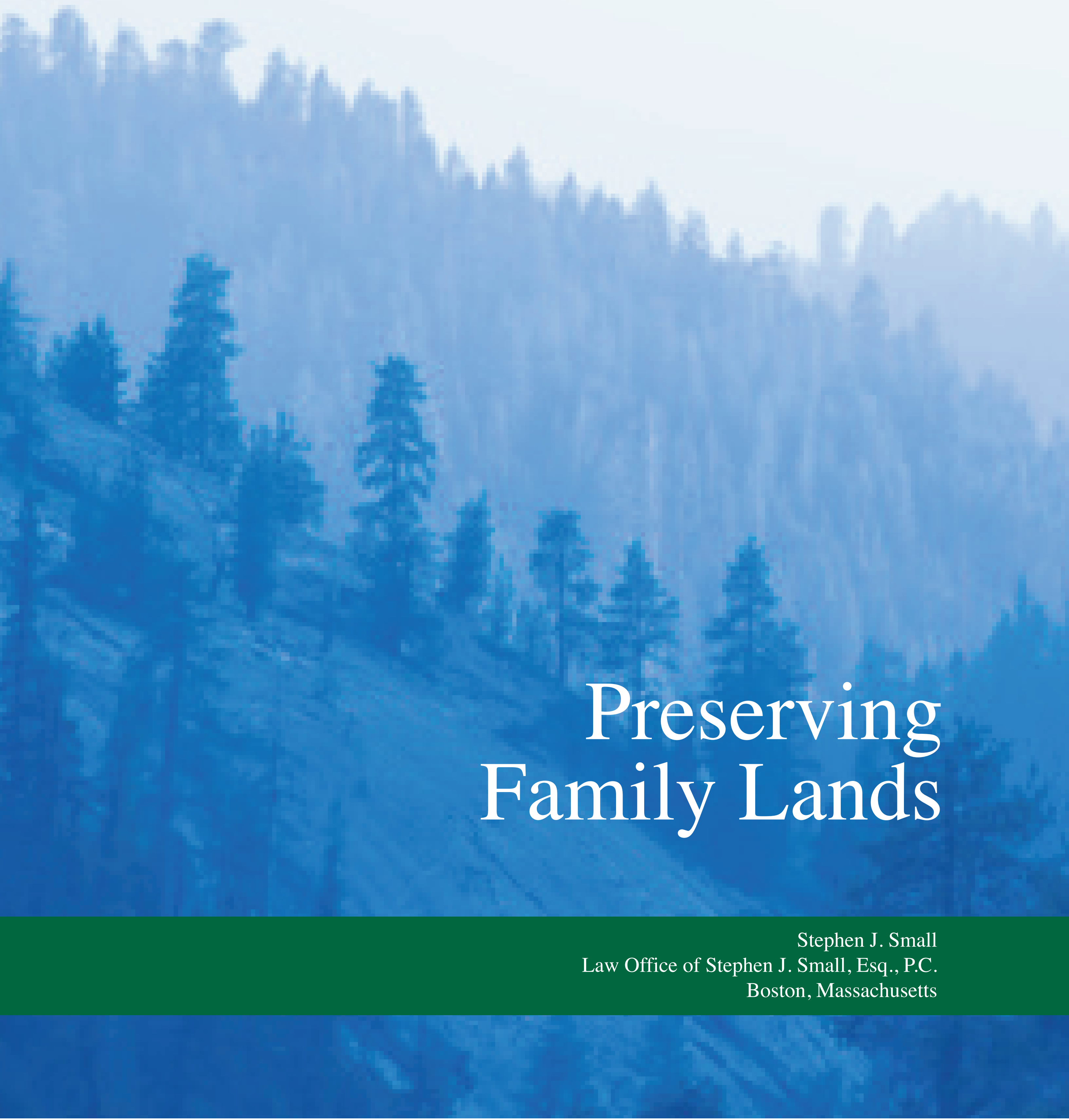
STEPHEN SMALL
LAW OFFICES



Preserving Family Lands

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I. WHAT'S A CONSERVATION EASEMENT: AN OVERVIEW

A. In general; must be perpetual.

B. *Remember, you still own your property if you donate an easement*.

C. Public access is generally *not* a requirement.

D. Flexibility: each property owner is unique, each piece of land is unique, and each easement must be unique.

1. When you think about a conservation easement, you have to think about how it relates to a *particular piece of property*.
2. For each piece of land, consider income-producing uses, compatible with the protection of the conservation values of the property.
3. Cuts across social, geographic, economic, and political lines
4. Landowners don't like to be told what to do with their real estate

E. *Read the statute!!* See §170(h), attached.

See, generally, Small, The Federal Tax Law of Conservation Easements (Land Trust Alliance, 1986), for annotated commentary on the Income Tax Regulations on easement donations and for a discussion of some of the tax considerations associated with easement donations. See also Preserving Family Lands (Book I), third edition, Landowner Planning Center, 1998; Preserving Family Lands: Book II – More Planning Strategies for the Future, Landowner Planning Center, 1997; Preserving Family Lands: Book III – New Tax Rules and Strategies and a Checklist, Landowner Planning Center, 2002.

II. TAX BENEFITS FROM EASEMENT DONATIONS

A. Valuation of an easement

1. §170(h) does *not* tell you how to value an easement; the regulations do and the cases do
2. Generally (but not always) "before and after," that is, fair market value of the property *before* the easement (highest and best use) minus fair market value *after* the easement (see later in this outline)
3. Examples: Aunt Sally's farm, etc.
4. Difficult to generalize about the extent of the reduction in value
5. Exceptions to the general rule (see later in this outline)

B. Estate tax benefits: *lower the value of the property*; avoid the forced sale of the property to pay estate taxes.

1. Run the numbers!! Don't assume anything!! See Chapter 7 of Preserving Family Lands: Book I, "Cash Sale Compared to Good Planning." See §2031(c) again.
2. *Give up value* but *gain control*
3. *Keep value in return*

C. Income tax deduction

1. Valuation of conservation easements: again, generally (though not always) using the "before and after" test.
2. "Old" law for easement donations (continues to apply to *prior* carryforwards) and existing law for other donations: limitation on benefits from a gift of *property* to charity: generally deductible up to 30% of adjusted gross income ("AGI"). Five-year carryforward. (A gift of cash is deductible up to 50% of AGI.) Possible election to take deduction up to 50% of AGI, *without deducting any appreciation*.
3. Example: John and Mary have adjusted gross income of $100,000. They give land with a value of $100,000 to charity. They can deduct $30,000 of the gift (30% times $100,000) in the first year, with a five-year carryforward of the $70,000 that's left. Any undeducted "value" remaining after six years disappears into thin air.
4. New law for "qualified conservation contributions":
   a. Deduction up to 50% of AGI, with 15-year carryforward, for individuals
   b. Deduction up to 100% of AGI, with 15-year carryforward, for "qualified farmers and ranchers"
   c. *Read the statute*
5. May be state income tax credit; state income tax credits raise complex tax questions. See Davenport and Hocker, "Federal Tax Treatment of State Tax Incentives for Real Estate Donations," Tax Notes, December 4, 2006, pp. 919-924.
6. Most easements *not* driven by income tax benefits.
7. Run the numbers!! Run the numbers!! See spreadsheets.

D. Lower property tax

1. Up to local assessors (or state statute), not federal tax law
2. State and local considerations; state statutory issues. See Rainbow Springs Partnership v. County of Macon, 79 N.C. App. 335, 339 S.E. 2d 681 (1986); Village of Ridgewood v. The Bolger Foundation, 101 N.J. 337, 517 A. 2d 135 (1986); Indian Garden Group v. Resort Township, Michigan Tax Tribunal Small Claims Division, MTT Docket Nos. 157543, 205036, February 17, 1995; Wilhelmina Dupont Ross v. Town of Waverly, State of New York, Supreme Court, County of Franklin (July 27, 1998); aff'd, Appellate Division, 3rd Department (November 10, 1999). Compare Adirondack Mountain Reserve v. Board of Assessors, 99 A.D. 2d 600, 471 N.Y.S. 2d 703 (3d Dept. 1984), aff'd, 64 N.Y. 2d 727, 485 N.Y.S. 2d 744, 475 N.E. 2d 115 (1984). Various states have enacted legislation or are considering legislation that would lower the property tax assessment on property subject to conservation easements.
3. Watch out for "revenue base" mentality. See, "Economic Benefits of Land Protection," Land Trust Alliance InfoPak Series, Land Trust Alliance, Washington, D.C., April, 1994; Brown and Fausold, "A Methodology for Valuing Town Conservation Land," Lincoln Institute of Land Policy, Cambridge, Mass. (1998); "Investing in the Future of Agriculture: The Massachusetts Farmland Protection Program and the Permanence Syndrome," American Farmland Trust, Washington, D.C. (1998).
4. *Special use assessment considerations and misconceptions*

III. FEDERAL ESTATE AND GIFT TAX "PRIMER"; 2001 TAX BILL

A. Introduction to concepts; most people *never ever* had to worry about this before.

B. General rule (old rule): all transfers of wealth are subject to gift tax or estate tax

C. Exceptions

1. $10,000/$20,000 (exclusion; see §2503(b)) (now $12,000/$24,000!!)
2. Between spouses (not subject to tax; see §2523)
3. Charitable (not subject to tax; see §2522)
4. "Old" rule: "$600,000 exclusion" may apply, increasing ("old" law) by gradual steps to $1,000,000 in 2006.
5. §2031(c) (see later in this outline); two benefits
   a. Exclusion
      i. $ 2,000,000 (the farm)
      -1,000,000 (the easement)
      1,000,000 ("after" value)
      -400,000 (the 40% exclusion)
      $600,000 (subject to tax)
      ii. Exclusion is capped at $500,000

b. Post-mortem easements

i. Situation 1 (see above)

ii. Situation 2 (see above)

iii. Situation 3 (see above); Letter Ruling 200418005

D. Relevant rules; Congress and the President have not repealed the estate tax

1.Exclusion went to $1,000,000 on January 1, 2002.

2. That went to $1,500,000 on January 1, 2004.

3. That went to $2,000,000 on January 1, 2006.

4. That goes to $3,500,000 on January 1, 2009.

5. Beginning January 1, 2010, there is NO ESTATE TAX… for one year.

6. If Congress takes no further action, on January 1, 2011, the estate tax comes back and the "exclusion" goes back to $1,000,000!! Ridiculous? Impossible? A bill of goods? True!!!

7. Estate tax *rates* drop.

8. Gift tax "credit" went to $1,000,000 in 2002 and is not scheduled to change.

9. In 2010 complex "carryover basis" rules go into effect.

E. According to a USDA report, the primary (farm) beneficiaries of estate tax repeal would be farm estates with net assets in excess of $5,000,000.

IV. "QUALIFIED CONSERVATION CONTRIBUTIONS" UNDER §170(h) OF THE INTERNAL REVENUE CODE OF 1986, AS AMENDED, AND THE REGULATIONS THEREUNDER (THE "CODE")

A. What donations qualify for deduction

1. "Qualified real property interest"

a. Easement (the regulations say, "an easement or other interest in real property that under state law has attributes similar to an easement")

b. Remainder interest in real property. For a ruling on the donation of a remainder interest in an historic residence, see Letter Ruling 9436039. For an interesting discussion of the tax consequences of the donation of a remainder interest in a mortgaged farm, see Letter Ruling 9329017.

c. Donation of a fee interest with reservation by donor of subsurface mineral rights. Special legislation for Louisiana landowner? Compare, under prior law, Rev. Rul. 76-331, 1976-2 C.B. 52 with Rev. Rul. 77-148, 1977-1 C.B. 63 and Rev. Rul. 75-373, 1975-2 C.B. 77. See Letter Ruling 8713018, and then see Rev. Rul. 85-99, 1985-2 C.B. 83, discussed later in this outline. See also Letter Ruling 9318027.

