A GUIDE TO THE TAX BENEFITS
of
DONATING A CONSERVATION EASEMENT

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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: A 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 state and federal 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 value of land subject to a qualified conservation easement, taking into account the reduction in value resulting from the conservation 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.

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 subject to the conservation easement. Unless the purpose of the easement is the conservation of some feature that is meaningless without public access, such as preservation of a scenic view, 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 such activities 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 appropriate 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 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 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 is dedicated to the conservation of the features identified in the easement. 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.

REQUIREMENTS FOR INCOME TAX BENEFITS

Section (§) 170(h) of the Internal Revenue Code (IRC) requires that 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 (Regs) have elaborate provisions controlling eligibility. The provisions of IRC §2031(c) providing federal estate tax benefits also require that an easement comply with §170(h). A detailed summary of §170(h) is contained in the Appendix. 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.

Generally, to be eligible for federal tax benefits a conservation easement must comply with the following requirements:

1. The easement must convey a "qualified real property interest."

A "qualified real property interest" includes restrictions (granted in perpetuity) on the use that may be made of the real property. IRC §170(h)(2)(c).

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)." Regs §1.170A-14(b)(2). In other words, it is the law of the state in which the easement is donated that dictates the basic form of the easement. 48 states currently have specific enabling legislation for conservation easements (the exceptions, as of 2004, were Wyoming and North Dakota). Easements in states having enabling legislation must comply with the specifics of the enabling legislation to qualify as a "perpetual conservation restriction."

> "Any rights retained by the donation of a perpetual conservation restriction must conform to the requirements of this section." Regs § 1.170A-14(h)(2).

2. The easement must provide a "qualified conservation contribution."

"A qualified conservation contribution is the contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes." Regs §1.170A-14(a).

3. The easement must be in perpetuity.

To be eligible for an income tax deduction the "conservation purposes" advanced by the easement must be protected in perpetuity. Regs §1.170A-14(a).

Note that the requirement that the easement be in perpetuity does <u>not</u> mean that the easement violates the "Rule Against Perpetuities" found in the common or statutory law of many states. The Rule Against Perpetuities requires that interests in real property "vest" in (become owned and possessed by) trust beneficiaries within a specified period of time. Conservation easements "vest" in the easement holder immediately upon recordation of the easement, thereby satisfying the requirements of the Rule.

4. 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. Regs §1.170A-14(g)(2). 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 Regs 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.

5. The easement must be conveyed to a "qualified organization."

"To be considered an eligible donee under this section, an organization must be a qualified organization, have a commitment to protect the conservation purposes of the donation, and have the resources to enforce the restrictions." Regs §1.170A-14(c).

Qualified organizations include local, state, and federal governmental agencies; and charitable organizations qualified under IRC §501(c)(3).

The easement document must limit any future transfer of the easement to qualified organizations that agree to carry out the conservation purposes of the donation.

The Regs do not preclude a trade organization from establishing a qualified organization to hold easements. For example, in Colorado and Wyoming associations of cattlemen have established land trusts to hold easements on ranch land. In other words, easements may be held by organizations that are not purely environmental.

Although the Regs do not elaborate on what "resources" are required to enforce restrictions, it is unlikely that an organization that has neither staff nor funding to monitor and enforce the terms of conservation easements would comply with this requirement.

6. The easement must advance a qualified "conservation purpose."

Qualified conservation purposes include the preservation of land areas for outdoor recreation by, or the education of the general public; the protection of a relatively natural habitat for fish, wildlife, or plants; the preservation of certain open space (including farm land and forest land); or the preservation of an historically important land area or certified historic structure. Regs §1.170A-14(d)(1).

7. Requirements for easements protecting "open space."

Easements protecting "open space" qualify if they fit one of two categories: easements that advance a specific governmental conservation policy and easements protecting scenic values. The Regs contain the following provisions governing easements preserving open space:

> "(4) *Preservation of open space* – (i) *In general.* The donation of a qualified real property interest to preserve open space (including farmland and forestland) will meet the conservation purposes test of this section if such preservation is—

> "(A) Pursuant to a clearly delineated federal, state, or local governmental conservation policy and will yield a significant public benefit, or
>
> "(B) For the scenic enjoyment of the general public and will yield a significant public benefit."
>
> Regs §1.170A-14(d)(4)(i).

"Governmental conservation policies" include local agricultural zoning or other specific land use designations recognizing the conservation value of the land. To the extent that there are specific public expenditures associated with these designations, e.g. a real estate assessment program providing tax relief to farms or open space, the policy is stronger and more likely to support the deductibility of the easement. See Regs §1.170A-14(d)(4)(iii).

In order to qualify as a "scenic easement" there must be visual access (not necessarily physical access) by the public to those features of the land considered scenic. See Regs §1.170A-14(d)(4)(ii).

The Regs specifically provide that "A deduction will not be allowed for the preservation of open space . . . if the terms of the easement 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 . . . " Regs §1.170-14(d)(4)(v).

The Regs contain unusually detailed requirements for easements the purpose of which is the preservation of open space. See Regs §1.170(d)(4).

8. 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, <u>even if those values are not specifically identified for protection in the easement</u>. The Regs give an example of an easement the purpose of which was to support a government flood control program. The easement permitted the unrestricted use of pesticides that could destroy a naturally occurring ecosystem on the property. The Regs state that such an easement would violate this requirement and would not be deductible. Regs §1.170A-14(e)(2).

A deduction will be denied for open space easements that retain 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. See Regs §1.170A-14(d)(4)(v).

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. Regs §1.170A-14(e)(3).

9. 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. Regs §1.170A-14(d)(4)(iii)(C).

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 would be scenic easements (scenic qualities must be publicly visible (Regs §1.170A-14(d)(4)(ii)(B)), or historic easements (public must have at least visual access to the historic area or structure) (Regs §1.170A-14(d)(5)(iv)).

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. Regs §1.170A-14(g)(4)(i).

Provided that the easement prohibits surface mining, an exception exists where mineral interests have been severed from the fee and are not owned by the grantor of the easement <u>and</u> the probability of surface mining such minerals is "so remote as to be negligible." Regs §1.170A-14(g)(4)(ii). A letter from a qualified geologist that the probability of surface mining on property where mineral interests have been separated from the surface "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 U.S. Court of Claims to be a reserved surface mining right defeating a $19 million tax deduction. See *Great Northern Nekoosa Corp. v. U. S.*, (38 Fed. Cl. 645, 1997).

11. Reservation of other mining or mineral extraction rights.

No deduction will be allowed where mining rights of any kind inconsistent with the conservation purposes of the easement are retained. 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. Regs §1.170A-14(g)(4).

A "qualified mineral interest" is the retention by "any person" of an interest in subsurface oil, gas, or other minerals and the right of access to such minerals. Regs §§1.170A-14(b)(1)(i) and 1.170A-14(g)(4).

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 has only a limited, localized impact on the land and that is not irremediably destructive of significant conservation interests. Regs §1.170A-14(g)(4)(i).

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. Regs §1.170A-14(g)(5).

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. Regs §1.170A-14(g)(5)(ii).

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. Regs §1.170A-14(g)(5)(ii).

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 <u>on the date of the conveyance of the easement</u>. Regs §1.170A-14(g)(5)(ii).

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) if any proceeds accruing to the easement holder as a result of the termination are required by the terms of the easement to be used by the holder in a manner that is consistent with the conservation purposes of the easement.

Regs §1.170A-14(g)(5)(ii).

17. Division of sales proceeds in the event of termination.

The easement must provide:

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 conveyance of the easement;

c) that the proportionate value of the easement described in the previous paragraph 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.

Regs 1.170A-14(g)(6)(ii).

Example:

If River Ranch is worth $1,000,000 (not counting improvements unaffected by the easement) in its unrestricted state and is worth $300,000 as restricted by the easement, the proportionate value 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.

INCOME TAX BENEFITS

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

1. The value of the easement is deductible.

A conservation easement donor that complies with the requirements of IRC §170(h) may deduct the value of the easement from his or her income. The value of the easement for purposes of the deduction is typically the difference in the value of the easement property before the donation and after the donation (pages 11 and 12 discuss valuation). Regs §1.170A-14(h)(3)(ii).

Example:

Mr. Jones donates an easement on land that is valued at $1,000,000 before the donation. After the donation the land is valued at $700,000. The value of the easement is the difference in these values of $300,000 ($1,000,000 – $700,000).

The maximum possible federal income tax benefit from any easement donation is calculated by multiplying the value of the easement by the top federal tax rate. Most states with an income tax provide a deduction for easement donations as well. 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 donation.

