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**NEWSLETTER**

**Conservation Easement Tax Benefits**

By John B. West

Conservation easements are a popular technique for providing landowners a means of protecting the conservation values of their property while simultaneously offering significant tax benefits. Recent federal and state legislation provides increased income tax benefits to donors of conservation easements. This article highlights income, estate and gift, and property tax benefits available to donors of conservation easements.

**General**

In layman's terms, a conservation easement is a legal agreement between a landowner and another party by which the landowner imposes restrictions on the way he and his successors in title may use the property in order to protect its conservation values. The recipients of conservation easements are generally governmental entities or nonprofit organizations. If drawn properly, a conservation easement can protect the conservation values of property but still reserve in the landowner important rights to use the property, including limited rights to subdivide and develop the property, the right to harvest timber or conduct agricultural activities, and the right to use the property for recreational purposes.

Internal Revenue Code (the "Code") Section 170(h) provides a charitable contribution income tax deduction for conservation easements which meet the requirements of that Section. Under Code Section 170(h), the donor of a "qualified

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conservation contribution” to a “qualified organization” exclusively for “conservation purposes” is allowed a charitable contribution deduction.<sup>1</sup> The term “qualified conservation contribution” includes a conservation easement.<sup>2</sup> (This article uses the term “conservation easement,” or simply “easement,” in place of the statutory term “qualified conservation contribution.”)

The “conservation purposes” for which easements may be donated and a deduction received are set out in the Code.<sup>3</sup> These purposes include: (i) preserving land for public outdoor recreation or education; (ii) protecting a natural plant or wildlife habitat; (iii) protecting qualifying open space, either for the enjoyment of the public or pursuant to a government conservation policy; and (iv) protecting historic property.<sup>4</sup>

The conservation purposes of an easement must be protected in perpetuity in order for a deduction to be allowed.<sup>5</sup> To ensure the permanent protection of easement property, Treasury Regulations require that easements be subject to legally enforceable restrictions preventing use of the property in a manner inconsistent with the easement’s conservation purposes.<sup>6</sup> Nevertheless, as stated above, a landowner may reserve important rights to use easement property, including limited development rights, the right to harvest timber or conduct agricultural activities, and the right to use the property for recreational purposes, and still comply with Treasury Regulations.

## Income Tax Benefits

### Federal Income Tax

The deduction provided donors of conservation easements is equal to the fair market value of the easement at the time of the donation.<sup>7</sup> Generally, the fair market value of an easement is equal to the difference between the value of the easement property before the conservation easement is imposed and the value of the easement property after the conservation easement is imposed.<sup>8</sup>

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<sup>1</sup> I.R.C. § 170(h)(1).

<sup>2</sup> I.R.C. § 170(h)(2).

<sup>3</sup> I.R.C. § 170(h)(4)(A).

<sup>4</sup> Id.

<sup>5</sup> I.R.C. § 170(h)(5)(A).

<sup>6</sup> I.R.C. § 170(h); Treas. Reg. 1.170A-14(g)(1).

<sup>7</sup> Treas. Reg. § 1.170A-14A(h)(3)(i).

<sup>8</sup> Id.

On August 17, 2006, President Bush signed into law the Pension Protection Act of 2006, H.R. 4, 109<sup>th</sup> Cong. (2006), which significantly enhanced existing federal income tax benefits of conservation easements. In summary, the Pension Protection Act:

- Raises the deduction a landowner can take for donating a conservation easement from 30% of his contribution base<sup>9</sup> (or adjusted gross income) to 50% of his adjusted gross income;
- Allows qualifying farmers and ranchers to deduct up to 100% of their income; and
- Increases the number of years over which a donor can take deductions in excess of the percentage limitation from 5 years to 15 years.

For example, under previous rules, a landowner with an annual adjusted gross income of \$100,000 who donated a \$1 million conservation easement could take a deduction of \$30,000 for the year of the donation and \$30,000 for the next 5 years – a total of \$180,000 worth of deductions. The new rules permit the landowner to deduct \$50,000 for the year of the donation and then \$50,000 for the next 15 years – a total of \$800,000 worth of deductions. If the landowner is a qualified farmer or rancher, he can deduct \$100,000 per year, up to the full \$1,000,000.