2. Donated to a "qualified organization"

a. Charitable organization or governmental unit

b. Generally must be in the conservation or historic preservation field, but see Letter Ruling 8810009; see "Common Ground," Vol. 12, No. 4, p. 4 ("In the 1980s, the [Conservation] Fund facilitated a conservation easement on the JY Ranch in an exchange for mineral rights in eastern Wyoming.")

c. Not, for example, a tax-exempt patriotic singing group

d. *Not* a "private foundation" (see elsewhere in this outline)

i. Important to ascertain in the usual easement donation situation

ii. For this reason, the transfer of a conservation easement to a charitable remainder trust *probably does not work*. See Letter Ruling 9501004 (transfer of an option to a CRT disqualifies the CRT because an *option* is not a deductible partial interest under §170(f)(3)); on the partial interest rule generally see Letter Ruling 200108012.

e. Certain "supporting organizations "under §509(a)(3) are eligible donees. See Letter Ruling 200403044.

3. "For conservation purposes"

a. Public outdoor recreation and education; must be for the "substantial and regular use of the general public or the community." Reg. §1.170A-14(d)(2)(i).

b. Protection of a significant habitat or ecosystem, including "buffer zones." See Reg. §1.170A-14(d)(3)(ii), and Example (2) of Reg. §1.170A-14(f), Letter Rulings 9218071, 9318017, and 9420008. For a complicated transaction involving an easement on important habitat around (but not on) a golf course, see Letter Ruling 9407005. See <u>Glass v. Commissioner,</u> 124 T.C. No. 16 (May 25, 2005), affirmed, 6th Circuit, December 21, 2006, No. 06-1398: significant habitat and a committed and credible donee (Little Traverse Conservancy).

c. Preservation of historic property, generally requiring classification as a National Register property by the National Park Service but also including "historically important land areas" of independent significance (such as an archaeological site or Civil War battlefield). For an interesting "open space" historic preservation easement, see Letter Ruling 8729061.

d. Preservation of open space, either

i. Pursuant to a clearly delineated governmental policy and will yield a significant public benefit, or

ii. For the scenic enjoyment of the general public and will yield a significant public benefit. See Letter Ruling 8546112 (easement on 3/4 acre) and Letter Ruling 8652013 (Martha's Vineyard property).

iii. Narrowing of prior law. Compare §170(h)(4)(A)(iii) and Reg. §1.170A-14(d)(4)(i) with Reg. §1.170A-7(b)(1)(ii) and Conf. Rep. No. 782, 91st Cong., 1st Sess. 294 (1969). See generally Browne & Van Dorn, <u>Charitable Gifts of Partial Interests in Real Property for Conservation Purposes</u>, 29 Tax Law. 69 (1975); Small, <u>The Tax Benefits of Donating Easements in Scenic and Historic Property</u>, 7 Real Est. L.J. 304 (1979).

iv. "Sliding scale" approach of regulations, at Reg. §1.170A-14(d)(4) (vi)(A) (the more clearly delineated the governmental policy, the easier to establish significant public benefit). Sliding scale not applicable to easements for scenic enjoyment: "scenic enjoyment" too subjective.

v. For farmland easements, see Letter Rulings 8422064, 8544036, 8623037, 8711054. See also Letter Ruling 9603018, in which the easement reserved to the owners the right to carry on certain agriculture, forestry, and equestrian activities.

vi. See Letter Ruling 9537018 for a specific list of permitted timber management and harvesting practices under a Forest Management Plan.

vii. See Letter Ruling 9736016 (taxpayer, a "water supplier", retained the right to continue to remove water from a reservoir subject to the easement).

e. For an important letter ruling representing a significant recognition by the Internal Revenue Service of the charitable goals of §170(h), see Letter Ruling 9526033 ("the standards under that section can serve as guidance in determining whether conservation activities are charitable").

f. Note that the average value per acre of farmland in the U.S. was roughly $100 in 1960 and $800 in 1996 ("Partial Interests in Land," Economic Research Service, U.S. Department of Agriculture, November, 1996; Agricultural Economic Report No. 744), and jumped to $933 per acre in 1997 ("1997 Census of Agriculture").

4. See <u>Turner v. Commissioner</u>, T.C. No. 5165-04, 126 T.C. No. 16, 5/16/06!!

5. See <u>Glass v. Commissioner</u>, cited above.

B. Other requirements

1. Enforceable in perpetuity. Deduction will not be disallowed if at the time of the gift the possibility of future inconsistent event is "so remote as to be negligible." Reg. §1.170A-14(g)(3) and Reg. §1.170-1(e). See 885 Investment Co. v. Commissioner, 95 T.C. 156 (1990), for a potential occurrence that was *not* so remote as to be negligible. Compare, in the Stotler and McLennan cases, cited below, how the court treated so-called *in terrorem* clauses in those easements. See also Letter Rulings 8243125 and 8302085 and TAM 200337012 (clause in gift assignment, voiding gift if IRS determines amount is above certain amount, is void as contrary to public policy).
2. Donors should be advised that an easement gift is not deductible (because it is not enforceable in perpetuity) until the easement is recorded. See Reg. §1.170A-14(g), Satullo v. Commissioner, T.C. Memo 1993-614, aff'd, 67 F.3d 314 (11th Cir. 1995), and the relevant state recording statutes.
3. *Run the title early*. See 4 and 5, below.
4. In the case of the donation of an easement on property subject to a mortgage, *no deduction will be allowed* "unless the mortgagee subordinates its rights in the property to the right of the qualified organization to enforce the conservation purposes of the gift in perpetuity." Reg. §1.170A-14(g)(2). See also Letter Ruling 9329017. See also §2031(c).
   a. Note what this requirement means. It does not mean the mortgagee can't recover the full amount of the *cash due* in the event of a foreclosure. It means that in the event of a foreclosure and a subsequent resale of the property, the easement *must remain in effect* as a recorded restriction on what can be done with the property.
   b. See the subordination language and related commentary in The Conservation Easement Handbook, published by the Land Trust Alliance and the Trust for Public Land.
   c. New territory for lenders.
   d. *Run the title early!!*
5. Under pre-1998 law, if the landowner did not own all mineral rights, the easement donation must have met specific tests to be deductible. Reg. §1.170A-14(g)(4); see Letter Rulings 8630057, 8721017, 9632003. See also Texaco, Inc., v. Short, 454 U.S. 516, 102 S. Ct. 781, 70 L. Ed. 2d 738 (1982), upholding the constitutionality of the Indiana Dormant Mineral Interest Act (Ind. Code Ann. §32-5-11-1 to 8).
   a. Rule through the end of 1997: deduction was allowable if
      i. Mineral interests were first separated before June 13, 1976, *and*
      ii. the likelihood of surface mining is "so remote as to be negligible" (which can be established by a geologist's report).
   b. If mineral interests were first separated after June 12, 1976, no deduction was allowed unless surface mining was completely prohibited.
   c. Beginning in 1998, if you don't own the minerals the date of separation is irrelevant, but you still must satisfy the "so remote as to be negligible" test, again generally established by a geologist's report. Even though the rule has been liberalized, *it is still important to know ASAP who owns the mineral interests*.
   d. For an important case with a confusing and incorrect analysis of the mineral interest rules, see Great Northern Nekoosa Corp. v. U.S., 38 Fed. Cl. 645, 1997, [80 AFTR 2d. Par. 97-5176], Case No. 589-89T (Fed. Cl. Aug. 1, 1997). Compare letter Rulings 8422064, 8428034, 8652013, 8713016, 9218071, 9537018 (balancing of reserved rights with conservation purposes). See also Virginia Vermiculite, Ltd., v. W.R. Grace & Co., 156 F.3d 535 (4th Cir. 1998), cert. denied, 119 S. Ct. 1458 (1999); Virginia Vermiculite, LLC, v. Historic Green Springs, Inc., 307 F.3d 277 (4th Cir. 2002); application for cert. pending.
6. Regulations require that "the donor must make available to the donee, prior to the time the donation is made, documentation sufficient to establish the condition of the property at the time of the gift" when the taxpayer reserves certain rights. Reg. §1.170A-14(g) (5). Consider the importance of such documentation in an effective monitoring and enforcement program by the donee organization.

7. Public access is generally not a condition of the gift, although the rules may be different in certain situations, including for historic preservation easements. See Reg. §1.170A-14(d).
8. Numerous approaches for reserved rights, including reserved residential development rights and potential charitable and/or commercial activities; see Letter Rulings 9603018 and 9632003. See also Letter Ruling 9736016 (reserved water rights); Letter Ruling 9730013 (use of appurtenant structures, including an indoor riding barn, for residential purposes); Letter Ruling 9722009.
9. Valuation
   a. If a substantial record of comparable marketplace sales of easements exists, value is based on such comparable sales. Reg. §1.170A-14(h)(3).
   b. If *no* substantial record of comparable marketplace sales exists, "as a general rule (but not necessarily in all cases)" value of an easement equals the fair market value of the unencumbered property (before the easement) minus the fair market value of the encumbered property. Reg. §1.170A-14(h)(3). Long-standing rule; see Prop. Reg. §1.170A-13(h)(3); Rev. Rul. 73-339, 1973-2 C.B. 68; Thayer v. Commissioner, T.C. Memo 1977-370. See also Charles H. Browning, Jr., et ux. v. Commissioner, 109 T.C. 303 (1997), holding that the purchase price paid by Howard County, Maryland, for an easement protecting agricultural land did not establish "fair market value" when it was clear the landowners intended a bargain sale and were able to establish the value of the charitable gift portion of the transaction.
   c. For the foreseeable future, as a practical matter, the "value before minus value after" will be the rule in almost every case. *Note increasing use of the cost-of-subdivision analysis*, as opposed to dollar-per-acre comparables. In that connection, see and compare Clemens v. Commissioner, T.C. Memo 1992-436, and Schapiro v. Commissioner, T.C. Memo 1991-128, especially the IRS' Action on Decision in Schapiro, AOD 1991-023. The facts in Clemens appear to raise issues not addressed by the Tax Court, such as the "dealer" question. See later in this outline and see Letter Rulings 8450065 and 8544036. See also Branch v. Commissioner, T.C. Memo 1987-321 (not an easement case), where the court rejected the comparable sales approach (similarities and differences "too numerous to be easily listed") in favor of the cost-of-subdivision approach; Glick v. Commissioner, T.C. Memo 1997-65 (also not an easement case), using cost-of-subdivision analysis; Wortmann v. Commissioner, T.C. Memo 2005-227 (evidence of recent sale price of subject property is "competent, substantial, and persuasive").
   d. Early Tax Court easement valuation cases (Symington v. Commissioner, 87 T.C. 892 (1986), Fannon v. Commissioner, T.C. Memo 1986-572, *modified on other grounds*, 842 F. 2d 1290 (4th Cir. 1988), and Stotler v. Commissioner, T.C. Memo 1987-275), demonstrated the appraisal methodology and the Tax Court's impatience with easement valuation cases.
      i. Prior to Stotler, many Tax Court easement valuation cases allowed a reduction in value (attributable to the easement) of 25% to 33%. The Stotler decision allowed a reduction of 90%. The Stotler case is a very important case for this reason.
      ii. Stotler should also be read for a look at the poor argument the IRS raised in an attempt to claim the easement was not deductible. Property owners should be aware that easement donations may be subject to a variety of attacks by the IRS. In that regard, see especially McLennan v. Commissioner, [91-1 USTC Par. 50,345], 23 Cls. Ct. 99 (1991), aff'd, No. 92-5122, 92-5128 (June 4, 1993); [91-2 USTC Par. 50,447], 24 Cls. Ct. 102 (1991).
      iii. In the historic preservation context, see Hilborn v. Commissioner, 85 T.C. 677 (1985), Nicoladis v. Commissioner, T.C. Memo 1988-163, Losch v. Commissioner, T.C. Memo 1988-230, Richmond v. U.S., 699 F. Supp. 578 (E.D. La. 1988), and Griffin v. Commissioner, T.C. Memo 1989-130, aff'd, 911 F.2d 1124 (5th Cir. 1990), generally allowing a reduction in value of 10-20% attributable to easements to protect buildings located in New Orleans and Washington, D.C., historic districts. See also Dorsey v. Commissioner, T.C. Memo 1990-242, for the proposition that in 1990 the Tax Court still had not decided how to value historic preservation easements. (See also Forte v. Commissioner, T.C. Memo 1991-36, for the proposition that the Tax

