Law Update

Federal Estate and Gift Tax Consequences of Donated Term Conservation Easements

by William M. Silberstein and Lawrence R. Kueter

Term conservation easements are conservation easements that are not perpetual, but, rather, restrict the property for a term of years. After the term has expired, the conservation easement restrictions terminate and no longer affect the land.

Term conservation easements are controversial within the land trust community because they do not protect the land permanently. There is certainly room in the toolbox for term conservation easements when temporary protection of land is appropriate, or is better than no protection at all. However, many land trusts are wary of using their resources on anything less than perpetual protection.

Donated term easements do not qualify for federal tax incentives, including income tax deductions. For example, Internal Revenue Code §170(h) specifies that conservation easement donors can only claim federal charitable income tax deductions if the easement is granted in perpetuity. Likewise, only permanent easements qualify for estate tax benefits.

As there are no federal tax incentives for donations of term conservation easements, some landowners (or their advocacy groups) have proposed that public funding should be provided for the purchase of term conservation easements. Certain segments of the agricultural community have advocated the sale of term conservation easements as a way for society to compensate farmers and ranchers for the open space and wildlife habitat they provide.

The debate about term conservation easements came to Colorado this year when a bill was introduced in the Colorado Legislature to create state income tax credits for donated term conservation easements. During 1999, the Colorado Legislature enacted tax credits for donated permanent conservation easements. The bill introduced this year would have extended those tax credits to donated term conservation easements with a term of at least 10 years. The bill was ultimately defeated. On behalf of the Colorado Coalition of Land Trusts, the authors and their colleagues researched the federal estate and gift tax consequences of donated term conservation easements. What we found was surprising, and our testimony on these points at the state legislative committees ultimately helped defeat the bill, along with persuasive arguments by Colorado land trusts.

During the process, we learned that there are difficulties in creating state tax incentives for less-than-permanent conservation easements. The thrust of the lobbying against the bill focused on the desirability of applying scarce resources only to permanent land protection. The information we provided about the estate and gift tax consequences also helped to persuade the legislature not to pass this legislation.

The Gift Tax Dilemma

Under the Internal Revenue Code, a tax is imposed on the transfer of property by gift. There are a number of credits and exclusions against the gift tax, including the annual exclusion of $10,000 (increased by the cost of living adjustment) for gifts to persons. There is also a unified credit that allows every person to transfer a certain amount by gift during their life or in their estate (that amount is $675,000 for the year 2000). Charitable gifts generally qualify for a deduction from the gift tax, and there is a specific deduction from the gift tax under Internal Revenue Code §2522(d) for donations of permanent conservation easements. However, there is no deduction for the gift of a less-than-perpetual conservation easement. Therefore, the donation of a term easement exposes the donor to gift tax liability.

Some might argue that the gift tax does not apply to a term easement donated to a land trust because a conservation easement has no taxable value in the hands of the land trust, but rather represents a liability to the land trust. Therefore, there is a good argument that no gift tax liability should accrue to the donor of a typical term conservation easement. To our knowledge, however, there is no precedent on this point and, thus, the donor of a term conservation easement may owe a gift tax.

Estate Tax Benefits Require Perpetuity

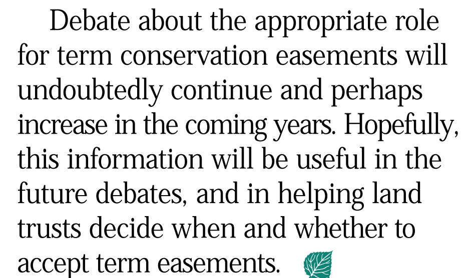
The analysis is similar in the estate tax area, but the result is much more troubling for the heirs. Under the Internal Revenue Code (IRC), an estate tax is imposed on the value of a decedent's

estate at the time of death if the estate value exceeds a designated amount. IRC §2055(f) creates a specific deduction to the estate tax for a permanent conservation easement granted by the decedent's estate. (The effect of a permanent conservation easement granted during the lifetime of a landowner is to remove the value represented by the conservation easement from the taxable estate of the landowner at death.)

