Tax Considerations with Virginia Conservation Easements

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The Virginia Easement Exchange, L.L.C. provides brokerage services to Virginia taxpayers desiring to reduce state and federal income taxes through the purchase of tax credits from land preservation and historic rehabilitation projects.

Our core business is matching Virginia taxpayers who are interested in purchasing Virginia tax credits with landowners who desire to sell such credits. We typically work with accounting firms, financial institutions, financial planners and institutional buyers to supply the firm's clients with tax credits in a timely and efficient manner and at a competitive price. We work closely with the firm to reduce the administrative burdens of the credit transfers, while allowing the firm to provide value-added services to their clients. We also offer services to accounting firms who have clients who desire to invest in Virginia and federal historic rehabilitation projects that generate tax credits.

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I. <u>What Is A Conservation Easement?</u>

A. Conservation Easement Defined. A conservation easement is a permanent restriction placed on real estate by a property owner limiting some or all of the development rights associated with the property. *See generally* S. Small, THE FEDERAL TAX LAW OF CONSERVATION EASEMENTS (Land Trust Alliance, 1997) and T. Lindstrom, A TAX GUIDE TO CONSERVATION EASEMENTS (Land Trust Alliance, 2016).

1. *Typical Transaction.* In a typical transaction, a landowner will enter into an agreement with a land trust or a state agency to limit future development of a property. Through a deed of easement, the landowner will relinquish some or all of the development rights on the property. To qualify, the easement must have some scenic, wildlife, watershed, historic, or open space value.

2. *Statutes Authorizing Easements.* There are two separate statutes in Virginia that authorize conservation easements on land located in the Commonwealth—the Open Space Land Act, and the Virginia Conservation Easement Act. Va. Code Ann. § 10.1-1700 and § 10.1-1009, *et. seq*. Compliance with one of these two statutory schemes is required.

B. Retained and Relinquished Rights. To obtain the favorable tax benefits attributable to the donation of the easement, the restrictions placed on the land must last in perpetuity. *See* I.R.C. § 170(h)(2)(c) and Va. Code Ann. § 58.1-511(A). As part of the easement, the landowner is not required to allow public access to their land, and the land remains fully transferable by sale, gift or inheritance. The landowner may continue to use the land as they please, except for the relinquished rights. The most important and valuable rights that are usually relinquished are subdivision rights—meaning the right to divide the property into multiple parcels for resale, along with buffers, setbacks and building restrictions to protect the conservation values of the property. The release of such rights results in a reduction in the overall value of the property.

C. Qualified Appraisal. The reduction in value as a result of the donation is determined in a qualified appraisal prepared and signed by a qualified appraiser licensed in the Commonwealth of Virginia and must be reported to the Internal Revenue Service and the Commonwealth of Virginia. *See Gemperle v. Commissioner,* T.C. Memo. 2016-1 (No deduction allowed for conservation easement, where return lacked a qualified appraisal). *See also Friedberg v. Commissioner*, T.C. Memo 2011-238. There are two statutory regimes regarding the definitions of qualified appraisal and qualified appraiser—one under Section 170 of the Internal Revenue Code concerning the charitable income tax deduction and one in Section 58.1-512 of the Code of Virginia concerning the Virginia land preservation tax credit. However, Section 58.1-512(B) of the Code of Virginia provides that the terms “qualified appraisal” and “qualified appraiser” have the same meanings as under federal law and regulations. *See also* Ruling of the Tax Commissioner, P.D. 07-09 (March 12, 2007) (concerning guidelines for qualified appraisals and incorporating the definitions found in I.R.C. § 170(h) for purposes of Section 58.1-512.1 of the Code of Virginia). These definitions are found in Section 170(f) of the Internal Revenue Code.

1. *Definitions*. The provisions contained in Section 170(f) of the Internal Revenue Code concerning the definition of "qualified appraisal" and "qualified appraiser" were substantially modified by the Pension Protection Act of 2006. Section 170(f)(11)(E)(i) of the Internal Revenue Code provides that the term "qualified appraisal" means an appraisal of property that is a qualified appraisal under the Treasury Regulations and is conducted by a qualified appraiser in accordance with generally accepted appraisal standards. Section 170(f)(11)(E)(ii) provides that the term qualified appraiser means an individual who (a) has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements set forth in regulations prescribed by the Secretary, (b) regularly performs appraisals for which the individual receives compensation, and (c) meets such other requirements as may be prescribed by the Secretary in regulations or other guidance. Section 170(f)(11)(E)(iii) further provides that an individual will not be treated as a qualified appraiser unless that individual (a) demonstrates verifiable education and experience in valuing the type of property subject to the appraisal, and (b) has not been prohibited from practicing before the IRS by the Secretary under section 330(c) of Title 31 of the United States Code at any time during the 3-year period ending on the date of the appraisal.

2. *Notice 2006-96.* The Service issued transitional guidance in Notice 2006-96, 2000-46 I.R.B. 902 (November 13, 2006). Notice 2006-96 provides that an appraisal will be considered qualified if the appraisal complies with all of the requirements of Section 1.170A-13(c) of the Treasury Regulations and is conducted by a qualified appraiser in accordance with the substance and principles of the Uniform Standards of Professional Appraisal Practice ("USPAP"). Under Notice 2006-96, an appraiser will be treated as having met minimum education and experience requirements if the appraiser is licensed or certified for the type of property being appraised in the state in which the appraised real property is located. Note that under the Virginia Code, the appraiser must be licensed in the Commonwealth. Va. Code Ann. § 58.1-512(B). In general, the Notice provides that all of the other requirements of existing regulations concerning qualified appraisals and qualified appraisers continue to apply, except to the extent they are inconsistent with Section 170(f)(11)(E).

3. *Proposed Regulations*. On August 7, 2008, the Service issued proposed regulations implementing the changes made in the Pension Protection Act. *See* Notice of Proposed Rulemaking, Vol. 73 Fed. Reg. 153 (August 7, 2008). Under Section 1.170A-16(d) of the Proposed Regulations, where contributions are claimed of more than $5,000, in addition to a contemporaneous written acknowledgement, a qualified appraisal is required, and either Section A or Section B of Form 8283 (depending on the type of property contributed) must be completed and filed with the return on which the deduction is claimed. For claimed contributions of more than $500,000, Section 1.170A-16(e) of the Proposed Regulations provides that the donor must attach a copy of the qualified appraisal to the return. The Proposed Regulations also provide that the requirements for substantiation that must be

submitted with a return also apply to the return for any carryover year under Section 170(d). *See* Prop. Reg. § 1.170A-16(f)(2). The Proposed Regulations apply to contributions occurring after the date the regulations are published as final regulations in the Federal Register.

a. *Definition of Qualified Appraisal.* Section 1.170A-17(a)(1) of the Proposed Regulations provides that a qualified appraisal means an appraisal document that is prepared by a qualified appraiser in accordance with generally accepted appraisal standards. Generally accepted appraisal standards are defined in the proposed regulations as the substance and principles of the Uniform Standards of Professional Appraisal Practice (USPAP), as developed by the Appraisal Standards Board of the Appraisal Foundation. Prop. Reg. § 1.170A-17(a)(2). The proposed regulations are similar to section 3.02(2) of Notice 2006-96, except that the proposed regulations require compliance with the *substance and principles* of USPAP. An appraisal that does not take into account a local ordinance is not consistent with the substance and principles of USPAP. *See also* Prop. Reg. § 1.170A-14(h)(3)(ii). The Tax Court has rejected conservation easement appraisals that fail to meet the requirements of a qualified appraisal under the Regulations. *See Costello v. Commissioner*, T.C. Memo. 2015-87. However, the Tax Court has also held that the concept of substantial compliance applies to these specific Treasury Regulations. *Cave Buttes, L.L.C., et al. v. Commissioner*, 147 T.C. No. 10 (September 20, 2016).

b. *Date of Appraisal.* Under the Proposed Regulations, the valuation effective date, which is the date to which the valuation opinion applies, generally must be the date of the contribution. Prop. Reg. § 1.170A-17(a)(5). In cases where the appraisal is prepared before the date of the contribution, the valuation effective date must be no earlier than 60 days before the date of the contribution and no later than the date of the contribution. Prop. Reg. § 1.170A-17(a)(5)(ii). The date the appraiser signs the appraisal report (appraisal report date) must be no earlier than 60 days before the date of the contribution and no later than the due date (including extensions) of the return on which the deduction is claimed or reported. Prop. Reg. § 1.170A-17(a)(4). *See Costello v. Commissioner*, T.C. Memo. 2015-87 (appraisal rejected by Tax Court that did not meet the date requirements). *See also Rothman v. Commissioner*, T.C. Memo. 2012-163 and *Zarlengo v. Commissioner*, T.C. Memo. 2014-161.

c. *Qualified Appraiser.* The Proposed Regulations modify the appraiser declarations required in the appraisal and on Form 8283. In addition, the Proposed Regulations contain several new terms implementing the Pension Protection Act requirements of a qualified appraiser. In general, under the Proposed Regulations, a "qualified appraiser" must be an individual with verifiable education and experience in valuing the relevant type of property for which the appraisal is performed. Prop. Reg. § 1.170A-17(b)(1).

> *See also Rothman v. Commissioner*, T.C. Memo. 2012-163. Note that the Proposed Regulations stress two types of education and experience: minimum *education and experience to establish qualification* as an appraiser generally, and *verifiable education and experience in valuing the type of property* subject to the appraisal. Prop. Reg. § 1.170A-17(b)(1). The Proposed Regulations provide that an individual has verifiable education and experience if the individual has successfully completed professional or college-level coursework in valuing the relevant type of property and has two or more years experience in valuing that type of property. Prop. Reg. § 1.170A-17(b)(2). Furthermore, because significant education and experience are required to obtain a designation from a recognized professional appraiser organization, under the Proposed Regulations appraisers with these designations are deemed to have demonstrated sufficient verifiable education and experience. Prop. Reg. § 1.170A-17(b)(2)(iii). Specific designations listed in the Proposed Regulations include MAI, SRA, SREA, and SRPA, but this list is not exclusive. *Id.* The Proposed Regulations require a statement in the appraisal of the appraiser's specified education and experience in valuing the relevant type of property. Prop. Reg. § 1.170A-17(b)(4). Note that section 3.03(3)(a)(ii) of Notice 2006-96 provides that, for real estate appraisers, education and experience are sufficient if the appraiser holds a license or certificate to value the relevant type of property in the state in which the property is located. This provision was not incorporated in the proposed regulations, which set forth more specific requirements applicable to all appraisers. Even though Section 170(f)(11)(E)(ii)(II) of the Internal Revenue Code appears to require compensation to be considered a qualified appraiser, the Proposed Regulations do not contain a compensation requirement.

4. *Federal Appraisal Methodology.* Treasury Regulation Section 1.170A-14(h)(3)(i) provides that the fair market value of the perpetual conservation restriction should first be based on the sales prices of such comparable easements. However, in reality no such comparable sales readily exist. *See Symington v. Commissioner*, 87 T.C. 892 (1986) (wherein the Tax Court stated: "unfortunately, since most open-space easements are granted by deed of gift there is rarely an established market from which to derive the fair market value."). *See also* Rev. Rul. 73-339, 1973-2 C.B. 68; Rev. Rul. 76-376, 1976-2 C.B. 53, *Thayer v. Commissioner*, T.C. Memo. 1977-370 (regarding valuation of a VOF easement); and *Browning v. Commissioner*, 109 T.C. 303 (1997) (bargain sale of development rights to county not indicative of value of easement). Accordingly, under the Treasury Regulation the fair market value of the donation is equal to the difference between the fair market value of the property it encumbers before the granting of the restriction and the fair market value of the encumbered property after the granting of the restriction. Treas. Reg. § 1.170A-14(h)(3)(i). *See also Stanley Works v. Commissioner,* 87 T.C. 389 at 399-400 (1986) (before and after approach is often used instead of comparable sales). Nevertheless, a mechanical application of this method, such as a mere percentage reduction, is not an appropriate application of this appraisal methodology. *See*

Scheidelman v. Commissioner, T.C. Memo. 2010-151, *aff'd*. 755 F.3d 148 (2nd Cir. 2014) (11.33% value diminution applied on a façade easement by appraiser, court held appraisal was not "qualified") and *Evans v. Commissioner*, T.C. Memo. 2010-207 (appraisal disregarded as not a qualified appraisal by a qualified appraiser); *See also* Chief Counsel Advisory 200738013 (August 8, 2007). The "before and after" valuation must take into account the current use of the property and the likelihood or immediacy of development, and the effect of any zoning or conservation laws that may restrict highest and best use. Treas. Reg. § 1.170A-14(h)(3)(i). Highest and best use can be any realistic, potential use of the property. *Symington v. Commissioner*, 87 T.C. 892, 896 (1986). *See also Terrene Investments v. Commissioner*, T.C. Memo. 2007-218 (sand and gravel mining was highest and best use for property). If the easement has the effect of increasing the value of other property held by the landowner, the value of the donation is reduced by the enhancement. Treas. Reg. § 1.170A-14(h)(3)(i). Also, easements covering contiguous property owned by the donor (and the donor's family) are valued based on the value of the entire contiguous portion before and after the easement. *Id*. For a good discussion of federal valuation methodology, including detailed treatment of both the enhancement and contiguous parcel rules, see Chief Counsel Advisory 201334039 (July 25, 2013).

a. *Recent Tax Court Cases.* There have been several recent cases in the valuation area relating to conservation easements: *Kiva Dunes Conservation, LLC v. Commissioner*, T.C. Memo. 2009-145; *Simmons v. Commissioner*, T.C. Memo. 2009-208; *Trout Ranch, L.L.C. v. Commissioner*, T.C. Memo. 2010-283; *Boltar v. Commissioner*, 136 T.C. 326 (2011); *Butler v. Commissioner*, T.C. Memo. 2012-72; *Esgar v. Commissioner*, T.C. Memo. 2012-35; *Mountanos v. Commissioner,* T.C. Memo. 2013-138 aff'd. unpub'd op. (9th Cir., June 1, 2016); *Palmer Ranch Holdings, Ltd. v. Commissioner*, T.C. Memo. 2014-79, *rev. in part and remanded* 812 F.3d 983 (11th Cir. 2016), T.C. Memo. 2016-190; *Schmidt v. Commissioner,* T.C. Memo. 2014-59; *SWF Real Estate, LLC v. Commissioner,* T.C. Memo. 2015-63; and *Costello v. Commissioner*, T.C. Memo. 2015-87. Note that these cases involve the donation of a conservation interest in land, rather than a façade easement, and some recent cases involving valuation of façade easements are not cited herein.