Court occasionally has had trouble with the concept of what is a "qualified conservation contribution.") Note: don't always believe what you hear about façade easements.

iv. Higgins v. Commissioner (T.C. Memo 1990-103) and Dennis v. U.S., [92-2 USTC Par. 50,498] (E.D. Va. 1992) use a "look-back" approach to valuation based on post-gift sales of easement-encumbered property. The valuation analysis in these cases depends on a percentage reduction in value attributable to the easement, rather than strictly speaking a calculation of "after" value.

v. The Tax Court gave a strong affirmation to the diminution in value approach in Johnston v. Commissioner, T.C. Memo 1997-475, based on the appraiser's analysis of "sales data of easement-encumbered properties," and allowed a 55% reduction in value attributable to an easement on a ranch in the Sheridan, Wyoming, area (according to the court, "a conservative diminution estimate" based on the data submitted).

vi. See also Strasburg v. Commissioner, T.C. Memo 2000-94, also affirming the diminution in value approach and allowing a deduction for an amendment of a previously recorded conservation easement.

vii. In Charles R. Schwab, T.C. Memo 1994-232, the court seems to have treated as a deductible conservation easement a "right to prevent development" purchased from the landowner and then donated to charity.

viii. While not easement valuation cases, Hughan v. Commissioner, T.C. Memo 1991-275, is a good example of how far an appraiser must go to value "restricted" land, and McMurray v. Commissioner is not. T.C. Memo 1992-27, aff'd, [93-1 USTC Par. 50,107], 985 F.2d 36 (1st Cir. 1993).

ix. Current IRS audit positions and activities; see Notice 2004-41, "Regarding Improper Deductions for Conservation Easement Donations."

e. With dramatically increased land values, it is impossible to overemphasize the importance of the valuation/appraisal process. In general, see Wolfsen Land & Cattle Company v. Commissioner, 72 T.C. 1 (1979).

f. If the easement covers a portion of the *contiguous* property owned by the donor *and the donor's family*, the value of the easement is equal to the value of the *entire contiguous portion* before the easement minus the value of the entire contiguous portion after the easement. Reg. §170A-14(h)(3)). This is *not* the same as the "enhancement" rule.

g. Must consider "enhancement" of *any (any)* property owned by taxpayer, taxpayer's family, or "related" parties (with expansive definition *of related parties* under Reg. §1.170A-14(h)(3)).

h. IRS will not give an advance ruling on the value of an easement, but see Rev. Proc. 96-15, 1996-1 C.B. 627, allowing a taxpayer to request a Statement of Value for a donation of art after the gift is made but before the tax return is filed claiming the deduction.

i. For an interesting look at the relevance of post-death events (held: not relevant) in arriving at estate tax value, see McMorris v. Commissioner, 87 AFTR2d Par. 2001-668 (10th Cir. 2001); Algerine Allen Smith v. Commissioner, 198 F.3d 515 (5th Cir. 1999); but see also Morrissey v. Commissioner, No. 99-71013 (9th Cir. Mar. 15, 2001).

10. Allocation of basis to easement, with resulting lower basis in retained interest. Reg. §1.170A-14(h)(3)(iii) and Examples (10), (11), and (12) of Reg. §1.170A-14(h)(4).

11. Under certain circumstances, if an easement is extinguished, and the subject land is later sold, Reg. §1.170A-14(g)(6) requires that the donee organization (that held the easement) be entitled to a portion of the proceeds from the sale. There appears to be no further law on this point (beyond the rule in the regulations). See, however, In re Preservation Alliance for Greater Philadelphia, Orphans' Court Division, Court of Common Pleas of Philadelphia (O.C. No. 759 of 1999), allowing the extinguishment of a Facade Easement on and the demolition of an historic structure that had fallen into extreme disrepair after its abandonment in 1989, subject to a further recorded "Mutual Termination and Extinguishment of Facade Easement and Declaration of Continuing and/or Additional Covenants and Restrictions" generally requiring that the site be used solely for park purposes. (According to counsel for the Preservation Alliance, there is apparently no evidence of any other historic preservation easement being extinguished in Pennsylvania.)

12. Letter Ruling 8810024 may have permitted amendment of an easement, but it is unclear from the ruling whether it related to an easement that had already been donated or simply modified an earlier ruling request. But see Strasburg, cited above, and "Amending Easements," later in this outline.

13. In *almost* every state, a conservation easement will generally not prevent condemnation. See, however, Va. Code Ann. §10-153(a). The regulations do *not* address the division of proceeds in the event of a condemnation of property subject to a conservation or preservation easement, and there is very little authority on this point. See, Hartford National Bank and Trust Company v. Redevelopment Agency of City of Bristol, 321 A.2d 469 (Conn. 1973); Schwartz v. State of New York, 95 Misc. 2d 525, 408 N.Y.S. 2d 239, aff'd, 72 App. Div. 2d 490, 426 N.Y.S. 2d 100. See also the National Historic Preservation Act, 16 U.S.C. §§470-470w-6 and §4(f) of the Department of Transportation Act, 49 U.S.C. §1652(f).

14. Water rights; see, on an unrelated water rights issue, Gladden v. Commissioner, 112 T.C. No. 15 (Apr. 15, 1999) rev'd on other grounds, No. 00-70081 (9th Cir. Aug. 20, 2001), 88 AFTR 2d Par. 2001-5028 (water rights in this case a capital asset); See Letter Rulings 200307013 and 200404044 (water rights as capital assets); compare Wiechens v. U.S., No. CIV 00-1858-PHX-SMM (D. Ark. Sept. 11, 2002) (water rights of a limited duration are not the same as perpetual water rights and are not "like-kind" for purposes of §1031); compare, on the capital asset question, TAM 200119005 (film library, in this case, not a capital asset).

15. For a brief but interesting discussion of the "partial interest" rules, see Revenue Ruling 2003-28, 2003-11 I.R.B. 594; see also TAM 200610017 on partial interest and deductibility issues.

16. Substantiation (Reg. §1.170A-13T(c)(1))

a. A taxpayer who claims a value in excess of $5,000 for a charitable gift must have a "qualified appraisal" supporting the claimed value.

b. If the value of the deduction is more than $500,000, the "qualified appraisal" must also be attached to the return. See the new Form 8283 and the new *instructions!!*

c. The taxpayer must file with his or her tax return IRS Form 8283, "Noncash Charitable Contributions."

d. Form 8283 requires an acknowledgment by the donee organization. If the donee organization disposes of the property within two years, the organization must file with the IRS Form 8282, "Donee Information Return," and must provide the taxpayer with a copy.

e. A "qualified appraisal" must include, among other things, a description of the property, the method of valuation used to determine the fair market value of the property, certain information about the appraiser, and a description of the fee arrangement between the donor and the appraiser.

f. The "qualified appraisal" must be done by a "qualified appraiser." See the new definition of "qualified appraiser," and see Notice 2006-96. Under some circumstances, however, reliance on the appraiser is not sufficient. See McMurray v. Commissioner, cited above.

g. The appraisal cannot be completed more than sixty days prior to the date of the gift. The appraisal must be received by the donor before the due date (including extensions) for the federal tax return for the year in which the gift was made. In the case of a deduction first claimed on an amended return, the appraisal must be received by the donor no later than the date on which the amended return is filed. Reg. §1.170A-13(c)(3)(i)(A).

h. Failure to comply with the appraisal requirements will mean that the deduction will not be allowed. In more than one case, the IRS has moved to disallow an easement deduction because the appraisal was totally inadequate. See, however, Bond v. Commissioner, 100 T.C. 32 (1993); Hewitt v. Commissioner, 109 T.C. 258 (1997); Ney v. Commissioner T.C. Summ. Op. 2006-154; No. 10257-05S; September 19, 2006.

i. See also the substantiation requirements under §170(f)(8) and Weiner v. Commissioner, T.C. Memo 2002-153, aff'd., No. 02-73609 (9th Cir. July 8, 2004); Addis v. Commissioner, 118 T.C. 32 (2002), aff'd., No. 02-73628 (9th Cir. July 8, 2004) (deduction denied for failure to substantiate).

17. Watch out for "bad" easement deals, either those allowing too much building to satisfy the conservation tests of §170(h) or those with grossly inflated/abusive appraisals. I have in my files offering papers for an interest in this transaction: (1) promoter/LLC purchases land for $3 million; (2) promoter has in hand (as I do) an appraisal that says a conservation easement on the property, the income tax deduction for which will flow through to investors, is valued at $54,800,000.

18. In that connection, see Stephen J. Small, "Conservation Easements Today: The Good and the Not-So-Good," Exchange (the Journal of the Land Trust Alliance), Vol. 22, No. 2, Spring 2003, pp. 32-34; and Stephen J. Small, "Local Land Trust Signed a Fraudulent Tax Form!", Exchange, Vol. 22, No. 3, Summer 2003, pp. 5-7.