Note: Federal tax rates for "C" corporations (i.e. corporations taxed as separate entities, rather than like partnerships as is the case with "S" corporations or limited liability companies) range from 15% to 39%, but not incrementally.

Example:

If Mr. Jones, in the previous example, earned sufficient income that the entire $300,000 represented by the easement deduction was taxed at the current top federal rate of 35%, the value of the deduction would be $105,000 (35% x $300,000).

If Mr. Jones resides in a state with a 6% income tax that recognizes the federal charitable deductions, he would enjoy an additional state income tax benefit of $18,000 (6% x $300,000).

Some states, in addition to the charitable deduction for the donation of a conservation easement, allow a credit against state tax due for easement donations. For example, Virginia allows a tax credit equal to 50% of the value of any conservation easement donated by a Virginia taxpayer over land in Virginia (providing that the easement qualifies as a charitable contribution under IRC §170(h)). See *Virginia Code* §58.1-512. That credit is limited to $600,000. State tax credit programs are few and far between and can vary significantly from state to state.

Example:

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. In addition to his federal and state charitable deductions, he can take a credit against his Virginia tax liability of $150,000 (50% x $300,000). This credit reduces his Virginia tax liability to $50,000.

2. The amount of the federal deduction is subject to an annual limitation.

When an individual makes a gift of "long-term capital gain" property (a capital asset held more than one year, e.g. a conservation easement on land owned for more than one year) the federal income tax deduction for that donation is limited to 30% of the donor's "contribution base" (adjusted gross income without regard to the amount of the contribution and without regard to any "net operating loss carryback"). Regs §1.170A-8(d)(1).

If the easement donation is made in the first year of ownership the deduction is allowed up to 50% of the donor's contribution base because the gift is considered a gift of "ordinary income property." However, a deduction for ordinary income property cannot exceed the donor's basis in the property (basis is essentially what the donor paid for the property). Regs 1.170A-8(b).

After the first year of ownership an individual donor may <u>elect</u> to limit the amount of the deduction to his or her basis and thereby qualify for the 50% limitation rather than the 30% limitation. See Regs §1.170A-8(d)(2).

In any event, the entire amount of a donor's charitable deductions made during a tax year is limited to 50% of the donor's contribution base. Thus if the donor has made gifts for which charitable deductions are available in addition to the conservation easement gift, the value of the other donations may reduce the amount of the deduction that may be taken for the easement donation.

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. IRC §170(b)(2).

Example 1:

Mr. Jones's easement is worth $300,000. He has owned the property that is subject to his easement donation for five years. Therefore, the gift is considered a gift of long-term capital gain property subjecting him to the 30% limitation. Mr. Jones's income is $124,000 annually. Thus he may only deduct $37,200 of his easement gift (30% x $124,000), even though the value of the easement is $300,000.

Example 2:

If Mr. Jones has made other charitable gifts amounting to $50,000 during the year in which he donates the conservation easement he may only deduct $12,000 of his easement gift because his total deduction for charitable gifts is limited to 50% of his contribution base (50% x $124,000 – $50,000 = $12,000). However, as described below, Mr. Jones may "carry forward" the unused portion of his deduction to future tax years.

Example 3:

Mr. Jones donates 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 $62,000 of the value of the easement (50% x $124,000), and carry the unused balance of the gift forward.

Example 4:

Assume that Mr. Jones only paid $250,000 for the property that he placed under easement. Also assume that he donates the easement six months after he acquired the property. Given these assumptions, even though the easement may be valued at $300,000 (which suggests that $250,000 was a real bargain), Mr. Jones may not deduct more than he paid for the property subject to the easement, so his easement deduction will be limited to $250,000. As noted above, because the easement was donated in the first year of Mr. Jones's ownership of the property, he may take the deduction up to 50% of his contribution base.

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

Any unused portion of an easement deduction may be "carried forward" for 5 years after the year of the donation (allowing a maximum of 6 years within which the deduction may be utilized), or until the amount of the deduction has been used up, whichever comes first. Regs §170A-10(c)(1)(ii).

Example:

In Example 1 on page 9, Mr. Jones was only able to use $37,200 of his $300,000 easement deduction in the year of the donation due to the 30% annual limitation. Assume that donation was made in 2004. Mr. Jones can carry the unused balance of $262,800 ($300,000 – $37,200) forward to 2005, 2006, 2007, 2008 and 2009. Assume Mr. Jones's income in 2005 and 2006 is $150,000; in 2007 it is $175,000, and in 2008 and 2009 it is $200,000. Given this increase in income and the ability to carry the deduction forward for five years, Mr. Jones will be able to use $299,700 of the $300,000 easement gift over the six years in which he can use the deduction ($37,200+ $45,000 + $45,000 + $52,500 + $60,000 + $60,000 = $299,700).

4. "Phasing" easement donations to extend income tax benefits.

As noted above, deductions for easement donations are limited to either 30% or 50% of the donor's contribution base. These limitations prevent some easement donors from deducting the full value of their easement gift. This problem can be addressed by "phasing" easement gifts.

Example:

Mrs. Blue donates a conservation easement over her 1,000-acre ranch. The value of the easement is $2,000,000. Mrs. Blue's average annual income is $500,000. The maximum deduction that Mrs. Blue can realize, assuming she is subject to the 30% annual limitation for gifts of appreciated property, is $900,000 (30% x $500,000 x 6).

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 $800,000 (taking into account enhancement of the value of the unrestricted portion of the ranch due to the conservation easement; see page 12 for a discussion of "enhancement").

Over a six year period Mrs. Blue will be able to fully deduct this gift (30% x $500,000 x 6 = $900,000). 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 $1,200,000. By the time of this gift, Mrs. Blue's average annual income has increased to $700,000. Over the six years beginning with the second easement donation Mrs. Blue will be able to fully deduct this $1,200,000 gift (30% x $700,000 x 6 = $1,260,000).

Note: Mrs. Blue could have phased her easement gifts differently by donating an easement over the entire ranch that eliminates only half of the development potential that she ultimately intends to eliminate. The second easement eliminates the balance of the development potential. In any case, each easement must <u>independently</u> meet the standards of IRC §170(h), including the generation of a significant public benefit.

In a phased conservation plan, such as Mrs. Blue's, it may be important to include a provision in the donor's will insuring that easements planned for the future will be bequeathed in the event the donor does not live long enough to donate them during his or her lifetime.

5. "Phase-Out" of itemized deductions.

For individuals whose adjusted gross income in 2004 exceeds the "threshold" level of $142,700 ($71,300 for married taxpayers filing separately) the amount of most itemized deductions, including charitable deductions for conservation easement gifts, is required to 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 <u>less</u>. IRC §68.

Example:

Mrs. Blue (from the example on page 10) earns $500,000 annually. In the year of the donation of her $2,000,000 conservation easement she is allowed a deduction for the gift of $150,000 due to the 30% limitation ($500,000 x 30%). The phase-out rule requires Mrs. Blue to reduce the amount of this deduction by the lesser of 3% of her income over $142,700, or 80% of the total of her itemized deductions. Assume that Mrs. Blue has itemized deductions (including the deduction for the easement) totaling $200,000. 3% of her income over $142,700 amounts to $10,719 ($500,000 – $142,700 x 3%). 80% of her total itemized deductions amounts to $160,000 ($200,000 x 80%). Therefore, she must reduce the total of her itemized deductions by $10,719. Because the easement gift generated 75% of her total of itemized deductions, it could be said that 75% of the phase-out of $10,719, or $8,039.25 ($10,719 x 75%) applies to her easement deduction, reducing it from $150,000 to $141,960.75.

6. The alternative minimum tax (AMT).

The AMT does <u>not</u> apply to conservation easement donations. Charitable contributions of conservation easements are not considered "tax preference items." The provision treating gifts of appreciated property as tax preference items (IRC §57(a)(5)(C)(iv), was repealed for gifts of appreciated property effective 12/31/92 by P.L. 103-66 (1993).

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

One of the most critical and frequently challenged aspects of easement donation 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 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 donation for deduction purposes. Regs §1.170A-14(h)(3); Rev. Rul. 73-339, 1973-2 C.B. 68, and Thayer v. Commissioner, T.C. Memo 1977-370. Of course, 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.

b. 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 (as in a "purchase of development rights" program) as comparables. However, the Regs recognize that in many cases there will 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. Regs §1.170A-14(h)(3)(i).

c. The value of the deduction must be substantiated.

Any claim for a charitable donation deduction exceeding $5,000 must be supported by a "qualified appraisal" (Regs §1.170A-13(c)(2) conducted by a "qualified appraiser." Regs §1.170A-13(c)(3), see Regs §1.170A-13(c)(5) for a definition of "qualified appraiser."