5. *Virginia Appraisal Methodology*. For purposes of the Virginia land preservation tax credit, the Commonwealth has also provided statutory guidance regarding appraisal methodology. Section 58.1-512.1(A) of the Code of Virginia provides that each appraisal estimating the value of any donation upon which tax credits are to be based shall employ proper methodology and be appropriately supported by market evidence. Section 58.1-512.1(A) of the Code of Virginia further provides Department of Taxation shall establish and make publicly available guidelines that incorporate, as applicable (without limitation), requirements under I.R.C. § 170(h) and the Uniform Standards of Professional Appraisal Practice ("USPAP"). *See* Ruling of the Tax Commissioner, P.D. 07-09 (March 12, 2007) (concerning guidelines for qualified appraisals and incorporating the definitions found in I.R.C. § 170(h) for purposes of Section 58.1-512.1 of the Code of Virginia).

Section 58.1-512.1(C) of the Code of Virginia further provides that the fair market value of any property with respect to a qualified donation shall not exceed the value for the highest and best use (a) that is consistent with existing zoning requirements, (b) for which the property was, or was likely to be, adaptable and needed in the immediate area in which the property is located, (c) that considers slopes, flood plains, and soil conditions and other factors of the property, and (d) for which existing roads serving the property are sufficient to support commercial or residential development in the event that is the highest and best use proposed for the property.

a. *Structures.* Section 58.1-512.1(B) of the Code of Virginia provides that for purposes of any appraisal of an easement, no more than 25% of the total credit allowed shall be for reductions in value to any structures and other improvements to land.

D. Federal and State Reporting Requirements. In addition to the Qualified Appraisal, there are additional requirements in order to claim the federal charitable deduction. For federal income tax purposes, the valuation of the easement donation is reported on Form 8283 (Noncash Charitable Contributions). For state income tax purposes, the valuation of the easement donation is reported on Form LPC-1 (Application for Land Preservation Credit).

1. *Baseline Documentation.* Section 1.170A-14(g)(5)(i) of the Treasury Regulations provides that the donor must make available to the donee (prior to the donation) baseline documentation in order to establish the condition of the property at the time of the gift. Such information is designed to protect the conservation values associated with the property. The Treasury Regulations provide a detailed listing as to what information is to be provided in the baseline documentation report. Treas. Reg. § 1.170A-14(g)(5)(i)(A)-(D). *See also* PLR 200403044 (January 16, 2004); PLR 200836014 (September 5, 2008); *Glass v. Commissioner,* 471 F.3d 698 (6th Cir. 2006). The report must also contain a statement, signed by the donor and the donee, that states: "This natural resources inventory is an accurate representation of [the protected property] at the time of the transfer." Failure to meet the baseline documentation requirements of the Treasury Regulations will result in the denial of the charitable deduction. *Bosque Canyon Ranch, L.P. v. Commissioner,* T.C. Memo. 2015-130 (Baseline report "was unreliable, incomplete and insufficient" and taxpayer's substantial compliance arguments were rejected by Tax Court). It is Service position that the information provided in the Form 8283 alone will not suffice as baseline documentation for purposes of the requirements in the Treasury Regulations.

2. *Form 8283.* In order to report the charitable contribution of the easement, the donor will file Form 8283 (Noncash Charitable Contributions). Form 8283 requires the donor to provide certain information on the donated easement including information to establish the condition of the property at the time of the gift (a base line documentation report). In addition to an appraisal, a statement is required that includes information that identifies the conservation purposes of the

easement, shows the fair market value of the gift, provides a statement of whether the gift was made in exchange for a permit or other approval from a governing authority, and information regarding whether or not any related person has an interest in any nearby property. The appraiser must complete Part III of Form 8283, and the appraiser is required to provide a special declaration. Lastly, the donee must acknowledge the donation and it must be executed by a person who is an official of the organization authorized to execute tax returns of the organization. A person specifically authorized to sign Form 8283 by the organization may also execute the Form. The failure to file a fully completed Form 8283 will result in the disallowance of the charitable deduction by the IRS. *See Costello v. Commissioner,* T.C. Memo. 2015-87 (Form 8283 not signed by donee rejected by the Tax Court). *See also RERI Holdings I, LLC v. Commissioner*, 149 T.C. No. 1 (2017) (Form 8283 failed to provide cost basis for the property which was significantly lower than the donated value, substantial compliance doctrine did not apply); *Gemperle v. Commissioner*, T.C. Memo. 2016-1. However, a reasonable cause exception does exist where the failure to file was not due to willful neglect, the taxpayer otherwise complies with Treas. Reg. § 1.170A-13(c)(3) and (c)(4), and the taxpayer submits a fully completed Form 8283 within 90 days of an IRS request.

3. *Acknowledgement Letter*. Section 170(f)(8)(A) of the Internal Revenue Code provides that no deduction is allowed for the donation of a conservation easement, unless the donor receives a contemporaneous written acknowledgement of the donation from the donee organization. Treas. Reg. § 1.170A-13(f)(2) details the required contents of the acknowledgement writing. Service position is that the acknowledgement must be in a separate writing delivered at the time of the donation and the deed of easement, the appraisal, and the deed of easement may not satisfy the requirement. Also, because of the statutory requirement that the notice be contemporaneous, Service position is that any defect may not be cured after the due date for filing of the donor's tax return for the year of the donation. Lastly, it is Service position that, because the requirement is statutory, the substantial compliance doctrine does not apply. *See* Chief Counsel Advisory 200848076 (Aug 27, 2008). At least one court supports the Service's position here. In *Bruzewicz v. Unites States*, Docket No. 1:07-cv-04074 (N.D. Ill. March 25, 2009), the District Court denied a charitable contribution for a façade easement because no acknowledgement letter was sent by the donee. The District Court rejected the taxpayer's substantial compliance arguments. However, in *Simmons v. Commissioner*, T. C. Memo. 2009-208, the Tax Court held that a conservation easement deed itself satisfied the acknowledgement letter requirement as the deed was executed by the donee, was contemporaneous with the donation of the easement, and described the property contributed. *See also 310 Retail, LLC v. Commissioner,* T.C. Memo. 2017-16 and *Big Run Development v. Commissioner*, T.C. Memo. 2017-166. The general approach of the Tax Court is that the typical documentation found in the donation of a conservation easement in land will meet the statutory requirement, but this may not be so with respect to façade easements. *Compare Lord v. Commissioner*, T.C. Memo. 2010-196; *Mitchell v. Commissioner*, 138 T.C. 324 (2012); *Averyt v. Commissioner,*

T.C. Memo. 2012-198; *RP Golf, LLC v. Commissioner,* T.C. Memo. 2012-282, *aff'd.* 860 F.3d 1096 (8th Cir. 2017); *Minnick v. Commissioner*, T.C. Memo. 2012-345; *Irby v. Commissioner*, 139 T.C. No. 14 (2012) with *Schrimsher v. Commissioner*, T.C. Memo. 2011-71 and *French v. Commissioner*, T.C. Memo. 2016-53. *See also DiDonato v. Commissioner*, T.C. Memo. 2011-153 (settlement agreement did not satisfy requirement) and Chief Counsel Advisory 201014056 (April 9, 2010). In addition, attempts to use Section 170(f)(8)(A) of the Internal Revenue Code to circumvent the acknowledgement requirement have been unsuccessful. *15 W. 17th Street LLC v. Commissioner*, 147 T.C. No. 19 (December 22, 2016) (since no regulations have been issued under this exception, it is not applicable until such time as the regulatory authority is exercised by the Secretary).

4. *Form LPC-1.* Taxpayers are required to file Form LPC-1 (Application for Land Preservation Credit) with the Department of Taxation in order to be awarded Virginia income tax credits. Pursuant to the instructions to Form LPC-1, the form should be filed within 90 days following the donation, and at least 90 days before filing of the donor's annual return to claim the tax credit. In all events, the Form LPC-1 must be filed with the Department on or before December 31st of the year following the year of the donation. Va. Code Ann. § 58.1-512(C)(4). Applicants with tax credits exceeding $1,000,000 should file at least 120 days prior to the annual return. The Department of Taxation will not guarantee that any application received in December will be processed within that taxable year. One Form LPC-1 is to be submitted per donation, even if the donated property has multiple owners. Schedule A to Form LPC-1 provides the opportunity to allocate the credit at the time of donation among multiple owners. Schedule B and C provide additional information that must be submitted if the tax credit claimed exceeds $1,000,000.

5. *Notice 2017-10*. The Service has added additional filing requirements for certain donations of conservation easements that are considered "listed transactions." Notice 2017-10, 2017-4 I.R.C. 544 (Jan. 23, 2017). This Notice is intended to place additional tax shelter filing requirements on certain syndicated conservation easement transactions. The Service describes the transaction as one where an investor receives promotional materials, including, but not limited to, documents described in § 301.6112-1(b)(3)(iii)(B) of the Treasury Regulations, that offers and investor in a pass-through entity the possibility of a charitable contribution deduction that equals or exceeds an amount that is two and one-half times the amount of the investor's investment. The investor purchases an interest, directly or indirectly (through one or more tiers of pass-through entities), in the pass-through entity that holds real property. The pass-through entity that holds the real property contributes a conservation easement encumbering the property to a tax-exempt entity and allocates a charitable contribution deduction to the investor. Following that contribution, the investor reports on his or her federal income tax return a charitable contribution deduction with respect to the conservation easement. If a transaction is the same or similar to that as described above, the transaction must be disclosed as a reportable transaction on Form 8886. The Service has issued

two additional Notices to clarify the filing dates and procedures—Notice 2017-29, 2017-20 I.R.B. 1243 and Notice 2017-58 (October, 2017).

II. Income Tax Considerations with Conservation Easements

The reduction in value as a result of the donation of a conservation easement creates potentially three federal and state income tax benefits, including (A) a federal income tax deduction; (B) a Virginia state income tax deduction; and (C) a transferable Virginia income tax credit. Note that the donation of the easement also creates incentives for reduction in local real estate taxes. *See* Va. Code Ann. § 10.1-1011.

A. Federal Income Tax Considerations. With respect to federal income taxes, the creation of a conservation easement is considered a charitable gift and may be deducted from the landowner's federal income taxes pursuant to I.R.C. §§ 170(a) and 170(h). So long as the donation of the conservation easement complies with the requirements of I.R.C. § 170(h), the donor may deduct the value of the easement for federal income tax purposes.

1. *Non Recognition Event on Transfer.* The donation of the conservation easement to a charity is not an income realization event for federal income tax purposes, even where the property has appreciated in value. *Rogers v. Commissioner,* 38 T.C. 785 (1962) (gift of timber interests). Of course, exceptions to this rule apply in the case of bargain sales, or pre-arranged sales with the charity. *See* I.R.C. § 1011(b), Rev. Rul. 78-197, 1978-1 C.B. 38, and Rev. Rul. 72-255, 1972-1 C. B. 221. The donation of a conservation easement in exchange for transferable state income tax credits is also not treated as a sale or exchange of the easement. Chief Counsel Advisory 201105010 (February 4, 2011).

