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INCOME TAX ASPECTS OF CONSERVATION EASEMENTS

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I. INTRODUCTION

In an excellent and comprehensive Comment,[1] Michael R. Eitel examined the legal context for conservation easements in Wyoming, and the debate over enactment of enabling legislation for conservation easements in the 2003 Session of the state legislature. The article that follows provides an explanation of the substantial income tax benefits that can be enjoyed by those donating, or selling for a bargain price, conservation easements in Wyoming.[2]

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1. Michael R. Eitel, Comment, *Wyoming's Trepidation Toward Conservation Easement Legislation: A Look at Two Issues Troubling the Wyoming State Legislature*, 4 WYO. L. REV. 57 (2004).

2. While a conservation easement can provide very substantial estate tax savings, treatment of the estate tax benefits is beyond the scope of this article. For a summary discussion

Notwithstanding the "trepidation" of the state legislature over creating statutory authority for conservation easements, conservation easements are an established part of the Wyoming landscape. Wyoming landowners have been donating conservation easements for twenty-five years based upon the common law principles described in Eitel's Comment, and enjoying substantial income and estate tax benefits as a result. Privately held conservation easements now apply to nearly 500,000 acres of land in Wyoming. The federal government also owns conservation easements in Wyoming, some of which it has purchased for substantial prices.[3]

In addition, the state itself has sold at least one conservation easement on state land for a very substantial price. In a 2004 decision,[4] the Wyoming Supreme Court tacitly recognized the validity of a Wyoming conservation easement by finding that the existence of the easement over a Wyoming ranch had substantially affected its fair market value.

Tax benefits can be a substantial factor in motivating easement donations. Between federal income tax benefits and estate tax benefits, the donor of a conservation easement and the donor's family can potentially recover over 100% of the value of a donated conservation easement.[5] For a landowner who is not interested in using the development potential of his or her land, a conservation easement can be an effective way of turning that development potential into cash while keeping the land intact. Furthermore, because conservation easements can be written to allow the retention of some development potential by the landowner,[6] substantial value and future flexibility in the use of the land can be retained in the process.[7]

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of the topic, *see* C. Timothy Lindstrom, A Guide to the Tax Benefits of Donating a Conservation Easement (2004), *at* http://www.jhlandtrust.org/media/pdfs/taxguide.pdf.

3. For example, the Bridger-Teton National Forest, using a federal Land and Water Conservation Fund grant, recently purchased a conservation easement in Teton County for over $3 million.

4. Wallop v. Wallop, 88 P.3d 1022 (Wyo. 2004).

5. If a landowner donates a conservation easement valued at $1 million, the donation generates a $1 million federal income tax deduction. This deduction, given the top federal income tax rate of 35%, could generate federal income tax savings of $350,000. The donation also reduces the donor's estate by up to $1.5 million (due to the reduction in the value of the estate, and the 40% exclusion available under 26 U.S.C. § 2031(c) (2004)). This reduction, given the current top estate tax rate of 47%, could generate federal estate tax savings of $705,000. The combined savings in this example amount to $1,055,000, or 106% of the value of the easement donated. In spite of the example, circumstances allowing tax benefits in excess of the value of the easement contribution itself are not the rule.

6. Such retained development potential must be "consistent" with the "conservation purposes" of the conservation easement to preserve the federal tax benefits. For a complete discussion, *see infra* note 39 and accompanying text.

7. Land subject to a conservation easement continues to have substantial value, depending upon the local market. Land in Teton County, Wyoming subject to conservation easements allowing *no* development has recently sold at public auction for $10,000 per acre. Of course, Teton County is an unusual market. However, the author donated a conservation

Some states offer significant incentives for the donation of conservation easements, including income tax deductions and credits against state income tax.[8] Residents of those states donating easements on Wyoming land may enjoy greater tax benefits due to the tax programs of their own state. However, Wyoming offers no incentives to easement donation. Yet its lack of income tax makes it a "tax haven" for many, resulting in an influx of wealthy land buyers, an increasing number of whom find the tax benefits of conservation easements very attractive.

The combination of tax benefits, and the aggressive use of these benefits by some individuals and organizations has led the IRS recently to issue a "Notice"[9] that it intends to crack-down on aggressive conservation easement appraisals, and certain types of conservation buyer transactions.[10] Recent inquiries have been made by prominent members of Congress into certain conservation transactions,[11] and legislation is reportedly now being drafted by Finance Committee staff. In addition, the Land Trust Alliance, an umbrella organization for the nation's some 1,300 land trusts,[12] is in the final process of tightening its *Manual of Standards and Practices*, which provides guidance to land trusts, in response to this recent scrutiny of conservation transactions. The Nature Conservancy itself has announced an internal investigation, reform measures, and is currently subject to an extensive IRS audit of its practices.

Notwithstanding this recent criticism, federal legislation expanding (and increasing the fairness of) existing tax benefits for conservation easement donors passed the U.S. House of Representatives during the last Con-

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easement on a farm in Virginia and still realized substantial appreciation in the value of the land after the donation. While this is anecdotal evidence, it reflects widespread experience.

8. C. Timothy Lindstrom, *State Tax Incentives for Conservation Easements Can Benefit Everyone*, J. OF MULTISTATE TAXATION & INCENTIVES, Nov.-Dec. 2002, at 20, 23.

9. I.R.S. Notice 2004-41, 2004-28 I.R.B. 31.

10. Conservation buyer transactions are sales of conservation-worthy land to buyers who can utilize the tax benefits of an easement donation to reduce the net cost of acquiring the land in transactions where the buyer makes some form of commitment to donate the easement once it is acquired. Such transactions are tricky, to say the least. For a complete discussion, *see infra* note 205 and accompanying text.

11. *See, e.g.*, Letter from Senator Charles E. Grassley, Chairman, and Senator Max Baucus, Ranking Member, United States Senate Committee on Finance, to Steven J. McCormick, President and Chief Executive Officer, The Nature Conservancy (July 16, 2003), *available at* http://grassley.senate.gov/releases/2003/p03r07-17b.htm; Letter from Senator Charles E. Grassley, Chairman, and Senator Max Baucus, Ranking Member, United States Senate Committee on Finance, to Steven J. McCormick, President and Chief Executive Officer, The Nature Conservancy (March 3, 2004), *available at* http://www.senate.gov/finance/press/Gpress/2004/prg030304b.pdf.

12. A "land trust" is a private, non-profit organization, typically recognized under § 501(c)(3) of the Internal Revenue Code as a public charity, which includes within its purposes the conservation of land. 26 U.S.C. § 501(c)(3) (2000). Land trusts that are "qualified organizations" can "hold" (essentially, enforce) conservation easements that qualify for federal tax benefits. For a complete discussion, *see infra* Part III.A.1.

gress.[13] The reason for continued, bi-partisan support for conservation easements is that they achieve, without governmental regulation, or public acquisition of land, the protection of many natural resources valuable to a broad range of citizens, without the cost of land acquisition and management—and without removing land from local tax rolls.[14]

II. WHAT ARE CONSERVATION EASEMENTS?[15]

Conservation easements are voluntary restrictions on the use of land negotiated by a landowner and a private charitable conservation organization or government agency chosen by the landowner to "hold" the easement (hereafter in this article such private organizations will be referred to as "land trusts").[16] "Holding" a conservation easement refers to having the right to enforce the restrictions imposed by the easement.

The terms of conservation easements are entirely up to the landowner and the land trust to negotiate. However, the Internal Revenue Code (hereafter in this article, the "Tax Code") establishes requirements that must be met if the donation of an easement is to qualify for federal tax benefits. Many states also grant tax benefits for easement donations that comply with the federal requirements.

Conservation easements do not generally provide third parties, or the public, with the right to access or use the land subject to the conservation easement; however, the grantor of the easement may provide for public use if he or she chooses. Unless the purpose of the easement is the conservation of some feature that is meaningless without public access, such as the preservation of a scenic view, no public access is required to qualify for federal tax benefits.

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13. The Charitable Giving Act, H.R. 7, 108th Cong. (2003), was passed by the U.S. House of Representatives on September 17, 2003, but no subsequent action was taken by the U.S. Senate. *See also* Contributions of Capital Gain Real Property, S. 701, 108th Cong. (2003). These measures are likely to be re-introduced in the next Congress, most likely accompanied by reform provisions as well.

14. Land values may be reduced by the restrictions of a conservation easement; however, in most cases the land was already taxed at a reduced rate to reflect its agricultural use. In addition, numerous studies have found that land in agricultural or open space use, even if generating reduced tax revenues, provides a fiscal benefit because the cost of services to such land is minimal. *See e.g.*, David T. Taylor & Roger H. Coupal, The Cost of Ranchland Conversion in Sublette County (2002) (unpublished report, Univ. of Wyo.) (on file with author); ROGER H. COUPAL, ET AL., *The Cost of Community Services for Rural Residential Development in Wyoming, in* WYO. OPEN SPACES (Dep't of Agric. & Applied Econ., B-1133, Dec. 2002),

15. *See* ALLISON PERRIGO & JON IVERSON, *Conservation Easements: An Introductory Review for Wyoming, in* WYO. OPEN SPACES (William D. Ruckelshaus Inst. of Env't and Natural Res., B-1132, Dec. 2002) (describing conservation easements); Eitel, *supra* note 1 (describing the purpose and evolution of conservation easements).

16. *See supra*, note 12.

The protection of farmland, ranch land, timberland, and open space (particularly where such land is under residential or commercial development pressure and where local planning regulations identify such activities as valuable to the community) are typical objectives of conservation easements. In addition, the protection of wetlands, floodplains, important wildlife habitat, scenic views, and historic land areas and structures are also appropriate purposes for easements.

Easements that are permanent, donated by the landowner (or conveyed pursuant to a qualified bargain sale),[17] and that conserve publicly significant natural resource values (described in the preceding paragraph), typically qualify for federal and state tax benefits. The amount of the deduction must be determined by an independent appraisal of the value of the easement.

In addition, easements normally permit the continuation of the rural uses being enjoyed by the landowner at the time of the donation of the easement. Land subject to a conservation easement may be freely sold, donated, passed on to heirs and transferred in every normal fashion, so long as it remains subject to the restrictions of the easement. It is also possible to retain some rights to limited residential development (e.g. one unit per 100 acres), so long as the retention of such rights does not conflict with the conservation purposes of the easement.

To qualify for federal tax benefits, easements must be held either by a federal, state, or local government agency, or by a "qualified" private organization.

III. REQUIREMENTS FOR FEDERAL TAX BENEFITS[18]

It cannot be sufficiently underscored that there is no common law "safety net" for conservation easement contributions that fail to meet the requirements of the Tax Code and Regulations. Furthermore, the Treasury and congressional tax committee staffs are extremely skeptical of charitable deductions derived from donations where the donor retains a substantial and continuing interest in the property subject to the donation. These folks tend to view such deductions as allowing taxpayers "to have their cake and eat it too." This is particularly true where the donor retains extensive rights to

17. A qualified bargain sale is a sale for less than fair market value, where the buyer and seller intend the difference as a charitable contribution, and the buyer is a public agency or a public charity. The difference between the property's fair market value and its selling price (established by a qualified, independent appraisal) is treated as a charitable contribution eligible for a federal income tax deduction under §§ 170 and 1011(b). 26 U.S.C. §§ 170, 1011(b) (2000). Bargain sales treatment is extended to the sale of a conservation easement for less than its fair market value. *See* 26 C.F.R. §1.170A-14(h)(3).

18. *See generally* STEPHEN J. SMALL, THE FEDERAL TAX LAW OF CONSERVATION EASEMENTS (1986).

continue to use such property, as is the case with many conservation easements.[19]

In the past, the IRS has primarily limited its inquiry to the valuation of the easement itself. The author is unaware of any published cases where the challenge has been to the substance of the conservation easement rather than the value claimed by the donor on his or her return, with three exceptions.[20] However, given the ever-increasing value of deductions for the donation of conservation easements, taxpayers should assume that future audits may scrutinize the terms of the easement for compliance with the requirements of the Regulations.[21] Compliance with these requirements *must be* an important part of the representation of any landowner wishing to donate a conservation easement.

Terminology may be somewhat confusing to the uninitiated. A "qualified conservation contribution" is most commonly known as a "conservation easement."[22] The Tax Code and Regulations frequently refer to "perpetual conservation restrictions."[23] A conservation easement represents only a partial interest in real property. Generally, a federal tax deduction *is*

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19. The author learned of this skepticism first hand during seven years of negotiations with Treasury Department staff and staff of the Joint Committee on Taxation over the addition of what is now § 2031(c), which provides additional estate tax benefits for conservation easement donors. 26 U.S.C. § 2031(c) (2000).

20. *See* Great Northern Nekoosa Corp. v. United States, 38 Fed. Cl. 645 (1997) (deduction denied because the grantor reserved the right to remove gravel for use on the property, which was deemed a reservation of a surface mining right); McLennan v. United States, 994 F.2d 839 (Fed. Cir. 1993) (court upheld donor's charitable intention and found requisite conservation purposes existed to support a deduction); Satullo v. C.I.R., T.C.M. 1993-614 (Dec. 22, 1993) (court determined that a façade easement was not "exclusively for conservation purposes" because of the existence of a prior, unsubordinated, lien on the property subject to the easement). There have been, however, approximately 43 Private Letter Rulings addressing taxpayer inquiries about whether a proposed conservation easement would qualify for a charitable deduction. *See also* Johnston v. C.I.R., T.C.M. 1997-475 (1997) (describing, *inter alia*, the substantive provisions of a conservation easement over a Wyoming ranch, although the principal case is decided on valuation).

21. In comments made to the American Society of Appraisers, Steven T. Miller, Commissioner of the Tax Exempt and Government Entities Division of the IRS, stated:

> There seems to be a popular perception that valuation of the easement is the only issue of concern under the regulations, and it is the primary issue we face in examination, *but in fact there are many requirements having nothing to do with valuation that must be complied with before we have a deductible charitable contribution.*

Steven T. Miller, Address to the American Society of Appraisers (Oct. 22, 2004). Miller went on to specifically mention the conservation purposes requirements of the Regulations, and the standards established by the Regulations for organizations qualified to hold conservation easements. *Id.*

22. "Conservation easement," or occasionally, "easement," is the term used in this article.

23. *See* MERTENS LAW OF FEDERAL INCOME TAXATION § 31.107 (citing 26 C.F.R. §1.170A-14(b)(2) (2004)).

not allowed for the contribution of less than the donor's entire interest in the property donated.[24] However, a conservation easement is an exception to this rule.[25]

A. Specific Requirements

The deduction allowed for the charitable contribution of a conservation easement is not only an exception to the general rule that partial interest gifts are not deductible, the deduction is entirely a creature of the Tax Code and Regulations; therefore, compliance with the technical details of the law is essential. There is no "common law" of taxation to fall back upon.

The Regulations summarize the requirements for a deductible conservation easement as follows:

> A qualified conservation contribution is the contribution of [1] a qualified real property interest [2] to a qualified organization [3] exclusively for conservation purposes. To be eligible for a deduction under this section, [4] the conservation purpose must be protected in perpetuity."[26]

This spare summation precedes (of course) twelve pages of finely printed regulatory elaboration. This section of the article will examine in detail the requirements of the preceding regulatory provision in numerical order.

1. The Easement Must Convey a "Qualified Real Property Interest"

"A perpetual conservation restriction is a qualified real property interest."[27] "'A perpetual conservation restriction' is a 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)."[28] In other words, it is the law of the state in which the easement is donated that dictates the basic form of the easement. Forty-eight states currently have specific enabling legislation for conservation easements (the exceptions, as of 2004, were Wyoming and North Dakota).

