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New Tax Law Could Enhance the Attractiveness of Conservation Easements

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Introduction

The Internal Revenue Code ("IRC" or "the Code") treats certain "qualified conservation contributions" as charitable contributions.[1] Properly drafted conservation easements qualify for a charitable contribution deduction under the provision, allowing the donor to take a deduction for income tax purposes.

In addition, encumbering the land with a conservation easement should qualify the land for a reduction in value upon the death of the owner. Finally, the conservation easement should lower the fair market value of the property for real property tax purposes. In the alternative, the conservation easement may qualify the property for special use valuation, also lowering the real estate tax burden. For an overview of conservation easements see, Richardson, Jr., Jesse J. "Maximizing Tax Benefits to Farmers and Ranchers Implementing Conservation and Environmental Plans", 48 *Oklahoma Law Review* 449-469 (Summer, 1995).

Section 508 (formerly the American Farm and Ranch Protection Act) of the Taxpayer Relief Act allows the executor of an estate of a decedent dying after December 31, 1997, to exclude from the decedent's gross estate up to 40 percent of the value of land subject to a qualified conservation easement.[2] The new provisions seek to target the most endangered open spaces - those on the urban-rural fringe. Environmentalists and land trust officials speculate that the new tax provisions will prompt a significantly higher number of donations of conservation easements.[3] This article provides a brief overview of the new provisions. The discussion excludes any consideration of the myriad questions arising from the new provisions.

Qualifying Land

IRC § 2031(c) applies to land subject to a qualified conservation easement located

1. In or within 25 miles of a metropolitan area as defined by the Office of Management and Budget;
2. In or within 25 miles of a national park or wilderness area, unless the Secretary of the Treasury ("Secretary") determines that such land is not under significant development pressure; or,
3. In or within 10 miles of an Urban National Forest as designated by the Forest Service of the U.S. Department of Agriculture.

Additionally, the decedent must have owned the land or a member of the decedent's family must have

owned the land at all times during the three-year period ending on the date of the decedent's death. The definition of "member of the family" contained in IRC § 2032A(e)(2) applies.[4] A legally adopted child of an individual is treated as the child of such individual by blood.

Further, the qualified conservation easement encumbering the land must have been granted by the decedent or a member of the decedent's family. A postmortem conservation easement on the property qualifies, provided the easement is donated no later than the date of the election. The election is irrevocable and is made on the estate tax return.

The Exclusion Amount

The amount excluded from the value of the decedent's gross estate ("exclusion amount") is the lessor of the "applicable percentage" or the "exclusion limitation." The exclusion limitation equals $100,000.00 in 1998, $200,000.00 in 1999, $300,000.00 in 2000, $400,000.00 in 2001, and $500,000.00 in 2002 and thereafter.

The "applicable percentage" means 40 percent reduced (but not below zero) by two 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. For purposes of calculating the applicable percentage, the value of the land is determined without regard to the value of the easement and is reduced by the value of any retained development rights. The Code defines development rights as "any rights retained to use the land for any commercial purpose which is not subordinate to and directly supportive of the land as a farm or for farming purposes within the meaning of Internal Revenue Code § 2032A(e)(5)." IRC § 2031(c)(5)(D). Therefore, if the value of the easement is 10 percent of the value of the land without the easement, less the value of any retained development rights, the applicable percentage equals zero. The exclusion amount is reduced further by the amount of any charitable deduction claimed by the estate for estate tax purposes under IRC § 2055(f) with respect to land subject to the easement.

The executor calculates the exclusion amount based on the value of the property after the conservation easement has been placed on the property. The applicable percentage multiplied by the value of the land as encumbered by the easement equals the exclusion amount (but the exclusion amount may be no greater than the exclusion limitation of 40%).

An agreement may extinguish permanently some or all of the development rights retained by the donor. If every person in being who has an interest in the land executes the agreement on or before the estate tax return due date, the estate tax may be reduced accordingly. However, if the heirs fail to implement the agreement by the earlier of the date that is two years after the decedent's date or the date of the sale of the land, an additional tax is imposed. The additional tax equals the amount of tax that would have been due on the retained development rights that were subject to the agreement. The value of retained development rights remains subject to the estate tax.[5]

Carry-Over Basis

To the extent that the value of land is excluded from the taxable estate, the basis of the land acquired at death is a carry-over basis.[6] No step up of basis for that portion of the value of the real estate is applicable.

Interaction Between Section 2032A (or Section 2032A) and Conservation Easements

Earlier Internal Revenue Service authority indicated that the granting of a conservation easement could constitute a disposition triggering additional tax under IRC § 2032A.[7] The new statute resolves this doubt and provides that the granting of a conservation easement does not affect specially valued property under IRC § 2032A.[8] Therefore, the granting of the easement will not trigger the additional estate tax. The new tax bill explicitly provides similar provisions under new alternative valuation Section 2033A.[9]

Doubt also existed as to whether IRC § 2032A and the conservation easement provisions could be coupled to gain enhanced reduction in value for the gross estate. The Senate Committee Report provides that the existence of a qualified conservation easement does not prevent the property from subsequently qualifying for special use valuation under IRC § 2032A.