2. *Federal Charitable Income Tax Deduction.* I.R.C. § 170(h) provides that a deduction will be allowed under I.R.C. § 170(a) with regard to a "qualified conservation contribution." I.R.C. § 170(h) provides further that a "qualified conservation contribution" means the contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes.

3. *Qualified Real Property Interest.* I.R.C. § 170(h)(2) defines three types of real property interests that will constitute a "qualified real property interest." These include: (1) the entire interest of the donor in the property, other than a qualified mineral interest; (2) a remainder interest following a life estate or a term of years, and (3) a perpetual conservation restriction. *See Schwab v. Commissioner*, T.C. Memo. 1994-232 (involving an agricultural and open space easement restricting in perpetuity the development and subdivision of the land) and *Higgins v. Commissioner*, T.C. Memo. 1990-103 (conservation easement restricting in perpetuity the subdivision of a farm). In the case of a conservation easement, this requirement will not be met if the easement allows subsequent modification of the restrictions by the donor. *Belk v. Commissioner*, 140 T.C. 1 (2013) *aff'd,* 774 F.3d 221 (4th Cir. 2014) (language in the deed of easement creating the ability of the donor to substitute other property parcels for the original parcels also violates the perpetuity requirement); *Balsam Mountain Investments, LLC v. Commissioner*, T.C. Memo. 2015-43 (language

in the deed of easement allowing the donor to change the boundaries of the restricted area for five years, caused the interest donated to fail the qualified real property interest requirement); *But see Bosque Canyon Ranch, II L.P. v. Commissioner,* 867 F.3d 547 (5th Cir. 2017), *rev'g*. T.C. Memo. 2015-130 ("floating" development rights whereby the donor could modify boundaries of homesite parcels within the eased parcel did not violate the perpetuity requirement).

4. *Qualified Organization*. Conservation easements must be donated to a "qualified organization" as defined in I.R.C. § 170(h)(3). There are generally four types of organizations that are qualified organizations: (1) a governmental unit defined in I.R.C. § 170(b)(1)(A)(v); (2) a publicly supported charitable organization described in I.R.C. § 170(b)(1)(A)(vi); (3) a publicly supported charitable organization described in I.R.C. § 509(a)(2); and (4) a support organization described in I.R.C. § 509(a)(3) that is controlled by a governmental unit or a publicly supported charitable organization. *See* Treas. Reg. § 1.170A-14(c)(1)(i). The Treasury Regulations further provide that the organization must have a commitment to protect the conservation purposes of the donation. *Id.; See also* PLR 200002020 (October 12, 1999) (ruling conditioned on government's agreement to amend deed to require commitment to conserve property and have resources to enforce the deed restrictions. For the discussion of revocation of tax-exempt status of organizations holding conservation or façade easements see PLR 201405018 (January 31, 2014) and PLR 201514009 (April 3, 2015). *See also Belk v. Commissioner*, 140 T.C. 1 (2013).

5. *Conservation Purpose*. A significant federal and state issue with respect to the donation of a conservation easement is the requirement that the property be donated "exclusively for conservation purposes." I.R.C. § 170(h)(1)(C). A further condition is added to this requirement that a contribution will not be treated as donated exclusively for conservation purposes unless the conservation purpose is protected in perpetuity. I.R.C. § 170(h)(5)(A).

a. *Exclusivity*. Section 1.170A-14(e) of the Treasury Regulations provides that, for a donation to be granted exclusively for conservation purposes, the property may not be put to a use that is inconsistent with the conservation purposes of the gift. In *Great Northern Nekoosa Corporation v. United States*, 38 Fed Cl. 645 (1997), the Claims Court denied a charitable deduction where the taxpayer donated two conservation easements on timberland in Maine but retained and utilized the mineral interests on the donated properties. The taxpayer continued to use the mining rights to extract gravel for use on logging roads. The court found the surface mining inconsistent with the conservation purpose. Nevertheless, the retention of limited development rights and the right to conduct agricultural, timber harvesting and equestrian activities will generally not constitute an inconsistent use where such use does not impair the conservation values on the property. *See* PLR 200208019 (November 26, 2001); PLR 9632003 (May 7, 1996); PLR 9603018 (October 19, 1995) and PLR 9537018 (June 20, 1995).

b. *Perpetuity*. In addition, for the easement to be considered as "exclusive," the donation must last in perpetuity. I.R.C. § 170(h)(5)(A). Treas. Reg. § 1.170A-14(e). Litigation regarding this requirement has typically involved: (1) the failure of a mortgage holder on the donated property to subordinate to the rights of the easement donee, (2) the rights of the donee to the proceeds from condemnation of the property subject to the easement or judicial extinguishment of the easement, or (3) the retention of certain rights in the easement by the donor that impair the conservation values.

i. *Subordination*. Under Treas. Reg. § 1.170A-14(g)(2), no charitable deduction is allowed for an easement donation unless a lien holder subordinates its right to the property to the rights of the donee organization to enforce the conservation purposes of the easement in perpetuity. *Satullo v. Commissioner*, T.C. Memo. 1993-614 (court held that easement was not protected in perpetuity where mortgage holder had a priority lien); *Mitchell v. Commissioner*, 138 T.C. 324 (2012) *aff'd*. 775 F.3d 1243 (10th Cir. 2015); *Minni*ck v. *Commissioner*, T.C. Memo. 2012-345 *aff'd.* 796 F.3d 1156 (1st Cir. 2015); *RP Golf, LLC v. Commissioner,* T.C. Memo. 2016-80, *aff'd.* 860 F.3d 1096 (8th Cir. 2017) (oral agreement with bank to subordinate did not suffice and post easement subordination did not cure); and *Palmolive Bldg. Investors, LLC v. Commissioner*, 149 T.C. No. 18 (Oct. 10, 2017). It is Service position in the Conservation Easement Audit Techniques Guide that substantial compliance does not apply to the failure to properly subordinate.

ii. *Condemnation or Extinguishment*. In the event of condemnation of the donated property or judicial extinguishment of the easement, the donee organization, on a subsequent sale, exchange, or involuntary conversion of the property, must be entitled to a portion of the proceeds at least equal to that proportionate value of the conservation easement, unless state law provides that the donor is entitled to the full proceeds from the conversion without regard to the terms of the prior perpetual conservation restriction. Treas. Reg. § 1.170A-14(g)(6). If this provision is not satisfied, the donation fails to comply with the perpetuity requirement. *Carroll v. Commissioner*, 146 T.C. No. 13 (April 27, 2016) (No deduction allowed where deed of easement provided that, in the event of extinguishment, donee organization only received value of charitable deduction allowable to the donor). *See also Wall v. Commissioner*, T.C. Memo. 2012-169.

iii. *Retained Rights*. Certain rights retained in the deed of easement may also violate the perpetuity requirement. Treas. Reg. §§ 1.170A-14(g)(e) and (g)(5). *See also Carpenter v. Commissioner*, T.C. Memo. 2012-1 (perpetuity requirement not met where easement could be extinguished by mutual consent). Language in the deed of easement creating the ability of the donor to substitute other property parcels for the original parcels also violates the perpetuity requirement. *Belk v. Commissioner*, 140 T.C. 1 (2013) *aff'd,* 774 F.3d 221 (4th Cir. 2014); *Balsam Mountain Investments, LLC v. Commissioner*, T.C. Memo. 2015-43 (language in the deed of easement allowing the donor to change the boundaries of the restricted area for five years, caused the interest donated to fail the qualified real property interest requirement); *But see Bosque Canyon Ranch, II L.P. v. Commissioner,* 867 F.3d 547 (5th Cir. 2017), *rev'g*. T.C. Memo. 2015-130 ("floating" development rights whereby the donor could modify boundaries of homesite parcels within the eased parcel did not violate the perpetuity requirement). It is also important to note, that state law alone may defeat the perpetuity requirement. *Wachter v. Commissioner*, 142 T.C. No. 7 (2014) (North Dakota law that easements valid for only 99 years, violated perpetuity requirement).

iv. *Remoteness.* However, a deduction will not be disallowed merely because the easement may be defeated by some act or event that, at the time of the donation, the occurrence of which is so remote as to be negligible. Treas. Reg. § 1.170A-1(e); *Stotler v. Commissioner*, T.C. Memo 1987-275 (abandonment and condemnation potential on easement was remote and would only affect a small portion of the land); *But see Kaufman v. Commissioner*, 134 T.C. 182 (2010) *aff'd*. 784 F.3d 56 (1st Cir. 2015) (perpetuity requirement was not met where bank who held mortgage on property retained right to all proceeds of condemnation and to all insurance proceeds as a result of any casualty, hazard, or accident occurring to or about the property); *1982 East, L.L.C. v. Commissioner*, T.C. Memo. 2011-84 (Same result); *Mitchell v. Commissioner*, 138 T.C. 324 (2012) *aff'd*. 775 F.3d 1243 (10th Cir. 2015); *Ten Twenty Six Investors v. Commissioner*, T.C. Memo. 2017-115. In addition, the remoteness standard found in the Treasury Regulations cannot be used to cure a lack of subordination by a lien holder on the donated property. *Mitchell v. Commissioner*, 138 T.C. 324 (2012) *aff'd*. 775 F.3d 1243 (10th Cir. 2015); and *Kaufman v. Commissioner*, 136 T.C. 294 (2011) *aff'd*. 784 F.3d 56 (1st Cir. 2015). In a recent façade easement case, the Tax Court held that a side letter between the donor and the donee that would return the cash contribution and remove the easement if the IRS disallowed all or part of the charitable contribution did not satisfy the remoteness test. *Graev v. Commissioner*, 140 T.C. No. 17 (June 24, 2013); *See also* TAM 200610017 (November 25, 2005) for a good discussion of remoteness in the context of a charitable deduction for a donation of land under the "Rails to Trails" program.

v. *Perpetuity in Virginia*. With respect to easements under the Virginia Open-Space Land Act, Section 10.1-1704 of the Code of Virginia provides that no land designated as open-space land shall be converted or diverted unless the conversion or diversion is determined by the public body to be essential to the orderly development and growth of the locality in accordance with the comprehensive plan for the locality and other property of equal or greater value is substituted. Under the Virginia Conservation Easement Act, Section 10.1010(F) of the Code of Virginia provides that grant of the easement does not affect the power of the court to modify or terminate a conservation easement in accordance with the principles of law and equity, or in any way limit the power of eminent domain as possessed by any public body. The Act further provides that in any proceeding the holder of the conservation easement shall be compensated for the value of the easement. Note that the language in the statutory scheme does not follow the language of the Treasury Regulation regarding compensation of the donee. *See* Treas. Reg. § 1.170A-14(g)(6). *Compare Wachter v. Commissioner*, 142 T.C. No. 7 (2014).

c. *Types of Conservation Purposes.* There are generally four conservation purposes identified in the Internal Revenue Code and the Treasury Regulations. *See* I.R.C. § 170(h)(4)(A) and Treas. Reg. § 1.170A-14(d)(1). The first conservation purpose is the preservation of land areas for outdoor recreation or educational use by the general public. I.R.C. § 170(h)(4)(A)(i). The second conservation purpose is the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem. I.R.C. § 170(h)(4)(A)(ii). The third conservation purpose is the preservation of open space, including farmland and forestland, where the preservation will yield a significant public benefit and either is for the scenic enjoyment of the general public or is pursuant to a clearly delineated federal, state, or local governmental conservation policy. I.R.C. § 170(h)(4)(A)(iii). The last conservation purpose is the preservation of a historically important land area or certified historic structure. I.R.C. § 170(h)(4)(A)(iv). The legislative history indicates that the term "conservation purposes" is intended to be liberally construed with regard to the types of property for which deductible conservation easements may be granted. *See Glass v. Commissioner,* 124 T.C. 258 (2005), *aff'd.* 471 F.3d 698 (6th Cir. 2006), *citing*, H. Conf. Rept. 95-263, at 30-31 (1977), 1977-1 C.B. 519, 523. For a good discussion of conservation purpose in a private letter ruling, see PLR 200836014 (June 3, 2008).

i. *Public Recreation, Education and Historic Properties.* Because public recreation or education use entails public access, most landowners do not rely on this conservation purpose. *See* Treas. Reg. § 1.170A-14(d)(2)(ii) (requiring "substantial and regular use" by the public). Similarly, many properties will not meet the requirements of a historically important land area or certified historic structure. A land area will be historically important if the land is an independently significant land area that: (a) satisfies the National Register Criteria for Evaluation; (b) is located within a registered historic district; or (c) is adjacent to a property listed on the National Register of Historic Places where the land contributes to the integrity of the registered property. *See* Treas. Reg. § 1.170A-14(d)(5)(i) and (ii). *See also Turner v. Commissioner*, 126 T.C. 299 (2006) (land adjacent to historic site did not contribute to integrity of site), *Herman v. Commissioner*, T.C. Memo. 2009-205 (easement on air rights above certified historic structure did not protect structure), and *1982 East, L.L.C. v. Commissioner*, T.C. Memo 2011-84 (easement failed to contain protection provisions, local law alone not sufficient).