Conservation easements in states having enabling legislation must comply with the specifics of the enabling legislation to qualify the easement as a "perpetual conservation restriction" for federal tax purposes. As dis-

24. 26 U.S.C. § 170(f)(3)(A) (2000).
25. *Id.* § 170(f)(3)(B)(iii); 26 C.F.R. § 1.170A-14(a) (2004).
26. 26 C.F.R. § 1.170A-14(a).
27. *Id.* § 1.170A-14(b)(2).
28. *Id.*

cussed by Eitel,[29] conservation easements in Wyoming are structured as appurtenant easements, in which the easement is conveyed as an appurtenant benefit to land owned by the land trust that holds the easement. In this arrangement the land to which the easement becomes appurtenant is the "dominant parcel," and the land over which the easement is conveyed is the "servient parcel."[30] Conservation easements in Wyoming often refer to the dominant parcel as the "trust parcel," and the servient parcel as the "principal parcel." This arrangement meets the federal requirements for a "qualified real property interest."

It is important to note that failing to create a conservation easement that qualifies under state law as a "qualified real property interest" may result in creation of a binding restriction on the grantor's future use of his or her property that fails to generate any tax benefits.[31]

2. The Contribution Must Be to a "Qualified Organization"

To be deductible a conservation easement must be conveyed to an organization that meets the federal requirements; *i.e.*, that is a "qualified organization." Currently there are over 1300 private "land trusts" in the United States that are considered "qualified organizations."[32]

"To be considered an eligible donee . . . an organization must be a qualified organization, have a commitment to protect the conservation purposes of the donation, and have the resources to enforce the restrictions."[33]

a. What Constitutes a "Qualified Organization?"

Qualified organizations include local, state, and federal governmental agencies and charitable organizations qualified under § 501(c)(3) of the Tax Code. To qualify under § 501(c)(3), an organization must be incorporated, and its articles of incorporation and by-laws must reflect that the corporation is organized exclusively for charitable purposes.[34]

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29. Eitel, *supra* note 1, at 64, 65.

30. *See* Mueller v. Hoblyn, 887 P.2d 500, 505 (Wyo. 1994) (describing the characteristics of an appurtenant easement in Wyoming).

31. Such a restriction would be in the nature of a personal covenant, which would bind the grantor, but not the grantor's successors in title, therefore failing the "perpetuity" requirement for deductibility. *See infra* note 76 and accompanying text.

32. For a complete listing compiled by the Land Trust Alliance, *see* http://www.lta.org.

33. 26 C.F.R. § 1.170A-14(c).

34. 26 U.S.C. § 501(c)(3) (2000) (providing that organizations "operated exclusively for . . . charitable purposes" may have "no part of the net earnings of which inures to the benefit of any private shareholder or individual" in order to be qualified exempt organizations).

b. Conservation Commitment

The required "commitment to protect the conservation purposes of the donation" can be ascertained from the articles of incorporation and by-laws of a land trust. The Regulations do not require that the land trust be organized solely for conservation purposes, but they do require that the land trust be *organized* and *operated* "substantially" or "primarily" for one of the conservation purposes recognized by the Regulations.[35]

These requirements are both organizational and operational. Therefore, the mere fact that the organizational documents demonstrate compliance with the requirements is only part of the test. The organization must actually be operated for the required purposes. As noted in the Introduction, the IRS has recently announced that it will increase its scrutiny of conservation easement transactions. It is likely that one focus will be whether a land trust actually is being operated for the proper purposes. If the IRS finds that an organization is acting more as a tax shelter than a conservation organization, both the exempt status of the organization, and the deductibility of the easements that it holds, may be in jeopardy.

The Regulations do not require that an organization be organized or operated *exclusively* for one or more of the conservation purposes. Therefore, organizations whose purposes include the advancement of agriculture, ranching, or timbering practices and providing assistance to landowners engaged in those practices, for example, could qualify. In Wyoming the Wyoming Stockgrowers Association has created the Wyoming Stockgrowers Agricultural Land Trust (WSGALT), which includes among its purposes the conservation of land devoted to agricultural uses. WSGALT is a "qualified organization." Colorado has a similar land trust created by the Colorado Cattlemen's Association. In other words, easements may be held by organizations that are not purely environmental.

c. Required Resources

The third regulatory requirement for holding deductible easements is that the land trust must "have the resources to enforce the restrictions" contained in the conservation easements that it holds.[36] This requirement is the one many land trusts are most in danger of failing to meet. Land trusts doing business in the United States range from those with hundreds of staff members and assets valued in the billions, to those with a staff of part-time volunteers and several hundred dollars in assets. Although the Regulations do not elaborate on what "resources" are required to enforce restrictions, it is unlikely that the latter type of organization complies with this requirement.

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35. 26 C.F.R. § 1.170A-14(c)(1).
36. *Id.*

The Regulations do provide that "[a] qualified organization need not set aside funds to enforce the restrictions that are the subject of the contribution."[37] However, it is difficult to see how an organization with a perpetual responsibility to monitor and enforce a conservation easement can effectively do so without substantial funds in the bank or an endowment.

Many organizations request, and some require, a cash contribution from the donor at the time of an easement donation to provide funds for future monitoring and enforcement of the easement. Donors sometimes look askance at such requests, feeling that they have already contributed something very valuable by donating the easement itself. Nevertheless, acceptance of a conservation easement by a land trust does not confer a financial benefit, but a perpetual obligation that will be costly to discharge.

One Wyoming land trust has determined, through an analysis of its easement stewardship program, that it costs approximately $2,800 per year per easement to monitor the conservation easements that it holds.[38] To completely endow this annual cost, assuming a 5% annual return on funds invested, would require a cash contribution of $56,000 for each easement. Obviously, this is a request that few, if any, land trusts are likely to be willing to make on a regular basis. Most land trusts heavily subsidize their easement stewardship through annual contributions.

From a practical standpoint, it is important for anyone representing a landowner who wants to protect his or her land with a conservation easement to investigate the proposed grantee's actual ability to monitor and enforce the conservation easement over time.

3. The Easement Must Be "Exclusively for Conservation Purposes"

There are two parts to the regulatory requirement that a conservation easement be "exclusively for conservation purposes." First, the easement must be for one or more recognized conservation purposes. Second, the easement can have no purposes other than the recognized conservation purposes.[39]

a. Conservation Purposes

Qualified conservation purposes include (i) the preservation of land areas for outdoor recreation by, or the education of, the general public;[40] (ii) the protection of a relatively natural habitat for fish, wildlife, or plants;[41] (iii)

37. *Id.*
38. The Jackson Hole Land Trust (operating primarily in Teton County, Wyoming).
39. 26 C.F.R. § 1.170A-14(a).
40. *Id.* §§ 1.170A-14(d)(1)(i), -14(d)(2)(ii).
41. *Id.* §§ 1.170A-14(d)(1)(ii), -14(d)(3)(ii).

the preservation of certain open space (including farmland and forest land);[42] or (iv) the preservation of an historically important land area or certified historic structure.[43] The Regulations include a number of examples illustrating the conservation purposes requirements.[44]

(1) Public Recreation or Education. The donation of a conservation easement for the purpose of preserving land areas for the outdoor recreation of the general public, or for the education of the general public, is a qualified conservation purpose.[45] The Regulations provide examples.[46] The Regulations also provide that to qualify under this purpose the conservation easement must make the land available for public use;[47] therefore, such easements must expressly provide for public access.

(2) Preservation of Natural Habitat. The protection of "a significant relatively natural habitat in which a fish, wildlife, or plant community, or similar ecosystem normally lives will meet the conservation purposes test . . . ."[48] Even if the habitat has been altered by human activity, so long as wildlife continues to exist in a relatively natural state the habitat will qualify.[49] Public access is *not* a requirement for qualification under this category of conservation purpose.[50]

Given the significant amount of publicly owned land in Wyoming, habitat protection is a likely category for many conservation easements here. Even protection of small parcels situated near public land may qualify as having a valid conservation purpose under the natural habitat category.

(3) Preservation of Open Space. Protection of "open space" is frequently a goal of conservation easements in Wyoming. Easements protecting "open space" qualify if they fit one of two subcategories: 1) easements that advance "a clearly delineated federal, state, or local governmental conservation policy"[51] or 2) easements "for the scenic enjoyment of the general public."[52] In either case the easement must yield a "significant public benefit."[53]

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42. *Id.* § 1.170A-14(d)(1)(iii).
43. *Id.* § 1.170A-14(d)(1)(iv).
44. *Id.* §§ 1.170A-14(f)(1) to (5).
45. *Id.* § 1.170A-14(d)(2).
46. *See id.*
47. *Id.* §1.170A-14(d)(2)(ii).
48. *Id.* § 1.170A-14(d)(3)(i); *see also id.* § 1.170A-14(d)(3)(ii).
49. *Id.* § 1.170A-14(d)(3)(i).
50. *Id.* § 1.170A-14(d)(3)(iii).
51. *See id.* § 1.170A-14(d)(4)(iii) for list of requirements.
52. *Id.* § 1.170A-14(d)(4)(i)(B).
53. *Id.* §§ 1.170A-14(d)(4)(iv)(A)(1) to (11) (listing elements to be considered in determining whether the easement confers a "significant public benefit").

"Governmental conservation policies" include local agricultural zoning or other specific land use designations recognizing the conservation value of the land. Specific public expenditures associated with these designations, *e.g.*, a real estate assessment program providing tax relief to farms or open space, or a purchase program for easements, demonstrate direct public investment in advancing open space policies.[54]

There have been, to date, fifteen IRS private letter rulings[55] providing guidance as to whether a proposed conservation easement qualified as protecting land pursuant to a "clearly delineated governmental policy." In every case the IRS has found the requirements to have been met by the proposed easements. A recent letter ruling summarizes the IRS's view of what constitutes a "clearly delineated governmental conservation policy."[56] A comprehensive review of the law relating to this conservation purpose resulted in the following summary:

> In conclusion, analysis of the Code, the Treasury regulations, and private letter rulings concerning the interpretation of a "clearly delineated governmental conservation policy" for charitable deduction purposes indicates that such a policy must be to preserve open space or agricultural land subject to a land use planning system designed and primarily implemented in a cohesive fashion by a public agency. The governmental level at which the policy is implemented is of no consequence, as long as the policy results in a process by which individual parcels may be singled out to be preserved in a manner identified in the published policy. The greater the number of overlapping policies, the more clearly the preservation goal is distinguished for tax purposes and the more likely the donation's conservation purpose will withstand IRS scrutiny.[57]

In order to qualify as a "scenic easement" there must be visual access (not necessarily physical access) by the public to those features of the

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54. *See id.* § 1.170A-14(d)(4)(iii).

55. Although letter rulings cannot serve as precedent, they are a good indication of IRS thinking. *See* 26 U.S.C. § 6110(k)(3) (2000).

56. *See* Priv. Ltr. Rul. 2004-18-005 (Dec. 24, 2003).

57. Mark E. Elliott, *Open Space Preservation: An Analysis of the Internal Revenue Code Definition of a Conservation Purpose, in* THE BACK FORTY ANTHOLOGY 3.9 (2003). *See also* SMALL, *supra* note 18; Anne Senti-Willis, *Internal Revenue Service Interpretation of Clearly Delineated Federal, State, of Local Governmental Conservation Policy, in* THE BACK FORTY ANTHOLOGY 5.27 (2003).

land considered scenic.[58] An extensive list of criteria for scenic easements is provided in the Regulations.[59]

Drafting suggestion: In drafting a conservation easement it makes sense to include a description of the conservation purpose(s) of the conservation easement in terms that replicate the description of conservation purposes recognized by the Regulations. The draftsman may also wish to embellish on such a bare-bones description by providing a brief description of the physical characteristics or local or state regulatory provisions, pertinent to the category of conservation purpose under which the conservation easement is believed to qualify.

b. The "Exclusivity" Requirement

The Regulations state: "To meet the requirements of this section, a donation must be exclusively for conservation purposes."[60]

In one of the only reported cases to examine the exclusivity requirement, the IRS challenged a conservation easement on the grounds that the easement was not donated exclusively for conservation purposes.[61] Specifically, the Service argued that the donor had donated the easement for purposes of obtaining a tax deduction and maintaining property values. The easement covered 169 acres. The donors reserved the right to divide the property into eight parcels and to construct four residences and appurtenant driveways on the property. The donation fit into a pattern of land protection designed to protect a scenic area known as the Ligonier Valley in Pennsylvania.

The court stated "plaintiff must have transferred the scenic easement for an exclusive conservation purpose to obtain the benefit of a charitable deduction."[62] In deciding that the easement was exclusively for conservation purposes the court did not question the substance of the conservation achieved, but instead inquired into the intentions of the donor in making the donation, and verified that the technical requirements of the regulations had been met.[63] The court also ruled that the desire to obtain tax benefits does not negate the "donative intent" necessary for a charitable deduction.[64]

58. 26 C.F.R. § 1.170A-14(d)(4)(ii).
59. *Id.* §§ 1.170A-14(d)(4)(ii)(A), 1.170A-14(4)(ii)(A)(1) to (8).
60. *Id.* § 1.170A-14(e)(1).
61. McLennan v. United States, 23 Cl. Ct. 99 (1991).
62. *Id.* at 107.
63. *Id.*
64. *Id. See infra* note 190 and accompanying text.

c. Inconsistent Use

Closely related to the requirement that the donation of the easement must be exclusively for conservation purposes is the prohibition against reserving uses in the easement document that are inconsistent with the conservation purposes advanced by the easement.[65] This does not prohibit the grantor from retaining any rights to use the property. Depending upon the conservation purposes of the easement, rights such as ranching, hunting, fishing, limited residential use, timbering, etc. may be retained in the easement, so long as those rights are consistent with the conservation purposes of the easement.

The Regulations include an example[66] of a scenic easement donated over a 900-acre woodland, pasture and orchards on the crest of a mountain. All of the property was visible from a nearby national park. The donor reserved in the easement the right to divide the property into 90-acre parcels with one single-family dwelling allowed on each parcel. Zoning allowed the property to be developed into 40-acre parcels. The Regulations state that a deduction would be denied in this case because the reserved development potential would destroy the scenic view, *i.e.*, the reservation would be inconsistent with the conservation purposes of the easement.

An alternative example provides that a portion of the 900 acres was not visible from the park, and that the conservation easement required that the reserved development rights be clustered on that portion of the property. In this example the Regulations state that a deduction would be allowed.[67]

The Regulations also provide that:

> [A] deduction will not be allowed if the contribution would accomplish one of the enumerated conservation purposes but would permit destruction of *other significant conservation interests*.[68]

Under this provision, a deduction will be denied if the donor has retained rights that would permit the destruction of significant conservation values, *even if those values are not specifically identified for protection in the easement*. The Regulations give an example of an easement the purpose of which was support for a government flood control program. The easement reserved the right to farm the property. It did not prohibit the use of pesticides that could destroy a naturally occurring ecosystem on the property. The Regulations state that such an easement would not be deductible

65. *See* 26 C.F.R. § 1.170A-14(g)(1).
66. *Id.* § 1.170A-14(f)(3).
67. *Id.* § 1.170A-14(f)(4).
68. *Id.* § 1.170A-14(e)(2).

because it reserved uses that could "impair other significant conservation interests."[69] It is important to note that in this example mere failure to prohibit pesticide use, not the specific reservation of such use, defeated deductibility.

However, where uses inconsistent with "other significant conservation interests" are necessary for the specific conservation purposes of the easement, the reservation of the rights to such uses in the easement *will not* preclude deductibility.[70] Thus, for example, if a specific conservation purpose of an easement is to preserve the use of land for ranching pursuant to a "clearly delineated governmental policy," the easement could allow the destruction of some significant conservation interests, such as elimination of sage brush from grazing areas, if necessary to advance the conservation purpose of ranching.

Drafting Suggestion: In defining the conservation purposes of the easement it is suggested that the draftsman include within the definition of the conservation purposes the protection of "other significant conservation interests (to the extent that it is not necessary to impair such other interests in order to advance the conservation purposes specifically described in this easement)." This provides an overall limitation on reserved uses that should insure compliance with the regulatory requirements.