If a conservation easement donor makes other charitable gifts in the year of the conservation easement donation, or if the donor is carrying forward charitable deductions from prior years, any non-conservation easement charitable deductions may be used first against the existing limitations. After those deductions are used to the maximum extent allowed, the deduction for the conservation easement donation may be taken into account. In the example above, if the landowner had donated \$100,000 to his college in the same year he donated the conservation easement, he could deduct \$50,000 in the current year for the donation to the college and then carry over the excess \$50,000 for up to 5 years. No current deduction would be allowed for the conservation easement donation, but the conservation contribution deduction could be carried forward for up to 15 years.

Interestingly, in light of the Pension Protection Act incentives, the donation of a conservation easement can result in a greater income tax benefit than the gift of a fee simple property interest.

The Pension Protection Act incentives apply only to gifts of “qualified conservation contributions” of “qualified real property interests,” which are generally defined by the Code as less than an entire property interest.<sup>10</sup> As such, only gifts of less than an entire interest qualify for the 50% deduction percentage and the 15-year carry-forward period.

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<sup>9</sup> I.R.C. § 170(b)(1)(G).

<sup>10</sup> I.R.C. § 170(h)(2).

On the other hand, gifts of entire interests in property are subject to the same percentage limitation and carry-forward rules under Code Section 170(b) applicable to all other property contributions. So for instance, if the donated property is capital gain property and the charitable deduction is based on fair market value, the deduction is limited to 30% of adjusted gross income and may be carried forward only 5 years.<sup>11</sup> If the donated property is not capital gain property, or a special election is made<sup>12</sup>, in which case the deduction is limited to basis, the deduction is limited to 50% of adjusted gross income but may be carried forward only 5 years.<sup>13</sup>

In view of these rules, it is certainly possible to imagine circumstances in which the donation of an easement that is a high percentage of the property's total fair market value could generate a greater income tax benefit than the donation of the entire property.

The Pension Protection Act incentives are currently set to expire December 31, 2007, although recent legislation seeks to make them permanent.

### Georgia Income Tax

On April 21, 2006, Governor Perdue signed into law House Bill 1107,<sup>14</sup> which provides a state income tax credit to donors of conservation easements which satisfy the requirements for such donations under the legislation.

Under the new law, donors of qualifying conservation easements may receive a state income tax credit equal to the lesser of: (a) 25% of the fair market value of the donated property in the year of the donation, or (b) \$250,000 (for individuals) or \$500,000 (for corporations).<sup>15</sup>

The credit is provided for "qualified donations" of property for "conservation purposes" to an eligible governmental entity or a nonprofit organization.<sup>16</sup> "Qualified donations" may be gifts of either permanent conservation easements or of fee simple property interests.<sup>17</sup> The "conservation purposes" for which property must be donated differ somewhat from the conservation purposes under Code Section 170(h).<sup>18</sup> They include, in general, protection of agricultural and forestry lands, protection of rivers, streams, lakes and wetlands, and protection of lands that serve as natural habitats for native plants and animals.<sup>19</sup>

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<sup>11</sup> I.R.C. § 170(b)(1)(C)(i) and (ii).

<sup>12</sup> I.R.C. § 170(b)(1)(C)(iii).

<sup>13</sup> I.R.C. § 170(b)(1)(A).

<sup>14</sup> 2006 Ga. Laws p. 351; O.C.G.A. § 48-7-29-12.

<sup>15</sup> O.C.G.A. § 48-7-29.12(b).

<sup>16</sup> Id.

<sup>17</sup> O.C.G.A. § 48-7-29.12(a)(2).

<sup>18</sup> O.C.G.A. § 48-7-29.12(a)(1); O.C.G.A. § 36-22-2(5).

<sup>19</sup> Id.