ii. *Habitat Protection*. Habitat protection constitutes a recognized preservation purpose and includes (a) protection of habitats for rare, endangered or threatened species of animals, fish or plants, (b) natural areas that represent high quality examples of terrestrial or aquatic communities, (c) and natural areas included in, or which contribute to, the ecological viability of a local state or national park, preserve, refuge, wilderness area or similar conservation area. Treas. Reg. § 1.170A-14(d)(3)(ii). *See also Glass v. Commissioner*, 124 T.C. 258 (2005), *aff'd* 471 F.3d 698 (6th Cir. 2006) and *Butler v. Commissioner,* T.C. Memo. 2012-72. *But see Atkinson v. Commissioner*, T.C. Memo. 2015-236 (discussing habitat protection in the context of an easement on a golf course). Section 1.170-14(d)(3)(i) of the Treasury Regulations states that the fact that the environment has been altered to some extent by human activity will not result in a denial of the deduction if the fish, wildlife or plants continue to exist in a relatively natural state. *See also* PLR 9537018 (June 20, 1995) (regarding previously logged timber stands) and PLR 200403044 (October 9, 2003) (previously farmed land). There are numerous private letter rulings providing general guidance on habitat protection. As an example, see PLR 200208019 (November 26, 2001).

iii *Open Space Protection*. Open space protection, including farm and forest land, is a permitted conservation purpose widely used in easements donated in the Commonwealth. Generally, one of two requirements must be met to satisfy this conservation purpose. Treas. Reg. § 1.170A-14(d)(4)(i). First, the donation will constitute a valid conservation purpose if it promotes the scenic enjoyment of the general public. In the alternative, the donation will constitute a valid conservation purpose if it promotes a clearly delineated federal state or local government conservation policy. Treas. Reg. § 1.170A-14(d)(4)(i). In any event, the preservation must yield a significant public benefit. I.R.C. § 170(h)(4)(A)(iii). Section 1.170A-14(d)(4)(iv)(A) of the Treasury Regulations provides detailed guidance on factors germane to the evaluation of whether an open space easement yields a significant public benefit. *See also Atkinson v. Commissioner*, T.C. Memo. 2015-236 (discussing public benefit in the context of an easement on a golf course). Preservation will be considered for the general public's scenic enjoyment if development of the land would impair the scenic character of a landscape or would interfere with a scenic panorama enjoyed by the public from a public park, preserve, road, waterway, trail or similar facility. Treas. Reg. § 1.170A-14(d)(4)(ii)(A). *See also* PLR 9632003 (May 7, 1996) and PLR 9603018 (October 19, 1995) (regarding scenic vistas from public roads). *See also McLennan v. United States*, 24 Cl. Ct. 102 (1991) (analyzing the deed restrictions and the donee organization in a scenic enjoyment finding). While visual access is essential, physical access to the property is not required. Treas. Reg. § 1.170A-14(d)(4)(ii)(B).

iv. *Government Policy*. Where the easement is intended to promote a delineated federal, state or local government conservation policy, the policy must be more than a general statement of conservation goals, but need not be as specific as identification of particular parcels to be protected. Acceptable purposes include donations that further a specific conservation project, such as a state or local landmark district; the preservation of a wild or scenic river, the preservation of farmland pursuant to a state program for flood prevention and control; or the protection of land that is contiguous to, or an integral part of an existing recreation or conservation site. Treas. Reg. § 1.170A-14(d)(4)(iii)(A). *See also* PLR 200418005 (April 30, 2004) (town policy) and PLR 200002020 (October 12, 1999) (county policy). Also note that the regulation provides that the more clearly delineated the governmental policy, the easier it will be to establish a significant public benefit. *See* Treas. Reg. § 1.170A-14(d)(4)(iii)(A). *See also* PLR 9603018 (October 19, 1995) (discussing the relationship of a government policy and significant public benefit).

v. *Department of Conservation Review*. Section 58.1-512(D) of the Code of Virginia provides that, after January 1, 2007, for easement donations that generate tax credits in excess of $1,000,000, the issuance of land preservation tax credits shall be subject to review by the Virginia Department of Conservation and Recreation (DCR). DCR reviews the conservation purpose of the easement as well as the public benefit derived from the donation, prior to issuance of the tax credits. Va. Code Ann. § 58.1-512(D)(1(a) and (c). The Virginia Land Conservation Foundation has developed detailed Conservation Value Review Criteria as of November 21, 2006, and amended on August 7, 2008 and March 27, 2009. While the determinations of DCR are not binding on the Internal Revenue Service or the Virginia Department of Taxation for audit purposes (*see* Va. Code Ann. § 58.1-512(D)(6)), a question arises as to the Service's or the Department's ability to challenge the easement for conservation purpose and public benefit where a state conservation agency has reviewed the donation for those exact issues. Section 1.170A-14(d)(4)(iii)(B) of the Treasury Regulations, provides in pertinent part, that acceptance of an easement by an agency of a state or local government tends to establish the requisite clearly delineated governmental policy. The more rigorous the review process by the governmental agency, the more the acceptance of the easement tends to establish the requisite clearly delineated governmental policy. *See also* PLR 200002020 (October 12, 1999) (ruling that governmental review process was sufficient under the Treasury Regulation). However, the Treasury Regulation is initially written with a view that the government agency is the donee of the easement. In Virginia, many donations are made to private land trusts. However, the Treasury Regulation also provides a safe-harbor in that "the donation of a perpetual conservation restriction to a qualified organization pursuant to a formal resolution *or certification* by a local governmental agency established under state law specifically identifying the subject property as worthy of protection for conservation purposes *will meet* the requirement of this paragraph." Emphasis added. *See* Treas. Reg. § 1.170A-14(d)(4)(iii)(A). In light of the vigorous review process by DCR, it appears difficult for the Department or the Service to maintain an argument that an open space easement lacks a conservation purpose or a public benefit when it has favorably completed DCR review. Of interest is Ruling of the Tax Commissioner, P.D. 07-172 (November 14, 2007), wherein the taxpayer opted out of DCR review by claiming less than $1,000,000 of tax credit even though the true donation would have yielded more. While the DCR review process is rigorous, opting out of such procedures creates a greater risk that the Department or the Service could challenge the conservation purpose of the easement donation.

vi. *Multiple Conservation Purposes*. A conservation easement may qualify for multiple conservation purposes. *See* PLR 9632003 (May 7, 1996) and PLR 9603018 (October 19, 1995). *See also* DCR review criteria.

vii. *IRS Scrutiny of Conservation Purpose.* Because of perceived abuses by taxpayers with regard to conservation easements, the Service has issued two Notices regarding conservation easements.

The first is Notice 2004-41, 2004-28 I.R.B. 31 (July 12, 2004). In the Notice, the Service indicated that it was concerned that claimed conservation purposes in the areas of habitat protection and preservation of open space did not provide a significant public benefit. *See* Treas. Reg. § 1.170A-14(d)(1)(iii), (iv), (v) and (vi). Two cases are illustrative of the concern of the Service. In *Turner v. Commissioner*, 126 T.C. 299 (2006), the Tax Court held that a conservation easement on property adjacent to Washington's Grist Mill in Fairfax County lacked a conservation purpose. The court found that the claimed conservation purpose of preservation of open space was not met, as the easement did not preclude residential development which would have impaired the open space values. The court further found that the easement did not preserve a historically significant land area or certified historic structure. In *Glass v. Commissioner*, 124 T.C. 258 (2005), *aff'd* 471 F.3d 698 (6th Cir. 2006), the Tax Court found that easements protecting 10 acres of bluffs along the shoreline of Lake Michigan had a conservation purpose. The property contained nesting bald eagles and a threatened plant species, and was also prime habitat for another threatened plant species. The court interpreted the terms "habitat" and "community" using the plain meanings of those terms. On appeal to the Sixth Circuit, the government argued that the Tax Court erred in finding that the habitat was too small to be considered "significant." The Sixth Circuit affirmed the decision of the Tax Court. *But see Atkinson v. Commissioner*, T.C. Memo. 2015-236 (discussing habitat protection and the public benefit of open space in the context of an easement on a golf course). In *Herman v. Commissioner*, T.C. Memo. 2009-205, the Service successfully challenged the grant of a conservation easement precluding development of 10,000 square feet of unused development rights ("air rights") over a certified historic structure. The taxpayer had claimed a charitable contribution of $21,850,000 for the grant of the easement. The Tax Court held that the taxpayer was not entitled to the deduction because the easement did not preserve a historically important land area or a certified historic structure. The main problem for the taxpayer was that the easement only applied to the development rights above the existing structure and did not preclude alteration or destruction of the historic structure. In addition, the court found that the easement did not preserve a historically important land area, because the land, apart from the structure, was not historically important. Practitioners who are relying on certified historic structures or historically important land areas for conservation purpose, should read *Turner* and *Herman* carefully.

The second Notice is Notice 2017-10, 2017-4 I.R.B. (12/13/2016). In this Notice the Service expressed concern regarding promotors syndicating conservation easement transactions to allow investors to obtain charitable deductions significantly in excess of the amount of their investment. Where an investor receives promotional materials for a conservation easement transaction that offers investors a charitable deduction that equals or exceeds an amount that is 2.5 times the amount of their investment, such a transaction is a listed transaction for purposes of Section 6111 and 6112 of the Internal Revenue Code, and Section 1.6011-4 of the Treasury Regulations.

6. *Amount of Charitable Deduction*. As stated, for purposes of I.R.C. § 170, the value of the contribution is typically the difference between the value of the eased property prior to the donation of the easement, and the value of the property after the contribution. *See* Treas. Reg. § 1.170A-14. The amount ultimately deductible by the donor is subject to several limitations including Section 170(e)(1)(A), *quid pro quo*, income percentage limitations and carryforward limitations.

a. *170(e)(1)(A) Limitation.* Pursuant to Section 170(e)(1)(A) of the Internal Revenue Code, the contribution is reduced by the amount of gain which would not have been long-term capital gain if the property were sold by the taxpayer for fair market value (determined at the time of contribution). This provision was intended to prevent the realization of tax benefits from gifts of appreciated property greater than the economic return if the property were merely sold—in essence to make the gift equivalent to a gift of cash. *See* S. Rep. No. 552, 91st Cong., 1st Sess. 80 (1969). When marginal rates are high, a taxpayer could possibly realize a greater economic benefit through a charitable donation than an actual sale. Today, this provision operates to reduce the allowable tax credit from an easement on a recently purchased property and is particularly troublesome in developer and conservation buyer scenarios. Note that in the case of a conservation easement, since the donor is only granting a partial interest, the donor does not have the full benefit of the entire cost basis in the computation of the limitation. The charitable deduction is limited to the basis in the easement, not the basis in the entire property. Cost basis in the easement "is equal to that portion of the adjusted basis of the entire property as the fair market value of the donated property bears to the fair market value of the entire property." *See Strasburg v. Commissioner*, T.C. Memo. 2000-94 (conservation easement donated to Montana land trust within one year of purchase limited to 32% of cost basis) and *DuVal v. Commissioner*, T.C. Memo. 1994-603. (contribution of real estate to Chesterfield County, Virginia by developer not subject to Section 170(e)(1)(A) because, although petitioner was a dealer, specific property was acquired for investment and donation was also not subject to *quid pro quo* rules). *See also* Rev. Rul. 74-348, 1974-2 C. B. 80. Of course, Section 170(e)(1)(A) does not apply where the property has not appreciated between the time of purchase and the time of the donation. *See Hughes v. Commissioner,* T.C. Memo. 2009-94 (May 6, 2009).

b. *Depreciable Property*. Although not usually an issue with easements restricting only land, Section 1.170-4(b)(4) of the Treasury Regulations also provides that depreciable property is treated as long-term capital gain property only to the extent that any gain recognized on the sale of such property would not constitute ordinary income under various recapture provisions of the Internal Revenue Code. Like Section 170(e)(1)(A) of the Internal Revenue Code, this provision limits the deduction to the long-term capital gain portion of the property donated.