Where the conservation purpose of an easement is the preservation of "open space" the Regulations prohibit the reservation of uses that would "permit a degree of intrusion or future development that would interfere with the essential scenic quality of the land or with the governmental conservation policy . . . ."[71] Many "open space" easements reserve the right to some additional residential development of the land subject to the easement. The Regulations do not impose a blanket prohibition of such reservations, but they do provide a basis for the disallowance of a deduction if too much development is reserved. How much is too much will depend upon the conservation purposes of the easement and the nature of the easement property.

Occasionally, landowners want to reserve a "floating home site" with the location to be determined by them in the future. However, unless the future location is limited to insure that the conservation purposes and "other significant conservation interests"[72] are not impaired, such a reservation could defeat the deductibility of the easement.

Retained residential rights are less likely to violate open space easements whose conservation purposes are agricultural as opposed to sce-

69. *Id.*
70. *Id.* § 1.170A-14(e)(3).
71. *Id.* § 1.170-14(d)(4)(v).
72. *See infra* note 68 and accompanying text.

nic, provided that the rights cannot be exercised in a manner that intrudes upon good agricultural soil, or with the agricultural use of the property. However, the amount of retained residential development will affect the value of the conservation easement: the more development retained, the lower the easement value and the lower the tax benefits.

Drafting Suggestion: When listing specific uses that are reserved by the grantor, it is prudent to make all such uses subject to the general condition that they be undertaken in a manner that is "consistent with the conservation purposes" identified in the easement. This should effectively refute any argument that a reserved use is inconsistent with the conservation purposes of the easement.

d. "Gaming the System"

The tax benefits of donating a conservation easement have become better known, and have been expanded in recent years. In addition, states themselves are beginning to create additional incentives for the donation of conservation easements. Most notable are state income tax credits, some of them transferable, being allowed by some states.[73] In some regions where property values are extraordinarily high the donation of conservation easements, even on relatively small parcels, can generate multi-million dollar tax deductions. These dynamics have begun to create an atmosphere in which some landowners may seek to "game" the system by attempting to maximize their tax benefits, while minimizing the restrictions on the future use of their land.

For example, the owner of 250 acres, which current zoning allows to be developed into 125 two-acre lots, may consider a conservation easement that reduces development potential to 50 lots, a reduction of 60 percent. Does a conservation easement reserving such density meet the standard that it be "exclusively for conservation purposes?" It is doubtful. The deduction for such an easement, if aggressively audited (and the IRS has put the public on notice that will aggressively audit at least some conservation easement transactions)[74] could be disallowed on any of the following grounds: (1) the easement is not exclusively for conservation purposes, (2) the reserved uses are inconsistent with the conservation purposes, (3) the reserved uses are inconsistent with other significant conservation values, or (4) the easement does not create a significant public benefit.

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73. *See, e.g.*, COLO. REV. STAT. § 39-22-527(1), (2) (LexisNexis 2004); VA. CODE ANN. §§ 58.1-512, 58.1-513.C (Michie 2000 & Supp. 2003). Colorado and Virginia allow easement donors to credit a portion of the value of the easement against their state income tax liability and make these tax credits transferable to other state taxpayers.

74. I.R.S. Notice 2004-41, 2004-28 I.R.B. 31.

It is possible that if the development potential reserved in this example was restricted in such a manner as to preserve the scenic qualities and to better advance the governmental conservation policy, such an easement might pass muster.[75] However, the size of the deduction for such an easement is likely to be marginal due to the magnitude of reserved development potential.

4. The Conservation Easement Must Be In Perpetuity

To be eligible for an income tax deduction the "conservation purposes" advanced by the easement must be protected in perpetuity.[76] This requirement is probably the one that is the most difficult for prospective easement donors. However, when a parishioner puts $100 in the collection plate, the gift is made with no expectation or reserved right that it can be taken back at a future time. In the same manner, the gift of an easement, to be deductible, must be irrevocable.

For an easement gift to be in perpetuity the easement deed cannot include any reversionary right in the donor, or the donor's successors in title, or any other provision that would allow the donor to unilaterally recover any or all of the rights conveyed by the easement.[77] Sometimes donors want to make an easement donation contingent upon obtaining favorable tax treatment of the transaction. This violates the perpetuity requirement.

In essence, the requirement of perpetuity means that the easement is irrevocable by the donor and his or her successors in title. In this sense, a conservation easement is very little different from other legal devices, such as restrictive covenants and subdivisions, which pertain to the land. Nevertheless, conservation easements, like other contracts, may be amended if all of the parties to the easement (typically the land trust and the landowner whose property is subject to the easement) consent.

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75. *See, e.g.*, 26 C.F.R. § 1.170A-14(f)(4) (2004).

76. *Id.* § 1.170A-14(a).

77. In certain cases the use of an escrow can accomplish essentially the same goal as a reversionary right or contingency included in the easement itself without defeating deductibility. For example, a landowner wishes to donate a conservation easement, but only if his neighbor donates a similar easement. If the two neighbors cannot enter into an agreement between themselves to donate easements and preserve the deductibility of the donations, the first landowner can agree with a land trust to place an easement in escrow with an independent party. The escrow agreement provides that the land trust may put the easement to record if it obtains a conservation easement from the neighbor within, for example, two years. If the neighboring easement does not materialize within two years, the escrow is terminated and the easement returned by the escrow agent to the landowner. If the neighboring easement is obtained, the escrowed easement is recorded. The donation, for tax purposes, will be considered to have occurred when the easement goes to record, not when the easement is placed in escrow. *See infra* note 220 and accompanying text. There are other circumstances where an escrow can be useful in conservation transactions as well.

There are a number of issues that relate to the requirement of perpetuity that are discussed below.

a. Amendments

As noted above, conservation easements are like any other contract in that they can be amended, if all of the parties to the easement agree. However, the ability to amend an easement and its perpetual nature seem to be in conflict. The Regulations make no provision for the amendment of a conservation easement.

Nevertheless, conservation easements are regularly amended: often to correct drafting errors, less frequently to make substantive changes. However, unlike a contract between private individuals, at least one of the parties to a conservation easement is severely constrained in terms of the type of amendment into which it may enter. The Tax Code and Regulations prohibit §501(c)(3) organizations, such as land trusts, from entering into "excess benefit transactions."[78] The prohibition is intended to insure that assets held by a public charity are not used to benefit private interests.[79]

The most familiar of the excess benefit prohibitions is the rule that none of the earnings of a §501(c)(3) organization may "inure" to the benefit of any of the organization's board members, staff, or "insiders" (anyone in a position to substantially influence the decisions of the organization, such as a significant donor), or the family members of such persons.[80] Thus, no easement amendment that might provide a financial benefit to any of these persons is permissible if the benefit inuring to the individual is disproportionate to that enjoyed by the public as a whole.[81]

The other excess benefit prohibition derives from the requirement that the assets and income of a §501(c)(3) organization be used "exclusively" for the approved public purposes of the organization.[82] This is sometimes referred to as the "private benefit" prohibition.[83] A §501(c)(3) organization may not engage in transactions that confer an economic benefit on

78. *See* 26 U.S.C. § 4958 (2000).

79. *See* Chris Cline, *Inurement and Private Benefit: Avoidable Perils, in* THE BACK FORTY ANTHOLOGY 1.7 (2003).

80. 26 U.S.C. § 501(c)(3).

81. There are exceptions, of course. For example, if a land trust chooses to undertake a project that has long been contemplated, where the public benefits are clear, substantial, and consistent with the mission of the organization, but where a board member may derive some special benefit (*e.g.*, he owns land next to land over which the land trust plans to purchase a conservation easement), provided that the board member has not voted or attempted to persuade other board members, it is unlikely that the prohibition against private inurement has been violated by the project.

82. 26 U.S.C. § 501(c)(3).

83. Private inurement and private benefit transactions are also known as "excess benefit transactions."

any private person other than an insider that is greater than that conferred on the public. In essence, land trust transactions must be economically neutral where private entities are uniquely benefited.

These two rules severely constrain land trusts in agreeing to amend conservation easements. Entering into an excess benefit transaction creates the possibility that the IRS will impose substantial excise taxes[84] on both the land trust and the private beneficiary of the transaction. In extreme or repeated cases, the IRS may seek to revoke the charitable status of the land trust. Simply put, land trusts cannot agree to amendments that will confer a financial benefit on the owner of the land subject to the easement—or on any other private entity or individual. On the other hand, a land trust can agree to amendments that create additional conservation benefits, even if the amendment confers a private economic benefit, provided that the beneficiary offsets any economic benefit so that the transaction is economically neutral.

For example, the owner of land subject to a conservation easement seeks an amendment to the easement allowing two additional home sites on a portion of the easement property. Such an amendment would constitute an excess benefit transaction. However, if the landowner agreed to donate an easement over additional land generating a substantial, additional public benefit, and the value of the easement equaled or exceeded the value of the two additional home sites allowed by the amendment, the transaction would not be an excess benefit transaction. Such transactions should be verified by independent, qualified appraisals. A cash contribution equivalent to or exceeding the "excess benefit" of the transaction should satisfy the Tax Code; however, land trusts typically avoid "selling" amendments in such a fashion. Furthermore, such "amendment sales" could raise substantial questions about the "perpetuity"[85] of easements.

b. Judicial Termination and Condemnation

In addition to amendments, conservation easements can be revised and terminated by judicial action. Under the common law doctrine of changed conditions, or *cy pres*,[86] a court can revise or terminate a conserva-

84. 26 U.S.C. § 4958 imposes an excise tax in the amount of 25% of the "excess benefit" on entities or individuals receiving such benefits, and a penalty of up to $10,000 on any land trust manager responsible for the transaction.

85. *See supra* note 76 and accompanying text for discussion of perpetuity.

86. As the Wyoming Supreme Court has explained:

> The term [*cy pres*] means "as nearly as possible." "Roughly speaking . . . it is the principle that equity will make specific a general charitable intent of a settlor, and will, when an original specific intent becomes impossible or impracticable of fulfillment, substitute another plan of administration which is believed to approach the original scheme as closely as possible.

tion easement that no longer serves its originally intended purpose. For example, a conservation easement granted to protect what was once a wetland, but which has over time dried up through natural causes, could be terminated by a court, assuming no other meaningful public conservation benefit for the continuation of the easement existed. The Regulations contemplate this possibility, and provide for the disposition of any sales proceeds resulting from such a termination.

Conservation easements held by private organizations are also subject to condemnation through the exercise of eminent domain by governmental agencies.

(1) Recognized Conditions for Termination

The Regulations address the potential for a conservation easement to be "extinguished" (terminated). The Regulations provide that the potential for termination will not defeat deductibility if the following conditions are met:

> a) The termination was by court order.
>
> b) The termination was due to changed circumstances making continued use of the property for the conservation purposes impractical or impossible.
>
> c) Any proceeds accruing to the land trust as a result of the termination are required by terms of the easement to be used by the land trust in a manner that is consistent with the conservation purposes of the easement.[87]

In essence, the Regulations recognize the potential for a court to apply the doctrine of *cy pres* to a conservation easement. By implication, the Regulations also recognize the potential for condemnation of a conservation easement (or portion thereof) pursuant to the governmental exercise of the power of eminent domain.[88]

> It is the theory that equity has the power to mould the charitable trust to meet emergencies."

Town of Cody v. Buffalo Bill Memorial Ass'n, 196 P.2d 369, 379 (Wyo. 1948) (quoting 2 BOGERT, TRUSTS AND TRUSTEES, § 431).

87. 26 C.F.R. § 1.170A-14(g)(6)(i) (2004).

88. *Id.* (referring to "involuntary conversion" of a conservation easement).

(2) Division of Proceeds Resulting from Termination

One of the more difficult requirements for a landowner to accept is that proceeds of any sale pursuant to easement termination (including condemnation) must be divided between the landowner and the land trust. The division must be in proportion to the value of their respective interests, based upon the value of the easement and the unrestricted value of the property subject to the easement at the time of the donation.[89]

For example, assume that Mr. Jones donates a conservation easement on his ranch. Before the easement is donated the ranch is worth $2 million. After the easement is donated the ranch is worth $800,000. The value of the easement is, therefore, $1.2 million.[90] $1.2 million represents 60% of the unrestricted value of the ranch. Sixty percent is the "proportionate value of the perpetual conservation restriction." If ten acres of the easement property is condemned for a new road, and the condemnation proceeds are $200,000, the land trust must receive 60%, or $120,000.

Assume a slightly different scenario in which Mr. Jones negotiates with the Wyoming Department of Transportation an exchange of the ten acres subject to condemnation for 50 acres of land in another location. No cash is paid. According to the Regulations, the land trust is entitled to 60% of the exchange property, or 30 acres.

Drafting Suggestion: The provisions regarding division of proceeds on termination are complex and it is strongly recommended that the draftsman not attempt a translation of the provisions, but merely repeat them in the easement, including the requirement that the land trust use any proceeds resulting from a termination of the easement, in whole or in part, in a manner that is consistent with the conservation purposes of the easement.[91]

c. Wyoming's Marketable Title Statute

Wyoming has enacted a "Marketability Statute."[92] The effect of this statute is to terminate certain non-possessory interests in real property unless the existence of such interests is renewed, as a matter of public record, at least every forty years. This statute appears to apply to easements in general, presumably including conservation easements, which are non-possessory in nature.

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89. *Id.*

90. *See infra* note 161 and accompanying text for a discussion of easement valuation.

91. 26 C.F.R. § 1.170A-14(g)(6)(i).

92. WYO. STAT. ANN. §§ 34-10-101 to 34-10-109 (LexisNexis 2003). *See also* Jay M. Zitter, Annotation, *Construction and Effect of "Marketable Record Title" Statutes*, 31 A.L.R. 4th 11 (1984 & Supp. 2004).

The Marketability Statute is an important one for land trusts and governmental agencies in Wyoming that hold conservation easements. They must re-record their easements within the required forty-year time frame to perpetuate the easement.[93] Failure to do so could deprive the easement holder of the ability to enforce the easement.

Even though the Marketability Statute obviously jeopardizes the perpetual nature of a conservation easement, it does not affect deductibility. This is because the possibility that the easement will be terminated by operation of the statute is considered by the Regulations to be a "remote future event" that does not affect deductibility.[94]

d. The Rule Against Perpetuities

Wyoming law prohibits perpetuities.[95] Some have argued that the Wyoming Rule Against Perpetuities prohibits perpetual conservation easements.[96] However, the Rule Against Perpetuities does not pertain to the perpetual nature of conservation easements (or the perpetual nature of any other kind of easement, for that matter).[97] The Rule dictates the time within which the beneficial interest in property held in trust (or through similar mechanisms) must vest in ownership. The focus of the Rule is primarily to prevent unreasonable restraints on the alienation of title to property.[98] Conservation easements vest in a land trust immediately upon delivery of the easement document. Furthermore, while conservation easements do impose restrictions on the uses to which property may be put, they do not impose any restraint on the alienation of title.

e. Subordination of Mortgages

For a conservation easement to be perpetual there can be no outstanding rights in the land subject to the easement that could defeat the conservation purposes of the easement or the enforcement of its terms, in perpe-

93. WYO. STAT. ANN. §34-10-106 (LexisNexis 2004) (providing for the filing of a notice perpetuating interests that might otherwise be cut-off by the operation of the marketability statute).

94. 26 C.F.R. § 1.170A-14(g)(3) (explaining the effect of a State's marketability statute as an example of a remote future event).

95. WYO. CONST. art. I, § 30; WYO. STAT. ANN. § 34-1-139 (LexisNexis 2003).

96. *See, e.g.*, comments of Senator April Brimmer Kunz during the debate of conservation easement enabling legislation by the Wyoming Senate, 2003. The argument that conservation easements violate the Rule Against Perpetuities was a major part of the debate in the Wyoming legislature's consideration of adoption of the Uniform Conservation Easement Act in the 2003 session. Ironically, it was during this same Session that the period during which interests must vest was increased from the traditional 21-year period to 1,000 years for qualified interests.