C. Other federal tax issues

1. See Stephen J. Small, "Proper – and Improper – Deductions for Conservation Easement Donations, Including Developer Donations," Tax Notes, October 11, 2004, pp. 217-224. Harry Investor has (at least) five problems.

a. The conservation purposes tests of §170(h).

b. *Quid pro quo* trap: Harry Investor proposes donating to the town a conservation easement if the town approves his application for a new subdivision. Harry's "deal" is not a gift, and no deduction is allowable. This not just "conservation" law, it is part of the underlying law of charitable contributions. See Ottawa Silica Company, Ct. Cl. No. 27-278, 49 AFTR 2d 1160 (1982); Jordan Perlmutter, 45 T.C. 311 (1965); and Reg. §1.170A-14(h)(3)(i). For a rather confusing discussion of a quid *pro quo* situation, see Letter Ruling 9239002. For another approach to this issue, read Perlmutter carefully and see Letter Ruling 9352006.

c. The appraisal rules.

d. The basis allocation rules.

e. If Harry can get by all of these other hurdles, will his deduction be limited to his "basis" (or cost) of the donated property? See §170(e)(1)(A) and Pasqualini v. Commissioner, 103 T.C. 1 (1994).

f. On the matter of "dealer" status, for cases favoring the taxpayer, see, Charles E. Meig, 32 T.C. 1314 (1959), acq. 1960-2 C.B. 6; Eline Realty Co., 35 T.C. 1 (1960), acq. 1961-1 C.B. 4; Frank H. Taylor & Son, Inc., T.C. Memo 1973-362; DuVal v. Commissioner, T.C. Memo 1994-603; Paullus v. Commissioner, T.C. Memo 1996-419. For cases in which the results have generally been unfavorable to the taxpayer, see, for example, Biedenharn Realty Co., Inc. v. United States [76-1 USTC Par. 9194], 526 F.2d 409 (5th Cir. 1976) (en banc), cert. denied, 429 U.S. 819, 97 S. Ct. 64, 60 L. Ed. 2d 79 (1976); Houston Endowment, Inc. v. United States [79-2 USTC Par. 9690], 606 F.2d 77 (5th Cir. 1979); United States v. Winthrop [69-2 USTC Par. 9686], 417 F.2d 905 (5th Cir. 1969); Suburban Realty Co. v. U.S., [80-1 USTC Par. 9351], 615 F.2d 171 (5th Cir. 1980). The Internal Revenue Service has an "ordinarily will not rule" policy on the question of whether property is held for sale to customers in the ordinary course of a trade or business. Sections 3 and 4 of Rev. Proc. 2005-3, IRB 2005-1; see Letter Ruling 9537018.

g. Very tricky issue: when does a landowner become a "dealer"? Watch out for situations in which a "mere" landowner blurs the line and begins to engage in development activity.

h. See the interesting separate line of cases on "liquidation" of inherited (or gifted) property, including J.C. Simpson Est., T.C. Memo 1962-71; Yunker v. Commissioner, [58-1 USTC Par. 9487], 256 F. 2d 130 (6th Cir. 1958) ("this elderly couple" could not have been "engaged in the ordinary course of business of selling lots"); Reidel v. Commissioner, [58-2 USTC Par. 9966], 261 F. 2d 731 (5th Cir. 1958). Compare United States v. Winthrop, cited above.

i. Common error by developers (and non-developers) in this field: failure to *start* planning with a review of the "conservation purposes" test. Deduction isn't simply for foregone building; first you must meet the conservation purposes test, *then* you get a deduction for foregone value.

j. See Turner v. Commissioner, cited above. Read the case and see how many things Mr. Turner did incorrectly.

2. Holding period issues; see §§170(e)(1)(A) and 1222(3) and (4) and Griffin v. Commissioner and Strasburg, cited above. The taxpayer was fortunate in Griffin that the calculation of "value" in fact relied on basis. This issue comes up frequently in "conservation buyer" cases.

3. Deductibility of corporate gifts limited to 10% of corporation's taxable income, with 5-year carryforward of the balance.

4. "Restricted" gifts: a potential trap. See Rev. Rul. 85-99, 1985-2 C.B. 83. A recent case on point was settled just before Tax Court trial, although see the deed of gift in Garrison v. Commissioner, T.C. Memo 1986-261. On the other hand, see Forte v. Commissioner, T.C. Memo 1991-36 and Letter Ruling 8713018. Compare Letter Ruling 200202032 (gift of art by will, subject to certain limiting conditions).

a. Never trust an unrestricted piece of property. See, "The Promised Land," Santa Barbara Magazine, May/June 1993. On the other hand, see "An act of love by Grand Marais," Minneapolis Star Tribune, January 1, 1997 (Grand Marais, Minnesota, donates an easement on 60 acres of publicly-owned but previously unrestricted open shoreline to the Minnesota Land Trust), and "Medford Jewel Protected by Conservation Team," Special Places (quarterly newsletter of The Trustees of Reservations), Volume 6, No. 1, winter 1998, pp. 3-4 (City of Medford donates conservation restriction to The Trustees of Reservations, Massachusetts District Commission, and Massachusetts Historical Commission on historic 49.8 acre estate). Land trusts are increasingly holding easements on land held by public or other charitable entities.

b. Never trust an unrestricted piece of property, but see "Nuns view land as a sacred trust," Boston Globe, December 23, 2004, Section W, p. 1; Dominican nuns have formed Religious Lands Conservancy Project, in partnership with Massachusetts Land Trust Coalition, to address land owned by religious organizations.

c. On the other hand, see Town of Chelmsford v. Greater Lowell Council, Inc., Boy Scouts of America, Mass. Land Court Misc. Case No. 261762, April 26, 2001 (deed from Town said grantee shall never deed or grant the premises to any other than grantor; held, charitable trust imposed and deed meant what it said; court noted parcel is "at the end of Penni Lane which (as the late John Lennon might have observed) sits 'there beneath the blue suburban skies' of Chelmsford").

d. Consider donation of easement to one organization and restricted fee to another organization (see VIII (B)(3), below).

e. See Reg. §1.170A-7(a)(2)(ii): "A deduction is allowed without regard to this section for a contribution of a partial interest in property if such contribution constitutes part of a charitable contribution not in trust in which all interests of the taxpayer in the property are given to a charitable organization described in Section 170(c)." This rule raises interesting drafting possibilities and may require only one appraisal for simultaneous "partial interest" gifts.

5. In Technical Advice Memorandum 8736003 and Letter Ruling 8808038, the IRS ruled that the donation of an easement on historic property with respect to which an investment tax credit had already been claimed would not trigger recapture of the investment tax credit. That position was reversed in Rev. Rul. 89-90, 1989-2 C.B. 3, and in Rome I Ltd. v. Commissioner, 96 T.C. 697 (1991).

6. The carryforward of the charitable income tax deduction is available only to the person who made the contribution. See Dieter Stussy v. Commissioner, T.C. Memo 1997-293.

D. Be aware of the potential estate tax valuation traps in connection with property subject to an easement that somehow fails to meet the requirements of §§170(h) and 2055. The rules of §2703 are an important reason to be especially cautious about less-than-perpetual easements.

1. Note that §2703(a) states that "the value of any property shall be determined without regard to... (2) any restriction on the right to sell or use such property." There is a general exception for so-called "bona fide business arrangements" (subject to specific Code requirements).
2. See Reg. §25.2703-1(a)(4), excepting from the rule of §2703(a)(2) "a perpetual restriction on the use of real property that qualified for a charitable deduction under either Section 2522(d) or Section 2055(f)."
3. What does this new scheme mean for 25-year easements sold to the county in a farmland-protection program? Bargain-sold to the county? For 30-year easements donated to the land trust?
4. "Private" restrictions: tax problems? Enforceability problems?

E. Generation skipping tax (§2601)

1. Subject for another program
2. *On top* of estate and gift tax; generally to be avoided
3. *Enormous* impact of successive generations subject to high estate tax (examples); GST exemption presents important planning opportunities (§2631)

F. State issues

1. Review and understanding of any relevant state authorizing legislation is essential.
2. Review and understanding of any relevant state case law is also essential. See, among others, Bennett v. Comm. of Food and Agriculture, 411 Mass. 1 (1991); Parkinson v. Board of Assessors of Medfield, 398 Mass. 112 (1986) and 395 Mass. 643 (1985); Goldmuntz v. Town of Chilmark, 38 Mass. App. Ct. 696, 651 N.E. 2d 864 (1995); compare Racine v. United States, 858 F. 2d 506 (9th Cir. 1988). See also Freeport Conservation Trust v. David J. Dunfey; Cumberland County (Maine) Superior Court Civil Action Docket No. CV-95-483 (three orders dated June 29, 1995, July 17, 1996, and August 22, 1996); French and Pickering Creeks Conservation Trust, Inc., v. Natale, No. 2131 Philadelphia 1992 (Superior Court), October 5, 1993 (reversing and remanding Final Decree of May 18, 1992, Court of Common Pleas of Chester County, Civi1 Division, at No. 89-09574); Arkansas Historic Preservation Program v. Johnston, No. IJ95-7635 (Ark. Chanc. Ct. Feb. 19, 1997); Chatham Conservation Foundation, Inc., v. Gould, Mass Land Court Misc. Case No. 251380, November 16, 2000; Maryland Environmental Trust v. Gaynor, 140 Md. App. 433, 780 A. 2d 1193 (2001), rev'd Maryland Court of Appeals, 370 Md. 89, 803 A.2d 512 (2002); Chatham Conservation Foundation, Inc., v. Farber, No. 01-P-63, June 18, 2002 - November 25, 2002 (dispute over walkway to beach); Weston Forest and Trail Association v. Fishman, No. 05-P-1076, June 30, 2006 (Fishman ordered to remove barn built in violation of conservation restriction).
3. See M.P.M. Builders, LLC, v. Dwyer, Mass. SJC-09195, April 8, 2004 – June 15, 2004, for an interesting discussion and analysis of common law, case law, and Restatement of Property views on amending old-fashioned easements.
4. See also Lamb et al v. Wyoming Game and Fish Commission, No. 98-14, Wyoming Supreme Court (July 14, 1999), requiring landowners to clear obstructions from public access easements (for recreational purposes) previously purchased by Game and Fish. On the other side. On the other had, see McLaughlin, "Could Coal Bed Methane Be the Death of Conservation Easements?", Wyoming Lawyer, October, 2006; Vol. 29, No. 5, and discussion therein.
5. For an important case upholding a 3-acre zoning scheme on Martha's Vineyard designed to protect "extremely sensitive environmental resources ... including Atlantic Ocean Coastal Ponds and rare coastal habitat," see Herring Creek Farm Trust v. Town of Edgartown, Mass. Land Court Misc. Case No. 198373, January 25, 1996. See also "Herring Creek Farm Sells for Record $64 Million; Conservation Vision Saves Fragile Lands After Decade of Environmental Battles," Vineyard Gazette, July 27, 2001, page 1ff.
6. The treatment of charitable contributions varies widely for state income tax purposes, and more states now have income tax incentives for easement donations. See, i.e., H.B. 260, Laws 1997 (North Carolina), allowing an individual a personal income tax credit of up to $100,000 ($250,000 for corporations) for real property donated for conservation purposes.
7. See ITA [technical assistance] 200126005 and ILM [legal memorandum] 200238041 for IRS views on the transferable and refundable Colorado state income tax credit for easement donations.

V. CONSERVATION EASEMENTS 2007 – HOW TO FIX WHAT'S WRONG

A. Crackdown on prior abuses: better enforcement and targeted audit policy.

1. See SCDOR
2. See Small, Tax Notes, October 11, 2004 (cited previously) on new questions for Form 8283

B. Tighter appraisal standards and penalties

C. Increased reporting requirements for easement donees: tell us about the monitoring you have done lately and what your monitoring and enforcement plans are next year.

D. Accreditation of donee organizations

E. Crackdown on prior abuses: better enforcement and targeted audit policy (sic).

VI. CURRENT AREAS OF CONCERN

A. Required endowment "contributions"

B. "Conservation buyer" deals, in which the buyer is permitted to purchase the subject property only with an enforceable commitment in place to donate a conservation easement; see Form 8283 instructions; see Letter Ruling 200530016 for a possible clue to structuring conservation buyer transactions.