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. Regs §1.170A-13(f).

Substantiating appraisals are complex and sometimes 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. Regs §1.170A-13(c)(3)(A).

Regardless of when the appraisal is made it must reflect the value of the easement on the date of the conveyance. Regs §1.170A-13(c)(3)(ii)(I).

For further information about the valuation and substantiation of easements see Appraising Easements, Third Edition (1999), a project of The National Trust and The Land Trust Alliance.

d. "Enhancement" may reduce the deduction.

Enhancement occurs when a landowner donates an easement that has the effect of increasing the value of unrestricted land owned by the donor or a member of the donor's family, whether or not the unrestricted land is contiguous to the conservation easement. Regs §1.170A-14(h)(3)(i).

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 also owns the 200 acres. The easement reduces the value on the subject 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.

e. 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 family member of the donor as a result of the donation of the easement. Regs §1.170A-14(h)(3)(i).

Example 1:

Mr. Blue agrees with the ABC Land Trust that he will donate an easement over his land if ABC will acquire and protect a parcel of land adjoining Mr. Blue's. 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 donation 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 it 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 for this qualified "bargain sale." See IRC §1011(b) for provisions regarding bargain sales.

8. "Donative intent" is required.

In order for the grant of a conservation easement to be a deductible gift the grantor of the easement must intend the grant to be a charitable contribution. U.S. Treasury Revenue Ruling (Rev. Rul.) 67-246. The intent to make a charitable contribution is known as "donative intent."

The requirement for donative intent should not be confused with the requirements of the Regs described in paragraph 7.e. above that any financial or economic benefit received in exchange for a conservation easement be subtracted from the value of the easement deduction. In the cases to which this economic benefit rule applies the grantor of the easement <u>intends</u> that the excess of the value of the easement over the benefit received be a charitable gift. However, where the grant of the easement is required by some regulatory or contractual arrangement (unless the contract is with a government agency or public charity recognized under IRC §501(c)(3)) there is no donative intent, even if the value of the benefit received is less than the value of the easement.

The requirement of donative intent precludes deductions for the conveyance of conservation easements in a number of circumstances. A few of the more common 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 it precludes donative intent. See Technical Advice Memorandum ("TAM") 9239002, 1992.

b. Reciprocal easements.

Where one landowner agrees to grant a conservation easement over his land if his neighbor does the same and the agreement is legally binding, 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.

However, where a land trust seeks to obtain conservation easements from a number of landowners within a region to advance a conservation goal that could not be met with the piecemeal contribution of easements, it may agree to escrow easements until it has received a certain number of easements. Such an arrangement does not preclude donative intent. However, until the easements are put to record no deductible gift has been made.

c. "Conservation Buyer" arrangements.

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 is 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. For this reason, conveyance of the easement pursuant to the option is the discharge of an obligation to a private party, not a charitable contribution.

There is a different outcome where the prospective buyer himself grants an option to acquire an easement directly to a land trust if the buyer closes the purchase. Assuming that the option is to sell the easement for less than fair market value, the ''bargain sale" should be deductible because the buyer is discharging an obligation he has made voluntarily to the land trust rather than discharging an obligation to a private party.

For a more detailed discussion of this topic see "The Use of Options in Conservation Transactions" by the author, published in the Fall 2003 issue of the Land Trust Alliance magazine *Exchange*.

9. The donation of a conservation easement will reduce the donor's basis.

When a landowner donates a conservation easement he must reduce his basis (essentially, what was paid for the property, see discussion of basis on page 27) in the property to reflect the value of the easement donated. This reduction in value must reflect the proportion of the unrestricted fair market value of the land at the date of the donation represented by the value of the easement. Regs §1.170A-14(h)(3)(iii).

Example:

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

Note: The basis adjustment does not reflect "enhancement" of adjoining unrestricted land. See example (11), Regs §1.170A-14(h)(3)(iii).

10. Treatment of easement donations by "dealers" in real estate.

Tax deductions for easement donations by "dealers" in real estate are limited to the donor's basis in the property subject to the easement donation. Regs §1.170A-4(a)(1) requires that the deduction for gifts of "ordinary income property" 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. 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 donor's basis.

Regs §1.170A-4(b)(1) provides that "ordinary income property" include property "held by the donor primarily for sale to customers in the 'ordinary course of his trade or business.'" It is possible for a dealer in real estate to hold property primarily as investment property and not for sale to customers. The donation of a conservation easement on such property will not be limited to basis.

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 10 lots, including development costs, is $10,000 each. His basis in the 100 acres is $100,000, his original cost (he made no improvements). The easement on the 10 lots is valued at $2,000,000 and on the 100 acres 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 must be reduced by $1,900,000, which is the amount that would have been ordinary income if he had sold the property ($2,000,000 – ($10,000 x 10 lots) = $1,900,000). 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.

ESTATE and GIFT TAX BENEFITS

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

A Note on the Future of the Federal Estate Tax

In 2001 Congress repealed the federal estate tax effective in 2010. 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 two principal components of the estate tax are the amount exempt from the tax (the "exclusion amount") and the top rate of the tax. These components will be changing over the next six years as follows:

- In 2004 the exclusion amount is $1.5 million; the tax rate on assets between $1.5 million and $2 million is 45% and on all assets over $2 million it is 48%.

- In 2005 the exclusion amount remains at $1.5 million; the tax rate on assets between $1.5 million and $2 million remains at 45% and on all assets over $2 million is 47%.

- In 2006 the exclusion amount increases to $2 million; the tax on assets over $2 million is 46%.

- In 2007 and 2008 the exclusion amount remains at $2 million; the tax on assets over $2 million is 45%.

- In 2009 the exclusion amount increases to $3.5 million; the tax on assets over $3.5 million is 45%.

Note that all of the examples that follow are based upon the exclusion amount and tax rates for 2004.

The Reduction in Value and the Estate and Gift Tax Deductions

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

The restrictions imposed by a conservation easement on real property assets included in a decedent's estate reduce the value of that property for estate tax purposes. This "reduction" in value is available regardless of whether the easement was sold or donated. 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.

Example:

Mrs. Smith owns land at her death worth $2,000,000 in its unrestricted state. However, before she died Mrs. Smith donated a conservation easement on that land reducing its value to $1,500,000 on the date of her death. Thus, the easement has reduced the size of Mrs. Smith's taxable estate by $500,000. Assuming that the other assets in Mrs. Smith's estate were substantial enough that the entire $500,000 removed by the easement would have been taxed at the top estate tax rate of 48% (the top 2004 rate), the estate tax savings due to the easement would be $240,000 (48% x $500,000).

Example:

Mr. Blue sold a conservation easement in 2000 for $550,000. After the easement was conveyed the value of the land subject to the easement dropped by $1,700,000 to $700,000. Thus the easement was worth $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 2004. 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 2004 would have been $5 million. Therefore, the easement has reduced Mr. Blue's estate by $2,500,000, generating estate tax savings of $1,200,000 (48% x $2,500,000). However, Mr. Blue invested the proceeds of the sale of his conservation easement in stocks that have a value at the date of his death of $1,000,000. The estate tax on this value will be $480,000 (48% 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 $720,000 ($1,200,000 – $480,000).

2. 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) <u>cannot</u> be taken into account by an estate in valuing the property for estate tax purposes. Regs § 25.2703-1.

However, "qualified easements" pursuant to IRC §170(h) made during a decedent's lifetime are exempt from this provision (Regs §25.2703-1(b)(4)), and are deductible for gift tax purposes under IRC §2522(d). In addition, easements qualified under IRC §170(h) conveyed by the terms of a decedent's will are qualified for estate tax deductions under IRC §2055(f), as noted on page 18.

In addition, other restrictions that do not comply with the requirements of IRC §170(h) may also 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.

Regs §25.2703-1(b)(1) and (2).

Example:

Mr. Brinkman sells a "scenic easement" over his ranch, Greenacre, to his neighbor the owner of Brownacre. The easement is in perpetuity and operates as a restrictive covenant benefiting his neighbor and any future owners of Brownacre. 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.

3. Estate and gift tax deductions for conservation easements.

Generally, gifts made during a person's lifetime are subject to the "unified estate and gift tax." However, IRC §2522(d) allows a deduction for donations of conservation easements that meet the requirements of IRC §170(h).

For donations of conservation easements made by will there is a formal deduction available valued in the same manner as an easement donated during the decedent's life, IRC §2055(f).

Both §§2055(f) and 2522(d) allow deductions regardless of whether the easement meets the "conservation purposes" test established for lifetime donations of easements by IRC §170(h)(4)(A) (the conservation purposes test is discussed on page 4).