There is no provision that allows for a deduction from the estate tax for the donation of a conservation easement that is not permanent. Also, IRC §2703(a) states that restrictions on the use of property, subject to certain exceptions, are disregarded for estate tax purposes. A term conservation easement might remove value from a decedent's estate under IRC §2703(a) if the term conservation easement were sold rather than donated.

If a landowner donates a term conservation easement and dies owning the land during the term of the conservation easement, the result can be as follows: The impact of the term conservation easement on the value of the property may be disregarded for estate tax purposes and the full, unrestricted value of the land will be subject to the estate tax. However, potential buyers of the property will most likely take the impact of the term conservation easement into account regarding the real market value of the property. If the heirs have to sell property to pay the estate tax (an all-too-common occurrence), they might find themselves in the worst of both worlds—unable to use the term conservation easement to reduce the value of the property for estate tax purposes and possibly forced to accept a reduced price for the property due to the term conservation easement.

Debate about the appropriate role for term conservation easements will undoubtedly continue and perhaps increase in the coming years. Hopefully, this information will be useful in the future debates, and in helping land trusts decide when and whether to accept term easements.



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IRS Issues Private Letter Ruling on Estate Tax Law

The U.S. Internal Revenue Service in March made public its first private letter ruling under Section 2031(c) of the Internal Revenue Code (IRC), the tax law allowing a new estate tax exclusion for certain land under conservation easements.

While the IRS specifies that its letter rulings discuss only the case presented for the ruling, and should not be cited as a legal precedent, they are often used for guidance in interpreting laws and to understand the IRS's current thinking.

The ruling was requested by Boston, MA-based attorney Stephen J. Small on behalf of the estate of a western rancher. At the time of the rancher's death, a trust he controlled owned the majority of the stock in a corporation, and a ranch with a number of conservation easements on it. The rancher's wife succeeded him as trustee of the trust, and she was also executor of his estate. She and the other surviving shareholders wanted to know if IRC 2031(c) estate tax benefits could be available to his estate.

Mr. Small advised that, in order for the easement to qualify for the estate tax benefits under IRC 2031(c) all but "de minimis commercial recreational activities" must be extinguished. He also recommended extinguishing remaining subdivision rights on the property to maximize the law's estate tax benefits.

"What really complicated the situation was that a corporation owned the ranch," said Mr. Small. "There was no clear legal authority on exactly how these rights could be extinguished. Even though we thought we knew the course of action to pursue, we suggested getting a letter ruling."

Perhaps the most significant clarification the IRS made in the ruling is that "unspecified, non-prohibited commercial activity"—such as the right to conduct commercial recreational activity — is considered a development right, and can be terminated under the the provisions of 2031(c), Mr. Small noted. "One relatively easy way to do this is by amending the existing easement after the death of the landowner," he said.

The ruling also noted that a written agreement among the surviving corporate shareholders to permanently extinguish the recreation and subdivision rights could satisfy the qualification requirements, if the agreement was executed on or before the due date for the estate tax filing return (nine months after the decedent's death), and included with the filing form (Form 706).

"This is a very unusual provison in 2031(c)," Mr. Small explained. "What it says is you can agree in writing to do something and you can file an estate tax return based on that agreement. Usually you can't file any tax return that's based on a promise that you will do something quite this complicated in the future."

Nevertheless, there were safeguards in the agreement in this case, Mr. Small noted. "We said in the agreement that all the people who signed would be liable for any additional estate tax that would be due if for some reason the development rights weren't extinguished as agreed."

Soon after the private letter ruling was made, the corporation completed one new conservation easement on the entire ranch, essentially amending, restating and tightening the prior conservation easements on the property, eliminating the retained subdivision rights and prohibiting any commercial recreational activity.

IRC 2031(c) was passed by Congress in 1997, and clarified with an additional provision in 1998. For a more extensive discussion of the law, see Mr. Small's article on page 8 of the Fall 1999 *Exchange.* The law and this ruling, Private Letter Ruling 200014013, are available on LTA's Web site at: www.lta.org/pubmain.html.