 40% exclusion removed an additional $240,000 (40% x $600,000) from the estate. Given the value of other assets in the estate, the entire value of the land subject to the easement would have been taxed at 45%. Thus, the post-mortem election saved Sam and Susie $288,000 (45% x ($400,000 + $240,000)) in estate tax.

Note: § 2031(c) merely controls the tax consequences of a post-mortem easement contribution; it does not authorize the contribution. *State law governs the powers of executors and trustees to make a post-mortem easement contribution, not federal tax law*. Unless state law specifically allows executors and trustees to donate a conservation easement, a decedent must specifically authorize his executor or trustee to contribute the easement in the will. If there is no provision in the decedent's will and no authority granted by state law, a court order may be required. However, at least three states (Colorado, Maryland and Virginia) have amended their laws to allow post-mortem easements to be donated by an executor or trustee in order to take advantage of the post-mortem election.

[260] I.R.C. § 2031(c)(9) (2004).

[261] *See* I.R.S. Priv. Ltr. Rul. 2004-18-005 (Apr. 30, 2004) (confirming use of the post-mortem election by a trust).