According to the Committee Report issued in 1986 the reason for not requiring that the conservation purposes test be met in the case of a testamentary easement bequest is 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 even though it is permanently restricted. See the Committee Reports on P.L. 99-514 (Tax Reform Act of 1986). Regulations have not been promulgated nor cases decided under this provision to give further guidance.

Note that it is also possible that a conservation easement failing 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 under IRC §2703, as discussed on page 17.

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 doesn't want to restrict his ability to sell the farm for top dollar while he is living (Mrs. Brown left, thoroughly disgusted with farming many years earlier). Therefore, he provides in his will for the donation of a conservation easement on the farm (including a completed 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, and after the easement at $2,000,000. The executor is able to deduct the $2,000,000 value of the easement under IRC §2055(f). This saves Mr. Brown's children $960,000 in estate taxes because the entire $2,000,000 is subject to the 48% marginal rate (the top rate in 2004). This, coupled with the exclusion available under IRC §2031(c) (discussed below) entirely eliminates the estate tax on Mr. Brown's estate.

Note: Under the terms of new §2031(c)(9) (see the discussion of "post-mortem" easements on page 28), even if Mr. Brown hadn't 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.

The 40% Exclusion

In addition to the reduction in value of estate property resulting from the restrictions of a conservation easement, federal tax law allows 40% of the <u>restricted</u> value of property subject to a conservation easement to be excluded from a decedent's estate. The exclusion was enacted in 1997. Formerly known as the American Farm and Ranch Protection Act, the new exclusion is provided for in IRC §2031(c). §2031(c) is a relatively new provision in the tax code. To date no regulations or cases are available to provide guidance.

Note that this "exclusion" should not be confused with the "exclusion amount" described on page 16. The §2031(c) exclusion is allowed in addition to the exclusion amount.

1. 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. In other words, the exclusion applies to the value of the land <u>taking into account</u> the restrictions of the easement. Values are determined as of the date of the decedent's death, or 6 months thereafter if the executor elects the "alternate valuation date." IRC §§2031(c)(1) and (2).

Example:

In the previous example, Mr. Brown's farm was worth $2,000,000 taking into account the restrictions of the conservation easement. Mr. Brown's executor may elect to exclude 40% of that value from his estate under §2031(c). Therefore, $800,000 (40% x $2,000,000) may be excluded. However, because the amount that can be excluded under §2031(c) is limited to $500,000 (see page 22) Mr. Brown's estate will be able to exclude only $500,000. Thus, the easement has reduced the taxable value of the land in Mr. Jones's estate by $2,500,000: $2,000,000 from the initial reduction in value and $500,000 due to the exclusion.

If Mr. Brown died in 2004 his easement donation would eliminate all federal tax on his estate. This is because the reduction in value of the farm due to the easement and the $500,000 exclusion under §2031(c) has reduced the size of Mr. Brown's estate so that it does not exceed the $1.5 million exclusion amount.

2. 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), described beginning on page 3, including the conservation purposes test. IRC §2031(c)(8)(B). 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 <u>will not</u> qualify for the §2031(c) exclusion, because they do not comply with IRC §170(h).

3. The exclusion applies to land only.

The exclusion applies only to the value of land, not to improvements on the land. IRC §2031(c)(1)(A). (This limitation does not apply to the income tax deduction and the estate tax benefits resulting from the reduction in value due to the easement. However, in order for any tax benefits to apply to the value of improvements the conservation easement must expressly restrict those improvements in a manner that reduces their fair market value.)

Example:

Mrs. White died owning a 200-acre farm subject to a conservation easement that meets the requirements of IRC §170(h). 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 he 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.

4. The exclusion does not apply to the gift tax.

Federal law taxes gifts made during a person'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 tax imposed on lifetime gifts of property subject to a conservation easement. For this reason estate-planning strategies based upon lifetime transfers of property should carefully evaluate the effect of making a lifetime gift of land subject to a conservation easement. A lifetime gift of land subject to a conservation easement that otherwise qualifies for the §2031(c) exclusion will waste the exclusion. However, there may be other overriding reasons to make lifetime transfers.

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; 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 gift and the bequest would have been taxed at 48% (the maximum gift tax rate in 2004), transferring the land by a lifetime gift rather than by will would cost Mr. Smith $38,400 (48% x $80,000) in gift tax over and above what the estate tax would have been had the transfer been made at death.

5. The exclusion does not apply to easements that are historic only.

The §2031(c) exclusion does not apply if the <u>only</u> conservation purpose of the easement is the preservation of the historic character of the land (historic structures, being improvements rather than land, aren't eligible for the exclusion either). IRC §2031(c)(8)(B). However, the fact that land is historic does not disqualify it for the exclusion if there is another bona fide conservation purpose for the easement.

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 local plan.

If the sole purpose of the easement and the only significant characteristic of the farm were its historical significance the exclusion would be unavailable. However, assuming that the easement complies with IRC §1700(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.

6. 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 make use of the exclusion.

7. Three-year holding period required.

The decedent or a member of the decedent's family must have owned the land subject to the easement for at least three years prior to the decedent's death to be eligible for the exclusion. IRC §2031(c)(8)(A)(ii). For purposes of this provision the term "member of the decedent's family" means:

a) an ancestor of the decedent;

b) the spouse of the decedent;

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

d) the spouse of any such lineal descendent.

IRC §2031(c)(8)(C), which incorporates the definition of "member of the family" contained in IRC §2032A(e)(2).

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 amounted to at least three years.

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

§2031(c) limits the amount that may be excluded to $500,000 per estate. 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 12/31/01. IRC §2031(c)(3).

Example:

James owns land subject to a conservation easement that meets all of the requirements of §2031(c). The value of the land after subtracting the value of the easement is $2,000,000. James dies in 2004. 40% 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's estate under §2031(c) is $500,000. Note, as explained in the next paragraph, that if James was married the amount that could be excluded might be greater.

9. The benefits of the exclusion may be multiplied.

Because the $500,000 limitation on the exclusion applies <u>per estate</u> (IRC §2031(c)(1)) one conservation easement can generate multiple exclusions.

Example 1:

Mr. Green and his wife own land as "tenants in common" with each entitled to a 50% share in the land. Each of them provide in their wills that their share of the land goes directly to their children rather than to the surviving spouse. The Greens put extensive easements on the land reducing the value of each share from $3,250,000 to $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 through the exclusion.

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 other beneficiaries.

Example 2:

Four brothers own a ranch inherited from their parents as equal tenants in common. They donate a conservation easement on the ranch that meets the requirements of §2031(c). The value of the ranch before the easement was $10,000,000 and after the easement it was worth $5,000,000. The brothers all die in a blizzard in 2004. Their executors each elect to take advantage of the 40% exclusion. Each estate receives the decedent brother's 25% interest, worth $1,250,000 (25% x $5,000,000), taking into account the restrictions of the easement. The value of the exclusion is $500,000 (40% x $1,250,000) per estate. 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 <u>four</u> 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 $7,000,000. This is the combination of the initial reduction in value due to the restrictions of the conservation easement ($10,000,000 – $5,000,000 = $5,000,000) 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 48% federal estate tax rate, total estate tax savings between the four estates would amount to $3,360,000 (48% x $7,000,000 = $3,360,000).

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 (see page 28).

10. 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 donation of the easement, may all be used in connection with the same easement donation.

Example:

Mr. Jones's 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's income is taxed at the federal rate of 35%, a state rate of 6%, and that the assets in his estate are taxed at the rate of 48%. Given these assumptions, donation of an easement valued at $300,000 would save Mr. Jones and his estate a total of $401,400 in state and federal taxes. These savings are made up of income tax savings of $123,000 (41% x $300,000); estate tax savings of $144,000 due to the reduction in the value of the estate resulting from the conservation easement (48% x $300,000); and additional estate tax savings of $134,400 due to the §2031(c) exclusion (40% x $700,000 x 48%).

In addition, the exclusion may be layered on top of the unified estate and gift tax credit (the "exclusion amount" described on page 16, the tax benefits available under the special valuation rules of IRC §2032A for qualified family farms, and the family-owned business exclusion provided for by IRC §2033A for qualified family businesses.

11. 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. IRC §2031(c)(8)(C). 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). 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.

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's 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 his land from 100 houses to 10 and generates a significant public conservation benefit. When he 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 qualifies under §2031(c). 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 doesn't 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 of her ancestors 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.

12. 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. IRC §§2031(c)(1) and (6). Federal law requires estate tax returns to be filed within nine months of a decedent's death. Extensions are available, however they are not automatic.