97. WYO. CONST. art. I, § 30; WYO. STAT. ANN. § 34-1-139 (LexisNexis 2003), *supra*.

98. *See, e.g.*, McGinnis v. McGinnis, 391 P.2d 927 (Wyo. 1964); *see also* Eitel, *supra* note 1, at 94-109.

tuity.[99] To comply with this requirement outstanding mortgages must be subordinated to the conservation easement applicable to the mortgaged property.[100] Where land is subject to a mortgage that has been sold into the secondary mortgage market (most always the case with residential mortgages), and where the prospective easement donor's equity in the land to be made subject to an easement is not substantial, obtaining subordination will be difficult. On the other hand, mortgages held by lo al banks and the Farm Credit Corporation, appear to be more easily subordinated.

The Regulations do not specify when an outstanding mortgage must be subordinated. Some easement deeds provide for the lender to join in the conveyance; in other cases the subordination occurs in a separate document recorded after the easement is put to record. It seems logical that the subordination must be completed no later than the date of filing of the tax return on which the easement donation is first deducted. In any event, having the subordination in hand before the conveyance is final is the only way to be sure that the donor will not permanently restrict his or her property only to later discover that the lender will not subordinate, thereby precluding a deduction.

If a lender refuses to subordinate its interest on a large property it may be possible to convince the lender to subordinate on a portion of the property, limiting its priority to the developed portion, where its highest value exists. The easement can then be limited to just that portion of the property over which the mortgage has been subordinated (or released), thereby preserving deductibility. If it suited the donor's goals, a nondeductible easement could be placed on the balance.

f. Mining and Mineral Extraction

The requirement of perpetuity limits easement deductibility on lands where the possibility of mining and mineral extraction exists. The Regulations pose substantial difficulties for prospective easement donors when the right to access and extract minerals has been severed from the surface. Severed mineral interests characterize vast amounts of otherwise conservation-worthy land in Wyoming. The Regulations provide:

> [N]o deduction shall be allowed in the case of a contribution of any interest when there is a retention by any person of a qualified mineral interest . . . if at any time there may be extractions or removal of minerals by any surface mining method. Moreover, . . . the requirement that the conservation purposes be protected in perpetuity is not satisfied if

99. 26 C.F.R. § 1.170A-14(g)(1).
100. *Id.* § 1.170A-14(g)(2).

> any method of mining that is inconsistent with the particular conservation purposes of a contribution is permitted.[101]

These Regulations distinguish between "surface mining" and other mining methods.

(1) Surface Mining. If "any person"[102] retains surface mining rights in property with respect to which a conservation easement is donated no deduction is available. It does not matter whether the interest is retained by the easement donor, or by some third party due to a prior severance of the minerals. Of course, a prohibition in a conservation easement against surface mining will not control a prior recorded mineral conveyance.

If the owner of the mineral rights *does* subordinate to a conservation easement prohibiting surface mining, the regulatory requirement *should be* satisfied because the prohibition will take precedence over the outstanding surface mining rights. However, subordination of surface mining rights does not, in a strictly technical sense, satisfy the regulatory requirement because the mining rights continue to exist; they are still "retained," merely subordinated to the prohibition on their exercise, which is different than being terminated. Any major donation relying on subordination, rather than a termination, of outstanding mineral rights where surface mining is a possibility may justify seeking a private letter ruling from the IRS.

There is an exception to the surface mining rule. When an easement is donated on property "in which the ownership of the surface estate and mineral interests has been and remains separated" a deduction may be allowed "if the probability of surface mining occurring on the property is so remote as to be negligible."[103]

This exception contains three parts. First, the mineral rights must have been separated from the surface rights prior to donation of the easement, and remain separated at the time of the easement. If the donor of the easement retains the mineral rights at the time of the donation the exception does not apply.[104]

Second, the owner of the mineral rights may not be related to the surface owner in any of the ways described in §§ 267(b) or 707(b) (family

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101. *Id.* § 1.170A-14(g)(4)(i).
102. *Id.*
103. 26 U.S.C. § 170(h)(5)(B)(ii); *see also* 26 C.F.R. § 1.170A-14(g)(4)(ii). The Regulations have not been changed to reflect the new law, which provides the exception regardless of when the mineral rights may have been separated.
104. 26 C.F.R. § 1.170A-14(g)(4)(ii)(1). This Regulation has not been changed to reflect the new law, which provides the exception regardless of when the mineral rights may have been separated.

member, or other described relationships).[105] In other words, even if the other elements of this test are met, if the severed minerals are owned by a member of the surface owner's family (ancestors, descendents, siblings, etc., or persons having some other fiduciary or business relationship), the exception will not apply.

Third, the probability of surface mining must be "so remote as to be negligible."[106] The "remoteness" part of the exception poses an evidentiary test. Typically, the prospective donor of a conservation easement on property where minerals have been severed will obtain a written report from a qualified geologist that the probability of surface mining is so remote as to be negligible. Such reports are frequently referred to as "remoteness letters." The IRS may challenge the conclusions of such a report, although the author is unaware of any such instances.

The Regulations state that whether the probability of surface mining is so remote as to be negligible is a matter of fact to be determined on a case-by-case basis.[107] Factors to be considered are included in the Regulations.[108]

In 1997 the Federal Claims Court addressed the surface mining prohibition in the case of *Great Northern Nekoosa Corporation v. United States*.[109] The *Nekoosa* case resulted in denial of a $19 million tax deduction for the donation of a conservation easement on the grounds that the donor had retained surface mining rights in violation of the Tax Code and Regulations. This decision was significant for two reasons. First, it is one of the few reported opinions to challenge the substance of an easement donation, not just the valuation of the contribution. Second, it is the only reported opinion to date relating to retained mineral rights.

The grantor of the easement in the *Nekoosa* case had retained the right to extract gravel for the purpose of constructing and maintaining roads on the property and the right to locate borrow pits and excavate from them material necessary for construction on the property. The terms of the easement clearly retained the right to surface mine these minerals. Because of this the government argued that no deduction could be allowed due to the statutory prohibition against retaining surface mining rights in a conservation easement.

In response the grantor argued that sand and gravel were not subsurface minerals and therefore, they were not within the definition of "qualified

105. *Id.* § 1.170A-14(g)(4)(ii)(2).
106. *Id.* § 1.170A-14(g)(4)(ii)(3).
107. *Id.*
108. *Id.*
109. Great Northern Nekoosa Corp. v. United States, 38 Fed. Cl. 645 (1997).

mineral interest" within the meaning of the regulatory prohibition. The court disagreed, stating:

> Because 26 U.S.C. section 170(h)(5) and (6) are part of a statutory scheme designed to promote conservation, it would be incongruous with the purposes of the statute to adopt a definition of "subsurface" which would allow disruption of the landscape by surface, or strip mining, to access gravel and sand.[110]

The easement grantor also argued that retention of surface mining rights was permissible so long as the mining activity had only a limited, localized impact on the property not irremediably destructive of significant conservation interests. This exception was based on a portion of 26 C.F.R. §1.170A-14(g)(4).[111] The court ruled that this interpretation of the Regulations ignored other provisions that were relevant and would "subvert the fundamental conservation purposes of the statute."[112] In fact, that regulatory exception does not pertain to retained surface mining rights.

There are several lessons to be learned from the *Nekoosa* case. First, the court looked at the substance of what was allowed by the easement, rather than the technical application of the law urged by the grantor. Second, the court rejected the effort to apply to surface mining the provisions pertaining to other "methods of mining" where the methods have a "limited and localized impact on the real property but that are not irremediably destructive of significant conservation interests."[113]

(2) Reservation of the Right to Extract Gravel. The *Nekoosa* case demonstrates that retaining the right to extract gravel for road construction and maintenance on the conserved property will jeopardize deductibility. Such extraction, however, is a typical ranching practice and reservation of this right is often important to easement donors in the West.

There are at least two ways to address the issue of retaining gravel extraction rights. The first is a technical one. Wyoming case law does not recognize gravel as a "mineral."[114] Although statutory law does classify

110. *Id.* at 657.
111. *See supra* note 120 and accompanying text.
112. *Great Northern Nekoosa*, 38 Fed. Cl. at 659.
113. *Id.*
114. Miller Land & Mineral Co. v. State Highway Comm'n of Wyo., 757 P.2d 1001, 1001 (Wyo. 1988); *but see Great Northern Nekoosa*, 38 Fed. Cl. at 655 (1997) (acknowledging taxpayer's concession that gravel was a mineral under Maine law).

gravel as a mineral for certain purposes[115] the definition would not appear applicable to rights reserved in conservation easements.

Another approach to the reservation of the right to extract gravel (or any other mineral) is to exclude the area in which gravel deposits lie from the easement. Although such an exemption may reduce the value of the tax deduction, it will preserve deductibility. The donor may want to protect the excluded area with a non-deductible easement.

(3) Subsurface Mineral Rights. In addition to the prohibition of surface mining, the Regulations require that a conservation easement prohibit any other "method of mining" that is "inconsistent with the with the particular conservation purposes of a contribution . . . ."[116] This Regulation implements the statutory requirements that the contribution of a conservation easement be "exclusively for conservation purposes."[117]

Other regulatory provisions that pertain to methods of mining other than surface mining are the prohibitions against retaining interests that are "inconsistent with the conservation purposes" of the easement[118] or that would "permit the destruction of other significant conservation interests."[119]

The Regulations also provide an exception to the prohibition against other methods of mining. The exception is for mining methods that meet three criteria: 1) the method has "limited" impact; 2) the method has "localized" impact; and 3) the method is "not irremediably destructive of significant conservation interests."[120]

5. Limitation on Transfer of a Conservation Easement

In order for a conservation easement contribution to be deductible the easement document must require that, in the event of any subsequent transfer of the conservation easement by the original holder, the subsequent holder agree to carry out the conservation purposes of the easement.[121] In addition, the document must prohibit the transfer of the conservation easement to any organization that is not a "qualified organization" within the meaning of §170(h).[122]

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115. WYO. STAT. ANN. § 35-11-103(e)(ii) (LexisNexis 2003).
116. 26 C.F.R. §1.170A-14(g)(4)(i) (2004).
117. 26 U.S.C. § 170(h)(1)(C) (2004); 26 C.F.R. §1.170A-14(e)(1).
118. 26 C.F.R. § 1.170A-14(g)(1). *See supra* note 65 and accompanying text.
119. 26 C.F.R. § 1.170A-14(e)(2). *See supra* note 68 and accompanying text.
120. 26 C.F.R. § 1.170A-14(g)(4)(i). See *id.* §§ 1.170A-14(e)(2), 1.170A-14(g)(4)(iii), for examples of the exception.
121. *Id.* § 1.170A-14(c)(2).
122. *Id. See also* Priv. Ltr. Rul. 199952037 (Dec. 30, 1999).

The Regulations *do not* require that a conservation easement be transferred to a governmental organization. Nevertheless, it is a concern of some critics of conservation easements that easements will ultimately end up in the hands of a governmental agency. The easements drafted by the author, reflecting the desires of the donors, typically only permit a transfer of a conservation easement to another land trust; they do not allow transfer of the easement to any governmental agency.

Because conservation easements held by land trusts are private property they are no more susceptible to government acquisition than any other type of private property. Furthermore, any effort by a legislative body to retroactively amend a conservation easement to make it transferable to a governmental agency (or any other retroactive amendment, for that matter) would be unconstitutional.[123] For these reasons, unless the easement donor expressly allows it, there is little chance that conservation easements will someday be taken over by a governmental agency.

6. Documentation of Conditions

If the donor retains any rights to use the property subject to the easement (*e.g.*, farming, limited residential use, recreational use) "documentation sufficient to establish the condition of the property at the time of the gift" is required by the Regulations.[124] Such documentation provides the land trust with a basis upon which to measure changes in the property over time. This is information essential to enforcement of the restrictions of any conservation easement. The Regulations include a list of suggested materials to include in the documentation (also referred to in the Regulations as a "natural resources inventory").[125]

The Regulations require that the donor make this documentation available to the land trust *prior to the conveyance* of the easement. Furthermore, a statement must accompany the documentation, *signed by both the donor and the land trust*, to the effect that it is an accurate representation of the protected property at the time of the donation.[126]

Easement documentation may be contracted for from firms specializing in environmental assessments. In addition, some land trusts undertake preparation of such documentation themselves. The existence of a documentation report is not conclusive evidence of the matters reflected in the report, but is a source of evidence of condition.

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123. The United States Constitution prohibits States from passing any law impairing the obligation of contracts. U.S. CONST. art. I, § 10. *See also* WYO. CONST. art. I, § 35, applied in the case of *In re* Hagood, 356 P.2d 135 (Wyo. 1960).

124. 26 C.F.R. § 1.170A-14(g)(5)(i).

125. *Id.* § 1.170A-14(g)(5)(i)(A) to (D).

126. *Id.* § 1.170A-14(g)(5)(i).

7. Notice, Inspection and Legal Remedies

In addition to documentation, the Regulations impose other requirements on conservation easement donations in which the donor reserves any rights to use the property that is subject to the donation. These requirements are intended to ensure that reserved rights are exercised in a manner that is consistent with the terms of the conservation easement. These requirements are mandatory and must be included in any deductible conservation easement.

a. Notice

The easement document must require the donor, and the donor's successors in interest in the property subject to the easement, "to notify the donee, in writing, before exercising any reserved right . . . which may have an adverse impact on the conservation interests associated with [the conservation easement]."[127] Although it is hard to know exactly what reserved rights may have an adverse impact on the "conservation interests associated with" the easement; just as it is hard to know which conservation interests are being referenced, a conservative approach to surviving an audit would be to comply strictly with these requirements.

Drafting Suggestion: The easement document should provide that the donor, and the donor's successors in title, must give *written notice* to the land trust *prior* to exercising any reserved rights that may be inconsistent with the conservation purposes as defined in the conservation easement. Limiting this blanket notice requirement should be carefully considered for compliance with the Regulations.

Occasionally prospective donors want to include a provision in their easement that states that if the land trust does not reply to a notice within a specified period of time (typically 30 or 60 days) the activity described in the notice will automatically be deemed approved. If such a provision is included in an easement, the easement should make it clear that such a default approval may not allow activity that would be inconsistent with the conservation purposes of the easement.

b. Inspection

In conservation easements where the donor has retained any rights to use the easement property the easement document must confer on the land trust the right to enter the property at reasonable times for purposes of inspection to verify compliance with the terms of the easement.[128] The Regu-

127. *Id.* § 1.170A-14(g)(5)(ii).
128. *Id.*

lations do not specify the frequency of inspections. Typically, conservation easements provide for at least annual inspection, after written notice to the landowner. If the easement requires notice to the landowner prior to inspection (not a regulatory requirement) the document should provide for immediate entry on the property without notice in the event of an existing or imminent violation that may significantly impair the conservation purposes of the easement.

c. Required Remedies

If the donor retains rights to use the easement property, the Regulations require that the easement document confer upon the land trust the right to "enforce the conservation restrictions by appropriate legal proceedings including, but not limited to, the right to require the restoration of the property."[129] Typically, conservation easements include the right to seek damages, legal fees, and to obtain injunctive relief, in the event of a violation. The Regulations *require* that the land trust be granted the right to seek restoration.

The restoration requirement is problematic because it requires that the easement permit the land trust to seek restoration of the property "to its condition at the time of the donation."[130] This fails to consider that the property may have been altered by activities authorized by the easement that are consistent with the conservation purposes. Therefore, it would seem reasonable for an easement to provide the land trust with the right "to enforce the restoration of the portions of the property affected by activities in violation of the easement to the condition that existed on the date of the conveyance hereof."[131]

IV. INCOME TAX BENEFITS AND LIMITATIONS

Section III examined the requirements established by the Tax Code and Regulations for the deductibility of donated conservation easements.