C. Amending easements

D. Some questions on amending easements:

1. Better, worse, neutral for conservation values?
2. Increase or decrease in value of restricted land?
3. If increase, offset by some additional (non-deductible?) "payment" by landowner?
4. If yes to #3, does this mean you can buy your way out of a perpetual easement?
5. If yes to #3, is *any* private inurement prohibited (even if you net it out, as in #3)?
6. What is the fiduciary responsibility of the easement holder to its members, the public, and its status as a charitable organization? One possible answer: to do the right thing, which means some amendments, on the right set of facts, might be permitted (but….might not).

VII. OTHER TAX INCENTIVES POTENTIALLY HELPFUL FOR LANDOWNERS — A VERY BRIEF OVERVIEW

A. Bargain sale

1. John and Mary paid $200,000 for their scenic property, and it is now worth $800,000
2. They "just want to get their money out," so they sell it to a tax-exempt conservation organization for $200,000.
3. Surprising tax results:
   a. Basis is allocated between the "sale" portion and the "gift" portion. §1011(b).
   b. The amount realized ($200,000) is 25% of the fair market value ($800,000); 25% of the basis is allocated to the "sale" portion and 75% of the basis is allocated to the "gift" portion.
   c. Gain is $150,000 ($200,000 minus $50,000 allocated basis); gift is $600,000, with a *basis* in the gift of $150,000.
4. For an analysis of the interaction between §1011(b) and §170(e)(1) (allowing, and sometimes requiring, a reduction in the amount deductible for charitable contribution purposes), see Estate of Bullard v. Commissioner, 87 T.C. 261 (1986).
5. See also Arbor Towers Associates, Ltd., v. Commissioner, T.C. Memo 1999-213, a "bargain

sale" case that is really a "fair market value" case (under Reg. §1.170A-1(c), fair market value is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts"). See Wortmann, cited above.

6. Increasing use of an option to bargain purchase an easement or a fee interest in property; see Rev. Rul. 82-197, 1982-2 C.B. 72 (an individual who grants an option on real property to a charitable organization is allowed a charitable deduction for the year in which the option is *exercised* [is *exercised*] in the amount of the excess of the fair market value on the date the option was exercised [was *exercised*] over the exercise price); "Determining The Value of Donated Property," IRS Publication 561 (Rev. February 2000), p. 2. See also Musgrave vs. Commissioner, T.C. Memo 2000-285, on the matter of the passing of the benefits and burdens of ownership; Letter Ruling 200241044 (agreement to endow a research institute not a completed gift until contributions were made). Compare Rev. Rul. 80-186, 1980-2 C.B. 280.

B. Gift of a remainder interest

1. After life estate or term of years
2. Can be a gift of a personal residence or farm under §170(f)(3)(B)(i), not subject to "conservation purposes" test of §170(h). See Letter Rulings 9538040 and 9714017.
3. Can be a gift of any real property, for conservation purposes, under §170(h). Difficult conceptual and tax planning problems; possible traps (see Rev. Rul. 85-99)?? Almost no law on this.
    a. Property is subject to "conservation purposes" restrictions during (and after?) the reserved estate
    b. Never trust an unrestricted piece of property.
    c. Consider donation of easement to one organization and remainder to another organization. Maximizes tax benefit; minimizes confusion; ensures protection of the property (remainder gift, under this scenario, can be given to non-conservation organization); avoids any possible "merger" issues. See, The Federal Tax Law of Conservation Easements, Appendix E; Parkinson v. Board of Assessors of Medfield, 398 Mass. 112 (1986), note 1, and Reg. §170A-7(a)(2)(ii).
4. Valuation of gift depends on actuarial tables based on interest rates that may now be redetermined monthly.
    a. Not very favorable *income* tax results
    b. The income tax deduction, using recent IRS tables, for the gift of a remainder interest in property worth $5,000,000, husband age 65 and wife age 62, is $1,180,950.
    c. The *estate tax* result is, of course, much more significant: the property is *not included* in the estate.

C. Testamentary gift (by will) (not §2031(c)(9))

1. Estate tax deduction allowed for a testamentary gift of an easement. §2055(a); see also §2055(f).
2. Almost no law on easement donations by wills, but see Letter Ruling 8204020.
3. Recommendation: for the highest level of certainty, to the extent possible the actual language of the deed of easement should be incorporated into the will. "Ascertainability at the date of death of the amount going to charity is the test." Estate of David N. Marine v. Commissioner, 97 T.C. 368 (1991); aff'd, [93-1 USTC Par. 60,131] (4th Cir. 1993); see also Estate of Lockett v. Commissioner, 75 T.C. Memo 1998-50 (decedent's designation in will to set aside her home as historical site did not qualify as estate tax charitable deduction).
4. Examples of when this may be useful; a very underrated planning tool. Compare with §2031(c)(9).
5. Note differences between pre-death planning and post-death planning. Consider the disclaimer rules under §2518; it does not appear possible to "disclaim" a conservation easement. For what appears to be (but was it??) interesting and sophisticated disclaimer planning, see Letter Rulings 9317039, 9319022, and 9320008; see also Letter Rulings 9532027 and 199903019.

D. Special use valuation for farmland and ranchland (§2032A)

1. *Grossly misunderstood* (ask the family's attorney for estate tax projections).
2. Certain farming and ranching property used as farming property will be valued, for federal estate tax purposes, *as farmland*, rather than at a higher, market value; limitation on *reduction in value* is now $850,000.
3. Election required; compliance with numerous technical and substantive requirements of the election is *critical*.
4. Many estates qualifying for special use valuation will also qualify for deferral and installment payments of federal estate tax under §6166. See also Estate of Hoover, 69 F.3d 1044 (10th Cir. 1995), allowing the §2032A reduction in value to be applied against the fair market value of a discounted minority interest in property.
5. Recapture tax applies if, within 10 years after the date of the decedent's death and before the death of the qualified heir, the qualified heir disposes of any interest in the property to someone outside the family or ceases to use the property for a qualified use. For many years the IRS treated the donation of an easement on property subject to a §2032A election as triggering recapture. See Letter Rulings 8731001 and 894011. However, §2032A has been amended and now the *donation* (not the sale; see Gibbs, cited below) of an easement in such cases will *not* trigger recapture. See also Letter Rulings 9503015 and 9604018, holding that an *exchange* of qualified property under §1031 is not a disposition for purposes of §2032A. Compare, for the fun of it, Hamilton v. Batchelder, 10 LCR 32, Mass. Land Court Misc. Case No. 256954, February 11, 2002 (donation of conservation restriction is not a "transfer" triggering a neighbor's right of first refusal to purchase some of Batchelder's land).
6. In a case concerning a New Jersey estate, the IRS initially claimed that the acquisition by the State of New Jersey of a 10-year "conservation servitude" on land that had been subject to a §2032A election triggered the recapture tax, but the IRS ultimately conceded the issue and no recapture tax was assessed. Estate of John J. Schnetzer v. U.S., United States District Court for the District of New Jersey, Civil Action No. 93-4267 (GEB). However, see Estate of Gibbs v. United States, 81 AFTR 2d. Par. 98-891 (D.N.J. 1997), rev'd 82 AFTR 2d. Par. 98-5557 (CA-3, 12/1/98). The trial court in Gibbs found that under New Jersey law the "conservation or equitable servitude" was not an interest in land but a contract right; the Third Circuit reversed and held that the granting of an easement was a disposition under §2032A.
7. This Code section is fraught with traps and landowners must pay very careful attention to all of the requirements. For one of the few favorable rulings on a §2032A election, and an unusual fact pattern (landowner planned to develop horse farm but died before subdivision application was filed), see Letter Ruling 9433003; see also FSA 1999-614.
8. For an interesting ruling that sometimes an irrevocable election isn't, see Letter Ruling 200229004 (not a §2032A matter, however).
9. Run the numbers!!

E. Tax-free swaps of real estate and interests in real estate (§1031)

1. Must be exchange of "property held for productive use in a trade or business or for investment" for "property of a like kind which is to be held either for productive use in a trade or business or for investment."
2. Much litigation, many rulings. Follow the rules carefully!! See Letter Ruling 9431025; Letter Ruling 9829025 (taxpayer's death before completion of deferred exchange ignored). But see Letter Ruling 20004017 (definition of U.S. is "enlarged" to include the U.S. Virgin Islands); Letter Ruling 200118023 (acquisition of the sole interest in a limited liability company, which owns real property, will be treated as acquisition of like-kind replacement property).
3. Understood and used by sophisticated investors, but not by landowners in general. Wide range of planning possibilities. See Peabody Natural Resources Co. v. Commissioner, 126 T.C. No 14, May 8, 2006 (coal supply contracts were covenants running with land in a §1031 exchange).
4. See especially Letter Rulings 8334026, 9215049, and 9232030, treating as a tax-free like-kind exchange the swap of a conservation easement for farmland. The state law characterization of an easement (for example, property interest or contract right) will potentially be important for §1031 purposes. See also Letter Rulings 9601046, 9621012, and 200203033, with similar holdings on the like-kind issue. But see Rev. Rul. 72-601, 1972-2 C.B. 467 (life estate not like kind with remainder interest).

5. See Letter Ruling 9612009, holding that ecological impact "mitigation credits" qualify as like-kind property; Letter Ruling 200532008, holding as "like-kind" FCC spectrum rights licenses.

6. Watch for post-exchange holding period requirements; see Click v. Commissioner, 78 T.C. 225 (1982)

7. See Rev. Proc. 2002-2 C.B. 438 (IRS will not rule on whether an undivided fractional interest in real property is eligible/ineligible for tax-free exchange treatment under §1031).

F. Consider in appropriate cases "leveraging acquisition dollars"

a. Find out: what does the seller really really want?

b Then do the tax planner for the seller

c Examples

VIII. ESTATE TAX TREATMENT OF CERTAIN LAND SUBJECT TO A "QUALIFIED CONSERVATION EASEMENT" (§2031(c))

A. Background

1. 1990 bill: land subject to a conservation easement shall be exempt from estate tax.

2. 1997 law (effective for decedents dying beginning in 1998) added two significant new tax incentives to the law:

a §2031(c) "exclusion": if you die owning land subject to a conservation easement, and if you meet the geographic, holding period, and activity limitations, up to 40% of the *land value* can be excluded from the gross estate.

b §2031(c)(9) allows an estate tax charitable deduction under §2055 for a *post-mortem* conservation easement donation. Compare **Example 1, Example 2,** and **Example 8,** below, with pre-§2031(c)(9) law.

3. Overview of exclusion

a. Note at the outset that the easement must have met the requirements of §170(h) for the estate to be eligible for §2031(c).

b. Briefly, to meet the requirements of §170(h):

i. The landowner must donate a qualified real property interest (a conservation easement is a qualified real property interest)

ii. To a qualified organization

iii. The gift must meet one of the "conservation purposes" tests

iv. The easement must be perpetual (see §2703 and Reg. §25.2703-1(a)(4) for possible estate and gift tax valuation consequences associated with the transfer of a non-perpetual easement)

c. It is possible to meet the requirements of §170(h) and *not* meet the requirements of §2031(c) (see below), but the tax benefits of §170(h) are available *whether or not* the estate takes advantage of §2031(c), and the benefits of §2031(c) are available *in addition* to the benefits of §170(h).

d. **Example 1: Lifetime Gift**. Sue owns Diamond Farm. In 1996, Sue donates a conservation easement on 1,000 acres of open land at Diamond Farm, permitting continuing agricultural and ranching activities but otherwise permitting no further development and prohibiting commercial recreational activities. Before the donation of the easement, the land was valued at $1,500,000. The easement met all the requirements of §170(h) of the Code and reduced the value of the restricted land to $1,000,000. Sue dies in 2001. Assume the land is still worth $1,000,000. Assume all the requirements of §2031(c) are met.

