CHAPTER 34

CONSERVATION EASEMENT EXCLUSION

INTRODUCTION

A very special and significant incentive is provided to private U.S. landowners to preserve undeveloped land. Specifically, IRC Section 2031(c) provides for a federal estate tax exclusion related to the value of land that is subject to a donated qualified conservation easement.

There are actually multiple advantages to the donation of a qualified conservation easement. First, donors of conservation easements that fulfill the requirements of IRC Section 170(h) are entitled to an income tax deduction. The income tax deduction is equal to the value of the public easement. Second, if the gift of the public easement is made either during lifetime or at death, the donor will also be entitled to reduce the value of the land for federal estate tax purposes to take into consideration the effect of the gift on the fair market value of the property. Third, there is an estate tax exclusion under IRC Section 2031(c), if, in general, the requirements of Section 170(h) are also met.[[1]](#endnote-1)

The value of the Section 2031(c) exclusion is limited to $500,000. In general, qualification for the exclusion is dependent on meeting certain geographical and ownership criteria, and on meeting specific requirements for the grant of the easement.

Within these limitations, the estate may deduct the lesser of (a) $500,000 or (b) 40 percent of the value of the land subject to a qualified conservation easement, reduced by 2 percent for every 1 percent that the easement represents less than 30 percent of the value of the land, to zero if the value is 10 percent or less of such land. The values taken into account are such values as of the date of the contribution of the qualified conservation easement.

WHEN IS USE OF SUCH A DEVICE INDICATED?

1. When the land meets the specified geographical requirements.

2. When the land has been owned by the decedent or a family member for at least three years immediately prior to decedent’s death.

3. When the easement is contributed on or before the due date (including extensions) for filing an estate tax return, and no interests are retained, except as allowed.

WHAT ARE THE REQUIREMENTS?

1. As of the decedent’s date of death, the land must be located in the United States or its possessions.[[2]](#endnote-2)

2. The land must have been continuously owned by the decedent, or a member of the decedent’s family, during the three years immediately preceding the decedent’s death.[[3]](#endnote-3)

3. The land must be subject to a qualified conservation easement, which is a “qualified conservation contribution of a qualified real property interest,” as generally defined in Section 170(h) and Treas. Reg. Section 1.170A-14.[[4]](#endnote-4)

4. The contribution must be made to a qualified organization and used exclusively for conservation purposes. In general, an organization is qualified to receive such a contribution if it is a federal, state, or local agency, or a charity qualifying under IRC section 501(c)(3).[[5]](#endnote-5) The recipient must be a qualified organization with a “commitment to protect the conservation purposes of the donation and have the resources to enforce the restrictions”.[[6]](#endnote-6)

5. A real property interest is qualified if it is a restriction granted in perpetuity on the use which may be made of the property.[[7]](#endnote-7) This requirement can be violated if the parties can revoke the interest through the consent of the parties.[[8]](#endnote-8)

6. A conservation purpose includes preservation of land for public recreation or education, protection of a natural habitat of fish, wildlife, or plants, or the preservation of open space, including farmland and forestland.[[9]](#endnote-9) The preservation of historically important land or certified historic structures, although referenced under Section 170(h)(4), is not a conservation purpose under Section 2031(c).[[10]](#endnote-10) The conservation purpose must be protected in perpetuity to be treated as exclusive.[[11]](#endnote-11)

7. The donor may not retain rights to develop the easement for commercial purposes (other than farming).[[12]](#endnote-12) To the extent that the donor does retain any development rights, than the value of what may be taken as a deduction, can be limited. If this should occur, and the heirs desire the full deduction, the heirs can agree to waive the development rights on a post mortem basis.

8. The applicable percentage of the value of the land subject to a qualified conservation easement that may be excluded from the decedent’s gross estate is equal to the lesser of (a) $500,000 or (b) 40 percent of the value of such land, reduced by 2 percent for each 1 percent (or fraction thereof) by which the value of the easement is less than 30 percent of the value of the land.[[13]](#endnote-13)

9. The election to take the exclusion under Section 2031(c) must be made on the decedent's estate tax return, and, once made, is irrevocable.[[14]](#endnote-14)

10. The taxpayer must satisfy certain substantiation requirements in order to obtain the deduction. The taxpayer must obtain a qualified appraisal, attach an appraisal summary to the tax return, and maintain proper records.[[15]](#endnote-15)

HOW IT IS DONE – AN EXAMPLE

Mary Peshel inherited a ranch in the backcountry located next to a national park. The ranch had been in the family for 40 years. At the time of her death, the ranch was worth $1,000,000, without regard to the easement, which she donated shortly prior to her death.