c. *Quid Pro Quo.* Of course, the donation of an easement in exchange for a favorable zoning result is a *quid pro quo*, and grounds for denial of the charitable deduction. *See Pollard v. Commissioner*, T.C. Memo. 2013-38. In addition, a donation of an easement required in order to allow the landowner to sell development rights to third parties is also a *quid pro quo*. *See Costello v. Commissioner,* T.C. Memo. 2015-97. However, the Service initially raised an issue in Chief Counsel Advisory 200230841 (July 24, 2002) as to whether the receipt of the tax credit is itself a *quid pro quo* requiring a reduction in the amount of the charitable deduction. *See also* TAM 9239002 (June 17, 1992) (conservation easement granted in exchange for zoning change was deductible to extent that value of easement exceeded value of zoning change to donor). Reduction in the value of the charitable contribution for such benefits is consistent with the return benefit analysis. *See* Rev. Rul. 67-246, 1967-2 C.B. 104 and *United States v. American Bar Endowment,* 477 U.S. 105 (1986).

i. *Tax Benefit is Not a Quid Pro Quo.* In Chief Counsel Advisory 200230841 (July 24, 2002) the Service stated "the tax benefit of a federal or state charitable contribution is not viewed as a return benefit that reduces or eliminates a deduction under section 170, or vitiates charitable intent." *See also* Chief Counsel Advisory 200435001 (July 28, 2004) and Chief Counsel Advisory 201105010 (February 2, 2011). The courts have also generally held that tax benefits received as part of a charitable donation of an easement are not a *quid pro quo*. *See Browning v. Commissioner*, 109 T.C. 303 (1997) (installment sale benefits, tax-free interest and economic value of deduction of easement limiting development rights held not a *quid pro quo*). *See also McLennan v. United States,* 24 Cl. Ct. 102 (1991), *aff'd* 994 F2d. 839 (1993) (court held that tax benefits were incidental to charitable purpose of taxpayers, despite heavy emphasis on tax benefits in transaction planning by local land conservancy). Service position is moving away from the *quid pro quo* issue raised in initial published guidance, and more recently, in Chief Counsel Advisory 201105010 (February 2, 2011), the Service stated:

> "Generally, however, a state or local tax benefit is treated for federal tax purposes as a reduction or potential reduction in tax liability. As such, it is reflected in a reduced deduction for the payment of state and local tax under §164, not as consideration that might constitute a *quid pro quo*, for purposes of §170, or an amount includible in income, for purposes of §61 and §1001. . . . In this respect, we see no reason . . . to distinguish between the value of a state tax deduction, and the value of a state tax credit, or to draw a bright-line distinction based on the amount of the tax benefit in question. . . . Similarly, the

> fact that excess charitable credits in the instant case can be carried over . . .[or] transferred to other taxpayers—does not, in our view, change the characterization of the credit from a reduction or potential reduction in liability, to consideration received in return for the charitable deduction."

ii. *Donative Intent Challenges*. The Service could also claim that donative intent may not exist as the donor may grant the easement solely to reap the tax benefits that result from the donation. *Cf. Perlmutter v. Commissioner*, 45 T.C. 311 (1965) (developer who conveyed parcel for recreation use pursuant to zoning ordinance not entitled to charitable deduction). This argument could be based on several grounds, including that the donor has no charitable intent, that the donation was not exclusively for conservation purposes, or that the private benefits outweighed the public benefits of the easement. In *McLennan v. United States,* 24 Cl. Ct. 102 (1991), *aff'd* 994 F2d. 839 (1993), the Service challenged a donation on donative intent grounds. This challenge is a different argument than the return benefit analysis and would disallow the entire deduction. Like the return benefit analysis, this will be an acute issue in developer and conservation buyer scenarios. *See* Treas. Reg. 1.1-170A-14(h)(3)(i) ("If, as a result of the donation of a perpetual conservation restriction, the donor or a related person receives, or can reasonably expect to receive, financial or economic benefits that are greater than those that will inure to the general public from the transfer, *no deduction is allowable under this section*." Emphasis added). *See also* Rev. Rul. 67-246, 1967-2 C.B. 104 and TAM 9239002 (June 17, 1992) (excess payment must be made with intention of making a gift, and Service position is that where a transaction involves a *quid pro quo*, this gives rise to a presumption that a gift was not made for purposes of Section 170, and that the burden is on taxpayer to rebut that presumption).

iii. *Cross Payments, Appraisal Fees and Stewardship Fees.* Payments between the donor of the easement and the donee organization can create charitable deduction issues. The payment by a state agency or a land trust of appraisal fees incurred by the donor would constitute a return benefit and could even trigger bargain sale treatment. In turn, stewardship fees paid by the donor to a state agency or a land trust to monitor easement compliance could also create return benefit issues. *See Scheidelman v. Commissioner*, T.C. Memo. 2010-151 *aff'd*. 755 F.3d 148 (2nd Cir. 2014).

7. *Income Percentage Limitations and Carry Forward.* The charitable deduction for easement contributions is limited, however, by I.R.C. § 170(b)(1) to 50% of the donor's "contribution base." I.R.C. § 170(b)(1)(F) provides that "for purposes of

this section, the term "contribution base" means adjusted gross income (computed without regard to any net operating loss carryback to the taxable year under section 172)." Nevertheless, pursuant to I.R.C. § 170(d)(1), any unused amount of the charitable deduction may be carried forward for 15 years, subject to the 50% limitation. *See also* Treas. Reg. § 170A-10(c)(1)(ii). Note that the carryforward of the charitable income tax deduction is available only to the person who made the contribution. *See Stussy v. Commissioner*, T.C. Memo. 1997-293. In addition, in planning for a client, practitioners should also take into account any itemized deduction phase-outs pursuant to I.R.C. § 68 of the Internal Revenue Code.

a. *Special Rule for Farmers.* Under the Pension Protection Act, for certain donations from 2005 through 2014, "qualified farmers" may claim the deduction against 100% of the contribution base. I.R.C. § 170(B)(1)(E)(iv). This provision was effective through 2014, and it is possible the provision will be extended or made permanent in the next round of tax legislation by Congress. I.R.C. § 170(B)(1)(E)(vi). A "qualified farmer" is a person (including partnerships, LLCs, and closely-held corporations) with more than 50% of their income arising from the business of "farming." I.R.C. §§ 170(B)(1)(E)(v) and 2032A(e)(5). If the 50% income requirement is met in the year of the donation, the 100% limitation applies through the entire carryforward period, regardless of whether the income requirement is met in later years. I.R.C. § 170(B)(1)(E)(v) ("50% of the taxpayer's gross income for the taxable year"); *See also* Notice 2007-50, 2007-25 I.R.B. 1430 (June 18, 2007) Q-2. Farming has the same definition as is provided in I.R.C. § 2032A(e)(5), which is summarized as follows: (1) cultivating the soil or raising any agricultural or horticultural commodity on a farm; (2) handling or storing any agricultural or horticultural commodity on a farm where one-half of the commodity is produced on the farm; and (3) cultivation and cutting of trees for market. I.R.C. §§ 170(B)(1)(E)(v) and 2032A(e)(5). The term "farm" includes stock, dairy, poultry, fruit, animal and truck farms, plantations, ranches, nurseries, greenhouses and similar structures used primarily for the raising of agricultural and horticultural commodities, and orchards and woodlands. I.R.C. § 2032A(e)(4). Note that for the 100% rule to apply, the easement must provide that the land will remain "available" for agriculture. I.R.C. § 170(B)(1)(E)(iv)(II). Also note that the proceeds from the bargain sale of the easement (such as pursuant to a purchase of development rights program) are not included in the farmer's income for purposes of the income requirement. *See* Notice 2007-50, 2007-25 I.R.B. 1430 (June 18, 2007) Q-6 and *Rutkoske v. Commissioner*, 149 T.C. No. 6 (August 7, 2017); *See also* I.R.C. § 2032A(e)(5).

b. *Notice 2007-50*. For further guidance on the changes in the limitation percentages and carryforward periods made in Pension Protection Act of 2006, *see* Notice 2007-50, 2007-25 I.R.B. 1430 (June 18, 2007).

c. *Planning the Use of the Deduction*. Where a client has made a donation that is subject to the 50% and 100% deduction regimens, practitioners should run calculations to determine whether it is more advantageous for the client to claim the deduction under the 50% or 100% regime if both are available. As tax brackets spread in the coming years, and with potentially longer carry-forward periods, it may be better to claim the deduction against the top 50% of AGI only. Detailed calculations would be required here. Practitioners should also be careful to take into account other charitable deductions of the client in computing the potential tax benefits of a conservation easement. Carryforward deductions from prior charitable contributions, and current year charitable contributions may reduce the income tax benefits of the easement for the donor. Note that if a taxpayer has any charitable deductions subject to the 50% limitation, those deductions may be "front-loaded" reserving the deductions subject to the 100% limitation for the 15-year carryforward period. However, once the 50% limitation is reached, any remaining deduction subject to the 50% limitation must be carried forward. Nevertheless, the taxpayer would then be able to utilize any deductions subject to the 100% limitation to offset their remaining income in that year. *See* Notice 2007-50, 2007-25 I.R.B. 1430 (June 18, 2007) Q-1 and Q-2.

8. *Basis Adjustment.* Where a landowner makes a qualified conservation contribution, the landowner must reduce the adjusted basis in the retained property by the amount of the total adjusted basis of the property allocable to the conservation easement. The portion allocable to the conservation easement is determined by the ratio of the value of the easement to the fair market value of the property before the easement. Note that the basis adjustment does not reflect the value of enhancement of adjoining land. Treas. Reg. § 1.170A-14(h)(3)(iii). For examples, see Treas. Reg. § 1.170A-14(h)(4), Examples (9) and (11).

9. *Alternative Minimum Tax*. A charitable deduction generated by the donation of a conservation easement is not a preference item for purposes of the alternative minimum tax (AMT). *See* Pub. L. 103-66, Section 13171(a) (repealing I.R.C. § 57(a)(6) concerning gifts of appreciated property).

10. *Pass-Through Entities.* Complex rules exist regarding the allocation and use of the resulting charitable deduction from the grant of the conservation easement by partners, LLC members and S corporation shareholders. These rules are developing and further guidance is needed in this area.

a. *Generally No Limitations on Use By Partners*. Because charitable contributions by partnerships are separately stated items under Section 702 of the Internal Revenue Code, the pass-through of such deductions is not limited by the partner's adjusted basis under Section 704(d), the at-risk rules under Section 465, and the passive loss rules under Section 469. *See* PLR 8405084 (November 3, 1983) and PLR 8753015 (October 2, 1987). The rationale for this treatment is that the donation is a contribution not a "loss." Each partner receives a distributive share of the charitable contribution. *See* PLR 9318017 (February 3, 1993) (discussing the tax treatment of the partner of a grant of a conservation easement by the partnership). *See also* PLR 200208019 (November 26, 2001) (regarding an easement donation by an LLC) and *Rutkoske v. Commissioner*, 149 T.C. No. 6 (August 7, 2017).

b. *Basis Adjustments to Partners.* The charitable donation reduces each partner's basis in the partnership (but not below zero) by the amount of the partner's share of the partnership's basis (not the fair market value) in the property contributed. *See* Rev. Rul. 96-11, 1996-1 C.B. 140. *See also* Honigman, *Partnership Treatment of Easement Contributions*, Tax Notes (April 6, 2009). Revenue Ruling 96-11 left unanswered issues in the Subchapter K area. One such issue is whether the grant of the conservation easement is a Section 704(b) revaluation event for purposes of the capital account maintenance rules. Treas. Reg. §§ 1.704-1(b)(2)(iv)(f)(5) and 1.704-1(b)(2)(iv)(q). Another unanswered issue is the implications of Section 704(c) of the Internal Revenue Code regarding the contribution. *See* Jackel, *Charitable Contributions of Code Section 704(c) Property by Partnerships*, 1 Journal of Passthrough Entities 8 (1998).

c. *Allocations of the Charitable Deduction.* Although there is no guidance on the issue, the allocation of a charitable deduction to a newly admitted partner appears to be possible despite the fact that the partner has been admitted to the partnership for less than a year. *See* Rev. Rul. 68-79, 1968-1 C.B. 310. This is because the holding period of the asset is determined at the partnership level.

d. *S Corporations.* With regard to donations by S corporations, the charitable deduction will pass-through to the shareholders in a similar manner to a partnership, however, historically the deduction was limited to the shareholders basis in stock and the shareholder's basis was reduced by the full pro rata share of the contribution, without regard to the actual deduction allowed to the shareholder. *See* PLR 9537018 (June 20, 1995) (discussing the historic tax treatment of a donation of a conservation easement by an S corporation). Recent tax legislation provides that the charitable deduction is not limited by the shareholder's basis in their S corporation stock. *See* I.R.C. §§ 1367(a)(2) and 1366(d)(4). *See also* Rev. Rul. 2008-16, 2008-11 I.R.B. 585 (March 17, 2008). Practitioners advising clients on easement donations through S corporations should review these provisions carefully.