To take advantage of the state credit, a donor must apply to the Georgia Conservation Tax Credit Program, which is administered jointly by the Georgia Department of Natural Resources and the Department of Revenue.<sup>20</sup> A donor may request pre-certification that a proposed conservation easement gift will be a “qualified donation” for purposes of the state tax credit.<sup>21</sup> Final certification that a donation qualifies for the credit may occur only after the donation has been completed and recorded by deed.<sup>22</sup>

### Estate and Gift Tax Benefits

Estate taxes can make it difficult for landowners to pass land on to their children and grandchildren. Heirs may be forced to sell all or a portion of their land in order to pay estate taxes. Conservation easements can provide a landowner ways of reducing its federal estate taxes.

First, Code Section 2031(c) allows an estate to exclude from a decedent’s gross estate up to 40% of the value of land subject to a qualified conservation easement.<sup>23</sup> The exclusion is limited to a maximum of \$500,000,<sup>24</sup> but it applies to conservation easements donated either before or after a decedent’s death.<sup>25</sup>

For example, assume that a landowner dies owning property with a fair market value of \$1.5 million and subject to a qualified conservation easement worth \$500,000. The value of the property, \$1.5 million, minus the value of the easement, \$500,000, is \$1 million, and multiplied by 40%, is \$400,000. Under Code Section 2031(c), the executor may elect to exclude up to \$400,000 from the decedent’s gross estate.

To qualify for the Code Section 2031(c) exclusion, the easement must qualify as a qualified conservation easement under Code Section 170(h), but the easement must additionally prohibit “de minimis” commercial recreational activities.<sup>26</sup> Also, the decedent or a member of his family must have owned the property subject to the easement continuously over the 3 years before the decedent’s death.<sup>27</sup>

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<sup>20</sup> O.C.G.A. § 48-7-29.12(c); Ga. Comp. R. & Regs. 391-1-6-.04(2) (2006).

<sup>21</sup> Ga. Comp. R. & Regs. 391-1-6-.04(2).

<sup>22</sup> Ga. Comp. R. & Regs. 391-1-6-.04(3).

<sup>23</sup> I.R.C. § 2031(c).

<sup>24</sup> I.R.C. § 2031(c)(1).

<sup>25</sup> I.R.C. § 2031(c)(6) and (8).

<sup>26</sup> I.R.C. § 2031(c).

<sup>27</sup> I.R.C. § 2031(c)(8)(A)(ii).

Second, Code Section 2055(f) allows an estate to take a charitable deduction for the transfer of a qualified conservation easement.<sup>28</sup> Unlike the Code 2031(c) exclusion, a deduction under Code Section 2055(f) is not limited to any cap. For post-death easement donations, the deduction is allowed only so long as no income tax charitable deduction is taken by any person with respect to the grant of the easement.<sup>29</sup> As such, an estate may not claim an income tax deduction for the post-death grant of a conservation easement even though the decedent could have taken an income tax deduction had the easement been conveyed during life.

Finally, placing a conservation easement on property can reduce or eliminate a landowner's estate tax liability to the extent the easement reduces the fair market value of the property at the time of a landowner's death.

From a gift tax perspective, as well, conservation easements can reduce or eliminate tax on transfers of property.

Landowners commonly transfer partial interests in property to their family and others using the annual federal gift tax exclusion under Section 2503(b), or if necessary, by making taxable gifts.<sup>30</sup> In 2007, an individual can give up to \$12,000 (\$24,000 for a married couple) per year, per person and not incur gift taxes,<sup>31</sup> and up to \$1 million can be gifted during a lifetime without incurring gift taxes.<sup>32</sup> By granting a conservation easement before making the gift, the landowner may reduce the value of the land so that the gift tax is substantially less or even eliminated, and it may allow the annual partial gifts to be completed more quickly.

#### Property Tax Benefits

Donors of conservation easements on property located in Georgia may qualify for a conservation use assessment of such property for ad valorem tax purposes.