Analysis: Sue was entitled to a $500,000 income tax deduction when she donated the easement and the land is valued at $1,000,000 in her estate. Sue's estate is eligible for the §2031(c) exclusion, which further reduces the value of the land to $600,000 (by excluding 40 percent of the $1,000,000); the exclusion is limited to $400,000 in 2001. (The exclusion increased by $100,000 each year until 2002; it is now capped at $500,000 for 2002 and thereafter.) If Sue's executor elects to claim the exclusion, $600,000 of land value ($1,000,000 minus $400,000) will be subject to tax in Sue's estate.

e. **Example 2: Easement Donated in a Will**. Assume the facts are the same as in Example 1, except that the easement is donated under Sue's will rather than during her lifetime.

Analysis: Because the easement was not donated during Sue's lifetime, she was not entitled to an income tax deduction. The full value of the land ($1,500,000) is included in Sue's estate, the easement is effective on Sue's death, and Sue's estate receives an estate tax charitable deduction under §2055(f) for the $500,000 value of the easement. In effect, $1,000,000 of land value is subject to estate tax. In addition, as in **Example 1,** Sue's estate is eligible for the $400,000 §2031(c) exclusion in 2001.

4. Message to landowners and the professional planning community: this is a very important new tax code provision. There are questions about how it works but there is a lot that we do know about how it works. See Stephen J. Small, "Understanding the Conservation Easement Estate Tax Provisions," Tax Notes, April 17, 2000, pp. 435-439; Stephen J. Small, "Understanding the IRC 2031(c) Estate Tax Provisions," Exchange (The Journal of the Land Trust Alliance), Vol. 18, No. 4, Fall 1999, pp. 8-12; L. Timothy Lindstrom and Stephen J. Small, "New Estate Tax Relief for Land Under Conservation Easement," Tax Notes, March 2, 1998, pp. 1171-1184; Robert H. Levin, "You're Not Too Late: Post-Mortem Donations of Conservation Easements," Tax Notes, October 30, 2000, p. 661.

B. Limitations

1. Exclusion was capped at $100,000 in 1998, increasing by $100,000 each year up to $500,000 in 2002 and thereafter.

a. if the planning is done correctly, the estates of *both spouses* can be eligible for the §2031(c) exclusion. Note that care must be taken in the allocation of assets in the estate plan; to the extent that land subject to a conservation easement and eligible for the §2031(c) exclusion is part of a marital bequest, the exclusion will be of no benefit on the death of the first spouse with respect to that land. See Kasner, "Using New Estate Tax Exclusions with Marital Deductions," Tax Notes, March 30, 1998, pp. 1658-1660.

b. The §2031(c) exclusion may be combined with other estate tax provisions that can benefit land-based businesses.

2. For decedents who died before January 1, 2001, the land had to be within a 25-mile radius of a national park, wilderness area, or Metropolitan Statistical Area, or within 10 miles of an Urban National Forest. This rule was eliminated in the 2001 tax act for decedents dying after December 31, 2000.

a. The national park or wilderness area rule states that such land is eligible for §2031(c) unless the Secretary of the Treasury determines that such land is "not under significant development pressure."

b. Based on a strict interpretation of that rule, such a determination could conceivably be made during an audit of the estate tax return claiming the §2031(c) exclusion.

3. Easement must have been donated and must have met the requirements of §170(h), although easements solely to protect historic assets are not eligible.

a. According to one account, the exclusion of historic property is an early drafting error that became law. According to another account, it represents an intentional policy decision.

b. This rule can be avoided in the case of many historic properties by taking care to craft a conservation easement that also meets one or more of the other conservation purposes tests under §170(h).

4. Land must have been owned by the decedent or a member of the decedent's family for at least three years prior to the decedent's death.

a. The easement must have been donated by the decedent or a member of the decedent's family (or by the executor of the decedent's estate or a trustee of a trust holding the subject property).

b. Mr. Able donates a conservation easement in 1998 and dies in 2003. He leaves his land to his daughter Sally. His estate is eligible for the §2031(c) exclusion. Sally dies in 2028. She leaves the land to her daughter. Sally's estate is eligible for the §2031(c) exclusion. Etc.

5. "Retained development rights" can be extinguished after the death of the decedent. See Letter Ruling 200014013 (December 22, 1999).

a. **Example 3: Easement with Retained Development Rights**. Assume the facts are the same as in Example 1 except that the easement reserved the right to build, subdivide, and convey into separate ownership two new residences on five-acre house lots on the land.

Analysis: §2031(c) says the exclusion does not apply to the value of "retained development rights." §2031(c)(5) generally defines a retained development right as a commercial right that is not "subordinate to and directly supportive of" the use of the land for farming purposes. The right to subdivide and convey two five-acre house lots certainly appears to be a retained development right. If Sue's heirs take no action, the value of the house lots will not be eligible for the §2031(c) exclusion and will be fully subject to estate tax (although the exclusion will apply to the remaining land value).

However, §2031(c)(5) also says that after the death of the landowner, the heirs can agree to extinguish any or all of the retained development rights; if they do that the estate tax will be recalculated as if the extinguished development rights had not been reserved in the easement in the first place. ("Heirs" is shorthand; the statute says that "every person in being who has an interest… in the land" can agree to extinguish retained development rights.)

If the heirs decide to do that, §2031(c)(5) says they must execute an "agreement" to extinguish the retained development rights within nine months after the decedent's death (by the original due date for the estate tax return; see Letter Ruling 200014013); they must file the agreement with the estate tax return (which is due nine months after the decedent's death, unless the estate receives a six-month extension), and then they have two years after the decedent's death to extinguish the development rights. The IRS is quite particular about the contents of the "Agreement to Extinguish," and has confirmed this in Letter Ruling 200014013.

b. Some landowners and/or donee organizations prefer leaving potential future house lot sites outside of the tract of land to be encumbered by a conservation easement. The ability to retain or *extinguish* those rights may make it prudent to include them under the easement.

c. This can provide a very important "second look," for economic, land protection, and estate planning purposes, after the landowner's death.

d. Neither the statute nor the legislative history gives us any guidance on how to extinguish retained development rights. It appears that there are at least two ways to do this. The preferred option is likely to depend on the particular set of facts.

i. Amend the existing conservation easement solely to eliminate the specific rights.

ii. Amend and restate the entire existing conservation easement.

6. The easement must prohibit all but "*de minimis*" commercial recreational use of the land.

a. §2031(c)(8)(B) reads as follows: "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."

b. **Example 4: Commercial Recreational Activities**. Once more, assume the same facts as in Example 1, except the easement does not specifically prohibit commercial recreational activities.

Analysis: Note first that for the estate to be eligible for the §2031(c) exclusion, under §2031(c)(8)(B) the easement must prohibit more than *de minimis* commercial recreational activities. Without any formal guidance from the IRS to date, it is not always clear what is meant by *de minimis* commercial recreational activities. (Would a dude ranch exceed *de minimis* commercial recreational activity? Most likely. A summer camp for children? Most likely.) What is clear is that the easement must prohibit more than *de minimis* commercial recreational activities to be eligible for any of the benefits of §2031(c). In addition, it appears under Letter Ruling 200014013 that commercial recreational activities are rights that can be extinguished *post-mortem*, if the heirs agree to do so. Since it is clear that the executor of an estate can donate a *post-mortem* easement (more on this in **Example 8**), the executor of an estate can also amend an existing easement to eliminate commercial recreational activities that would otherwise make an estate ineligible for the §2031(c) exclusion.

c. Much remains to be learned about this rule.

d. The conference committee report notes that "de minimis commercial recreational activity that is consistent with the conservation purpose, such as the granting of hunting and fishing licenses, will not cause the property to fail under this provision."

e. If possible, consider using one easement on a portion of the property where commercial recreational activities are non-existent or clearly *de minimis* and another easement where such income-producing activities occur.

f. Although it is understood that the executor can donate a *post-mortem easement amendment* in order to eliminate otherwise prohibited commercial recreational activities and therefore allow the estate to be eligible for §2031(c), note the complex and difficult state law and other issues that arise in connection with post-mortem charitable gifts. Those issues are beyond the scope of this outline, except as noted in D below. See Letter Ruling 200014013 (December 22, 1999), the first letter ruling issued under §2031(c), ruling (among other things) that the right to carry on commercial recreational activities is a retained development right that can be extinguished *post-mortem*.

7. An amount of land value equal to the amount of any mortgage on the property will not be eligible for the exclusion.

8. To the extent of the exclusion land will receive a "carryover basis," rather than a "stepped-up basis" at the decedent's death.

a. In the vast majority of cases when an estate is eligible for the §2031(c) exclusion it will make sense to make the election. Obviously, if the taxable estate is below the unified credit threshold the election will not be necessary or warranted.

b. The methodology for making the basis calculations does not appear to involve a simple dollar-for-dollar tradeoff.

c. **Example 5: Carryover Basis Calculation**. Mr. Able owns land with a fair market value of $2,000,000 and a basis of $200,000. In 1998 he donates a qualifying conservation easement that reduces the value of his land to $1,000,000. Under Reg. §1.170A-14(h)(3)(iii), the basis of the easement is $100,000 and the basis of the land is reduced to $100,000. He dies in 2003; the land is valued in his estate at $1,000,000. His executor elects to take the §2031(c) exclusion and $400,000 of the land value (40% of $1,000,000) is excluded from his estate. That portion of the land not subject to the exclusion (60%) will receive a stepped-up basis; the portion of the land subject to the exclusion (40%) will receive a carryover basis. Accordingly, the basis of the land in the hands of his heirs is $40,000 (40% of $100,000) plus $600,000 (60% of $1,000,000), or $640,000.

9. The 40% exclusion will be reduced by two percentage points for each percentage point by which the easement fails to reduce the value of the property by at least 30%. Under a provision in the 2001 tax act, the 30% determination is made as of the date of the donation.

10. The exclusion may apply when land is owned by a family partnership, corporation, or trust as long as the decedent owned at least a 30% interest in the entity at the time of death.

a. **Example 6: Land Owned By a Corporation**. Assume the same facts as Example 1, except that Diamond Farm Corp., not Sue, owns Diamond Farm, and at her death Sue owns 60 percent of the stock of Diamond Farm Corp. To keep this as simple as possible, assume that Diamond Farm Corp.'s only asset is the 1,000 acres under easement. Does the §2031(c) exclusion work? How?

Analysis: §2031(c)(10) states that the benefits of §2031(c) are available if the decedent owned 30 percent or more of the interests in a partnership, corporation, or trust. In the legislative history for the statute, this is referred to as a "look-through" rule.

