

Philanthropic Estate Planning

By Janet Nava Bandera

Charitable Conservation Easements

Last week, the Bush administration released the fiscal 2006 budget plan. It included a tax incentive for legitimate sales or donation of land for “conservation purposes” as well as penalties to curb increasing abuses of the deduction. What is a “conservation purpose”? A conservation purpose includes protecting open space, a wildlife habitat, farmland and forestland and watershed and scenic property. Typically, the landowner does not transfer the entire interest in land, rather a restriction is placed on the use of property. These restrictions are referred to as conservation easements.

Easements in General

An easement is a right of use over the property of another. A landowner granting an easement gives up, either temporarily or permanently, part of the rights in the full ownership of land. For example, a landowner may grant a right-of-way (a common type of easement) over his land so a neighbor may access his property. Utility companies and government entities acquire easements by negotiation or eminent domain to deliver services essential to the community or public.

A conservation easement is a legal agreement that a landowner makes to limit the type and amount of development on his property. The restrictions are written in a deed, which is recorded with the land records.

Uses of Conservation Easements

There are several financial reasons why a landowner may grant a conservation easement, including estate and gift tax planning, property tax savings and income tax deductions.

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Property Tax Savings

After granting a conservation easement, real property tax savings may result if the market value of the real estate is reduced.

Charitable Income Tax Deduction

Generally, a conservation easement donor may take a federal income tax deduction of up to 30 percent of his adjusted gross income, and any excess amount may be carried forward and deducted over the five succeeding years. The income tax deduction is equal to the fair market value of the property before the restriction minus the fair market value of the subject property after the restriction.

Gift Tax Savings

If the value of the property with the restriction is reduced, greater portions may be transferred to a donee under the \$11,000 annual gift tax exclusion.

Estate Tax Savings

The value of an easement is not included in the landowner's taxable estate at death. Additionally, the executor of the estate of a taxpayer may elect to exclude from the gross estate up to 40 percent of the value of the land (up to a maximum of \$500,000) subject to a qualified conservation easement. To qualify, the land must have been owned by the taxpayer or a member of the taxpayer's family during the three-year period ending on the date of the taxpayer's death, and the land must be subject to a qualified conservation easement granted by the taxpayer or a member of the taxpayer's family.

Technical Provisions

Generally, no charitable contribution deduction is allowed for a transfer to a charitable organization of only part of the interest in property.¹ However, under Code Sec. 170(h), there is an exception to this rule in the case of a qualified conservation contribution.² A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for certain conservation purposes.³ A qualified interest includes a restriction (granted in perpetuity) on the use that may be made of the real property.⁴

Substantiation

A charitable contribution is allowed as a deduction only if substantiated in accordance with regulations

prescribed by the Treasury. Under Code Sec. 170(f)(8), a taxpayer must substantiate its contributions of \$250 or more by obtaining from the charitable organization a statement that includes (1) a description of any return benefit provided by the charitable organization, and (2) a good-faith estimate of the benefit's fair market value.⁵

If all requirements of Code Sec. 170 are satisfied and a deduction is allowed, the amount of the deduction is the fair market value of the contributed property on the date of the contribution (reduced by the fair market value of any consideration received by the taxpayer).⁶

Fair Market Value

Fair market value is the price at which the contributed property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and each having reasonable knowledge of relevant facts.⁷ If the donor (or a related person) reasonably can expect to receive financial or economic benefits greater than those that will inure to the general public as a result of the donation of a conservation easement, no deduction is allowable.⁸ In other words, if the donation of a conservation easement has no material effect on the value of real property or enhances rather than reduces the value of real property, no deduction is allowable.⁹

Example. Granting a conservation easement on wetlands may have significant conservation value and may meet the definition of conservation purpose. But if you can't build on the wetlands anyway, there is no material effect on the dollar value of the property and therefore little or no income tax deduction.

Fair Market Value and Land Development

Reg. §1.170A-(h)(3)(l) includes two appraisal rules of concern where a family wishes to sell land for development. The first rule is that when a landowner donates a conservation easement on a portion of the contiguous real estate owned by that landowner and the landowner's family, the deduction is equal to the value of all the contiguous property owned by the landowner and the landowner's family before the

easement minus the value of all of the contiguous property after the easement.

So, any increase in value to land abutting the restricted land reduces the deduction. In some situations the “*all before minus all after*” rule can have a significant impact on the amount of the deduction.

The second appraisal rule is also designed to consider any increase in value to the landowner or a related party. The second rule is that, when a landowner donates a conservation easement and as a result there is an increase in the value of any other land, whether or not contiguous, owned by the landowner, the landowner’s family, or a “related party” (broadly defined to include certain partners and partnerships, corporations and shareholders, trusts and beneficiaries, *etc.*), the value of the deduction is reduced by any such increase in value to such other property.