Mary had conveyed a qualifying easement worth $250,000 (25 percent of the property value) for use by the Friends of the Earth organization, reducing the net value of the property to $750,000. Friends of the Earth qualifies as a publicly supported charity under IRC Section 501(c)(3). Mary retained the right to operate the property only for ranching and farming. She gave up and retained no development rights.

Since only 25 percent of the value was conveyed, the 40 percent exclusion percentage is reduced by 2 percent for each 1 percent that the easement is below 30 percent of the value of the entire property. The reduction equals 10 percent [(30% - 25%) x 2%)]. This results in a 30 percent exclusion (40 percent less the 10 percent reduction), and the estate benefits from an estate tax exclusion of $225,000 (30 percent of $750,000). This is less than the $500,000 exclusion limit. Thus, Mary’s estate can exclude $225,000 under Section 2031(c).

TAX IMPLICATIONS

1. The decedent’s gross estate is reduced by the qualified conservation easement exclusion.

2. The basis in the property subject to the qualified conservation easement exclusion is not stepped-up for income tax purposes with respect to the exclusion.

IMPLICATIONS AND ISSUES IN COMMUNITY PROPERTY STATES

Where property is held as community property, both spouses must consent to the granting of the conservation easement. Also, each spouse will be entitled to an exclusion for a qualified conservation easement as to each spouse’s respective one-half of the gift.

In the case of community property, a conservation easement is a legal agreement between both spouse/community property owners and a governmental body or land trust that restricts the type and amount of development and use that may take place on the property. The restriction is a "perpetual conservation restriction" granted in perpetuity on the use which may be made of real property—including, an easement or other interest in real property that under state law has attributes similar to an easement (e.g., a restrictive covenant or equitable servitude). For these purposes, the terms easement, conservation restriction, and perpetual conservation restriction have the same meaning.[[16]](#endnote-16)

FREQUENTLY ASKED QUESTIONS

**Question** – Does it matter when the easement was donated?

*Answer* – Generally, no. The exclusion election is available after the qualified easement donor's death. The amount of the exclusion is calculated based on the date of transfer of the easement (although an easement donated after death must be made within a certain period after death, see below).

**Question** – May a married couple both use the exclusion for separate transfers of easements in the same property?

*Answer* – Yes. The exclusion is applied to a decedent’s gross estate, without regard to the individual property, so that a married couple may exclude up to $1 million for gifts of easements in one property.

**Question** – May an executor or trustee donate land subject to a qualified conservation easement and make a post-mortem election under Section 2031(c), even though the decedent made no provision during his lifetime for such transfer?

*Answer* – Yes. Under Section 2031(c)(8)(A)(iii), an executor or trustee may make the necessary election and donate the easement.

**Question** – May an executor or trustee take remedial action after the death of the decedent to qualify an easement under Section 2031 that would not otherwise qualify for the exclusion?

*Answer* – Yes. Section 2031(c)(8)(A)(iii) also presents an opportunity for the executor or trustee to correct defects that might prevent an easement that was transferred inter vivos from qualifying for the exclusion. Thus, to the extent that an easement is not qualified, an executor or trustee may donate an interest that will qualify for the exclusion, since an executor or trustee are considered qualified persons.

**Question** – Will the decedent’s heirs receive a full stepped-up basis in land subject to a qualified conservation easement?

*Answer* – No. The portion of basis equal to that fraction of the value of the land represented by the qualified conservation easement receives a carryover basis.[[17]](#endnote-17) For example, using the illustration provided in the preceding section, the exclusion allowed to Mary’s estate represented 30 percent of the estate tax value of the ranch. Thus, 30 percent of the basis in the ranch would be carried over to Mary’s heirs, and added to 70 percent of the fair market value at death (representing the step-up), to arrive at the adjusted basis. Figure 34.1 illustrates the steps necessary to calculate the heirs’ basis in Mary’s ranch, assuming that at Mary’s death, the property had a basis of $100,000 and a fair market value of $750,000 after the gift of the easement.