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129. *Id.* The Regulations do not say who has standing to enforce a conservation easement, other than the land trust holding the conservation easement. However, standing is an important question. A detailed discussion of standing is beyond the scope of this article. Note, however, in an interlocutory order in *Hicks v. Dowd*, the Wyoming Fourth District Court held that the conservation easement held by the Johnson County Scenic Preserve Trust was held by a "charitable trust" and that, pursuant to WYO. STAT. ANN. §§ 4-10-103, 4-10-110 (LexisNexis 2003), beneficiaries of the trust included the citizens of Wyoming and the Attorney General of Wyoming and that such beneficiaries had standing to sue to enforce the terms of the trust. Hicks v. Dowd, No. 2003-0057, Fourth Judicial District, Johnson County, Wyoming (2003); *see also supra* note 77.

130. 26 C.F.R. § 1.170A-14(g)(5)(ii).

131. Provision from a conservation easement form developed by and on file with the author.

This section examines the tax benefits themselves, and the limitations imposed upon enjoyment of those benefits by the Tax Code and Regulations.

A. The Value of a Donated Conservation Easement is Deductible

A conservation easement donor who complies with the requirements of §170(h) may deduct the value of the easement from his or her income for tax purposes.[132] The value of the easement is typically the difference in the value of the easement property before the donation and after the donation.[133]

Example: Mr. Jones donates an easement on land that is valued at $1,000,000 before the donation. The value of the land drops to $700,000 after the easement is donated due to the restrictions on future use imposed by the easement. This approach to valuation is the "before and after" approach.[134] The value of the easement is $300,000, which is the difference in values of the property before and after the donation of the easement ($1,000,000 – $700,000).

Prospective donors of conservation easement often obtain preliminary valuations of a proposed easement. In such cases, the appraiser assumes that the donation has taken place.

The principal component of value in a conservation easement is the amount of development potential allowed by existing land use regulations that will be eliminated by the easement. There are other measures as well: the value of a conservation easement preserving a valuable stand of timber would likely be measured in terms of the value of the timber as well as any development potential eliminated.

The *maximum* possible federal income tax benefit that can result from a conservation easement donation is calculated by multiplying the value of the easement by the top federal tax rate then applicable. Although not relevant to Wyoming, which does not have an income tax, most states with an income tax provide a deduction for easement donations as well. Adding the applicable top federal and state tax rates together and multiplying the value of the easement by these combined rates provides the *maximum* possible combined federal and state income tax benefit of any easement donation.[135]

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132. *See supra* Section III.

133. 26 C.F.R. § 1.170A-14(h)(3)(ii). *See infra* note 161 and accompanying text for discussion of valuation.

134. *See infra* note 162 and accompanying text.

135. The current top federal individual income tax rate is 35%. 26 U.S.C. § 1 (2004). Note that federal income tax rates for "C" corporations (*i.e.*, corporations taxed as separate entities, rather than like partnerships as is the case with "S" corporations or limited liability companies) range from 15% to 39%, but not incrementally. 26 U.S.C. § 11 (2004).

Example: If Mr. Jones, in the previous example, earned sufficient income that the entire $300,000 offset by the easement deduction would have been taxed at the current top federal rate of 35%, the value of the deduction would be $105,000 (35% x $300,000).

If Mr. Jones resided in California, which has a top individual income tax rate of 9% and recognizes the federal charitable deductions, he would enjoy an additional state income tax benefit of $27,000 (9% x $300,000).

Some states, in addition to the charitable deduction for the donation of a conservation easement, allow a state income tax credit for easement donations. For example, Virginia allows a tax credit equal to 50% of the value of any conservation easement donated by a Virginia taxpayer over land in Virginia (providing that the easement qualifies as a charitable contribution under §170(h)). That credit is limited to $100,000.[136] State tax credit programs are few and far between and can vary significantly from state to state.

2. The Annual Limitation on Charitable Deductions[137]

Generally, the Tax Code limits individual deductions[138] for charitable donations to public charities such as land trusts, to 50% of the donor's "contribution base" annually.[139] Contribution base is an individual's adjusted gross income without regard to the amount of the contribution and without regard to any "net operating loss carryback."[140] However, when an individual makes a gift of "long-term capital gain" property (a capital asset held more than one year; also referred to as "30-percent capital gain property"—for example, a conservation easement on land owned for more than one year)[141] the federal income tax deduction for that donation is limited to 30% of the donor's contribution base.[142]

136. *See* VA. CODE ANN. § 58.1-512(B)(1) (2004).
137. In addition to the limitations described in this section, the Tax Code imposes a "phase-out" of itemized deductions for individuals with substantial incomes. This phase-out may further limit the tax benefits of donating a conservation easement, but the limitation is usually only a small percentage of the value of the deduction. *See* 26 U.S.C. § 68 (2004).
138. C corporations are limited to deducting no more than 10% of their "taxable income" for charitable contributions, regardless of the length of time the property that is contributed has been owned by the corporation. 26 U.S.C. § 170(b)(2). Individuals and pass-through entities, such as limited liability companies, partnerships, limited partnerships, and S-corporations, are all allowed to deduct charitable gifts up to 50% of their contribution base. 26 U.S.C. § 170(b)(1).
139. *Id.* § 170(b)(1)(A).
140. *Id.* § 170(b)(1)(F).
141. 26 C.F.R. § 1.170A-8(d)(3) (2004).
142. *Id.* § 1.170A-8(d)(1).

If the easement donation is with respect to property held for one year or less (normally "ordinary income property")[143] the deduction is allowed up to 50% of the donor's contribution base.[144] However, deductions for the donation of ordinary income property cannot exceed the donor's basis (basis is essentially what the donor paid for the property plus the cost of improvements)[145] in the donated property, in this case the easement. Because a conservation easement is only a partial interest in property, the donor must allocate his or her basis in the easement property between that property and the easement.[146] Note that the holding period of property received as a gift includes the donor's holding period.[147] Property received as a bequest or devise from a decedent's estate is automatically treated as long-term capital gain property.[148]

A donor making a donation of long-term capital gain property may *elect* to have the donation treated as a donation of ordinary income property and thereby qualify for the 50% limitation rather than the 30% limitation. However, in making this election, the donor must agree to limit the amount of the deduction to his or her basis in the donated easement.[149] Such an election makes sense when the donor has owned property over which he or she plans an easement donation for more than one year, but where the value of the easement does not exceed the donor's basis in the easement.

Because the *entire* amount of a donor's charitable deductions made during a tax year is limited to 50% of the donor's contribution base, it is necessary to determine what other gifts a prospective easement donor has made during the year and the value of those gifts, to know how much of the easement deduction the donor will be able to use in that year. Thus, if the donor has made gifts for which charitable deductions are available in addition to the conservation easement gift, the value of the other donations may reduce the amount of the deduction that may be taken for the easement donation during that year.

Example 1: Mr. Jones' easement is worth $300,000. He has owned the property that is subject to his easement donation for five years. Therefore, the gift is considered a gift of long-term capital gain property subjecting him to the 30% limitation. Mr. Jones' income is $124,000 annually. Thus, he may only deduct $37,200 of his easement gift (30% x $124,000) annually, even though the value of the easement is $300,000. However, Mr.

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143. *Id.* § 1.170A-4(b)(1).
144. *Id.* § 1.170A-8(b).
145. 26 U.S.C. § 1012; 26 C.F.R. § 1.10162(a).
146. 26 U.S.C. § 170(e)(2); 26 C.F.R. § 1.170A-14(h)(3)(iii). *See also*, Strasburg v. Comm'r, 79 T.C.M. (CCH) 1697 (2000); 26 C.F.R. § 1.170A-4(a)(1).
147. 26 U.S.C. § 1223(2).
148. *Id.* § 1223(11).
149. *See* 26 C.F.R. § 1.170A-8(d)(2).

Jones may "carry forward" the unused portion of his deduction to future tax years.[150]

Example 2: If, in addition to his conservation easement donation, Mr. Jones has made other charitable gifts amounting to $50,000 during the year in which he donates the conservation easement he may only deduct $12,000 of his easement gift[151] because his total deduction for charitable gifts is limited to 50% of his contribution base (50% x $124,000 – $50,000 = $12,000).

Example 3: Mr. Jones donates his easement six months after he purchases the property to which the easement applies. Thus, the property is treated as "ordinary income property" and the deduction may be used up to 50% of Mr. Jones' contribution base. In this case he may deduct $62,000 of the value of the easement (50% x $124,000), and carry the unused balance of the gift forward. However, because this is a gift of ordinary income property, Mr. Jones' deduction may not exceed his basis in the easement.

Example 4: Assume that Mr. Jones paid $250,000 for the property that he placed under easement. Also assume that he donates the easement six months after he acquired the property. Further assume that Mr. Jones' appraiser determines that the fair market value of the property before the easement is donated is $400,000 (notwithstanding that Mr. Jones only paid $250,000 for it), and that the value after the easement is donated is $100,000. Given these assumptions, Mr. Jones can determine what his basis in the easement is. He figures this by calculating what percentage of the appraised "before" value is represented by the easement. In this case that percentage is 75% ($300,000/$400,000). He then multiplies his basis in the easement property ($250,000)[152] by 75% to determine his basis in the easement, in this case $187,500 (75% x $250,000). Thus, the maximum deduction that Mr. Jones can take for this easement donation is $187,500, which is his basis in the easement.[153]

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150. *See infra* note 154 and accompanying text.

151. It is not technically true to say that Mr. Jones can only deduct $12,000 of his easement gift. In fact, his total deduction for charitable gifts is limited to $62,000. Because his total donations for the year amount to $350,000 (the easement gift and the other charitable donations) he has unused, *and undifferentiated*, charitable donations of $298,000 that he must carry forward. The law is not concerned with whether the unused charitable deduction carried forward is from the easement gift, or from other gifts, except that the deduction for the easement gift is limited to 30% of his contribution base, whereas the other gifts may be deducted up to 50% of his contribution base (for gifts of ordinary income property).

152. Structural improvements on the property are subtracted from the donor's basis in the property for purposes of this calculation if the donated easement restricts the use of land only and not structures (*e.g.* it is not a "façade" easement).

153. Generally speaking, where the "before" value, as determined by appraisal, exceeds what the donor paid for the easement property, limiting the deduction to the donor's basis in the easement will limit the deduction to an amount that is less than the value of the easement.

3. Carrying Deductions Forward

Any unused portion of a charitable deduction, including a deduction for the donation of a conservation easement, may be "carried forward" for 5 years after the year of the donation (allowing a maximum of 6 years within which the deduction may be utilized), or until the amount of the deduction has been used up, whichever comes first.[154] The deduction carried forward has the same characteristics as the original deduction; therefore if the deduction was for a gift of ordinary income property (*i.e.*, held one year or less), the amount of the deduction carried forward continues to be subject to the 30% limitation described above. If the deduction carried forward is for a gift of long-term capital gain property (i.e., held for more than one year), it will be subject to the 50% limitation.

Example: In Example 1, Mr. Jones was only able to use $37,200 of his $300,000 easement deduction in the year of the donation due to the 30% annual limitation. Assume that donation was made in 2004. Mr. Jones can carry the unused balance of $262,800 ($300,000 – $37,200) forward to 2005, 2006, 2007, 2008 and 2009. Assume Mr. Jones' income in 2005 and 2006 is $150,000; in 2007 it is $175,000, and in 2008 and 2009 it is $200,000. Given this increase in income and the ability to carry the deduction forward for five years, Mr. Jones will be able to use $299,700 of the $300,000 easement gift over the six years in which he can use the deduction ($37,200 + $45,000 + $45,000 + $52,500 + $60,000 + $60,000).

4. "Phasing" Easement Donations

Deductions for easement donations are limited to either 30% or 50% of the donor's contribution base.[155] These limitations prevent some easement donors from deducting the full value of the easement. This problem can be addressed, in some cases, by "phasing" easement donations. The phasing of easement donations is intended to scale deductions to the donor's income, thus maximizing the tax benefits from the donation. Phasing works particularly well where a landowner wants to protect a large tract of land and where protection of only a portion of that land will generate a significant public benefit and advance a valid conservation purpose.

Example: Mrs. Blue donates a conservation easement over her 1,000-acre ranch. The value of the easement is $2,000,000. Mrs. Blue's average annual income is $500,000. The maximum deduction that Mrs. Blue can use, assuming she is subject to the 30% annual limitation, is $900,000 (30% x $500,000 x 6 years).

If the "before" value is the same as, or less than, what the donor paid for the easement property, the limitation to basis will not affect the amount of the deduction.

154. 26 C.F.R. § 170A-10(c)(1)(ii).

155. *See supra* note 137.

However, Mrs. Blue could increase the amount of the deduction she can use by protecting her ranch in two phases, using two separate easements donated at different times. For example, the first easement could cover 500 acres of her ranch. Assume that the value of that easement is $800,000 (taking into account enhancement of the value of the unrestricted portion of the ranch due to the conservation easement).[156]

Over a six-year period Mrs. Blue will be able to fully deduct this gift. Once this gift has been fully deducted Mrs. Blue donates a second easement over the remaining 500 acres of the ranch. The second easement is worth $1,200,000 (reflecting both enhancement from the first donation, and appreciation due to market forces). By the time of this gift, Mrs. Blue's average annual income has increased to $700,000. Over the six years beginning with the second easement donation Mrs. Blue will be able to fully deduct this $1,200,000 gift because the six-year limitation on her deduction is now $1,260,000 (30% x $700,000 x 6 years).

Mrs. Blue could have phased her easement gifts differently by donating an easement over the entire ranch eliminating some, but not all, of the development potential that she ultimately intended to eliminate. For example, if local zoning allowed the ranch to be divided into 28 large parcels, Mrs. Blue might donate an easement limiting development on her ranch to 10 parcels. In the second easement, donated after Mrs. Blue has used up the deduction from the first easement donation, Mrs. Blue could further restrict the ranch to two parcels. With this approach to phasing easement donations it is particularly important to remember that each donation must, *on its own*, meet the requirements of §170(h). It is possible that Mrs. Blue's first donation would fail to meet these requirements because the IRS might successfully challenge it on the grounds that she had retained uses inconsistent with the conservation purposes, or that there was no significant public benefit being provided.[157]

In a phased conservation plan the donor may want to include a provision in his or her will directing the executor to convey any planned, but uncompleted, easements. Such will provisions should include a draft of the conservation easement that the testator intends to give.

5. The Alternative Minimum Tax (AMT) and the 2% Floor on Itemized Deductions

The AMT *does not* apply to conservation easement donations. Charitable contributions of conservation easements are not considered "tax

156. *See infra* note 184 and accompany text for discussion of "enhancement."