11. *Income Tax Deduction by Grantor Trusts.* Easement donations by revocable trusts and defective trusts taxable as grantor trusts will be entitled to the same tax treatment as if the donation were made directly by the owner of the trust. This is because grantor trusts are generally disregarded as separate taxpayers for federal income tax purposes. *See* I.R.C. § 671 and Treas. Reg. § 1.671-1. Note that a single trust may have multiple tax owners for purposes of the grantor trust rules. I.R.C. § 678; Treas. Reg. §1.678(a)(1). Examples of such a situation would be a joint revocable trust among spouses or a Crummey Trust with multiple power holders.

a. *Planning Note.* For more complex estate planning through irrevocable trusts, the tax status of the irrevocable trust becomes a critical component of the charitable income tax deduction for a conservation easement. Practitioners should carefully consider provisions in the trust that provide certainty as to grantor trust status. *See* Rev. Rul. 2008-22, 2008-18 I.R.B. 796 (April 21, 2008) (retention of power by settlor to substitute trust corpus creates grantor trust status and trust property will not be included in gross estate of settlor). So-called "toggle" provisions could also be utilized to trigger grantor trust status for the period of the donation of the easement. *But see* Notice 2007-73, 2007-36 I.R.B. 545.

12. *Income Tax Deduction For Non-Grantor Trusts and Estates.* All non-grantor trusts that donate conservation easements from trust principal are not entitled to a charitable deduction under I.R.C. § 642(c) and are not allowed a distribution deduction under I.R.C. § 661(a)(2) with respect to the transfer. Rev. Rul. 2003-123, 2003-50 I.R.B. 1200 (trust not entitled to I.R.C. § 642(c) deduction for qualified conservation contribution because contribution was from principal rather than income). *See also Goldsby v. Commissioner,* T.C. Memo. 2006-274 (sole income beneficiary and trustee of trust may not deduct conservation easement contribution made by trust because beneficiary owned only income portion of trust and did not show that trust made the contribution from trust income). Similarly, an estate will not be entitled to a charitable income tax deduction under the same reasoning. *See Crestar Bank v. Commissioner*, 47 F. Supp. 2d 670 (E.D. Va. 1999) (estate not entitled to a deduction under section 642(c) for the value of stock bequeathed to a charitable trust from the estate); *see also* Chief Counsel Advisory 200140080 (September 4, 2001) and *Hubbell Trust v. Commissioner,* T.C. Summ. Op. 2016-67 (Oct. 13, 2016). Accordingly, a non-grantor trust will not be entitled to a charitable deduction for a conservation easement contribution, because such a contribution will always be from principal rather than income. *But see* Rev. Rul. 2004-5, 2004-3 I.R.B. 295 (January 20, 2004) (trust allowed a 642(c) deduction for pass through charitable contribution from a partnership, despite the fact that trust instrument did not authorize the trustee to make charitable contributions). *See also* Chief Counsel Advisory 200140080 (September 4, 2001) (same result). It is also important to note that in the case of a donation by a non-grantor trust, the trust will be entitled to the Virginia tax credit, as will the beneficiaries in the case of a post-mortem donation by an estate. *See* Ruling of the Tax Commissioner, P.D. 09-19 (February 4, 2009) and Ruling of Tax Commissioner, P.D. 08-66 (May 19, 2008).

a. *Purchase of Donated Property with Trust Income.* Where the property subject to the easement was purchased with income from the trust and later donated, Service position appears to be that the amount of the deduction under Section 642(c) is limited to the adjusted basis of the property. This would be particularly acute in fee simple donations. *See* Chief Counsel Advisory 201042023 (May 10, 2010).

b. *Planning Opportunity*. Rev. Rul. 2004-5, cited above, presents a planning opportunity for trusts that would allow a charitable deduction to a non-grantor trust where the trust is entitled to the deduction as part of the trust's distributive share from a partnership in the trust's capacity as a partner. A similar rule is also available for S corporations and ESBT's. *See* Treas. Reg. § 1.641(c)-1(d)(2)(ii). Practitioners should be cautious here as the partnership should have an independent non-tax business purpose. *See* Treas. Reg. § 1.701-2 and Chief Counsel Advisory 200704028 (January 26, 2007) (partnership established to facilitate transfer of Virginia historic rehabilitation credits disregarded for federal tax purposes).

13. *Bargain Sales*. Many Virginia taxpayers enter into easement transactions with county programs whereby the county will purchase development rights from the landowner through an administered program. Such transactions will be treated as sales of the easement for federal income tax purposes. *See* Rev. Rul. 77-414, 1977-2 C.B. 299 and Rev. Rul. 72-255, 1972-1 C. B. 221. Accordingly, such sales may also be eligible for non-recognition of gain under Section 1031 of the Internal Revenue Code. *See* PLR 200651018 (December 1, 2006). *See also* PLR 200201007 (October 2, 2001) (conservation easement is property for purposes of section 1031). Because such purchases are pursuant to a county administered program, the sales proceeds are usually less than the value of the easement actually granted. *Browning v. Commissioner*, 109 T.C. 303 (1997) (values determined under county easement purchase program not definitive of value). Accordingly, a taxpayer may also be entitled to a charitable income tax deduction in the amount of the bargain. Treas. Reg. § 1.170A-4(c)(2) and *Hay v. Commissioner*, T.C. Memo. 1992-409; *but see Costello v. Commissioner,* T.C. Memo. 2015-97 (charitable deduction disallowed and bargain sale treatment rejected where donation was a requirement to allow landowner to sell development rights to third parties). In addition, Virginia tax credits may also be available in the amount of the bargain. *See* Rulings of the Tax Commissioner, P.D. 06-36 (April 3, 2006) and P.D. 07-132 (August 24, 2007).

14. *Historic Tax Credit Recapture*. Note that the grant of a conservation easement will trigger historic rehabilitation and investment tax credit recapture. *See* Rev. Rul. 89-90, 1989-2 C.B. 3. *See also Rome I, Ltd. V. Commissioner,* 96 T.C. 697 (1991) (approving of Rev. Rul. 89-90 and providing the rationale that to allow the investment tax credit and the charitable deduction on the donated property would yield a double benefit to the taxpayer). The IRS Conservation Easement Audit Techniques Guide alerts examiners of this issue.

B. State Income Tax Deduction and Exclusion. Virginia allows a state income tax deduction for conservation easement donations by individuals and corporations. For individuals, Section 58.1-322(D)(1)(a) of the Code of Virginia provides that in computing Virginia taxable income there shall be deducted from Virginia adjusted gross income the amount allowable for itemized deductions for federal income tax purposes where the taxpayer has elected for the taxable year to itemize deductions on his or her federal return. Section 58.1-402(A) of the Code of Virginia provides a similar deduction for corporations. In addition, Section 58.1-402(C)(16) of the Code of Virginia provides for an exclusion from Virginia taxable income of the gain derived from the sale or exchange of real property, or the sale or exchange of an easement to real property, which results in the real property or the easement thereto being devoted to open-space use, as that term is defined in § 58.1-3230, for a period of time not less than 30 years. To the extent a subtraction is taken, no tax credit for donating land for its preservation shall be allowed for three years following the year in which the subtraction is taken. This provision is repealed for donations in years 2015 and thereafter and was designed to avoid a double benefit of the exclusion from income from the sale of an easement, followed by tax credits for the donation of the fee interest in the land.

C. Virginia State Income Tax Credits. Section 58.1-512(A) of the Code of Virginia provides that there shall be allowed as a credit against Virginia income tax an amount equal to 40% of the fair market value of any land or interest in land located in Virginia which is conveyed for the purpose of agricultural and forestal use, open space, natural resource, and/or biodiversity conservation, or land, agricultural, watershed and/or historic preservation, as an unconditional donation by the landowner/taxpayer to a public or private conservation agency eligible to hold such land and interests therein for conservation or preservation purposes. The purpose of Virginia Land Conservation Incentives Act of 1999 is to supplement existing land conservation programs to further encourage the preservation and sustainability of Virginia's unique natural resources, wildlife habitats, open spaces and forested resources. Va. Code Ann. § 58.1-510.

1. *Interest in Real Property*. For purposes of the Virginia land preservation tax credit, Section 58.1-511 of the Code of Virginia provides that an "interest in real property" means any right in real property provided such interest complies with Section 170(h) of the Internal Revenue Code. Section 58.1-512(C)(2) of the Code of Virginia provides that a qualified donation includes the conveyance of less-than-fee interest in real property provided that such less-than-fee interest qualifies as a charitable deduction under Section 170(h) of the Internal Revenue. An interest in open space land provided as a development proffer is not an eligible donation. *See* Va. Code Ann. § 58.1-512(C)(3) and Ruling of the Tax Commissioner, P.D. 14-169 (September 12, 2014).

2. *Qualified Holder*. The Virginia Conservation Easement Act and the Virginia Land Conservation Incentives Act of 1999 provide detailed rules on the types of organizations that are qualified to hold conservation easements.

a. *Public or Private Conservation Agency*. For purposes of the land preservation tax credit, Section 58.1-512(A) of the Code of Virginia provides that the donation must be made to a public or private conservation agency. Section 58.1-511 of the Code of Virginia defines a "Public or Private Conservation Agency" as any Virginia governmental body, or any private not-for-profit charitable corporation or trust authorized to do business in the Commonwealth and organized and operated for natural resources, land conservation or historic preservation purposes, and having tax-exempt status as a public charity under the Internal Revenue Code and having the power to acquire, hold and maintain land and/or interests in land for such purposes.

b. *Tax Credit Eligibility*. Section 58.1-512(C)(4) of the Code of Virginia provides that qualified donations shall be eligible for the tax credit described if such donations are made to the Commonwealth of Virginia, an instrumentality thereof, or a charitable organization described in Section 501(c)(3) of the Internal Revenue Code, if such charitable organization (i) meets the requirements of Section 509(a)(2) or (ii) meets the requirements of Section 509(a)(3) and is controlled by an organization described in Section 509(a)(2). An organization classified as a private foundation is not a qualifying donee for purposes of the land preservation tax credit. *See* Ruling of the Tax Commissioner, P.D. 03-55 (August 7, 2003).

c. *Virginia Conservation Easement Act*. In order for a private conservation agency to hold a conservation easement, Section 10.1-1009 of the Code of Virginia provides that a "holder" is defined as a charitable corporation, association or trust exempt from taxation under Section 501(c)(3) of the Internal Revenue Code and the primary purposes or powers of which include: (i) retaining or protecting the natural or open-space values of real property; (ii) assuring the availability of real property for agricultural, forestal, recreational, or open-space use; (iii) protecting natural resources; (iv) maintaining or enhancing air or water quality; or (v) preserving the historic, architectural or archaeological aspects of real property. Section 10.1-1010(C) of the Code of Virginia provides additional requirements that the holder must either have had a principal office in the Commonwealth for at least five years, or be a national organization in existence for at least five years which has an office in the Commonwealth and has registered and is in good standing with the State Corporation Commission. Until a holder has met these requirements, the holder may co-hold a conservation easement with another holder that meets these requirements.

d. *Federal Agencies*. It is interesting to note that the statute does not list agencies of the federal government, such as the National Park Service, as qualifying organizations. Such organizations should presumably qualify as public conservation agencies. In Ruling of the Tax Commissioner, P.D. 07-132 (August 24, 2007), the Tax Commissioner ruled that despite the fact that the National Park Service is not listed as a qualified organization is Section 58.1-512(C)(4) of the Code of Virginia, the National Park Service is a qualifying donee for purposes of Section 58.1-512(A) of the Code of Virginia.

e. *Amendment to Charter to Qualify*. A non-profit may amend its organizational documents in order to qualify as a private conservation agency for purposes of the Land Preservation Credit. In Ruling of the Tax Commissioner, P.D. 05-66 (April 26, 2005) the Tax Commissioner ruled that a non-profit created to provide athletic facilities was allowed to amend its charter to hold land for conservation purposes and qualify for the tax credit.