The Abuses

Like so many income tax deductions, Code Sec. 170(h) was well intended and accomplished its purpose for many years. Then tax professionals discovered it and began marketing it as a tax shelter, and the abuses began. In the spring of 2003, THE WASHINGTON POST began a series of articles on The Nature Conservancy (TNC) and some transactions the organization had entered into. Those stories were followed with others on certain conservation easement “deals.” The stories caught the eye of the government, including the IRS. After investigation, the IRS concluded that, “some taxpayers are claiming inappropriate charitable contribution deductions under §170 for cash payments or easement transfers to charitable organizations in connection with the taxpayers’ purchases of real property.”

These questionable cases included instances where the charitable organization purchased property, placed a conservation easement on the property and then sold the property subject to the easement to a buyer for a price that is substantially less than the price paid by the charitable organization for the property. As part of the sale, the buyer made a second payment, designated as a “charitable contribution,” to the charitable organization. The total of the payments from the buyer to the charitable organization fully reimbursed the charitable organization for the cost of the property.

So, last summer, in Notice 2004-41, the IRS announced that it would disallow improper charitable deductions involving conservation easements.

Notice 2004-41

In Notice 2004-41, the IRS stated that “[t]he Internal Revenue Service is aware that taxpayers who (1) transfer an easement on real property to a charitable organization, or (2) make payments to a charitable organization in connection with a purchase of real property from the charitable organization, may be improperly claiming charitable contribution deductions under §170 of the Internal Revenue Code. The purpose of this notice is to advise participants in these transactions that, in appropriate cases, the Service intends to disallow such deductions and may impose penalties and excise taxes. Furthermore, the Service may, in appropriate cases, challenge the tax-exempt status of a charitable organization that participates in these transactions. In addition, this notice advises promoters and appraisers that the Service intends to review promotions of transactions involving these improper deductions, and that the promoters and appraisers may be subject to penalties.”¹⁰

Notice 2004-41 also stated that the IRS will disallow deductions for conservation easement transfers if the taxpayer fails to comply with the substantiation requirements. The IRS is considering changes to forms to facilitate compliance with and enforcement of the substantiation requirements.

Penalties, Excise Taxes and Tax-Exempt Status

Taxpayers have been warned that the IRS intends to disallow all or part of any improper deductions and may impose penalties under Code Sec. 662. The IRS intends to assess excise taxes under Code Sec. 4958 against any disqualified person who receives an excess benefit from a conservation easement transaction and against any organization manager who knowingly participates in the transaction. In appropriate cases, the IRS may challenge the tax-exempt status of the organization, based on the organization’s operation for a substantial non-exempt purpose or impermissible private benefit. In addition, the IRS intends to review promotions of transactions involving improper deductions for conservation easements. Promoters, appraisers, and other persons involved in these transactions may be subject to penalties under Code Secs. 6700, 6701 and 6694.

Proposed Incentive

Although the IRS is more closely scrutinizing such transactions to ensure that there is truly a substantiated decrease in the value of the land where it is restricted for a conservation purpose, the proposed incentives for legitimate transactions increase the deductions available to a taxpayer.

The proposed regulations provide that if the buyer furnishes a written statement representing that it is a qualified conservation organization that will hold the property exclusively for conservation purposes and not transfer it "for valuable consideration other than to a qualified conservation organization," only 50 percent of any capital gain would be included in the income of the seller.

The partial exclusion would not be available for transfers under a condemnation order but would apply to any gain recognized in a sale made in response to the threat or imminence of a condemnation order. If a taxpayer sells less than its entire interest in the property, it must satisfy requirements like those applicable to qualified conservation contributions under Code Sec. 170(h), the Treasury description explains. Also, the taxpayer or a member of the taxpayer's fam-

ily must have owned the property for the three years immediately before the sale date.

Stiff penalties would apply if the property is transferred or used for nonconservation purposes or if a conservation restriction in an instrument of conveyance of the property is removed.

Conclusion

Conservation easements are alive and may soon be better than ever, but only for those that truly wish to preserve or protect our natural resources, not for those that are merely looking for a tax shelter for the profit on land that is being passed to the next generation or has been made valuable by increasing demand.

ENDNOTES

- ¹ Code Sec. 170(f)(3).
- ² Code Sec. 170(f)(3)(B)(iii).
- ³ Code Sec. 170(h)(1), (2), (3) and (4); Reg. §1.170A-14(a).
- ⁴ Code Sec. 170(h)(2)(C); *see also* Reg. §1.170A-14(b)(2).
- ⁵ *See* Reg. §1.170A-13 for additional substantiation requirements.
- ⁶ *See* Reg. §1.170A-1(c)(1), (h)(1) and (2).
- ⁷ Reg. §1.170A-1(c)(2) and *see* Reg. §1.170A-14(h)(3) and (4) for a discussion of valuation.
- ⁸ Reg. §1.170A-14(h)(3)(i).
- ⁹ Reg. §1.170A-14(h)(3)(ii).
- ¹⁰ Notice 2004-41, IRB 2004-28, 1 (June 30, 2004).