This appears to be the result: (1) the assets of Diamond Farm Corp. are valued at $1,000,000; (2) since Sue owns 60 percent of the stock, assume her Diamond Farm Corp. stock is valued at $600,000 in her estate; (3) her executor elects to take the §2031(c) exclusion, and that reduces the estate tax value of Sue's Diamond Farm Corp. stock to $200,000 ($600,000 minus $400,000). Note that this was essentially the fact pattern in Letter Ruling 200014013, although the IRS was not asked for guidance on the issues raised in this example or in any of the following examples.

b. **Example 7: Retained Development Rights on Corporate-Owned Land Under Easement**. Assume the same facts as in Example 6 but the easement reserves the right to create two more house lots (as in **Example 3**) and does not prohibit commercial recreational activities (as in **Example 4**).

Analysis: Based again on the "look-through" rule, I believe the shareholders of Diamond Farm Corp. can vote to extinguish the retained development rights (the right to create additional house lots), and can amend the easement to eliminate the right to carry on commercial recreational activities. Alternatively, the shareholders could treat both the subdivision rights and the commercial recreational activities as retained development rights and agree to extinguish them.

If the reserved house lot sites and the commercial recreational activities are eliminated, (1) the value of Diamond Farm is reduced; (2) the value of Diamond Farm Corp. stock in Sue's estate is reduced; and (3) Sue's estate is eligible for the §2031(c) exclusion. If, for example, the right to carry on commercial recreational activities is eliminated but the reserved house lots are not, the valuation and calculations will get a bit more complicated. This is because in that situation the value of the reserved house lots will be included in calculating the value of Diamond Farm (and accordingly the value of the Diamond Farm Corp. stock), but the §2031(c) exclusion will only apply to the value of the restricted land in the corporation, not the value of the house lots.

c. This can provide an important "second look" for the family that uses a land-owning limited partnership (for example) as a vehicle in an extensive lifetime giving program. When the 30% ownership threshold is reached the family can reassess whether to stop gifting and retain eligibility for §2031(c) or to continue gifting without reliance on the exclusion. *In this connection, note that the exclusion provided by §2031(c) does not apply to the gift tax.*

d. One can assume a calculation methodology similar to that in Estate of Hoover, 69 F.3d 1044 (10th Cir. 1995), that is, fair market value of the easement-restricted property, minus appropriate discounts, minus the full exclusion amount (as opposed to a pro-rated portion of the exclusion amount).

11. It is understood that §2031(c), as included in the Taxpayer Relief Act, was intended to allow a "post-mortem" easement donation that was deductible under §2055(f) *and* made the estate eligible for the §2031(c) exclusion.

a. It is now clear this is how the statute works. See Section 6007(g), a technical amendment to the Internal Revenue Service Restructuring and Reform Act of 1998, adding new §2031(c)(9).

b. §2031(c)(9) reads as follows: "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."

c. **Example 8: Post-Mortem Conservation Easement**. Sue owns Diamond Farm. She loves Diamond Farm and has always talked about putting an easement on it, but she dies without having done so. Nor did she include an easement in her will, which leaves Diamond Farm to her two daughters. The daughters are faced with a very large estate tax bill. They want to know what, if anything, they can do to protect and hold onto the farm.

Analysis: Sue's daughters can agree to donate a *post-mortem* conservation easement on Diamond Farm. Assuming Sue's daughters can deal successfully with any state law issues, once the conservation easement is donated there is an estate tax charitable deduction under §2055(f) for the value of the easement and the estate is eligible for the §2031(c) exclusion. This is exactly the same result as if Sue had included an easement in her will (see **Example 2**).

d. The *post-mortem* easement must be recorded (and the election made) by the due date, including extensions, for the estate tax return (§2031(c)(6)). It is reasonable to assume the qualified appraisal must also be in the donor's hands by the time the estate tax return is filed. See Reg. §1.170A-13(c)(3)(i)(A), and earlier in this outline.

e. In many situations this will be a critical and important post-mortem tool but because of the complexity and uncertainty of post-mortem planning issues (see below) landowners and their advisors should not plan to rely on this provision in the post-mortem period.

f. **Example 9: Post-Mortem Easement on Land Owned By a Corporation**. Diamond Farm Corp. owns Diamond Farm. Sue owns 60 percent of the stock of Diamond Farm Corp. There is no easement on Diamond Farm. Sue dies. Can a conservation easement donation still qualify for the §2031(c) estate tax benefits?

Analysis: The only way §2031(c) makes sense is if §2031(c)(9) (the post-mortem easement donation rule) and §2031(c)(10) (the look-through rule) work together. In effect, the look-through rule means that the estate tax results under §2031(c) should be the same whether the decedent owned the land directly or through a partnership, corporation, or trust.

First, Diamond Farm Corp. donates a conservation easement (essentially a post-mortem easement). Note that there is no §2055(f) estate tax charitable contribution deduction because neither the decedent (Sue) nor her estate made the donation, but the effect on Sue's estate should be the same (as in **Example 1**). The easement reduces the value of the land, the value of the stock in Sue's estate is reduced for estate tax purposes, and Sue's estate is also eligible for the §2031(c) exclusion. Note also that I believe no income tax deduction will be available to Diamond Farm Corp., under an analysis parallel to the rule of §2031(c)(9) that the estate is entitled to a §2055(f) deduction only if no income tax charitable deduction is taken by anyone in connection with the easement donation.

g. **Example 10: A Conservation Easement By Will on Co-Owned Land**. Bob and Sue are co-owners of Diamond Farm. Bob and Sue each own an undivided 50 percent interest in Diamond Farm as tenants in common. Bob dies. Bob has included in his will a conservation easement on Diamond Farm.

Analysis: The easement in Bob's will is ineffective. A co-owner cannot restrict his or her undivided interest in this manner. Even if Sue agrees to the conservation easement, the easement is ineffective because Sue's agreement was not certain as of the date of Bob's death. (See Reg. §20.2055-2(b)).

There is no estate tax deduction for the donation under Bob's will. Nevertheless, Bob's heirs and Sue might still have an important planning opportunity that accomplishes the same result (see Example 11).

h. **Example 11: A Post-Mortem Conservation Easement on Co-Owned Land**. Now, assume the same facts as in Example 10, except that it makes no difference whether or not Bob included an easement in his will.

Analysis: Whether or not Bob included an easement in his will, Bob's estate and/or heirs can join with Sue in the donation of a post-mortem conservation easement on Diamond Farm. Such a post-mortem easement would qualify under §2031(c)(9).

As it turns out, the ability under §2031(c)(9) to donate a post-mortem easement could have the happy effect of saving Bob's (and Sue's) heirs considerable estate tax, whereas in the prior scenario (Example 10) all of Bob's good intentions, memorialized in the form of a conservation easement in his will on his 50 percent undivided interest, would have gone for naught.

i. See Letter Ruling 200143011: three co-tenants (an estate and, apparently, two individuals) conveyed a post-mortem conservation easement on land they owned; the IRS ruled the estate could claim a deduction under §2055(f) for the value of the easement attributable to its (68.8%) tenancy in common interest and A and B could both claim income tax deductions under §170(h) for their respective 15.6% interests in the property.

C. General Observations

1. Every single easement must now take into account the rules of §2031(c) as part of the planning process.

2. Every single family lands planning situation must now take into account the rules of §2031(c).

As a matter of course in every situation where it might be relevant, language should be included in the landowner's will authorizing (but not directing) the executor and/or the heirs to donate a *post-mortem* conservation easement. One can even have a deathbed codicil authorizing the executor and/or the heirs to donate a *post-mortem* conservation easement

3. Every single recorded easement should be reviewed with §2031(c) eligibility in mind if the land is still owned by the same family that donated the easement.

4. Planning immediately after the death of many landowners will now become more complex, difficult, expensive, possibly highly beneficial, and *absolutely necessary*; see below.

D. *Post-Mortem* §2031(c) Planning Checklist

1. Have an accurate appraisal of the subject property, the value of structures, the value of any reserved development rights, and the value of an easement
2. Understand and resolve any state law issues. In that connection, see new §15-1-804(hh), Colorado Revised Statutes, adding to the Colorado Fiduciaries' Powers Act the power of a fiduciary (such as the executor of an estate) to grant a conservation easement, subject to certain qualifications. Similar language has been added to the Virginia Code. See the Levin article cited earlier in this outline.
3. Understand and resolve any family issues
4. Reach agreement with the easement holder or donee
5. Run all the numbers
6. Perhaps record an easement or an "Agreement to Extinguish" or an easement amendment
7. Have a final qualified appraisal in hand
8. File the §2031(c) election

E. Examples of *post-mortem* planning

IX. PLANNING FOR THE LANDOWNER

A. Historically, goal of estate planning has been to put the client's affairs in order.

B. Beyond that, biggest problem: how to get the family's *business* through the estate tax, intact, and into the hands of the next generation.

1. Example: valuable family business - what happens when clients visit advisor.
2. Example: valuable family land - what happens when clients visit advisor.
3. Landowners are asking for the same planning attention and creative energy by professionals as business owners are receiving - and landowners are *not getting it!!*
4. Understanding *the process*: how do you get the family to agree??
5. What are some of the things the attorney needs to know about to be able to help the family reach agreement (this is not intended to be an all-inclusive list):

   a. The estate and gift tax rules, especially with respect to transfers that are *not* subject to transfer tax

   b. Conservation and preservation easements, including qualification under the tax rules, valuation, donee organization rules, all related issues

   c. The income tax deduction limitation rules, including the substantiation requirements

   d. The estate tax incentives for certain land subject to conservation easements

   e. Bargain sales

   f. Tax-free swaps of real estate and interests in real estate

   g. Certain estate tax valuation rules

   h. Generation-skipping tax rules

   i. Choice of entity issues:

      i. How is a corporation taxed? Who has decision-making authority? What if more than one person wants decision-making authority?

      ii. How is a partnership taxed? Who has decision-making authority? What if more than one person wants decision-making authority?

      iii. How is an S corporation taxed? Who has decision-making authority? What if more than one person wants decision-making authority?

      iv. What are the restrictions on eligibility for shareholders of an S corporation?

      v. What is a "Limited Liability Company"? Is it better than a partnership?

      vi. What is a "family trust"? How is a trust governed? Taxed?

      vii. What are the potential planning problems for tenants in common (undivided interests)?

   j. Valuation discounts

   k. So-called private foundations and other non-public and non-private tax-exempt entities, including, for example, charitable trusts and "supporting organizations"

   l. Charitable trusts and related vehicles

   m. Taxation of life insurance

   n. Hazardous waste liability issues

   o. Water rights law

   p. Mineral rights law

   q. State law, real estate law, land use controls, zoning, state and local taxation of real estate

   r. Community property law

X. OTHER FEDERAL TAX AND LEGAL ISSUES: AN OVERVIEW

A. Choice of entity issues (See Chapter 5 in <u>Preserving Family Lands: Book II</u>)

1. Corporations (Subchapter C of the Code)

   a. "Double-tax" problem (see primarily §336)

   b. Note that many property owners are "comfortable" with the idea of a corporation, shares of stock, etc.

   c. Income tax deduction for charitable contribution does not "flow through" to shareholders.

   d. An easement on real estate held in a corporation may nevertheless bring estate tax relief (by lowering the value of the corporation's assets).

   e. If shareholders donate (or sell) all of a corporation's stock to a charity and the charity then liquidates the corporation, the liquidating corporation's gain will be taxed under §337(b)(2). See Letter Ruling 199923009 (ruling request was submitted prior to publication of final regulations under §337(d)).