157. *See supra* notes 53 and 65 and accompanying text for discussion of these requirements. For an example of a Tax Court ruling upholding the phasing of a conservation easement, *see* Strasburg v. Comm'r, 79 T.C.M. (CCH) 1697 (2000).

preference items." The provision treating gifts of appreciated property as tax preference items[158] was repealed for gifts of appreciated property effective December 23, 1992.[159] Furthermore, the limitation on certain itemized deductions to allow only those in excess of 2% of the taxpayer's adjusted gross income *does not* apply to charitable contributions.[160]

6. Easement Valuation[161]

One of the most critical and frequently challenged aspects of easement donation is the valuation of the easement. Easements resulting in reductions in fair market value have been judicially recognized ranging from 16% to over 90%.

a. The "Before and After" Valuation Method

In the before and after approach the easement property is valued before the easement is in place and after the easement is in place. The difference represents the value of the easement donation for deduction purposes.[162] An experienced appraiser can estimate the value of a potential donation by knowing the terms of the proposed easement and assuming it is in place. Such pre-donation estimates can be a valuable tool for prospective donors.

b. The "Comparable Sales" Valuation Method

Although the before and after method is recognized by the IRS when there are no comparable sales of easements, the comparable sales method is preferred, using actual easement sales as comparables. However, the Regulations recognize that in many cases there will not be a "substantial record" of comparable easement sales. In such cases the IRS will accept valuations based upon the before and after method.[163]

158. *See* 26 U.S.C. § 57(a)(5)(C)(iv) (1986).
159. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312 (1993).
160. 26 U.S.C. § 67(b)(4) (2004).
161. *See also*, 8 MERTENS LAW OF FED. INCOME TAX'N § 31:66 (2004); Lonnie Goldman, *Conservation Easement Appraisal Methodologies: Their Evaluation by the Tax Court, in* THE BACK FORTY ANTHOLOGY 5.89 (2003).
162. 26 C.F.R. § 1.170A-14(h)(3)(ii) (2004); Rev. Rul. 73-339, 1973-2 C.B. 68; Thayer v. Comm'r, 36 T.C.M. (CCH) 1504 (1977). For an example of the "before and after" method, *see* 26 C.F.R. § 1.170A-14(h)(4), example (4).
163. 26 C.F.R. § 1.170A-14(h)(3)(i).

c. *Requirements for Substantiating Easement Values*[164]

Any deduction for the donation of property exceeding $5,000 in value must be supported by a "qualified appraisal"[165] conducted by a "qualified appraiser."[166] Substantiating appraisals are complex and sometimes costly. They must be conducted no earlier than 60 days prior to the conveyance of the easement, and no later than the due date for the tax return on which the deduction is first claimed.[167] Regardless of the date upon which the appraisal was conducted, the valuation must be of the value of the easement on the date that it was donated, which is the date that it was officially recorded.[168]

Form 8283, "Noncash Charitable Contributions," which is a summary of the appraisal, must accompany any return claiming an easement deduction. This form must be signed by the land trust receiving the easement gift. By signing the Form the land trust *is not* verifying the valuation of the donation, only the receipt of the donation. The taxpayer does not file the actual appraisal with the return claiming the deduction, only Form 8283.[169]

In addition to signing Form 8283, the land trust must separately acknowledge receipt of the gift in writing. In this acknowledgment the land trust is required to state whether the donor has received any goods or services in exchange for the gift.[170]

d. *Overvaluation*

The Tax Code imposes substantial penalties in the event of the overvaluation of a charitable contribution, including the contribution of conservation easements.[171] A "substantial valuation misstatement"[172] (200% over actual value) can result in a penalty of 20% of the amount of the undervaluation.[173] A "gross valuation misstatement"[174] (400% over actual value) can

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164. For further information about the valuation and substantiation of easements, *see* LAND TRUST ALLIANCE, APPRAISING EASEMENTS (3d ed. 1999).
165. 26 C.F.R. § 1.170A-13(c)(2).
166. *Id.* § 1.170A-13(c)(3). *See also id.* § 1.170A-13(c)(5) for a definition of "qualified appraiser."
167. *Id.* § 1.170A-13(c)(3)(i)(A).
168. *Id.* §§ 1.170A-13(c)(3)(i)(I), 1.170A-14(h)(3)(i).
169. 26 U.S.C. 170(f)((11)(D), added by section 883(a) of the American Jobs Creation Act of 2004, requires that the appraisal be included with the return for donations in excess of $500,000.
170. 26 C.F.R. § 1.170A-13(f).
171. 26 U.S.C. § 6662 (2004).
172. *Id.* § 6662(e)(1)(A).
173. *Id.* § 6662(a).
174. *Id.* § 6662(h)(2)(A).

result in a penalty of 40% of the amount of the undervaluation.[175] These penalties are imposed on the taxpayer. In addition, a penalty in the amount of $1,000 may be imposed on anyone "aiding and abetting" in the overvaluation.[176] This would include return preparers and appraisers providing valuations of conservation easements for tax return purposes.

e. Current Issues Regarding Valuation

As noted above, the majority[177] of cases considering challenges by the IRS to conservation easement deductions have focused on easement valuation. As also noted above, the IRS recently issued a Notice[178] critical of aggressive easement valuation practices, among other things. The Notice stated that the IRS plans to closely scrutinize easement values in the future. A recent article also criticized easement valuation practices.[179] The valuations that appear to be targeted by these criticisms are ones where conservation easements are valued far in excess of what the donors paid for the property within a year or so of the donation.[180]

Such aggressive values often are the result of appraisals conducted by valuing individual lots into which the land being appraised could be developed under existing zoning regulations.[181] Each potential lot into which the parcel could be divided is valued independently and the total value of all lots is then discounted to reflect development and selling costs, and for estimated "market absorption time." Nevertheless, the Tax Court has expressly upheld the development approach.[182]

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175. *Id.* § 6662(h)(1).

176. *Id.* § 6701.

177. Only three out of twenty-three reported cases have looked beyond valuation. *See also* the remarks of Steven T. Miller, *supra*, note 21.

178. I.R.S. Notice 2004-41, 2004-28 I.R.B. 31.

179. Nancy A. McLaughlin, *Questionable Conservation Easement Donations*, PROBATE & PROPERTY, September/October 2004.

180. Easements donated in the first year of ownership of the easement property are limited to the donor's basis in the easement. This limitation tends to automatically correct the effect of the aggressive valuation of the easement property. *See supra* note 149 and accompanying text.

181. *See* McLaughlin, *supra* note179.

182. Schapiro v. Comm'r, 61 T.C.M. (CCH) 2215 (1991). However, McLaughlin comments on Shapiro as follows:

> The decision in Schapiro prompted the IRS to issue an Action on Decision recommending "nonacquiescence" and stating that "the court erred on a legal matter when it adopted the petitioners' expert's version of the development analysis because his method did not take into account all of the development costs and, therefore, overstated the value of each parcel of land before the granting of the easement." Action on Decision Re: John and Eleanor Schapiro v. Commissioner, AOD 1991-023, 1991 WL 772481 (1991). Moreover, Shapiro: (i) does not change established ap-

f. "Enhancement"

Proximity to potential open space enhances property values. One study of enhancement in Jackson, Wyoming suggested that such proximity could increase property values by as much as 23%.[183] More recently, the author has seen a number of conservation easement appraisals in which the appraiser estimated enhancement to property in proximity to the easement property at 10%. The Regulations require that enhancement to the value of property not subject to the easement (whether or not the property is contiguous to the easement), be taken into account in valuing the easement, if an easement donor, or member of the donor's family owns such property.[184]

Example: The land Mr. Jones placed under easement is just a quarter of a mile from 200 acres that overlooks the easement property. Mr. Jones also owns the 200 acres. The easement reduces the value on the property subject to the easement by $300,000, but the 200 acres increases in value by $100,000 because the view from this property will be permanently protected by the easement. This $100,000 "enhancement" must be subtracted from the $300,000 value of the easement. Therefore, Mr. Jones' deduction will be reduced to $200,000.

g. Other Benefits Must Be Offset

The amount of an easement deduction must be reduced by any cash payment or other economic benefit received, or reasonably expected, by the donor or family member of the donor, as a result of the donation of the easement.[185] This limitation relates to cash payments, governmental approv-

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praisal standards limiting the use of the SDA (the AOD rather pointedly mentions a version of the threshold rule regarding the SDA, which the Tax Court apparently ignored in Schapiro: "If the market data approach is rejected because there are no sufficiently comparable properties, then it may be appropriate to use a development analysis to value vacant land." (p. 3, emphasis added)), (ii) does not change the fundamental rule that, for purposes of the federal charitable income tax deduction, the before-easement value of the land is defined as the FMV of that land, or the price at which the land would change hands between a willing buyer and a willing seller (*i.e.*, price at which the donor could realistically sell his land in its current state in the open market), and (iii) is not likely to be followed in future cases as both the IRS and judges become more sophisticated in their understanding of the SDA.

Nancy A. McLaughlin, lecture notes (2004). For a different result using the development approach, *see* C.W. Fannon, Jr., 52 T.C.M. (CCH) 1113 (1986). For a different result using the development approach, *see* Fannon v. Comm'r, 52 T.C.M. (CCH) 1113 (1986).

183. The survey of valuations was conducted for The Jackson Hole Land Trust by Hoffman and Associates, Jackson, Wyoming, in 1994, and is on file with the author.

184. 26 C.F.R. § 1.170A-14(h)(3)(i) (2004). For an example of the application of the enhancement rules, *see id.* § 1.170A-14(h)(4), example (10).

185. *Id.* § 1.170A-14(h)(3)(i); Rev. Rul. 67-246, 1967-2 C.B. 104 (1967).

als granted in exchange for the donation of conservation easements, reciprocal easement donations, bargain sales of conservation easements, and certain conservation buyer transactions.[186]

Example 1: Mr. Blue agrees with the ABC Land Trust that he will donate an easement over his land if ABC will acquire and protect a parcel of land adjoining Mr. Blue's land. ABC agrees to do this. The acquisition by ABC enhances the value of Mr. Blue's land by $150,000. The value of Mr. Blue's easement is $400,000. ABC is required to notify Mr. Blue that, in exchange for his easement donation to ABC, he has received $150,000 in "goods and services"[187] from ABC, thereby reducing the amount of Mr. Blue's deduction to $250,000 ($400,000 – $150,000).

Example 2: Ms. Brown agrees to sell to the XYZ Land Trust a conservation easement on land that she owns adjoining one of XYZ's most important holdings. The agreed price for the easement is $50,000. An appraisal of the easement shows that its value is $150,000. Ms. Brown is allowed a deduction of $100,000 ($150,000 – $50,000) for this qualified "bargain sale."[188]

Example 3: Mr. Jones elects to develop his property under an optional provision of the local land use regulations that allow a 20% increase in permitted density if the landowner agrees to donate a conservation easement over 70% of the property. The value of the property before the easement donation is $1,000,000 and after the donation it is $700,000. However, the value of the additional 20% density is $400,000. Because the value of the economic benefit received in return for the easement exceeds the value of the easement there is no deduction. Furthermore, because the local regulations *required* the donation of the conservation easement in exchange for the increased density, the donation was made as the result of a regulatory requirement and lacked the "donative intent" required for a charitable contribution. Such transactions are sometimes referred to as "*quid pro quo*" transactions.[189]

Example 4: Ms. Black receives a $10,000 grant to cover her costs incurred in donating a conservation easement. The value of the grant must be subtracted from the value of the easement to determine the amount of the contribution that may be deducted, in this case $140,000 ($150,000 - $10,000). However, it is possible that Ms. Brown may be able to deduct some or all of the expenses that she incurs in making the contribution.

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186. *See infra* notes 198-205 and accompanying text.

187. 26 C.F.R. § 1.170A-13(f)(5) defines "goods or services" as cash, property, services, benefits, and privileges.

188. *See* 26 U.S.C. § 1011(b) (2004) for provisions regarding bargain sales.

189. *See infra* note 197 and accompanying text for discussion of donative intent and "*quid pro quo*."

6. "Donative Intent"

The overriding question in evaluating the deductibility of any alleged charitable donation is whether or not the conveyance was made with the required "donative intent."[190] The recent IRS Notice[191] strongly suggests that donative intent will become an increasing focus of future audits.

The issue of donative intent is important in a number of settings. For example, if a landowner donates a conservation easement over a portion of his property in anticipation that he will receive a higher density on the remainder of his property, is the intention primarily charitable, or is the motivation obtaining the economic advantage of increased density? If the prospective buyer of a ranch grants an option to a land trust to acquire a conservation easement on the ranch after closing, and the option was a precondition to entering into the purchase contract, is the buyer motivated by charitable impulses, or merely complying with a precondition to the sale? Or, suppose a land trust buys property and places a conservation easement on the property and then later sells it for a reduced price reflecting the restrictions of the easement, but only to a buyer who agrees to make a cash contribution to the land trust of the difference between what the trust bought the land for and sells the land for. Is the cash contribution a charitable one, or part of the price of acquiring the property?[192]

A charitable contribution is defined in 26 U.S.C. §170(c) as a "contribution or gift," and the term "gift" for tax purposes was elaborated upon by the United States Supreme Court, as used in the provision for exclusion from gross income of property acquired by gift, in *Commissioner v. Duber-*

190. However, in the case of Short v. Comm'r, 73 T.C.M. (CCH) 2937 (1997), the Tax Court makes no mention of "donative intent" in listing the six factors required for a charitable contribution:

> In determining the existence and timing of a charitable contribution, we apply the same analysis as that in determining the existence and timing of a gift. We have consistently held that there are six essential elements of a bona fide inter vivos gift. These six elements are: (1) a donor competent to make the gift; (2) a donee capable of taking the gift; (3) a clear and unmistakable intention on the part of the donor to absolutely and irrevocably divest himself of the title, dominion, and control of the subject matter of the gift, *in praesenti;* (4) the irrevocable transfer of the present legal title and of the dominion and control of the entire gift to the donee, so that the donor can exercise no further act of dominion or control over it; (5) a delivery by the donor to the donee of the subject of the gift or of the most effectual means of commanding the dominion of it; (6) acceptance of the gift by the donee.

Id. at 2938.

191. I.R.S. Notice 2004-41, 2004-28 I.R.B. 31.

192. This example is taken from I.R.S. Notice 2004-41, 2004-28 I.R.B. 31, critical of certain conservation transactions, including the one described in the example.

stein.[193] It said that if a payment proceeded primarily from the constraining force of a moral or legal duty, or from the incentive of an anticipated benefit of an economic nature, it was not a gift, holding that the controlling factor was the intention with which the transfer, however voluntary, had been made. The proper criterion was one that inquired what the basic reason for the transferor's conduct was in fact, the court stated, that is, the dominant reason that explained his action in making the transfer. The principles with respect to determining intent applied by the Supreme Court in *Duberstein* to gifts that may be excluded from income, are applicable in determining whether a charitable contribution of land to a governmental entity qualified for tax deduction under 26 U.S.C. §170.[194]

The question of donative intent is a subtle one. For example, in one case the Ninth Circuit Court of Appeals held that dedication of land for a public street was not a gift because the taxpayer expected to (and did) obtain a rezoning of its property as a result of the dedication.[195] Yet in another case the Ninth Circuit held that the dedication of nine acres of redwood trees resulting in a rezoning of the balance of the donor's property was a charitable gift because the donor clearly intended to make a gift of the property for purposes of preserving the trees.[196]

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193. Comm'r v. Duberstein, 363 U.S. 278 (1960).

194. *See* Collman v. Comm'r, 511 F.2d 1263 (9th Cir. 1975). *See also* Jean F. Rydstrom, Annotation, *Taxpayer's Conveyance or Dedication of Land to or for Use of Governmental Entity as Charitable Contribution Qualifying for Tax Deduction under 26 U.S.C.S. § 170*, 30 A.L.R. FED. 796 (Supp. 2004); Hernandez v. Comm'r, 490 U.S. 682 (1989).

195. Stubbs v. United States 428 F.2d 885 (9th Cir. 1970). The *Stubbs* court stated:

> The inquiry into motive and purpose here does more than probe the subjective attitude of the donors and the extent to which public spirited and charitable benevolence prompted their action. The inquiry serves to expose the true nature of the transaction: that, as the jury found, the "gift" was in expectation of the receipt of certain specific direct economic benefits within the power of the recipient to bestow directly or indirectly, which otherwise might not be forthcoming. Taxpayers apparently wished to assure favorable zoning (otherwise uncertain) by guaranteeing public access to the mobile home development, and to secure public street frontage for some of their property. In both respects their objectives were realized.

Id. at 887 (internal citations omitted).