3. *Conservation Purpose.* Section 58.1-512(A) of the Code of Virginia provides that state tax credits are allowable for donations conveyed for the purpose of agricultural and forestal use, open space, natural resource, and or biodiversity conservation or land, agricultural, watershed and/or historic preservation.

a. *Department of Conservation Review.* Section 58.1-512(D) provides that, after January 1, 2007, for easement donations that generate tax credits in excess of $1,000,000, the issuance of land preservation tax credits shall be subject to review by the Virginia Department of Conservation and Recreation (DCR). DCR reviews the conservation purpose of the easement as well as the public benefit derived from the donation, prior to issuance of the tax credits. Va. Code Ann. § 58.1-512(D)(1)(a) and (c). The Virginia Land Conservation Foundation has developed detailed Conservation Value Review Criteria as of November 21, 2006, and amended August 7, 2008 and March 27, 2009. Determinations of DCR are not binding on the Virginia Department of Taxation for audit purposes. Va. Code Ann. § 58.1-512(D)(6). Section 58.1-3(F) of the Code of Virginia provides that any information submitted to any government official pursuant to Section 58.1-512 shall be treated as confidential tax information. Section 58.1-512(D)(3)(b) of the Code of Virginia provides that in determining the amount of credit from any one donation, prior donations of another portion of a parcel of land within the prior 11 years are aggregated with the credit claimed for the current donation. This rule does not apply, if the person who made the prior donation is not related to the current donor.

b. *Exclusivity and Perpetuity.* Section 58.1-512(C)(4) of the Code of Virginia provides that the preservation and conservation purpose of such property shall be assured in perpetuity. *See also* Ruling of the Tax Commissioner, P.D. 06-36 (April 3, 2006) (conveyance of fee simple property to DCR was considered a transfer in perpetuity despite the fact that deed contained no such restriction). *But see* Va. Code Ann. § 10.1-1704.

c. *Open-Space*. Section 58.1-512(A) of the Code of Virginia provides that the tax credit is available for donations conveyed for the purpose of open-space. Indeed, Section 58.1-510 of the Code of Virginia provides that one of the purposes of the Virginia Land Conservation Incentives Act of 1999 is to encourage the preservation and sustainability of Virginia's open spaces. However, the terms "open-space" and "open-spaces" are not defined in the Virginia Land Conservation Incentives Act of 1999. Ruling of the Tax Commissioner, P.D. 05-66 (April 26, 2005). The Department of Taxation has ruled that for purposes of the Virginia Land Conservation Incentives Act of 1999, real estate devoted to open-space use shall have the same meaning as provided in Section 58.1-3230 of the Code of Virginia. Section 58.1-3230 of the Code of Virginia provides that "real estate devoted to open-space use" shall mean "real estate used as, or preserved for, (i) park or recreational purposes, (ii) conservation of land or other natural resources, (iii) floodways, (iv)

> wetlands as defined in § 58.1-3666, (v) riparian buffers as defined in § 58.1-3666, (vi) historic or scenic purposes, or (vii) assisting in the shaping of the character, direction, and timing of community development or for the public interest and consistent with the local land-use plan under uniform standards prescribed by the Director of the Department of Conservation and Recreation . . . ." The Open-Space Land Act defines "open-space land" as "any land which is provided or preserved for (i) park or recreational purposes, (ii) conservation of land or other natural resources, (iii) historic or scenic purposes, (iv) assisting in the shaping of the character, direction, and timing of community development, or (v) wetlands as defined in § 28.2-1300." Va. Code Ann. § 10.1-1700.

4. *Valuation.* For purposes of determining the amount of the tax credit in Virginia, valuation is determined under the same appraisal standards used for the charitable income tax deduction under Section 170(h) of the Internal Revenue Code through a qualified appraisal. *See* Ruling of the Tax Commissioner, P.D. 07-09 (March 12, 2007) (concerning guidelines for qualified appraisals and incorporating the definitions found in I.R.C. § 170(h) for purposes of Section 58.1-512.1 of the Code of Virginia). Valuation for purposes of the Virginia tax credit is also subject to the charitable deduction limitations found in Section 170(e) of the Internal Revenue Code. *See* Va. Code Ann. § 58.1-512(B). Of importance is that valuation is determined at the time of the contribution, and practitioners should be cautious that subsequent reformation of a deed of easement could trigger a new contribution date, resulting in a reduction in the total diminution of value for the donation. See Ruling of the Tax Commissioner, P.D. 15-120 (June 23, 2015).

5. *Bargain Sales*. Bargain sales of outright interests and easements to charitable organizations, and sales to localities pursuant to purchase of development rights programs (PDRs), may also generate land preservation credits in the amount of the bargain. *See* Rulings of the Tax Commissioner, P.D. 06-36 (April 3, 2006) and P.D. 07-132 (August 24, 2007).

6. *State Income Tax Treatment to Landowner On Issuance of Tax Credit.* The issuance of the tax credit does not result in a taxable gain for the landowner for Virginia income tax purposes. Va. Code Ann. § 58.1-513(E). In addition, Section 58.1-513(D) of the Code of Virginia provides that Virginia taxable income is reduced by any federal taxable income recognized by a taxpayer on the application of a tax credit against a Virginia income tax liability.

7. *Federal Income Tax Treatment to Landowner on Issuance of Tax Credit*. The Service has indicated that the issuance of a transferable tax credit is not an income or gain recognition event for the donor of the easement. *See* Chief Counsel Advisory 201105010 (February 4, 2011) (transferable state tax credits retain their character as a potential reduction in state taxes until sold or transferred to a third party); Chief Counsel Advisory 201423020 (June 6, 2014) ("The amount of a state tax credit that reduces a potential tax liability as part of computing how much tax is due to the state does not represent an accession to wealth"); Chief Counsel Advisory

200211042 (February 5, 2002) (Missouri remediation credits); Chief Counsel Advisory 200704028 (January 26, 2007) (Virginia historic rehabilitation credits) and Chief Counsel Advisory 200451041 (December 17, 2004) (Wisconsin Dairy Investment Tax Credit) all citing Rev. Rul. 79-315, 1979-2 C.B. 27 (holding (3) on the Iowa tax rebate). *See also* Chief Counsel Advisory 200238041 (July 24, 2002). In Chief Counsel Advisory 200451041 (December 17, 2004), the Service also indicated that an accrual-basis taxpayer is not required to take the value of future tax credits into income; as the credits will simply reduce the taxpayer's otherwise-deductible tax liabilities as, and if, they accrue. *See also Snyder v. United States*, 894 F.2d 1337 (6th Cir. 1990) (reduction in state taxes is not "income" from the state).

8. *Federal Tax Treatment of Landowner on Use of the Tax Credit.* Where the landowner uses the tax credit to offset their Virginia income tax liability, this will have the effect of reducing the state income tax deduction on Schedule A of the federal income tax return by the amount of the tax credit utilized to offset the Virginia tax liability. Since the landowner has no basis in the tax credit, the state income tax deduction under Section 164 of the Internal Revenue Code will be reduced by the full value of the tax credit. *See* Chief Counsel Advisory 201140724 (November 25, 2011) ("the federal tax effect of such a state tax credit is normally to reduce any deduction for payment of state tax the taxpayer may otherwise have had under § 164") and Chief Counsel Advisory 201105010 (February 4, 2011). *See also* Chief Counsel Advisory 200238041 (July 24, 2002) and Rev. Rul. 86-117, 1986-2 C. B. 157. For this reason, practitioners should carefully consider whether it is advisable for the landowner to use the tax credits on their return or sell the tax credits to third parties.

9. *Nonrefundable Credit*. The tax credit is nonrefundable—meaning that the amount claimed in any one taxable year may not exceed the amount of tax due by a given taxpayer in that taxable year. Va. Code Ann. § 58.1-512(C)(1).

10. *$75,000,000 Cap.* The Commonwealth imposes a $75,000,000 statewide limitation on the amount of tax credit that the Department may issue in any one calendar year. Va. Code Ann. § 58.1-512(D)(4). Note that because of the cap, tax credits may not be transferred until the credits are registered with the Department. *See* Rulings of the Tax Commissioner, P.D. 07-201 (November 30, 2007) and P.D. 07-95 (May 25, 2007). Credits are issued in the order that applications are filed with the Department by mail or commercial service with the postmark or confirmation of shipment as the filing date. Va. Code Ann. § 58.1-512(C)(4).

11. *Annual Limitation.* The amount of credit that may be claimed by any taxpayer for the 2017 taxable year is limited to $20,000 per year, and $50,000 for 2018 and years thereafter. *See* Va. Code Ann. § 58.1-512(C)(1)*; see also* Virginia Attorney General's Opinion, P.D. 02-094 (November 19, 2002). For fee simple donations, the limitation is $100,000, provided there was no bargain sale element to the donation of the fee interest. *See* Va. Code Ann. § 58.1-512(C)(1),

12. *Carryforward.* Any remaining tax credit may generally be carried forward for an additional 10 years. Va. Code Ann. § 58.1-512(C)(1). The Tax Commissioner ruled that the Department has no authority to extend this period for unusual circumstances of a taxpayer. Ruling of the Tax Commissioner, P.D. 15-253, (December 28, 2015).

13. *Landowner/Taxpayer.* Section 58.1-512(A) of the Code of Virginia provides that the donation of land must be made by a "landowner/taxpayer." Section 58.1-1 of the Code of Virginia defines a "taxpayer" as every person, corporation, partnership, organization, trust or estate subject to taxation under the laws of the Commonwealth, or under the ordinances, resolutions or orders of any county, city, town or other political subdivision of this Commonwealth. In the Virginia Attorney General's Opinion, P.D. 02-094 (November 19, 2002), the Attorney General stated that "[a]ny person, corporation, partnership, organization, trust or estate falling into these categories could hold and transfer a tax credit."

a. *Husband and Wife.* Where one spouse is the titled owner of the property subject to the donation, the other spouse is not considered the landowner for purposes of Section 58.1-512(A) of the Code of Virginia, and for purposes of the $50,000 yearly limitation. This is despite the fact that the property was purchased with marital funds. *See* Ruling of the Tax Commissioner, P. D. 13-24 (March 4, 2013).

b. *Pass-through Entities*. Section 58.1-513(B) of the Code of Virginia provides that any tax credits that arise from the donation made by a pass-through entity shall be used either by such entity or by the members, shareholders or beneficiaries in proportion to their interests or as set forth in the agreement of the entity. Such tax credits shall not be claimed by both the entity and the members, shareholders or beneficiaries for the same donation. *See also* Instructions to Form LPC-1 (Application for Land Preservation Tax Credit).

c. *Trusts and Estates.* In the case of a non-grantor trust, the trust is considered the landowner for purposes of the issuance of the tax credit. *See* Ruling of the Tax Commissioner, P.D. 09-19 (February 4, 2009). Presumably, a grantor trust will be disregarded and the individual owner will be entitled to claim to tax credit. However, for a donation by an estate, the beneficiaries of the estate are considered the landowners. *See* Ruling of Tax Commissioner, P.D. 08-66 (May 19, 2008). These rulings appear to be in conflict and it is important to note that in P.D. 09-19, the Tax Commissioner ignored the beneficial interests of the beneficiaries of the trust and also ignored Section 58.1-513(B) of the Code of Virginia as it relates to whether the trust was to pass-through all of its income to the beneficiaries under the trust instrument. Section 58.1-513(B) provides that "[a]ny tax credits . . . from the donation . . . made by a pass-through tax entity such as a trust, . . . shall be used either by such entity if it is the taxpayer on behalf of such entity or by the . . . beneficiary, as the case may be, in proportion to their interest in such entity in the event that income, deductions and tax liability pass through such entity to such . . . beneficiary or as set forth in the agreement of said entity. Such tax credits shall not be claimed by both the entity and the . . . beneficiary for the same donation." It appears that Section 58.1-513(B) of the Code of Virginia, will distinguish both between a grantor and non-grantor trust and a simple and complex trust. Where a trust agreement requires that all income be distributed to the beneficiary at least quarterly, the trust will be characterized as a simple trust for income tax purposes. In such a case, income, deductions and tax liability will pass through to the beneficiary. Where income is accumulated, the trust is generally treated as the taxpayer. In the case of a non-grantor trust taxed for federal income tax purposes as a simple trust, the beneficiaries would appear to be entitled to the tax credits pursuant to Section 58.1-513(B) of the Code of Virginia. Accordingly, Ruling 09-19, appears to be overbroad in that it does not distinguish between a simple and complex trust.

d. *Non-Profit Entities*. A non-profit entity (that is not organized or eligible to hold conservation easements) is a taxpayer for purposes of Section 58.1-512 and may donate an easement and transfer the tax credits. *See* Ruling of the Tax Commissioner, P.D. 05-125 (July 26, 2005). However, property held by an entity qualified to hold conservation easements is not eligible for tax credits for a donation of an easement on such property. In Ruling 05-125, the Department stated that if the taxpayer itself is eligible to hold a conservation easement, "the purpose of the Act would be accomplished once ownership of the land is held by a conservation agency that is able to ensure that the land is preserved. Any subsequent transfer of the land, or any interest in the land, to a similarly qualified organization would be redundant and would merely be done to gain tax credits." *See also* Va. Code Ann. § 58.1-512(C)(5) (stating that "[n]o credit shall be allowed with respect to any subsequent conveyances by the charitable organization."). In Ruling 05-125, the Department also stated "that the credits must be transferred or sold to another taxpayer who may actually use the credits on a Virginia income tax return." Thus, transferring or selling the credit to another nonprofit agency is not allowed. Accordingly, transfers of credit to a non-profit as a donation, or between related non-profits, are not permitted. In Ruling of the Tax Commissioner, P.D. 15-215 (November 24, 2015), the Tax Commissioner ruled that a local Economic Development Authority was not a taxpayer eligible to earn land preservation tax credits.