Failure to elect the exclusion does not preclude subsequent generations from electing the exclusion. Form 706, Schedule U ("Qualified Conservation Easement Exclusion") 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 amount sheltered by the unified credit). This is because, to the extent of the election, land passing through a decedent's estate is denied a "stepped-up" basis, see page 26.

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

The 40% exclusion will be reduced if the conservation easement is valued at less than 30% of the unrestricted value of the land to which it applies. The statute provides that the 40% exclusion is to be reduced by two percentage points for each percentage point that the easement fails to reduce the land's value by 30%. Values are to be determined as of the date of the decedent's death (or the alternate valuation date if elected). IRC §2031(c)(2). 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 <u>at the time of the original donation</u> of the easement. IRC §2031(c)(2). 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 donation. However, if the estate qualifies for the exclusion, the exclusion is applied to the restricted value of land under easement as of the date of the decedent's death (or the alternate valuation date, if selected).

Example:

Mrs. Johnson's land was valued at $1,250,000 before she donated her easement and $1,000,000 after she donated 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). 20% is ten percentage points less than 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 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, the value of the land restricted by the easement has appreciated to $2,500,000 on the date of Mrs. Johnson's death. 20% of this value is $500,000 (20% x $2,500,000). $500,000 is the maximum amount that can be excluded under §2031(c). 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 $200,000 (20% x $1,000,000).

14. Retained development rights are not eligible for the exclusion.

Any "development rights" retained in the easement agreement are not eligible for the exclusion. However, if the heirs agree before the due date for the decedent's estate tax return (including extensions) to terminate some or all such retained rights the exclusion will apply as though the terminated rights never existed. Heirs 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). IRC §§2031(c)(5)(A) and (B).

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." Rights to maintain a residence for the owner's use, as well as normal farming, ranching, and forestry practices probably would not be considered retained development rights. Retained rights to sell land for development, or establish houses for sale or rent, probably would be considered as retained development rights. IRC §2031(c)(5)(D).

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 - $250,000 = $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 the heirs 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 48% federal estate tax rate terminating these rights would save the heirs $48,000 (48% x $100,000) in estate taxes.

Note that the heirs could take advantage of the "post mortem" easement provisions of §2031(c)(9) (see the discussion of post-mortem easements on page 28) and eliminate the retained development rights by donating a new easement before the estate tax return is due. This would qualify the termination of the retained rights for both an expanded exclusion as well as well as an estate tax deduction under §2055(f). 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.

As noted above, retained development rights are defined by §2031(c)(5)((D) as "any right to use the land subject to the qualified conservation easement . . . for any commercial purpose which is not subordinate to and directly supportive of the use of such land as a farm for farming purposes (within the meaning of section 2032A(e)(5))."

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 the reserved right by the grantor to personally use a residence does not constitute a "commercial purpose."

15. 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 disqualified for the §2031(c) exclusion. IRC § 2031(c)(8)(B).

The official explanation of this provision provided by the Joint Committee on Taxation includes a statement that retaining in an easement the rights 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. See Joint Committee on Taxation, "General Explanation of Tax Legislation Enacted in 1997."

No other official clarifications of this provision have been provided. 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.

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 (see the discussion of post-mortem easements on page 28). If the easement donor is unable to amend the easement, such a post-mortem correction may be the only alternative. However, amendment of the easement is a far more reliable approach to compliance with this requirement of §2031(c).

16. The exclusion imposes a carryover basis.

IRC §1014(a)(4) provides that, to the extent of the §2031(c) exclusion, land received from a decedent shall have a "carryover basis" in the hands of heirs rather than a "stepped-up basis." As noted elsewhere in this Guide, 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 what the property sold for.

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. 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.

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 (adjusted to reflect the easement donation, see page 15) 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 is 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).

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.

17. 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 Metropolitan Statistical Areas (MSA), national parks and national wilderness areas. IRC §2031(c)(8)(i). This requirement was eliminated by the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16). The current provision only requires that land, to be eligible under §2031(c), must be located within the United States or any U.S. possession. IRC §2031(c)(8)(i).

18. Debt-financed property.

If a landowner incurred debt to purchase land with respect to which the §2031(c) exclusion is elected, the amount of that debt that remains unpaid when the landowner dies must be subtracted from the value of the land before calculating the exclusion. IRC §2031(c)(4). However, the debt is deductible under other provisions of the federal estate tax code.

Example:

If land has a value of $700,000 after taking into account the restrictions of a conservation easement, 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).

19. Property owned by partnerships, corporations, limited liability companies, and trusts.

If the decedent's interest in land eligible for the exclusion is held indirectly through a partnership, corporation, or trust his 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. IRC §2031(c)(10).

Although the statute does not speak of limited liability companies it is likely that such entities will qualify for similar treatment because they are treated like partnerships for most other purposes under the tax code.

Example:

Mrs. Sanders, a widow, placed the land making up the family farm to 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 (see page 22) her estate can only exclude $500,000.

20. Easements donated after the decedent's death ("post-mortem" easements).

§2031(c) provides that 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. IRC §§2031(c)(8)(A)(iii) and (C), and §2031(c)(9). The grant of a post-mortem conservation easement must be completed prior to the due date for the estate tax return (9 months after the date of the decedent's death), plus any extensions granted for filing the return. IRC §2031(c)(9).

§2031(c)(9) provides that 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 for the conveyance of the easement. This provision makes available an important "retroactive" estate planning technique. See P.L.R. 200418005, confirming use of the post-mortem election by a trust.

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 was worth $400,000, thereby generating a $400,000 deduction under §2055(f). The value of the farm's land, taking the restrictions of the easement into account, was $600,000. Therefore, the exclusion removed an additional $240,000 (40% x $600,000) from the estate. Given the value of other assets, the entire value of the land subject to the easement would have been taxed at 48%. Thus, the post-mortem election saved Sam and Susie $307,200 (48% x ($400,000 + $240,000)) in estate tax.

Note: §2031(c) merely controls the tax consequences of a post-mortem easement donation; it does not authorize the donation. State law governs the powers of executors and trustees to make such a donation. Unless state law specifically allows executors and trustees to donate a conservation easement, a decedent must specifically authorize his executor or trustee to donate the easement. 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 recently amended their laws to allow post-mortem easements to be donated by an executor or trustee in order to take advantage of §2031(c).

PLANNING CONSIDERATIONS IN THE USE OF CONSERVATION EASEMENTS

1. Addressing fears over "giving away" land value by easement donation.

Many landowners are reluctant to donate easements, even though they are concerned about conserving their land and would benefit significantly from the income tax and estate tax savings. The reason is their fear of reducing the value of assets available for their children. Responses to this fear include the following:

a. Tax benefits may make up most of, if not more than, the lost value.

With enactment of §2031(c) it is possible that the entire value of the easement, or more, can be recovered through the various federal and state tax benefits associated with easement donation.

Example:

Mr. Jones's 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; the restrictions of the easement remove at least $300,000 in taxable value from his estate; and the executor can elect to exclude $280,000 of the remaining value under §2031(c). Thus, the easement removes $580,000 from the estate, in addition to generating state and federal income tax deductions.

Assume that Mr. Jones's income is taxed at the top federal rate of 35%, a top state rate of 6%, and that the assets in his estate are taxed at the top marginal rate of 48%, an easement donation would save Mr. Jones and his estate a total of $401,400 in state and federal taxes. This reflects income tax savings of $123,000 (41% x $300,000) plus estate tax savings of $278,400 (48% x $580,000).

These tax savings represent 134% of the value lost by the easement donation.

b. Conservation easements protect intergenerational transfers from estate tax.

When a landowner's goal is to keep land in the family rather than to maximize the value of the land as an asset in the hands of the heirs, a conservation easement can be an important estate planning tool. Compared to the requirements of IRC §§2032A (the special use valuation provisions pertaining to farmland, etc.) and 2057 (pertaining to family-owned businesses) the tax benefits available for donation of a conservation easement may be more extensive and more easily obtained.

c. "Value replacement."

Income tax savings from easement donation can be used to replace value lost in the donation by providing premium payments for the purchase of life insurance or other investments. If the insurance is placed in an "inter-vivos" trust that also holds all of the "incidents of ownership," proceeds of the policy will be exempt from both income and estate taxes.

Tax savings generated by the donation of a conservation easement can be applied to the payment of premiums on a whole life policy or other investments held by an inter-vivos trust. This strategy can replace the value lost by the donation of an easement. In many cases of value replacement the total value passing to an easement donor's heirs may be substantially greater than it would have been had the easement not been donated.