196. Allen v. United States, 541 F.2d 786 (9th Cir. 1976). The court stated:

> We said [in the *Stubbs* case] that it is the dominant purpose of a transaction that is the determining factor; the expectation of a benefit need not be the sole purpose of a transaction in order to preclude treatment as a charitable deduction. We affirmed a trial court in its instructions that the existence of a *quid pro quo* could be considered by the jury as evidence that the dominant purpose behind the taxpayer's transfer was the expectation

In other words, there may be mixed motivations behind the uncompensated conveyance of property, or an interest in property such as a conservation easement. However, the determining factor in deciding whether the conveyance was a charitable contribution entitled to a tax deduction, or a "*quid pro quo*" transaction that is not entitled to a deduction, is what the trier of fact determines to be the dominant motivation.[197]

The Supreme Court addressed "dual character" payments, where part of the payment is for a purchase of goods or services, and part of the payment is a charitable contribution, as follows:

> A payment of money generally cannot constitute a charitable contribution if the contributor expects a substantial benefit in return. However, as the Claims Court recognized, a taxpayer may sometimes receive only a nominal benefit in return for his contribution. Where the size of the payment is clearly out of proportion to the benefit received, it would not serve the purposes of §170 to deny a deduction altogether. *A taxpayer may therefore claim a deduction for the difference between a payment to a charitable organization and the market value of the benefit received in return, on the theory that the payment has the "dual character" of a purchase and a contribution.*
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> . . . .
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> The *sine qua non* of a charitable contribution is a transfer of money or property without adequate consideration. The taxpayer, therefore, must at a minimum demonstrate that he purposely contributed money or property in excess of the value of any benefit he received in return.[198]

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of economic benefit. *Stubbs* teaches that motive and purpose are questions of fact.

Id. at 788.

197. *See* Rev. Rul. 67-246, 1967-2 C.B. 104 (1967) for treatment of payments for tickets to charitable events where part of the payment is for the value of the service provided, and part is a charitable donation. *See also* McClennen v. United States, 23 Cl. Ct. 99 (1991) (holding that tax motivations do not negate donative intent); Jean F. Rydstrom, Annotation, *Taxpayer's Conveyance or Dedication of Land To or For Use of Governmental Entity as Charitable Contributions Qualifying for Tax Deduction Under 26 USCS §* 170, 30 A.L.R. FED. 796 (Supp. 2004) (discussing how taxpayer's counsel should handle a claim for a charitable deduction where there a mixed motivations for the contribution).

198. United States v. Am. Bar Endowment, 477 U.S. 105, 117, 118 (1986) (emphasis added). *See also* 26 C.F.R. § 1.170A-1(h) (2004) (governing "dual character" donations); Priv. Ltr. Rul. 2002-13-021, (sanctioning a proposed dual character transaction involving the

The requirement for donative intent should not be confused with the regulatory requirement, described above, that any financial or economic benefit received in exchange for a conservation easement be subtracted from the value of the easement deduction.[199] In the cases to which this economic benefit rule applies the grantor of the easement *intends* that the excess of the value of the easement over the benefit received be a charitable gift. However, donative intent may be severely compromised when the taxpayer is required by some regulatory or contractual arrangement to convey an easement, even if the value of the benefit received is less than the value of the easement.[200]

The requirement of donative intent may preclude deductions for the conveyance of conservation easements in a number of circumstances. A few of the more common are described below.

a. Cluster Development Projects. A growing number of localities allow a landowner increased residential density, or simply the right to cluster permitted residential density, in exchange for the grant of a conservation easement on that portion of the property from which the clustered density has been derived.

The IRS addressed this type of project and ruled that a charitable deduction would be properly allowed if: (1) the taxpayer established that the value of the open space easement was more valuable than the benefits received from the variance change related to the project, and (2) the taxpayer established that the excess value was purposely contributed.[201] The grant of an easement as a requirement of local regulation may entirely preclude donative intent where the grant resulted from a legal obligation or governmental compulsion.[202]

b. Reciprocal easements. Where one landowner agrees to grant a conservation easement over his land if his neighbor does the same and the agreement is legally binding, the contractual obligation to grant the easement would appear to preclude donative intent. Performance of a contractual obligation owed to a private individual does not constitute a charitable gift.[203]

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purchase of burial facilities for prices in excess of fair market value where the excess payment is treated as a charitable contribution to the Roman Catholic Church).

199. 26 C.F.R. § 1.170A-14(h)(3)(i). *See supra* note 185 and accompanying text.

200. *See, e.g.*, Pettit v. Comm'r, 61 T.C. 634 (1974). However, at this point there are no iron-clad rules when donations are the result of mixed motivations.

201. Priv. Ltr. Rul. 92-39-002 (June 17, 1992).

202. *See* Stubbs v. U.S., *supra* note 195.

203. Comm'r v. Duberstein, 363 U.S. 278, 285 (1960). The Court stated:

However, where a land trust seeks to obtain conservation easements from a number of landowners within a region to advance a conservation goal that could not be met with the piecemeal contribution of such easements, it may agree to escrow the easements until it has received a sufficient number of easements to accomplish the land trust's conservation goal. Such an arrangement does not preclude donative intent, provided that the escrow *is a condition imposed by the land trust for its own benefit, and not a condition imposed by the landowner for his or her benefit.*[204] Until the easements are put to record no deductible gift occurs because a conservation easement is not a completed gift until recorded.

c. "Conservation Buyer" Transactions.[205] An increasingly important tool for land conservation organizations (and realtors) is the "conservation buyer transaction." There are a number of variations on the conservation buyer transaction. In the most straightforward the seller of conservation-worthy property donates a conservation easement on his or her property before selling it. In such a transaction the seller takes advantage of the tax benefits of the donation and the buyer, typically, purchases the property for a reduced price reflecting the restrictions of the easement. A similar transaction is one in which the seller is a land trust and it retains the easement at the closing of sale. In such cases there is no deduction involved because the seller is tax-exempt; however, the buyer acquires the easement restricted property for a reduced price reflecting the restrictions imposed by the retained easement.

The IRS recently criticized a variation of the latter example.[206] The variation is best understood through an example. The CTN Land Trust purchases a ranch for $2,000,000. It offers the ranch for sale restricted by a

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> For the Court has shown that the mere absence of a legal or moral obligation to make such a payment does not establish that it is a gift. And, importantly, if the payment proceeds primarily from "the constraining force of any moral or legal duty," or from "the incentive of anticipated benefit" of an economic nature, it is not a gift.

Id. Duberstein addressed the question of whether a certain payment to the taxpayer constituted income, or a non-taxable gift, not whether a certain payment constituted a charitable contribution. However, the principles of *Duberstein* have been applied to charitable contributions. *See* Rydstrom, *supra* note 194.

204. The fact that a donation is made pursuant to a charitable pledge to a public charity does not prevent the donation from being deductible, even though the pledge is legally enforceable. *See, e.g.*, Petty v. Comm'r, 40 T.C. 521 (1963). However, where the pledge is conditioned upon the performance of an undertaking by the charity that provides an economic advantage to the maker of the pledge, discharge of the pledge may not be deductible. *See, e.g.*, Strandquist v. Comm'r, 29 T.C.M. (CCH) 387 (1970).

205. For another discussion of this topic, *see* C. Timothy Lindstrom, *The Use of Options in Conservation Transactions*, EXCHANGE (Fall, 2003).

206. I.R.S. Notice 2004-41, 2004-28 I.R.B. 31.

conservation easement to be retained at closing. An independent appraisal shows that the value of the restricted ranch will be $1,000,000. CTN then offers the ranch, subject to the easement, for $1,000,000 on the condition that any purchaser, in addition to paying the purchase price, makes a cash donation to CTN in the amount of $1,000,000. The net result of this transaction, in theory, is that CTN ends up with $1,000,000 in the form of a cash contribution, it has $1,000,000 in cash from the sale, and the ranch is permanently protected. The buyer ends up with a permanently restricted ranch worth $1,000,000 and a charitable deduction worth $1,000,000. The buyer has paid $2,000,000 to a public charity and has received property valued at $1,000,000.

The IRS's criticism denies, in essence, that this type of transaction is a "dual character" transaction. This position seems contrary to the holding in *United States v. American Bar Endowment*,[207] the text of the Regulations,[208] agency Revenue Rulings[209] and a Technical Advice Memorandum,[210] all of which sanction dual character contributions. (Note, however, that the IRS has taken the position that the two Revenue Rulings cited are limited to payment for tickets to charity events, and membership in charitable organizations.)[211] After all, the parties (assuming an accurate and independent appraisal) have each ended up where they should be to sustain a charitable deduction: CTN has a $1,000,000 gift, and property permanently protected by a conservation easement meeting all of the requirements of the Tax Code and Regulations. Buyer has property worth $1,000,000 and has paid $2,000,000 to a public charity in two transactions that both parties acknowledge was partly motivated by the intent to make a charitable contribution. To prevail, the IRS must successfully contend that the donated $1,000,000 is the fair market value of the "privilege" of being able to purchase easement-restricted property so that there was no "difference between [the] payment to [the] charitable organization and the market value of the benefit received in return."[212]

It may be argued that the buyer gained an economic advantage by agreeing to make a $1,000,000 contribution in order to qualify to purchase the property. However, it is hard to believe such an advantage is worth

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207. United States v. Am. Bar Endowment, 477 U.S. 105 (1986).

208. *See* 26 C.F.R. § 1.170A-1(h) (2004). These Regulations specifically allow a deduction where 1) a taxpayer intends to make a contribution that exceeds the fair market value of goods or services received in exchange for the contribution and, 2) in fact, makes such a payment. Thus, if the value of the easement contributed was $1,000,000, the value of acquiring restricted property in exchange would have to equal the purchase price paid plus the $1,000,000 easement donated—an unlikely result in most any case. *Id.*

209. *See* Rev. Rul. 67-246, 1967-2 C.B. 104 (1967); Rev. Rul. 68-432, 1968-2 C.B. 104, 105 (1968).

210. Tech. Adv. Mem. 92-39-002 (June 17, 1992).

211. Gen. Couns. Mem. 38,055 (August 22, 1979).

212. *Am. Bar Endowment*, 477 U.S. at 118.

$1,000,000. The IRS position would be justified if the buyer ended up with property that was actually worth significantly more than the $1,000,000 paid for it. Assuming the value of the ranch does not exceed what was paid, based upon an independent and qualified appraisal, the IRS position in the Notice is hard to reconcile with the undeniable conservation results of the transaction and with existing law. Most importantly, the IRS position would frustrate a transaction specifically structured to generate a substantial charitable outcome.

Another type of conservation buyer transaction is where the seller wants to receive the unrestricted fair market value of property, but also wants the buyer to donate a conservation easement permanently restricting the property. The seller may be a conservation organization, or an individual. The general rule of thumb here is that the more tightly the buyer is bound to convey the easement, the greater the risk that a deduction for the easement will be denied for lack of donative intent. When a donor is under a legal or moral obligation to make a donation, the requisite donative intent may be found lacking.[213] This is certainly true if the seller and buyer are private, non-charitable entities and they include in the sales contract a requirement for the conveyance of an easement by the buyer. This makes the conveyance of the easement the discharge of a contractual obligation, not a charitable donation. By the same token, where title to property is conveyed subject to a pre-existing, recorded option held by a land trust to acquire a conservation easement, the ultimate conveyance of the easement pursuant to the option is merely the discharge of a legal obligation that the buyer assumed in acquiring title.

However, where the obligation to convey an easement in a conservation buyer transaction is created between the buyer and *a public charity*, rather than between the buyer and a private individual or entity, the legal obligation is in the nature of a pledge to a public charity and the donation of a conservation easement pursuant to this pledge should be deductible, as is the discharge of any other pledge to make a gift. Most often, this "pledge" takes the form of an option granted by the prospective buyer granting the land trust the legal right to acquire the easement after the buyer purchases the property.[214]

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213. *See* Duberstein v. Comm'r, 363 U.S. 278 (1960).

214. Some tax advisors are counseling clients that, in the wake of the Notice, *supra* note 191, even this approach is too risky. For now, the conservative approach to conservation buyer transactions being suggested by some is to avoid any commitment to anyone (whether it is the seller or a land trust) to donate a conservation easement in the future if a deduction is important to the prospective donor. The author does not agree that such a conservative stance is justified; however, there is no question that great care is necessary in properly structuring a conservation buyer transaction given the current posture of the IRS.

Such arrangements, although different from the specific form criticized in the Notice, still run a risk that the IRS will "ignore the form" of the transaction and disallow a deduction for the donation of the easement. Here, again, such treatment would seem to ignore the substance of the transaction (assuming the transaction is properly structured): the land is permanently protected by a valid conservation easement conveyed to a qualified organization; the value of the restricted land and the value of the conservation easement gift have been validated by an independent appraisal and the amount of the deduction sought conforms to those values. The buyer has paid $X for the property, as a result his property is now worth $Y, and his deduction equals $X – $Y.

The fact that a prospective buyer in a conservation buyer transaction is willing to enter into an agreement with a land trust to insure that property with high conservation value will be permanently protected after closing of purchase should not, in and of itself, disqualify that buyer from enjoying a tax deduction for the ultimate contribution of the easement. It is hard to decipher what public policy goal is advanced by denying a deduction to a buyer willing to commit to donate an easement, and allow a deduction to a buyer unwilling to make such a commitment, but who later donates a conservation easement providing the same public benefits. Conservation buyer agreements are entirely consistent with the public policy goal behind conservation easement deductions: ensuring and facilitating voluntary land conservation.

Example 1: Mrs. Brown owns a ranch that has been in her family for three generations. Mrs. Brown is too old to continue to operate the ranch and needs to sell in order to provide funds for her future care. However, Mrs. Brown cannot bear the thought that her ranch might be developed. A local land trust learns of Mrs. Brown's plans and agrees to help her and her realtor[215] locate a "conservation buyer" for the ranch. The land trust consults its list of potential conservation buyers and locates a prospect who, it turns out, is very interested in buying Mrs. Brown's ranch. The ranch sells for $2,000,000 and the buyer promptly donates a conservation easement on the ranch to the land trust that reduces its value to $1,000,000. The buyer, a California resident, takes a $1,000,000 income tax deduction on his state and federal returns and reaps a tax savings of $440,000, effectively reducing the net cost of buying the ranch to $1,560,000. Because the buyer had no interest in developing the ranch, the conservation easement generates a financial benefit for an asset the buyer would not otherwise have used. The result: This "no strings attached" donation should be deductible.

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215. Wyoming law prohibits anyone other than a licensed realtor from receiving compensation of any sort for arranging the sale of real estate. *See* WYO. STAT. ANN. § 33-28-114 (LexisNexis 2004).

Example 2: The buyer, Mrs. Brown, and the land trust have a "hand shake" agreement that the buyer will donate a conservation easement when the purchase has closed. The result: The donation should be deductible, assuming the easement meets federal requirements and that the land trust is a qualified organization. Because an unwritten agreement pertaining to the conveyance of land or interests therein is unenforceable due to the "Statute of Frauds"[216] the buyer is under no legal constraint (although, arguably the buyer has a "moral duty"[217] to conform to the agreement) to grant the easement, presumably sanitizing any future donation. Of course, the buyer is equally free to forget that he or she ever shook hands and refuse to make the donation.

Example 3: Mrs. Brown executes an option to donate (or "bargain sell" for a nominal price)[218] a conservation easement to the land trust, which the land trust records. The sale closes and the land trust exercises the option. The buyer conveys the easement and seeks a deduction for its value. Likely result: The deduction, if audited, could be denied because the conveyance was legally required by a condition of title to the property. However, if the buyer were to donate the easement before the land trust exercised the option, the results might be different because the buyer conveyed the easement independent of his legal obligation under the option, which might or might not have ever been exercised.[219]

Example 4: The buyer executes an option granting the land trust the right to acquire a conservation easement, if the buyer acquires title to Mrs. Brown's ranch. The sale closes, the land trust exercises its option, the buyer conveys the easement. Possible result: The buyer should get a deduction for the value of the easement. Even though the buyer was legally constrained by the option to grant the easement, the option was in the nature of a charitable

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216. *Id.* § 1-23-105(a)(v).