Under Georgia Code Section 48-5-7.4, "bona fide conservation use property" is assessed at 40% of its "current use value."<sup>33</sup> Assessment at "current use value" will typically give a reduced assessment to the owner of this type property when compared to other property assessed at 40% of fair market value. Since "bona fide conservation use property" is generally defined to include agricultural land, timberland and environmentally sensitive land,<sup>34</sup> property subject to certain conservation easements may qualify for the Georgia conservation use assessment, as well.

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<sup>28</sup> I.R.C. § 2055(f).

<sup>29</sup> I.R.C. § 2031(c)(9).

<sup>30</sup> I.R.C. § 2503(b).

<sup>31</sup> I.R.C. § 2503(b).

<sup>32</sup> I.R.C. § 2505(a)(1).

<sup>33</sup> O.C.G.A. §§ 48-5-7, 48-5-7.4.

<sup>34</sup> O.C.G.A. 48-5-7.4(a)(1).

One caveat exists as to the availability of this potential tax reduction. Real estate tax assessments are based on the property's value as determined by the local assessor. In theory, the assessed value of property can be reduced by a conservation easement as set out above. However, the Georgia Land Conservation Program reports that this principal has had mixed results in Georgia due to each county having its own interpretation of how property is assessed. The Program recommends that donors check with their local tax assessor's office to determine if the donation of a conservation easement will result in a property tax reduction.

### Practical Considerations

In accordance with normal non-cash charitable contribution rules, donors of conservation easements worth more than \$5,000 must submit IRS Form 8283 with their tax return in order to claim a charitable deduction.<sup>35</sup> The Form 8283 must set out the value of the easement donation, as evidenced by an appraisal attached to the Form 8283, and the donee organization must acknowledge the receipt of the easement.<sup>36</sup>

While the Pension Protection Act provides incentives which make conservation easements more attractive, the Act also imposes strict requirements for easement appraisals and assesses heightened penalties for improper valuations. In general, appraisals must be "qualified appraisals" conducted by "qualified appraisers" in accordance with generally accepted appraisal standards and Treasury Regulations.<sup>37</sup> Appraisers must have specific education and experience in valuing conservation easements.<sup>38</sup>

Under general appraisal rules, easement appraisers must first take into account the sale price of a comparable easement, and only if no such sales exist may it value the property based on the fair market value before and after the easement. The appraisal may not be made earlier than 60 days before the date the easement is contributed.<sup>39</sup> The Act also increases taxpayer penalties for substantial valuation misstatements, and appraisers are themselves subject to increased penalties for understatements of value.<sup>40</sup>

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<sup>35</sup> I.R.C. § 170(f)(11)(C).

<sup>36</sup> Id.; Treas. Reg. § 1.170A-13(c)(3)(i).

<sup>37</sup> Treas. Reg. § 1.170A-13(c)(13); I.R.S. Notice 2006-96, 2006-46 I.R.B. 902.

<sup>38</sup> Id.

<sup>39</sup> Treas. Reg. § 1.170A-13(c)(3)(i)(A).

<sup>40</sup> I.R.S. Notice 2006-96.

In short, it is more crucial than ever that an appraiser in a conservation easement transaction understands the appraisal rules and that he meet all qualifications under the Pension Protection Act and Treasury Department regulations.

Finally, the year-end deadline for taking advantage of the Pension Protection Act incentives raises an important practical point. Preparing a conservation easement transaction can take several months, particularly if a government agency is involved. The easement document must be negotiated and drafted, tax advisors must be consulted, baseline property evaluations and an appraisal must be prepared, and lawyers must review title records. If the transaction is part gift-part sale, or more than one agency is involved, the complications can increase exponentially. Landowners hoping to complete a conservation easement transaction by year-end should get started soon.

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If you would like to discuss your conservation easement transaction in light of the issues raised in this Newsletter, please call one of the lawyers at Hull, Towill, Norman, Barrett & Salley listed below.

*This Newsletter provides a general summary of recent legal developments. It is not intended to be and should not be relied upon as legal advice.*

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