Thus, the conservation easement excluded from the gross estate does not receive a basis stepped-up to fair market value.. However, even for estates in the lowest marginal estate tax bracket, the election should be beneficial, to the extent that the capital gains tax is lower than the estate tax rate.

**Figure 34.1**

|  |  |  |
| --- | --- | --- |
| 1. | Gross Value of Ranch Prior to Easement  | $1,000,000 |
|  |  |  |
| 2. | Fair Market Value of Ranch After Gift of Easement  | $ 750,000 |
|  |  |  |
| 3. | Basis of Ranch at Mary's death  | $100,000 |  |
|  |  |  |  |
| 4. | Value of Exclusion to Mary's Estate  | $225,000 |  |
|  |  |  |  |
| 5. | Percentage of Gross Value Represented By Exclusion Amount (line 4 divided by line 2)  | 30% |  |  |
|  |  |  |  |  |
| 6. | Carryover Basis (line 3 multiplied by line 5)  | $ 30,000 |  |
|  |  |  |  |
| 7. | Stepped-Up Basis (line 2 multiplied by 70%)  | $525,000 |  |
|  |  |  |  |
| 8. | TOTAL ADJUSTED BASIS (line 6 plus line 7)  | $ 555,000 |

**Question** – What type of development rights would disqualify an estate under Section 2031(c), should they be retained?

*Answer* – Section 2031(c)(5)(D) defines a development right as “any right to use the land subject to the qualified conservation easement in which such right is retained for any commercial purpose which is not subordinate to and directly supportive of the use of such land as a farm for farming purposes (within the meaning of section 2032A(e)(5)).” Thus, a donor must carefully assess whether he will, even inadvertently, retain rights to the easement that may fall under this broad definition. Counsel should use caution in drafting easements until regulations and judicial decisions become available for guidance.

**Question** – Will an executor or trustee be able to save the exclusion, if the decedent (or any other party) retained development rights in the easement?

*Answer* – Yes. Section 2031(c)(5)(B) provides that, if those persons with an interest in the land execute an agreement to extinguish some or all development rights on or before the filing date of the estate tax return, the exclusion shall be allowed to the extent that such rights were terminated. In addition, the IRC allows a donor to provide flexibility to heirs, since such an agreement need not be implemented until the earlier of (a) two years after the decedent’s death, or (b) the sale of the land. Thus, where commercial development may prove more profitable than the value to the estate of the exclusion, the donor may wish to retain commercial development rights when creating the easement. If the agreement is not implemented within the proscribed period, an additional tax will be due, equal to the tax saved by the exclusion.

**Question** – Will recreational use of a commercial nature on the easement prevent qualification for the exclusion?

*Answer* – Yes, if it is more than a de minimis use for a commercial recreational activity. Congressional intent in this area was to prevent the nominal preservation of land that would be used for large commercial enterprises, such as golf courses or ski resorts. Committee Reports indicate that it was also intended to provide exceptions to leased use for hunting and fishing. However, in the absence of regulations, a donor should carefully consider any type of commercial use before relying on qualification for the exclusion.

**Question** – Does land that is subject to indebtedness qualify for the exclusion?

*Answer* – No. To the extent that property is debt-financed, and such debt is acquisition indebtedness, as defined under Section 2031(c)(4), the exclusion will not apply.

**Question –** Can someone who has made an election under IRC Section 2032A sell a conservation easement?

*Answer* - IRC Section 2032A permits certain shareholder to value their real estate at its special use value. This approach allows property to be valued as it is being used, as opposed to what its highest and best use might otherwise be (which is the typical standard). A typical example of this type of property might be a farm, where its value would be much higher if the land were to be developed as opposed to being operated as a farm. However, when a taxpayer claims this special use valuation approach, the property can not be disposed of within ten years – without a tax penalty. Should a disposal within 10 years occur, the tax savings under the special use valuationapproach are recaptured. If the heir wants to make an election under both Section 2032A and implement a conservation easement, than the easement must be contributed (and not sold) to the charitable entity.[[18]](#endnote-18)