Example:

Assume that John and Joan are aged 51 and 43 respectively. Assume that they donate an easement worth $1,800,000 and that the income tax deduction saves them $738,000 in income tax. They spend $58,000 on a new car and buy a "second to die" life insurance policy with the remaining $680,000 of their income tax savings. They place the policy into an "inter-vivos" trust for the benefit of their children and transfer all of the "incidents of ownership" to the trust.

A premium payment of $680,000 for a second to die policy on a couple John's and Joan's ages will buy $12,500,000 in coverage. Properly placed in an inter-vivos trust there will be no tax on the policy proceeds. <u>Thus, John and Joan have replaced $1,800,000 in land value lost due to the easement with $11,820,000 (face value of the policy less the premium) in tax-free cash</u> payable directly to their children.

Note that investing the $680,000 in stocks or mutual funds transferred to an inter-vivos trust could generate substantial results as well. There are many variations.

2. Using easements to maximize credits and exclusions.

Easements can significantly reduce the value of an important real estate asset without significantly affecting (in most cases) the current use of the real estate or its utility to the donor or donor's family. This attribute of a conservation easement provides important leverage for various estate tax credits and exclusions.

a. Maximizing the annual gift tax exclusion.

By reducing the value of land, conservation easements can increase the amount of acreage that can be transferred by gift under the annual $11,000 (in 2004) gift tax exclusion. (The $11,000 exclusion is adjusted annually for inflation.) Conservation easements also insure that land gifted to another individual will continue to be used in a manner that is consistent with the wishes of the person making the gift.

Donating an easement prior to beginning the transfer of ownership through a gifting program insures that the value of the income tax deduction is available to the family members most likely to be able to take full advantage of the deduction. However, consideration should be given to identifying which "generation" has the most income in order to maximize use of the deduction, as it may not necessarily be the parents.

Example:

Mr. and Mrs. Savage own a 20,000-acre ranch valued at $5,000,000. They have five children, each married. Mr. and Mrs. Savage want to begin giving the ranch to their children using the $11,000 annual gift tax exclusion. The Savages can each give $11,000 a year to each child and to each child's spouse. Thus, the Savages can transfer a total of $220,000 in ranch value annually ($11,000 x 2 x 10). If they make the transfer based upon the value of the ranch unrestricted by a conservation easement it will take them 25 years to complete the transfer, assuming the ranch doesn't change in value (which it certainly will).

If a conservation easement were donated on the land reducing its value to $2,000,000 it would be possible for the Savages to make the transfer in 10 years (again, assuming no inflation in value). In addition, the Savages would be assured that the ranch would not be developed, even after control passes to their children. Furthermore, if the Savages invest the income tax savings realized from the easement donation in a value replacement scheme (see page 30) they could provide their children with potentially substantial cash to operate the ranch.

b. Transfers using partnerships, limited liability companies, family corporations, etc.

By reducing the value of land transferred via partnerships, corporations, etc., conservation easements can accelerate the transfer of land to family members.

c. Increasing the amount of land passing under the unified credit provisions of IRC §2010.

In a similar fashion, easements can reduce the value of land passed either outright or in trust under the unified credit provided for in IRC §2010, thereby maximizing the use of the credit and minimizing the problem of overloading the surviving spouse's estate with taxable value.

d. Increasing the amount of land passing under the valuation provisions of IRC §2032A.

Easements can be used to maximize the amount of land that can be covered by the reduced assessment for agricultural land included in a decedent's estate provided by IRC §2032A.

Care must be taken that an easement conveyance does not reduce the value of qualified land and personal property used in an agricultural operation that would otherwise qualify under §2032A below 50% of the total value of the adjusted gross estate, or reduce the value of qualified land below 25% of the value of the adjusted gross estate. These percentages are a prerequisite to qualifying under §2032A.

e. Increasing the Generation-Skipping Tax (GST) exemption under IRC §2631.

Easements can maximize the amount of land that can be passed under the exemption for "generation-skipping transfers."

3. Controlling future use.

Easements can control the future use of the land in estate planning programs that depend upon transfer of all, or portions, of the land to heirs prior to a landowner's death.

a. Controlling gifts of undivided land interests to family members.

In programs which depend upon transferring undivided interests in land to children using the $11,000 annual gift tax exclusion, imposing a conservation easement on the land prior to the transfers insures that the conservation intentions of the grantors will not be violated when ownership becomes fragmented, should a majority of the new owners later consider development, or a minority of owners seek partition. The same principle applies where land is given outright in its entirety, but the grantors wish it to remain in rural use.

b. Controlling gifts of stock, partnership interests, etc.

Where interests in land are conveyed indirectly by the use of a corporation, partnership, limited liability company, trust, etc. imposition of a conservation easement on the land prior to beginning the transfer program will have the same benefits as described in the preceding paragraph.

"C" corporations are only entitled to deduct 10% of their taxable income for charitable gifts, as opposed to 30% or 50% for individuals (see page 9), so making the easement donation before transferring land out of individual ownership and into corporate ownership may result in improved tax savings. Note that the 10% limitation does not apply to "S" corporations where donations are deductible at the shareholder level rather than the corporate level.

c. Controlling future use of charitable transfers.

Easements insure that future land use is controlled in the event of the transfer of land to a charity, either as an outright bequest, gift, or transfer to a charitable remainder trust.

1) Avoiding unpleasant surprises.

Donors to land conservation organizations (and other charities and public agencies) are sometimes surprised to see the organization sell the land or use it in a fashion inconsistent with the donor’s expectations. The best way to insure future use is not to rely upon expectations and assurances, but to legally bind the donee and its successors to specified uses through the imposition of a conservation easement.

2) Avoiding the effect of “merger.”

A conservation easement and the fee interest in the land subject to the easement must be held by legally separate entities to avoid "merger" of the interests. Merger essentially terminates the restrictions imposed by the easement. Therefore, easement land <u>should not</u> be donated to an organization that already holds the easement on that land, or *vice versa*, unless it is intended that the organization own unrestricted land.

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APPENDIX

Summary of the Provisions of the Treasury Regulations Governing
The Deductibility of Conservation Easement Donations
(*There is* <u>*NO*</u> *Substitute for Reading the Regulations!)*

To be deductible a conservation easement must fit the definition of a "qualified real property interest." Regs. §1.170A-14(a)

There are two types of qualified real property interests:

1. The entire interest of the donor other than a "qualified mineral interest." Regs §1.170A-14(b)(1); and

2. A "perpetual conservation restriction." Regs §1.170A-14(a)(2). Conservation easements are perpetual conservation restrictions if they:

a. Impose a restriction on the use of real property. Regs §1.170A-14(b)(2) (Easements or other similar restrictions recognized by state law.)

b. Are in perpetuity. Regs §1.170A-14(b)(2)

c. Are held by a qualified organization. Regs §1.170A-14(c). Qualified organizations:

1) Must have commitment to protect conservation purposes. Regs §1.170A-14(c)

2) Must have resources to enforce restrictions (funds need not be set aside). Regs §1.170A-14(c)

3) Must be governmental units. Regs § 1.170A-14(c)(i), or

4) Public charities qualified under IRC § 501(c)(3). Regs §1.170A-14(c)(ii)-(iv)

The easement document must:

1. Prohibit the donee from transferring the easement unless the conservation purposes are required to be carried out by the transferee. Regs §1.170A-14(c)(2)

2. Prohibit the donee from transferring the easement to other than qualified organizations qualified at the time of the transfer. Regs §1.170A-14(C)(2)

3. Require that in the event of an unexpected change making the purposes of the easement impossible or impractical to achieve the proceeds of any sale or exchange be used consistently with conservation purposes of the original donation. Regs §1.170A-14(C)(2)

Qualified conservation purposes include:

1. The preservation of land for recreational use by the public. Regs **§**1.170A-14(d)(1)(i)

    a. The easement must provide for substantial public use, Regs **§**1.170A-14(d)(2)(ii), and for

    b. Regular public use. Regs **§**1.170A-14(d)(2)(ii)

2. The preservation of a significant, relatively natural animal or plant habitat. Regs **§**1.170A-14(d)(1)(ii)

    a. Some alteration by man is allowed if animals or plants continue to live in relatively natural state. Regs **§**1.170A-14(d)(3)(i)

    b. Significant habitats include:

        1) habitats of rare, endangered or threatened species; Regs **§**1.170A-14(d)(3)(ii)

        2) natural high quality examples of terrestrial or aquatic communities; Regs **§**1.170A-14(d)(3)(ii)

        3) natural areas contributing to ecological viability of public parks or preserves. Regs **§**1.170A-14(d)(3)(ii)

    c. Public access is not required for habitat preservation easements. Regs **§**1.170A-14(d)(3)(iii)

3. The preservation of open space (including farm and forest land). Regs **§**1.170A-14(d)(1)(iii)

    a. Preservation may be pursuant to a clearly delineated governmental policy; Regs **§**1.170A-14(d)(4)(i)(A)

        1) A general declaration by a single official or legislative body isn't enough. Regs **§**1.170A-14(d)(4)(iii)

        2) There is no requirement for certification of specific properties. Regs **§**1.170A-14(d)(4)(iii)

        3) Donations furthering a specific, identified, conservation project must meet this requirement. Regs **§**1.170A-14(d)(4)(iii), examples include:

            a) preservation of significant land within a local landmark district

            b) preservation of wild or scenic rivers

            c) preservation of farmland pursuant to a state flood prevention or control program

d) protection of scenic, ecological, or historic character of land contiguous to or an integral part of the surroundings of existing recreation or conservation sites

4) Programs must involve a significant governmental commitment. Regs §1.170A-14(d)(4)(iii)(A)

a) Program need not be funded to satisfy this requirement; however

b) Preferential tax assessment programs, or

c) Preferential zoning for property deemed worthy of protection demonstrate requisite commitment. Regs §1.170A-14(d)(4)(iii)(A).