2. Partnerships (Subchapter K of the Code)

   a. *One tax*

   b. "A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities." §701, in its entirety.

   c. Important and often-missed rule: charitable contribution deductions apparently flow through partnership without regard to "at risk" rules, "passive loss" rules, or partner's basis in partnership interest. See Rev. Rul. 96-11, 1996-1 C.B. 140; Letter Rulings 8405084, 8753015, 8811060, and 9318017; Reg. §1.704-1(d)(2).

d. Excellent planning tool; continuing litigation by IRS on discounting; need to think through long-term planning issues (see §§731, 737).

3. S Corporations (formerly and still referred to as "Subchapter S" corporations; Subchapter S of the Code)

a. Generally, one tax, on shareholders (§1366), though some exceptions to that rule (see, for example, §§1374 and 1375)

b. Restrictions on eligible shareholders (§1361). This may present problems for long-term planning.

c. Previously, important and often-missed rule: charitable contribution deductions (like other deductions) flow through only to the extent of shareholder's basis in stock (§1366(d)(1)). *Rule was changed by Pension Protection Act of 2006!!* See Letter Ruling 9537018; see also Letter Ruling 9703028 (§170(c)(2) limit on corporate contributions to charities outside of the United States does not apply to an S corporation because "deductibility…is determined at the shareholder level"); Technical Advice Memorandum 199908039 (charitable contribution by S corporation is deductible *by shareholders* in the year in which actually paid, not necessarily the tax year of an S corporation that is on the accrual basis). See also Rev. Rul. 2000-43, 2000-41, I.R.B. 333.

d. Conversion from "C" to "S" can be simple or very complicated. See St. Charles Investment Co. v. Commissioner, No. 99-9020 (10th Cir. Nov. 14, 2000).

e. See Letter Ruling 200402003 for the tax consequences of a merger of an S corporation with a charity.

4. Limited Liability Companies

a. "Hybrid" entity

b. Creature of state law and IRS rulings

c. Generally taxed like a partnership even though no participant is personally liable

5. Trusts

a. Tax treatment depends in part on characterization (see §7701)

b. A "trust" can be characterized and taxed as a corporation, as a partnership, as a trust (Subchapter J of the Code), or as if the trust didn't exist at all.

c. Critical issue is that the attorney drafting the trust must *understand the tax consequences* of using that particular vehicle. See, i.e., Rev. Rul. 2004-5, 2004-3 I.R.B. 295 (trust may take charitable contribution deduction that flows through partnership in which trust has an interest); however, see Rev. Rul. 2003-123, 2003-2 C.B. 1200 (trust *not allowed a deduction* for donation of a conservation easement); then read Goldsby v. Commissioner, T.C. Memo 2006-274; No. 8232-05.

Many people mistakenly believe "putting it into a trust" will solve all of their problems, including their estate tax problems. "Living trusts," "living wills," and "avoiding probate" have people quite confused.

e. "Killer trust" example

6. Fiduciary obligations of majority shareholders, general partners, trustees; but see Bowgren v. Commissioner, 79 AFTR 2d Par. 97-391 (7th Cir. 1997), Swain v. U.S., 80 AFTR 2d Par. 97-5145 (C.D. I11. 1997).

7. Tenants in common/undivided interests

a. Liquidity problems ("Preserving Family Lands" problem taken to another planning level). For a few thoughts on this issue, see Letter Rulings 9535028-033.

b. Management and deadlock issues; partition suit possibilities

c. Note that a *pro-rata* partition of real property by tenants in common will generally not be a taxable event, although see Letter Rulings 9327069 and 200328034, holding the event non-taxable under §1001 (without reference to §1031); Letter Ruling 200303023.

8. Minority (and other) discount valuation possibilities? See Estate of Berg v. Commissioner, 976 F.2d 1163 (8th Cir. 1992). The IRS continues to fight back; see Letter Ruling 9436005 (although a minority discount may be appropriate, a "swing vote" premium may also be appropriate). Note recent IRS attempts to apply Section 2703 rules to ignore discounts of limited partnership interests; see Technical Advice Memorandum 9719006 and Letter Ruling 9730004. Query whether the IRS will accept a discount for ownership of C corporation stock to reflect the double-tax cost. See Estate of Kett, T.C. Docket No. 1742-94, where it is understood the Service accepted a 40% discount for ownership of 100% of the stock of a C corporation owning real estate; Knapp v. Commissioner, T.C. Memo 1977-389 (reduction in value of gift of easement by co-owners of property to reflect minority discounts); compare Letter Ruling 199927014 (no discussion of valuation of undivided interests); Borgatello v. Commissioner, T.C. Memo 2000-64 (discount for "potential corporate …. tax"). Now see Estate of Strangi, T.C. Memo 2003-145 (property transferred by decedent to limited partnership includible in decedent's estate).

B. Tax-exempt entities as part of the property owner's planning menu

1. So-called "private foundations". See, Edie, First Steps in Starting a Foundation (Council on Foundations, 1993). See Wing's Neck Conservation Foundation, Inc., v. Board of Assessors of the Town of Bourne, Commonwealth of Massachusetts Appellate Tax Board, Docket Nos. F262914, F262915, F262916, Promulgated July 11, 2003.

2. "Supporting organizations" under §509(a)(3) combine qualities of both private foundations (donor and/or family board involvement) with favorable tax status of publicly-supported charitable organizations.

3. Charitable remainder trusts (§664)

a. Subject for another seminar

b. Common misconceptions; traps for the unwary: it does not appear that you can contribute an easement to a charitable remainder trust (see, for example, Letter Ruling 9501004); but potentially important planning tools

c. Often combined with life insurance in "wealth replacement trust" setting

C. Life Insurance

1. Subject to estate tax

2. Not subject to estate tax if structured correctly

3. Consider use of irrevocable life insurance trust, often with premiums funded through annual exclusion gifts or current estate tax exclusion

4. For spouses, compare use of "second-to-die" policies with two individual policies

5. Excellent planning tool

D. Hazardous waste and related issues

1. Generally a subject for another program

2. See Long Beach Unified School District v. Dorothy B. Godwin California Living Trust, 32 F. 3d 1369 (9th Cir. 1994), noting in dictum that it would be inappropriate to subject holders of "scenic" easements ("which preserve the 'scenic and historical attractiveness' of the dominant estate") to CERCLA liability. Easement drafters should pay careful attention to the issues of "ownership" and "control" discussed in this case. See also Grand Trunk Western Railroad Company v. Acme Belt Recoating, Inc., 859 F. Supp. 1125 (W.D. Mich. 1994); Asset Conservation, Lender Liability, and Deposit Insurance Protection Act of 1996, Pub. L. 104-208, 110 Stat. 3009.

XI. SPREADSHEETS: See www.stevesmall.com and article on "New Conservation Tax Incentives"

XII. CONCLUSION

I.R.C. §170(h) Qualified conservation contribution

(h) Qualified conservation contribution

(1) In general

For purposes of subsection (f)(3)(B)(iii), the term "qualified conservation contribution" means a contribution—

(A) of a qualified real property interest,

(B) to a qualified organization,

(C) exclusively for conservation purposes.

(2) Qualified real property interest

For purposes of this subsection, the term "qualified real property interest" means any of the following interests in real property:

(A) the entire interest of the donor other than a qualified mineral interest,

(B) a remainder interest, and

(C) a restriction (granted in perpetuity) on the use which may be made of the real property.

(3) Qualified organization

For purposes of paragraph (1), the term "qualified organization" means an organization which—

(A) is described in clause (v) or (vi) of subsection (b)(1)(A), or

(B) is described in section 501(c)(3) and—meets the requirements of section 509(a)(2), or

(ii) meets the requirements of section 509(a)(3) and is controlled by an organization described in subparagraph (A) or in clause (i) of this subparagraph.

(4) Conservation purpose defined

(A) In general

For purposes of this subsection, the term "conservation purpose" means—

(i) the preservation of land areas for outdoor recreation by, or the education of, the general public,

(ii) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem,

(iii) the preservation of open space (including farmland and forest land) where such preservation is—

(I) for the scenic enjoyment of the general public, or

(II) pursuant to a clearly delineated Federal, State, or local governmental conservation policy, and will yield a significant public benefit, or

(iv) the preservation of an historically important land area or a certified historic structure.

[Note: Section 170(h)(4)(B), as set forth below and before amendment by P.L. 109-280, applies to contributions made before July 26, 2006:]

(B) Certified historic structure

For purposes of subparagraph (A)(iv), the term "certified historic structure" means any building, structure, or land area which—

(i) is listed in the National Register, or

(ii) is located in a registered historic district (as defined in section 47(c)(3)(B)) and is certified by the Secretary of the Interior to the Secretary as being of historic significance to the district.

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

[Note: Section 170(h)(4)(B), as set forth below, as added by P.L. 109-280, applies to contributions made after July 25, 2006:]

(B) Special rules with respect to buildings in registered historic districts

In the case of any contribution of a qualified real property interest which is a restriction with respect to the exterior of a building described in subparagraph (C)(ii), such contribution shall not be considered to be exclusively for conservation purposes unless—

(i) such interest—

(I) includes a restriction which preserves the entire exterior of the building (including the front, sides, rear, and height of the building), and

(II) prohibits any change in the exterior of the building which is inconsistent with the historical character of such exterior,

(ii) the donor and donee enter into a written agreement certifying, under penalty of perjury, that the donee—

(I) is a qualified organization (as defined in paragraph (3)) with a purpose of environmental protection, land conservation, open space preservation, or historic preservation, and

(II) has the resources to manage and enforce the restriction and a commitment to do so, and

(iii) in the case of any contribution made in a taxable year beginning after the date of the enactment of this subparagraph, the taxpayer includes with the taxpayer's return for the taxable year of the contribution—

(I) a qualified appraisal (within the meaning of subsection (f)(11)(E)) of the qualified property interest,

(II) photographs of the entire exterior of the building, and

(III) a description of all restrictions on the development of the building.

[Note: Section 170(h)(4)(C), as set forth below, as redesignated and amended by P.L. 109-280, applies to contributions made after August 17, 2006:]

(C) Certified historic structure

For purposes of subparagraph (A)(iv), the term "certified historic structure" means—

(i) any building, structure, or land area which is listed in the National Register, or

(ii) any building which is located in a registered historic district (as defined in section 47(c)(3)(B)) and is certified by the Secretary of the Interior to the Secretary as being of historic significance to the district.

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

(5) Exclusively for conservation purposes

For purposes of this subsection—

(A) Conservation purpose must be protected

A contribution shall not be treated as exclusively for conservation purposes unless the conservation purpose is protected in perpetuity.

(B) No surface mining permitted

(i) In general

Except as provided in clause (ii), in the case of a contribution of any interest where there is a retention of a qualified mineral interest, subparagraph (A) shall not be treated as met if at any time there may be extraction or removal of minerals by any surface mining method.

(ii) Special rule

With respect to any contribution of property in which the ownership of the surface estate and mineral interests were separated, subparagraph (A) shall be treated as met if the probability of surface mining occurring on such property is so remote as to be negligible.

(6) Qualified mineral interest

For purposes of this subsection, the term "qualified mineral interest" means—

(A) subsurface oil, gas, or other minerals, and

(B) the right to access to such minerals.

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