217. Which, under *Duberstein*, may negate donative intent.

218. The question of adequacy of consideration for such an option opens up an entirely new field of inquiry. For purposes of this article it is probably sufficient to state that there are no Wyoming cases dealing with the enforceability of charitable pledges; generally speaking, other jurisdictions seem to be trending towards enforcing charitable pledges on public policy grounds. Where detrimental reliance upon a charitable pledge exists, most jurisdictions are willing to enforce the pledge on traditional contract grounds. *See* Russell G. Donaldson, Annotation, *Lack of Consideration as Barring Enforcement of Promise to Make Charitable Contributions—Modern Cases*, 86 A.L.R. 4th 241 (1991).

219. Some would argue that the land trust in this case is under an "economic compulsion" to exercise the option because the cost of exercising the option is insubstantial, or, in this case, non-existent. However, because the conservation easement has no economic value once conveyed, and in fact represents a financial liability, the "economic compulsion" argument should not apply. *See* Rev. Rul. 2003-97, 2003-34 I.R.B. 380.

pledge between the buyer and a public charity. Charitable pledges are deductible when paid.[220]

Example 5: Mrs. Brown grants an option to the land trust to purchase from her a conservation easement on her ranch for $1,000,000, subject to appraisal. An independent appraisal undertaken by the land trust confirms that the value of the proposed easement is $1,000,000 and that the value of the ranch, subject to the easement, is $750,000. The buyer makes an unrestricted gift of $1,000,000 to the land trust. The buyer then contracts with Mrs. Brown to acquire her ranch for $750,000. The land trust exercises the option prior to the sale. The easement is conveyed and the sale of the ranch closes. The possible result: The buyer should get a $1,000,000 tax deduction; Mrs. Brown gets full price for the ranch and the knowledge that it will be forever protected; the land trust gets a permanent easement on the ranch valued at $1,000,000.[221] An important variable is whether the land trust is constrained by the terms of the pledge to use the pledge payment exclusively for purchase of an easement on Mrs. Brown's ranch. A further variable is how the pledge is paid.[222] This is similar to the type of transaction specifically criticized in the July IRS Notice, and the IRS may try to "collapse" the transaction and claim that the $1,000,000 gift was actually part of the purchase price of the ranch, thereby denying a deduction for the gift.

Conservation buyer transactions are likely to become an increasingly important tool for land conservation in Wyoming, and throughout the nation.

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220. The buyer, in negotiating the option, may have anticipated a surge of income in two years and, in view of that, may have stipulated that the option could not be exercised before a date two years from the grant of the option. Because the law does not treat a gift granted pursuant to an option as having been made, for deductibility purposes, until the option is exercised (and the easement conveyed), such a stipulation would effectively defer any deduction for the gift for at least two years. *See, e.g.*, Determining the Value of Donated Property, Treas. Pub. 561 (2000), *available at* http://www.irs.gov/publications/p561/ar01.html.

221. What is the value of a conservation easement once conveyed to a land trust? Unless the land trust expressly reserves the right to resell the development potential represented by the easement, once the easement has been conveyed it has no economic value. In fact, a conservation easement as held by a qualified organization typically represents an economic liability because of the permanent obligation imposed upon the land trust to perpetually monitor and enforce compliance with the terms of the easement. There is virtually no market for a conservation easement once it has been conveyed by the original landowner—and hence, no market value.

222. For example, if the pledge is earmarked for the purchase of an easement on Mrs. Brown's ranch and the payment of the pledge is made with appreciated stock (the intention being to avoid gain on the sale of the stock, yet obtain a deduction for the fair market value of the stock on the date it was given to the land trust), it is likely that, if audited, the IRS would at the least impose the "constructive receipt" doctrine upon the sale and charge the buyer with the gain that would have been realized had the stock been sold by him or her and the proceeds paid to the land trust. This is because, by directing the land trust in the use of the funds in a manner that benefited the buyer, the buyer has "enjoyed" the proceeds of the sale. *See, e.g.*, Blake v. Comm'r, 42 T.C.M. (CCH) 1336 (1981).

There can be no question that they must be approached with great care, and sensitivity to the recent criticism of some of these transactions by the IRS.[223]

7. Effect of Easement Donations on Basis

When a landowner donates a conservation easement he must reduce his basis (essentially, what was paid for the property)[224] in the easement property to reflect the easement donation because the donation represents the conveyance of a part of the property. This reduction in value must reflect the proportion of the unrestricted fair market value of the land at the date of the donation represented by the value of the easement.[225] When the donor later sells the easement property the adjustment means that additional taxable gain must be recognized. This gain reduces the tax benefit of the original donation. However, because the gain on sale would be taxed at long-term capital gain rates, and the income sheltered by the deduction would be taxed at ordinary income rates[226] the basis adjustment is not a significant disincentive to easement donations.

Example 1: Mr. Green donates an easement on his land. Before the easement the land was valued at $1,000,000. After the easement the land was valued at $700,000. Therefore, the value of the easement donation is $300,000 ($1,000,000 - $700,000). Mr. Green's basis in his land before the donation was $100,000. The easement represents 30% of the unrestricted value of the land when the donation was made ($300,000/$1,000,000).

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223. A final comment on the Notice: The Notice appears to have had its origin in a series of newspaper articles critical of certain practices of The Nature Conservancy, including conservation buyer transactions involving Conservancy Board members. *See, e.g.*, Joe Stephens & David B. Ottaway, *Non-profit Land Bank Amasses Billions*, WASH. POST, May 4, 2003, at A1; *How a Bid to Save a Species Came to Grief*, WASH. POST, May 5, 2003, at A1; *Nonprofit Sells Scenic Acreage to Allies at a Loss*, WASH. POST, May 6, 2003, at A1. The articles implied that Conservancy "insiders" were getting special deals in these transactions. There can be no question that if insiders are able to acquire property from a public charity at prices below fair market value "private inurement" in violation of federal law is occurring. *See supra* note 80 and accompanying text. To the extent that conservation buyer transactions are conferring financial benefits on land trust insiders, such transactions are justifiably criticized. However, where buyers are paying less than a land trust has paid for property due to the retention by the land trust of permanent conservation easements on the property, which meet federal standards, and the sales prices are based upon independent qualified appraisals, the criticism may not be well placed—provided that proper procedures were in place to insure that the buyer did not exert improper influence on the transaction.

224. *See supra* note 145 and accompanying text.

225. 26 C.F.R. § 1.170A-14(h)(3)(iii) (2004).

226. This raises an important tax planning point: When a taxpayer is contemplating an easement donation with the expectation of maximizing the tax benefits from the donation, care should be taken to avoid making the donation in a year during which a significant percentage of the taxpayer's income is capital gain. This is because offsetting a deduction against long-term capital gain will generate tax savings at the capital gains tax rate (typically 15%) rather than the considerably higher ordinary income rate (maximum of 35%).

Therefore, Mr. Green's adjusted basis after the easement donation will be $70,000 ($100,000 – (30% x $100,000)).

Example 2: Ms. Pink donates a conservation easement over 500 acres of her 2,500-acre ranch. Ms. Pink's basis in the entire ranch is $1,000 per acre. The easement is worth $700,000, reducing the value of the 500 acres from $1,000,000 to $300,000, the easement also enhances the value of the unrestricted portion of the ranch by 10%, from $3,000,000 to $3,300,000. Therefore, the net deduction that Ms. Pink is entitled to is $400,000 ($700,000 – $300,000). Only that portion of Ms. Pink's ranch that is subject to the conservation easement is required to receive an adjusted basis. The adjustment does not take into account the enhancement to the unrestricted part of Ms. Pink's ranch, even though that enhancement reduced her deduction (it did not reduce the value of the easement, it merely offset that value for deduction purposes). The percentage of the unrestricted value of the 500 acres represented by the easement was 70% (($1,000,000 – $300,000) / $1,000,000). Therefore, the adjusted basis for the portion of the ranch subject to the easement will be $300 per acre ($1,000 – (70% x $1,000)).

Assuming that Ms. Pink was able to use the entire $400,000 deduction and that the income sheltered by that deduction would have been taxed at 35%, the initial tax benefit will be $140,000 (35% x $400,000). The additional gain on that portion of the ranch subject to the easement when Ms. Pink sells the ranch will be $700 greater per acre because of the basis adjustment required to reflect the easement donation ($1,000 – $300). Thus, Ms. Pink will pay long-term capital gains tax on an additional $350,000 ($700 x 500 acres) of value, or $52,500 ($350,000 x 15%). This increased capital gains tax must be subtracted from the initial benefit derived from the easement donation to determine Ms. Pink's net tax benefit ($140,000 – $52,500).[227]

8. Easement Donations By "Real Estate Dealers" and Landowners Who Subdivide[228]

The Regulations provide that ordinary income property includes property "held by the donor primarily for sale to customers in the 'ordinary course of his trade or business.'"[229] These regulations have particular relevance for gifts of conservation easements made by "real estate dealers." Because lots held by dealers for sale to customers will be considered ordi-

227. *See*, 26 C.F.R. § 1.170A-14(h)(4), example (11) (2004). Of course, to truly complicate this calculation, values should be discounted for time.

228. *See* Rev. Rul. 79-256, 1979-2 C.B. 105. *See also* Pasqualini v. Comm'r, 103 T.C. 1 (1994), for an application of the principles discussed in this section to a non-commercial setting.

229. 26 C.F.R. § 1.170A-4(b)(1).

nary income property, any deduction for the donation of a conservation easement over such property will be limited to the dealer's basis in the easement over lots, significantly limiting the tax benefits to be derived from such a donation.[230]

Real estate dealer status is not limited to commercial developers, but may include any landowner who subdivides his or her property. If a landowner subdivides property into more than five lots or parcels and sells or exchanges the lots or parcels, or if the landowner sells fewer than five lots or parcels but fails to meet the three conditions provided in 26 U.S.C. §1237 (a), other lots or parcels retained by the landowner as part of the subdivision may be considered property held primarily for sale to customers in the ordinary course of business.[231] As noted in the preceding paragraph, any deduction for an easement over such lots or parcels will be limited to the landowner's basis in the easement.

However, not all property owned by a dealer is ordinary income property, and property that is ordinary income property may become "long-term capital gain property,"[232] with respect to which the donation of an easement will not be limited to the dealer's basis in the easement. Whether property is ordinary income property or long-term capital gain property is a factual question to be determined on a case-by-case basis. For example, property designated as "open space" on a subdivision plat that has never been offered for sale, and that has been carried on the developer's books as a capital asset rather than as inventory, is likely to be treated as long-term capital gain property. Similarly, property once held as inventory that a developer ceases to hold for sale, and that is re-characterized on the books as a capital asset will, in time, likely qualify as long-term capital gain property.

Furthermore, simply because a landowner subdivides his or her property does not make the landowner a "dealer."

Example: Jack Hoyle is a real estate developer. He has developed 50 lots for sale, but has identified 100 acres of the development property for "open space" protection and it has never been offered for sale. On his books Jack carries the 50 lots as "inventory" and the 100 acres as a capital asset.

Five years later, after having sold 40 lots, Jack decides to start a new project and wrap this one up. He agrees with a local land trust to donate a conservation easement on the remaining 10 lots, plus the 100 acres. His

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230. *See supra* note 143 and accompanying text for a discussion of treatment of donations of ordinary income property.

231. 26 U.S.C. § 1237(b) (2004).

232. *See* M.T. Brunner, Annotation, *Federal Income Tax: When Property is Deemed to be Held Primarily for Sale to Customers in Ordinary Course of Trade or Business*, 46 A.L.R. 2D 615, 678-81 (1956).

basis in the 10 lots, including development costs, is $10,000 each. The fair market value of each lot is $100,000, and the easement reduces the value to $5,000 each. Therefore, the easement on each lot is valued at $95,000, which is 95% of the fair market value. Accordingly, Jack's basis in the easement on each lot is $9,500 ($10,000 x 95%), so the maximum deduction that Jack can take for each lot easement is $9,500. His basis in the 100 acres is $100,000, his original cost (he made no improvements). The easement on the 100 acres is valued at $5,000,000.

Jack will be allowed to deduct $95,000 for the donation of the easement on the lots (10 x $9,500) due to the limitation to basis for gifts of ordinary income property. He will be allowed to deduct the full $5,000,000 on the 100 acres because this property was clearly not held for "sale to customers in the ordinary course of his trade or business" and is treated as long-term capital gain property.

9. Contributions by Trusts

The IRS has ruled that complex trusts (i.e. trusts that are not required to distribute all of their income currently) may not deduct charitable contributions of conservation easements.[233] This is because a conservation easement donation is considered by the IRS to be a distribution of corpus, not income.[234] Although the Ruling only addressed deductions by complex trusts, the principle involved would appear applicable to all trusts.

The IRS Ruling does not pertain to "grantor trusts." A grantor trust is a trust that is considered to be owned by the grantor due to the reservation by the grantor of certain interests in or powers over the trust. All of the income and deductions pertaining to a grantor trust are passed through to the owners of the trust.[235]

However, if the trustee of a grantor trust is not expressly authorized to make a charitable contribution of a conservation easement the conveyance may be subject to challenge by a trust beneficiary as being *ultra vires*, and possibly by the beneficiary's successors in title to the trust property as well.[236] This raises important issues as to whether the easement has been donated in perpetuity as required by law.

Increasingly individuals are transferring title to their homes to a type of grantor trust known as a "qualified personal residence trust" ("QPRT")[237] for estate planning purposes. The Regulations prohibit such trusts from dis-

233. Rev. Rul. 2003-123, 2003-50 I.R.B. 1200.
234. *Id.*
235. *See* 26 U.S.C. § 671 to 677 (2004).
236. Assuming such successors have standing, a question beyond the scope of this article.
237. 26 C.F.R. § 25.2702-5 (2004) (detailing the requirements of a QPRT).

tributing any of their corpus, directly or indirectly, to or for the benefit of a beneficiary or the grantor, during the term of the trust. However, because a land trust is not a qualified beneficiary or grantor of a QPRT,[238] the donation of a conservation easement to such an entity would not appear to violate the requirements. Because QPRTs cannot hold real property other than the grantor's personal residence,[239] they typically do not hold large acreage and, therefore QPRT assets, are unlikely to figure significantly in major easement donations.

The existence of a conservation easement over a taxpayer's personal residence will not disqualify that property from being included in a QPRT.[240]

VI. CONCLUSION

As with any creature of the Tax Code, charitable deductions for the donation of conservation easements are complex. However, the tax benefits associated with such donations are substantial. Landowners whose primary motivation in donating a conservation easement is land conservation have little to fear from the law, or the recent tough posture of the IRS with respect to conservation transactions, provided that they have sound legal advice. However, where the primary motivation is to use the tax benefits relating to conservation easements as a tax shelter without serious concern for land conservation, the IRS has raised the stakes—and the complexity of the rules provides ample opportunity for it to challenge deductions for easements providing marginal public benefit, or where easement values strain credulity.

It can be expected that there may be changes in the Tax Code and Regulations pertaining to conservation easements. Here in Wyoming it is very likely that the legislature will once again consider easement legislation in the 2005 legislative session. If enabling authority for conservation easements is enacted, strict compliance with its provisions will be crucial. On the federal level it is possible that the tax benefits for conservation easement donations will be further expanded, and that reform measures, such as tightening appraisal requirements and standards for land trusts may be also be enacted.

In any event, easements are likely to be around for a long time to come. A thorough understanding of conservation easements, and the benefits of easement donation, is increasingly important for those representing clients who may acquire land subject to a conservation easement, or a substantial part of whose assets include land.

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238. *Id.* § 25.2702-5(c)(4).
239. *Id.* § 25.2702-5(c)(5); *see also id.* § 25.2702-5(d), example (5).
240. Priv. Ltr. Rul. 2000-39-031 (June 30, 2000).