5) Acceptance of the easement by a governmental agency tends to establish compliance with clearly delineated governmental policy, depending upon existence of other factors and rigor of agency review. Regs §1.170A-14(d)(4)(iii)(B)

6) Public access is not a requisite unless the conservation purpose would be undermined without such access. Regs §1.170A-14(d)(4)(iii)(C)

b. Or, for the scenic enjoyment of public. Regs §1.170A-14(d)(4)(i)(B)

1) Development would impair scenic character of local rural or urban landscape Regs §1.170A-14(d)(4)(ii)(A), or

2) Development would interfere with a scenic panorama viewed from a

a) park,

b) preserve,

c) road,

d) water body,

e) trail,

f) historic area or structure,

Regs §1.170A-14(d)(4)(ii)(A); and

3) The land area or transportation way is open to or used by the public. Regs §1.170A-14(d)(4)(ii)(A)

4) Visual access, not physical access, to the view is required. Regs §1.170A-14(d)(4)(ii)(B).

5) See 1.170A-14(d)(4)(ii)(A)(1)-(8) for criteria to evaluate scenic quality.

c. Open space contributions must yield a significant public benefit. Regs §1.170A-14(d)(i)(A) and (B). Factors include:

1) Uniqueness of property subject to easement to the area, Regs §1.170A-14(d)(4)(iv)(A)(1);

2) The intensity of existing and planned development in the area, Regs §1.170A-14(d)(4)(iv)(A)(2);

3) The consistency of proposed open space with public conservation programs in the region, Regs §1.170A-14(d)(4)(iv)(A)(3); including

a) outdoor recreation,

b) irrigation or water supply protection,

c) water quality maintenance or enhancement,

d) flood prevention and control,

e) erosion control,

f) shoreline protection,

g) protection of land areas included in or related to a government master plan or land management area;

Regs §1.170A-14(d)(4)(iv)(A)(3)

4) The consistency of proposed open space with existing private conservation programs in the area. Regs §1.170A-14(d)(4)(iv)(A)(4)

5) The likelihood that development of the property would lead to degradation of scenic, natural or historic character of area. Regs §1.170A14(d)(4)(iv)(A)(5)

6) The opportunity of the public to use property or enjoy its scenic values. Regs §1.170A-14(d)(4)(iv)(A)(6)

7) The importance of the property in preserving a local or regional landscape or resource that attracts tourism or commerce in the area. Regs §1.170A-14(d)(4)(iv)(A)(7)

8) The likelihood that the donee organization will acquire equally desirable and valuable property or property rights. Regs §1.170A-14(d)(4)(iv)(A)(8)

9) The cost to donee of enforcing the easement. Regs §1.170A-14(d)(4)(iv)(A)(9)

10) The population density in the area of property. Regs §.170A-14(d)(4)(iv)(A)(10)

11) The consistency of the proposed open space with a legislatively mandated program identifying specific parcels for future protection. Regs §1.170A-14(d)(4)(iv)(A)(11).

d. Open space easements can't allow retention of development rights that would interfere with the scenic quality or governmental conservation policy furthered by donation. Regs §1.170A-14(d)(4)(v)

4. The preservation of historically important land or certified structures. Regs §1.170A-14(d)(1)(iv)

a. Historic easements on land in an historic district must require that any development allowed conform to applicable construction standards for the district. Regs §1.170A-14(d)(5)(i)

Historic land area includes:

1) Independently significant land areas, Regs §1.170A-14(d)(5)(ii)(A);

2) Land and buildings in an historic district which contribute to the significance of the district, Regs §1.170A-14(d)(5)(ii)(B);

3) Land areas adjacent to National Register properties if the features of the land area contribute to the character of the Register property, Regs §1.170A-14(d)(5)(ii)(C);

Certified historic structure means any structure or land area:

1) Listed on the National Register, Regs §1.170A-14(d)(5)(iii)(A);

2) Located in a registered historic district certified by the Secretary of Interior, Regs §1.170A-14(d)(5)(iii)(B);

3) Structures include residences. Regs §1.170A-14(d)(5)(iii)

b. There must be visual access to a structure or at least a meaningful portion of a land area to qualify for a deduction. If the property isn't accessible, then arrangements must be made to allow the public visual access on a regular basis. Regs §1.170A-14(d)(5)(iv)(A).

Subparagraphs (B) and (C) provide guidelines for public access to historic land areas and structures.

5. Regs §1.170A-14(f) contains examples of conservation purposes.

An easement must prohibit Inconsistent Uses. Regs §1.170A-14(e):

1. An easement must be exclusively for conservation purposes. Regs §1.170A-14(e):

a. An easement may not allow uses inconsistent with significant conservation interests even though they are not the conservation purposes enumerated in the easement. Regs §1.170A-14(e)(2)

b. The retention of rights to use property which rights do not impair significant conservation interests are not inconsistent uses. Regs §1.170A-14(e)(2)

c. Uses destructive of conservation interests are permitted if necessary for the protection of the conservation purposes of the easement. Regs §1.170A-14(e)(3)

2. An easement may preserve a preexisting use of property if the use is not in conflict with the conservation purposes of the easement. Regs §1.170A-14(e)(3)

An easement must be enforceable in perpetuity. Regs §1.170A-14(g):

1. Uses retained in the easement must be subject to legally enforceable restrictions preventing their exercise in a manner that would be inconsistent with conservation purposes of the easement. Regs §1.170A-14(g)(1)

2. A remainder interest contribution must be restricted so that life tenants will not be able to diminish the conservation values protected by the contribution. Regs §1.170A-14(g)(1)

3. The holder of any mortgage on the property must subordinate its interest to the rights of the easement holder to enforce the terms of the easement. Regs §1.170A-14(g)(2)

4. Events that might defeat the purpose of the contribution do not violate the requirement that the easement be in perpetuity so long as the events are, at the time of the donation, so remote as to be negligible. Regs §1.170A-14(g)(3)

5. Retention of a qualified mineral interest will not violate the requirement of perpetual enforceability unless:

1) Surface mining of such minerals is possible. Regs §1.170A-14(g)(4)(i)

2) Mining in a manner inconsistent with the conservation purposes is allowed. Regs §1.170A-14(g)(4)(i)

3) Mining having a localized, limited impact not irremediably destructive of significant conservation interests is permissible. Regs §1.170A-14(g)(4)(i)

4) A separation of the mineral interests in property is allowable so long as the probability of surface mining such minerals is so remote as to be negligible. Regs §1.170A-14(g)(4)(ii)

Documentation of conditions is required if the donor retains any rights to use the property that is subject to the easement. Regs §1.170A-14(g)(5):

1. Documentation sufficient to establish property condition must be given to the donee prior to the donation if rights to use the property are retained which could impair the conservation interests of the property. Regs §1.170A-14(g)(5).