Historic Easements Not Benefited

For the purposes of the exclusion, the preservation of a historically important land area or a historic structure does not qualify as conservation purpose.[10] Therefore, the exclusion is not allowed for historic easements. The provision does not address whether previously granted historic easements, which otherwise qualify, may be amended to derive the benefit of the exclusion.

Commercial Recreational Activities

The easement must prohibit commercial recreational activities.[11] However, a *de minimus* commercial recreational activity consistent with the conservation purpose, such as the granting of hunting or fishing licenses, does not cause the property to fail to qualify for the exclusion.[12] The Secretary shall provide guidance regarding the definition of *de minimus* activities.

Retained Mineral Interest

The law also provides that the contribution of a permanent conservation easement qualifies for a charitable deduction for estate and income tax purposes even when a mineral interest has been retained and surface mining is possible. However, the probability of any surface mining occurring must be so remote as to be negligible. The prior law allowed a charitable deduction as to such contribution only if the mineral interest where separated from the land prior to June 13, 1976.

Debt Financed Property

"Debt financed property" means property with respect to which there is an acquisition indebtedness on the date of the decedent's death. Acquisition indebtedness includes (1) indebtedness incurred by the donor in acquiring the property, (2) indebtedness incurred before the acquisition of the property if such indebtedness would not have been incurred except for such acquisition, (3) indebtedness incurred after the acquisition of the property if such indebtedness would not have been incurred except for such acquisition, and the incurrence of the indebtedness was reasonably foreseeable, and (4) the extension or renewal of the financing of an acquisition indebtedness. Debt financed property remains eligible for the exclusion to the extent of the net equity in the property.

Examples

Example (1). Taxpayer dies owning land subject to a qualified conservation easement on January 2, 1998. He did not retain any development rights in the property. The fair market value of the real property on the date of death was $1,000,000 without the conservation easement and $800,000 with the easement.

The value of the conservation easement equals $200,000 ($1,000,000 - $800,000), or 20 percent of the value of the real property without the easement. The applicable percentage is 20 percent (40% - [2 x (30% - 20%)]). The exclusion amount is $100,000 (the lessor of the applicable percentage (20% - $800,000 = $160,000) and the exclusion limitation ($100,000).

Example (2) . Taxpayer dies owning land subject to a qualified conservation easement on January 2, 2002. She retained development rights on the property valued at $100,000. The fair market value of the real property on the date of death was $500,000 without the conservation easement and $400,000 with the easement. The value of the conservation easement is $100,000, or 25 percent of the value of the real property without the easement, as reduced of the value of any retained development rights ($100,000 Ö [$500,000 - $100,000]). The applicable percentage multiplier for the estate equals 25 percent. Therefore, the exclusion amount is $75,000 (25% of $300,000).

Example (3) . Taxpayer dies owning land subject to a qualified conservation easement on January 2, 2002. She did not retain any development rights in the property. The fair market value of the real property on the date of death was $1,000,000 without the conservation easement and $900,000 with the easement. Thus, the value of the conservation easement is $100,000 or 10 percent of the value of the real property without the easement. The applicable percentage for the estate is 0 percent (40 percent reduced by twice the difference between 30 percent and 10 percent). Therefore the exclusion amount is zero.

Conclusion

Section 508 seeks to target preservation of land subject to intense development through estate tax benefits. This article merely described the provisions. Many questions remain as to the provisions' meaning and effectiveness.

For additional information on this topic see: "Open Space Land Conservation New Federal and State Financial Incentives," by Tamara Vance and Sherry Buttrick. Horizons January-February, 1998.

[1]IRC § 170 (1997).

[2]IRC § 2031(c) (1998).

[3]See, e.g., Bowman, Rex "New Tax Laws could Aid Land Trusts," *Richmond Times-Dispatch*, pp. B1, B4 (September 9, 1997).

[4]IRC § 2032A(e)(2) defines "member of the family" as only

> (A) an ancestor of such individual;
> (B) the spouse of such individual;
> (C) a lineal descendant of such individual, of such individual's spouse, or of a parent of such individual; or
> (D) the spouse of any lineal descendant described in subparagraph (C).

[5]IRC § 2031(c)(5)(A).

[6]IRC § 1041(a)(4) 1998.

[7]See, e.g., Richardson, *supra.*, pp. 463-464.

[8]IRC § 2032A(c)(8).

[9]IRC § 2033A(f)(1)(B).

[10]IRC § 2031(c)(6)(B).

[11]IRC § 2031(c)(6)(B).

[12]*Id.*, and Conference Committee Report.

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