**Question** – Can a conservation easement be extinguished after it is granted?

*Answer* – Generally no. The Regulations provide a limited opportunity to terminate the easement if “a subsequent unexpected change in the conditions surrounding the property . . . make it impossible or impractical for the continued use of the property for conservation purposes, the conservation purpose can nonetheless be treated as protected in perpetuity if the restrictions are extinguished by judicial proceeding and all of the donee's proceeds (determined under paragraph (g)(6)(ii) of this section) from a subsequent sale or exchange of the property are used by the donee organization in a manner consistent with the conservation purposes of the original contribution.”[[19]](#endnote-19) In one case, the court denied the deduction where the easement could be extinguished through the mutual consent of the parties.[[20]](#endnote-20)

**Question** – Can a conservation easement be granted on a property subject to a mortgage?

*Answer* – Only if the mortgage is subordinate to the conservation easement. Generally, in order to obtain the deduction, the donation must be in perpetuity. If the underlying property is subject to a mortgage, a question can arise as to whether the donation is in perpetuity. The Regulations provide that the mortgage will be permitted so long as the mortgage is subordinate to the contribution.[[21]](#endnote-21)

CHAPTER ENDNOTES

1. . Treas. Reg. Sec. 1.170A-14 became applicable on May 1, 2009. These Regulations address how a taxpayer can obtain a deduction for a “qualified conservation contribution”. [↑](#endnote-ref-1)
2. . 2012 Tax Relief Act, Section 101. [↑](#endnote-ref-2)
3. . IRC Sec. 2031(c)(8)(A)(ii). [↑](#endnote-ref-3)
4. . IRC Sec. 2031(c)(8)(B). [↑](#endnote-ref-4)
5. . IRC Sec. 170(h)(3); Treas. Reg. Sec. 1.170A-14(c). [↑](#endnote-ref-5)
6. Treas. Reg. Sec. 1.170A-14(c)(1). [↑](#endnote-ref-6)
7. . IRC Sec. 170(h)(2) ; Treas. Reg. Sec. 1.170A-14(b). [↑](#endnote-ref-7)
8. . *Kayln M. Carpenter, et al. v. Commissioner*, TC Memo 2012-1 (01/3/2012). [↑](#endnote-ref-8)
9. . IRC Sec. 170(h)(4); ; Treas. Reg. Sec. 1.170A-14(d). [↑](#endnote-ref-9)
10. . IRC Sec. 2031(c)(8)(B). [↑](#endnote-ref-10)
11. . IRC Sec. 170(h)(5)(A).; ; Treas. Reg. Sec. 1.170A-14(e). [↑](#endnote-ref-11)
12. . IRC Sec. 2031(c)(5) ; Treas. Reg. Sec. 1.170A-14(g)(4) and (5). [↑](#endnote-ref-12)
13. . IRC Sec. 2031(c)(2). However, this provision expired on December 31, 2012 along with the overall expiration of EGTRRA, unless extended by Congress. [↑](#endnote-ref-13)
14. . IRC Sec. 2031(c)(6). [↑](#endnote-ref-14)
15. Treas. Reg. Sec. 1.170A-14(i), which cross references to the substantiation requirements of Treas. Reg. Sec. 1.170A-13(c). See also, *E, B. DiDonato, et ux. V. Commissioner*, TC Memo 2011-153 (06/29/2011) where the deduction was denied for failing to obtain a contemporaneous written acknowledgement under Treas. Reg. Sec. 1.150A-13(f)(2). [↑](#endnote-ref-15)
16. Treas. Reg. § 1.170A-14(b)(2). [↑](#endnote-ref-16)
17. . IRC Sec. 1014(a)(4). [↑](#endnote-ref-17)
18. . PLR 200840018. [↑](#endnote-ref-18)
19. . Treas. Reg. Sec. 1.170A-14(g)(6). [↑](#endnote-ref-19)
20. . *Kayln M. Carpenter, et al. v. Commissioner*, TC Memo 2012-1 (01/3/2012). [↑](#endnote-ref-20)
21. . Treas. Reg. Sec. 1.170A-14(g)(3). See also *Ramona L. Mitchell v. Commissioner*, 138 T.C. No. 16, (04/3/2012) in which the deduction was denied where the mortgage was not subordinate to the easement at the time easement was granted. [↑](#endnote-ref-21)