Documents should include:

a. U.S.G.S. survey maps showing property lines and nearby protected areas, Regs §1.170A-14(g)(5)(i)(A);

b. Scale maps of the area showing manmade and natural features of significance, Regs §1.170A-14(g)(5)(i)(B);

c. Aerial photos of the property taken as close to the time of donation as possible, Regs §1.170A-14(g)(5)(i)(C);

d. On-site photos of the property taken from appropriate locations, Regs §1.170A-14(g)(5)(i)(D);

2. Easements with restrictions pertaining to specific natural resources must be accompanied by documentation of the condition of the resource at or near the time of donation. Regs §1.170A-14(g)(5)(i)(D)

3. All documentation must be accompanied by a statement signed by the donor and donee that "This natural resource inventory is an accurate representation of [the protected property] at the time of the transfer." Regs §1.170A-14(g)(5)(i)(D)

The donee must be able to inspect property if donor retains rights to use property. Regs §1.170A-14(g)(5)(ii)

1. The donor must agree to notify donee, in writing, before exercising any rights reserved in the easement if the exercise of those rights might impair the conservation interests of the property. Regs §1.170A-14(g)(5)(ii)

2. The easement must provide the donee with the right to enter the property at reasonable times to inspect. Regs §1.170A-14(g)(5)(ii)

3. The easement must provide that the donee may enforce the easement by appropriate legal proceedings, including, but not limited to, the right to require the restoration of the property to its condition at the time of the donation. Regs §1.170A-14(g)(5)(ii)

Extinguishment of an easement in whole or in part will not affect deductibility if:

1. The termination was by court order, Regs §1.170A-14(g)(6)(i);

2. The termination was due to a change in conditions surrounding the property making continued use for conservation purposes impractical or impossible, Regs §1.170A-14(g)(6)(i); and

3. All the donee's proceeds from a subsequent sale or exchange are used by donee in a manner that is consistent with the conservation purposes of the original donation. Regs §1.170A-14(g)(6)(i)

The value of the donee's interest in the easement must be fixed in the easement.

1. The easement must provide that the donee's interest is a vested property interest. Regs §1.170-14A(g)(6)(ii)

2. The fair market value of the donee's interest must at least equal the proportionate value that the easement at the time of the donation bears to the value of the property as a whole at the time of the donation. Regs **§**1.170A-14(g)(6)(ii)

3. The easement must provide that that proportionate value will remain constant. Regs **§**1.170A-14(g)(6)(ii)

4. The easement must provide that, in the event of extinguishment, the proceeds of any sale, exchange or involuntary conversion must be at least equal to that proportionate value. Regs **§**1.170A-14(g)(6)(ii)

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FEDERAL ESTATE TAX SECTION 2031(c)

(c) Estate Tax With Respect To Land Subject To a Qualified Conservation Easement.—

(1) In General.— If the executor makes the election described in paragraph (6), then, except as otherwise provided in this subsection, there shall be excluded from the gross estate the lesser of –

(A) the applicable percentage of the value of land subject to a qualified conservation easement, reduced by the amount of any deduction under section 2055(f) with respect to such land, or

(B) the exclusion limitation.

(2) Applicable Percentage.— For purposes of paragraph (1), the term "applicable percentage" means 40 percent reduced (but not below zero) by 2 percentage points for each percentage point (or fraction thereof) by which the value of the qualified conservation easement is less than 30 percent of the value of the land (determined without regard to the value of such easement and reduced by the value of any retained development right (as defined in paragraph (5)). The values taken into account under the preceding sentence shall be such values as of the date of the contribution referred to in paragraph (8)(B). **[Editor's Note: the preceding sentence applies to the estates of decedents dying after December 31, 2000. This sentence does not apply to estates of decedents dying prior to that date.]**

(3) Exclusion Limitation.— For purposes of paragraph (1), the exclusion limitation is the limitation determined in accordance with the following table:

In the case of estates of decedents dying during:	*The exclusion limitation is:*
1998	$100,000
1999	$200,000
2000	$300,000
2001	$400,000
2002 or thereafter	$500,000

(4) Treatment of Certain Indebtedness.—

(A) In General.— the exclusion provided in paragraph (1) shall not apply to the extent that the land is debt-financed property.

(B) Definitions.— For purposes of this paragraph--

(i) Debt-financed property.— The term "debt-financed property" means any property with respect to which there is an acquisition indebtedness (as defined in clause (ii)) on the date of the decedent's death.

(ii) Acquisition Indebtedness.—The term "acquisition indebtedness" means, with respect to debt-financed property, the unpaid amount of—

(I) the indebtedness incurred by the donor in acquiring such property,

(II) the indebtedness incurred before the acquisition of such property if such indebtedness would not have been incurred but for such acquisition,

(III) the indebtedness incurred after the acquisition of such property if such indebtedness would not have been incurred but for such acquisition and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition, and

(IV) the extension, renewal, or refinancing of an acquisition indebtedness.

(5) Treatment of Retained Development Right.—

(A) In General.-- Paragraph (1) shall not apply to the value of any development right retained by the donor in the conveyance of a qualified conservation easement.

(B) Termination of Retained Development Right.— If every person in being who has an interest (whether or not in possession) in the land executes an agreement to extinguish permanently some or all of any development rights (as defined in subparagraph (D)) retained by the donor on or before the date for filing the return of the tax imposed by section 2001, then any tax imposed by section 2001 shall be reduced accordingly. Such agreement shall be filed with the return of the tax imposed by section 2001. The agreement shall be in such form as the Secretary shall prescribe.

(C) Additional tax.**—** Any failure to implement the agreement described in subparagraph (B) not later than the earlier of—

(i) the date which is 2 years after the date of the decedent's death, or

(ii) the date of the sale of such land subject to the qualified conservation easement,

shall result in the imposition of an additional tax in the amount of the tax which would have been due on the retained development rights subject to such agreement. Such additional tax shall be due and payable on the last day of the 6th month following such date.

(D) Development Right Defined.— For purposes of this paragraph, the term "development right" means any right to use the land subject to the qualified conservation easement in which such right is retained for any commercial purpose which is not subordinate to and directly supportive of the use of such land as a farm for farming purposes (within the meaning of section 2032A(e)(5)).

(6) Election.— The election under this subsection shall be made on or before the due date (including extensions) for filing the return of tax imposed by section 2001 and shall be made on such return.

(7) Calculation of Estate Tax Due.— An executor making the election described in paragraph (6) shall, for purposes of calculating the amount of tax imposed by section 2001, include the value of any development right (as defined in paragraph (5)) retained by the donor in the conveyance of such qualified conservation easement. The computation of tax on any retained development right prescribed in this paragraph shall be done in such manner and on such forms as the Secretary shall prescribe.

(8) Definitions.— For purposes of this subsection—

(A) Land Subject To a Qualified Conservation Easement.— The term ''land subject to a qualified conservation easement'' means land--

[Editor's Note: The following subparagraph "(i)" applies to the estates of decedents dying prior to January 1, 2001.]

(i) which is located—

(I) in or within 25 miles of an area which, on the date of the decedent's death, is a metropolitan area (as defined by the Office of Management and Budget),

(II) in or within 25 miles of an area which, on the date of the decedent's death, is a national park or wilderness area designated as part of the National Wilderness Preservation System (unless it is determined by the Secretary that land in or within 25 miles of such a park or wilderness area is not under significant development pressure), or

(III) in or within 10 miles of an area which, on the date of the decedent's death, is an Urban National Forest (as designated by the Forest Service),

[Editor's Note: The following subparagraph "(i)" applies to the estates of decedents dying after December 31, 2000.]

(i) which is located in the United States or any possession of the United States,

(ii) which was owned by the decedent or a member of the decedent's family at all times during the 3-year period ending on the date of the decedent's death, and

(iii) with respect to which a qualified conservation easement has been made by an individual described in subparagraph (C), as of the date of the election described in paragraph (6).

(B) Qualified Conservation Easement.-- The term ''qualified conservation easement'' means a qualified conservation contribution (as defined in section 170(h)(1)) of a qualified real property interest (as defined in section 170(h)(2)(C)), except that clause (iv) of section 170(h)(4)(A) shall not apply, and the restriction on the use of such interest described in section 170(h)(2)(C) shall include a prohibition on more than a de minimis use for a commercial recreational activity.

(C) Individual Described.— An individual is described in this subparagraph if such individual is—

(i) the decedent,

(ii) a member of the decedent's family,

(iii) the executor of the decedent's estate, or

(iv) the trustee of a trust the corpus of which includes the land to be subject to the qualified conservation easement.

(D) Member of family.--- The term "member of the decedent's family" means any member of the family (as defined in section 2032A(e)(2)) of the decedent.

(9) Treatment of Easements Granted After Death.--- In any case in which the qualified conservation easement is granted after the date of the decedent's death and on or before the due date (including extensions) for filing the return of tax imposed by section 2001, the deduction under section 2055(f) with respect to such easement shall be allowed to the estate but only if no charitable deduction is allowed under chapter 1 to any person with respect to the grant of such easement.

(10) Application of this section to interests in partnerships, corporations, and trusts.— This section shall apply to an interest in a partnership, corporation, or trust if at least 30 percent of the entity is owned (directly or indirectly) by the decedent, as determined under the rules described in section 2057(e)(3).

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