14. *Troublesome Issues with Partnerships and the Tax Credit.* Donations by partnerships create troublesome issues for the partnership and the partners with respect to the federal income tax treatment of the state income tax credit. This is caused by uncertainty at the federal level as the Service treats the tax credit as a tax attribute for purposes of the donor, property for purposes of the sale of tax credits, and property in the hands of any transferee of the credits. *Compare* Chief Counsel Advisory 200238041 (July 24, 2002) and PLR 200126005 (June 29, 2001). For a general discussion *see* Kalinka, *Transferable State Income Tax Credits: Are They*

"Property" or "Tax Items" For Federal Income Tax Purposes? 2004 State Tax Today 182-1 (September 20, 2004).

a. *Tax Credit as a Partnership Item.* If the tax credit is viewed as a partnership item under Subchapter K of the Internal Revenue Code, then Section 704(b) would control the tax treatment of the allocation of the tax credit by the partnership among the partners. Sections 704 (a) and (b) of the Internal Revenue Code generally provide that a partner's distributive share of credit shall be determined by the partnership agreement, provided however, that the distributive share shall be determined in accordance with the partner's interest in the partnership if: (1) the partnership agreement does not provide for the distributive share, or (2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

i. *No Economic Effect.* Allocations of partnership tax credits cannot have economic effect because they are not reflected by adjustments to the partners' capital accounts and the tax credits must be allocated in accordance with the partners' interests in the partnership at the time the tax credit arises. Treas. Reg. § 1.704-1(b)(4)(ii). The Regulations provide further that if a partnership expenditure (whether or not deductible) that gives rise to a tax credit in a partnership taxable year also gives rise to valid allocations of partnership loss or deduction (or other downward capital account adjustments) for such year, then the partners' interests in the partnership with respect to such credit (or the cost giving rise thereto) shall be in the same proportion as such partners' respective distributive shares of such loss or deduction (and adjustments). *See* Treas. Reg. § 1.704-1(b)(4)(ii) and Treas. Reg. § 1.704-1(b)(5), example (11). Accordingly, for federal income tax purposes, it appears that allocations of the tax credit would have substantial economic effect if they are allocated in the same manner as the charitable deduction. *See* PLR 200609002 (March 3, 2006) (regarding the federal renewable electricity production credit). Of course, the allocation of the charitable deduction would have to meet the substantial economic effect test of Section 704(b). Allocations among related parties that are not in accordance with the partner's interest in the partnership could raise suspicion with the Service of taxable gifts. *See* Treas. Reg. §§ 1.704-1(b)(1)(iv) and 1.704-1(b)(5), Example (14)(iv) (alerting of potential disguised gifts among partners).

b. *Tax Credit as Partnership Property.* If the tax credit is treated as an interest in property, then the allocation of the credit among the partners of a partnership should be treated as a distribution of property for federal income tax purposes. I.R.C. § 731(a)(1). *See also Tempel v. Commissioner*, 136 T.C. No. 15 (2011) *aff'd*. 744 F.3d 648 (10th Cir. 2014). The distribution of property would not be treated as an allocation subject to Section 704(b) of the Internal Revenue Code, and could be allocated as the partners desire subject only to the disguised sale rules of Section 707 of the Internal Revenue Code, and potential disguised gifts in the case of related parties. *See Virginia Historic Tax Credit Fund 2001, LP v. Commissioner*, Docket No. 10-1333 (4th Cir. March 29, 2011) (Virginia historic rehabilitation tax credits were property and the transfer within the partnership was a disguised sale under I.R.C. § 707); *Route 231, LLC v. Commissioner,* T.C. Memo. 2014-30; and *SWF Real Estate, LLC v. Commissioner,* T.C. Memo. 2015-63 (allocation of Virginia land preservation tax credits was a disguised sale for purposes of § 707). *But see Rosenblum v. Virginia Department of Taxation*, 86 Va. Cir. 21; Va. Cir. LEXIS 200 (August 12, 2012) (Virginia land preservation "tax credits are an expectation and, therefore, cannot be treated as property"). If the tax credit is a distribution of property, the capital gain/ordinary income character distinction becomes important. Generally, the distribution of capital assets will not result in gain or loss to the partners and the partnership. I.R.C. § 731(a)(1). In the case of an operating distribution, the partner will take the basis of the partnership in the tax credit, which is presumably zero. I.R.C. § 732(a); *See also* Chief Counsel Advisory 200211042 (February 5, 2002) (basis in Missouri remediation credits was zero). If the distribution is in liquidation of the partnership then the partner will take the credit with a basis equal to the partner's adjusted basis in their partnership interest. I.R.C. § 732(a). If the allocation is treated as the distribution of property that is not a capital asset, then the tax credit is an unrealized receivable as defined in Section 751(c) of the Internal Revenue Code. Section 751(c) of the Internal Revenue Code provides that the term "unrealized receivables" includes, to the extent not previously includible in income under the method of accounting used by the partnership, any rights (contractual or otherwise) to payment for goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset. In the case of the receipt of the tax credit as an unrealized receivable in a non-liquidating distribution, the partner would receive the tax credit with a basis of zero. I.R.C. §§ 732(a)(2) and 732(c)(1)(A)(i). Otherwise, in a liquidating distribution under Section 732, the partner's basis in the unrealized receivable is the lesser of the partnership's basis in the tax credit (zero) or the partner's adjusted basis in their partnership interest. On the liquidating distribution, the partner would have a capital loss. I.R.C. §§ 731(a)(2)

i. *Planning Note.* If the allocation of the tax credit is treated as a distribution of property by the partnership to the partners, this will reduce the partners' capital accounts. Practitioners should carefully review the partnership agreement and prior tax returns to determine what effect, if any, the capital account reduction will have on the partners. The decrease in the partners' capital accounts could affect future allocations of income and loss, amounts received on dissolution of the partnership, and could trigger deficit restoration obligations or qualified income offsets in the partnership agreement.

15. *Relationship to the Historic Tax Credit*. Section 58.1-513(A) of the Code of Virginia bars a taxpayer from claiming the historic rehabilitation tax credit for the costs related to a project for which the land preservation tax credit is claimed for a period of five years. Conversely, the Section also bars a taxpayer from claiming the land preservation tax credits where such credits are based on any building on which historic rehabilitation credits are claimed for a period of five years. However, if expenses incurred to rehabilitate a historic structure do not increase the value of the conservation easement, that section would not bar a claim of the historic rehabilitation tax credit. *See* Ruling of the Tax Commissioner, P.D. 02-158 (December 10, 2002). *See also* Va. Code Ann. § 58.1-339.2.

16. *Relationship to Other Tax Provisions.* A donor claiming tax credits may not also claim a credit for the costs incurred in instituting agricultural best management practices. Va. Code Ann. § 58.1-513(A). Section 58.1-513(A) of the Code of Virginia also provides that the taxpayer may not claim reductions for the gain on the sale of property subject to an open space easement for a period of three years following the year in which the tax credit is claimed. *See also* Va. Code Ann. § 58.1-402(C)(16) (generally excluding from Virginia taxable income gain from the sale of property or an easement devoted to open space).

17. *Relationship to Section 170 of the Internal Revenue Code.* The Virginia Land Conservation Incentives Act of 1999 references Section 170 of the Internal Revenue Code in numerous provisions.

a. *Qualified Donations.* Section 58.1-511 of the Code of Virginia provides that the definition of "interest in real property" includes "any right in real property, . . . including but not limited to an open-space easement or conservation easement, provided such interest complies with the requirements of the U.S. Internal Revenue Code § 170(h) . . ." Section 58.1-512(C)(2) of the Code of Virginia provides that qualified donations shall include the conveyance of a fee interest in real property or the conveyance in perpetuity of a less-than-fee interest in real property, such as a conservation restriction, preservation restriction, agricultural preservation restriction, or watershed preservation restriction, provided that such less-than-fee interest qualifies as a charitable deduction under §170(h) of the United States Internal Revenue Code of 1986, as amended. Thus, in order for a conservation easement to qualify for the Virginia tax credit, the donation must also qualify as a charitable deduction under Section 170(h) Internal Revenue Code. *See also* Rulings of the Tax Commissioner, P.D. 03-77 (October 31, 2003) ("In order to qualify for the credit, a donation of an interest in real property must qualify as a charitable deduction under . . . § 170(h)"). P.D. 05-76 (May 19, 2005) ("If the easement does not meet . . .[§ 170(h)], it also does not meet the conditions established under the Act, and, therefore, the easement cannot qualify for the Land

Preservation Tax Credit."), and P.D. 05-122 (July 22, 2005) ("an easement must qualify as a charitable deduction under IRC § 170(h). If the easement does not meet any of those requirements, it also does not meet the conditions established under the Act, and, therefore, the easement cannot qualify for the Virginia credit. The statute provides no authority for the Department to allow an exception."). It is critical to note, however, that the requirements to comply with Section 170(h) of the Internal Revenue Code apply only to donations of conservation easements, and not to fee simple donations of land, that otherwise qualify for the tax credit under the plain language of Section 58.1-511 of the Code of Virginia. *Forest Lodge, LLC v. Virginia Department of Taxation*, 86 Va. Cir. 230, Ca. Cir. LEXIS 39, (February 3, 2013).

b. *Incorporation of 170(e) Limitations.* Section 58.1-512(B) of the Code of Virginia provides that "the value of the donated interest in land that qualifies for credit under this section, as determined according to appropriate federal law and regulations, shall be subject to the limits established by United States Internal Revenue Code § 170(e)." Accordingly, as the Section 170(e)(1)(A) limitation will limit the charitable donation, it will similarly limit the available tax credit.

c. *Appraisal Standards.* Section 58.1-512.1 of the Code of Virginia incorporates the provisions of Section 170(h) for purposes of appraisal requirements and valuation rules. *See* Ruling of the Tax Commissioner, P.D. 07-09 (March 12, 2007) (concerning guidelines for qualified appraisals and incorporating the definitions found in I.R.C. § 170(h) for purposes of Section 58.1-512.1 of the Code of Virginia).

d. *DCR Review Standards.* Section 58.1-512(D)(2) of the Code of Virginia provides with respect to DCR review that applications for otherwise qualified donations of a less-than-fee interest shall be accompanied by an affidavit describing how the donated interest in land meets the requirements of § 170(h) of the United States Internal Revenue Code of 1986, as amended, and the regulations adopted thereunder.

e. *Rulings by the Department*. In Ruling of the Tax Commissioner, P.D. 03-77 (October 31, 2003), the Department stated that: "Virginia Code § 58.1-512(B)(2) and IRC § 170(h) define the type of real property interest that would qualify for the Credit. As such, the Credit is not dependent upon the amount allowed as a federal itemized deduction for charitable donation on the Taxpayer's federal return." In Ruling of the Tax Commissioner, P.D. 05-122 (July 22, 2005), the Department stated that "should the IRS review a land conservation easement and disallow the associated charitable deduction . . . the Department is required . . . to make a corresponding adjustment to Virginia taxable income and also disallow the Virginia Credit." Later, in Ruling of the Tax Commissioner, P.D. 09-19 (February 4, 2009), the Department stated:

> Public Document ("PD") 05-122 (July 22, 2005) concluded that "an easement must qualify as a charitable deduction under IRC § 170(h)" to be eligible for the Credit. Therefore, if the easement does not meet the requirements of IRC § 170(h), it also does not meet the conditions established for the Credit, and, therefore, the easement cannot qualify for the Credit. The same is true for all of the other federal requirements that are referenced by the Virginia Land Conservation Incentives Act (*Va. Code* § 58.1-510, *et al.*). However, this does not mean a taxpayer must file or be eligible for the federal deduction to receive the Credit.

Although seemingly inconsistent, it appears that the Department's position is that if a donation meets the requirements of Section 170(h), the taxpayer will be entitled to the tax credit, despite a limitation on the deductibility of the charitable deduction at the federal level such as the percentage limitations or the limitations on trusts. This should not, however, be confused with denial of the deduction based on the technical requirements of Sections 170(h) or 170(e), which are incorporated requirements under the Virginia Code.

f. *Relationship with Section 2055(f).* As is discussed later in this outline, Section 2055(f) of the Internal Revenue Code provides a charitable estate tax deduction to the estate of a decedent for the donation of a conservation easement. However, in order to be eligible for the estate tax deduction, the easement does not need to meet the conservation purpose requirement of I.R.C. § 170(h)(4)(A). This raises two issues with respect to the land preservation tax credit. First, whether the tax credit is available for an easement that qualifies under Section 2055(f) but does not meet the conservation purpose requirement of I.R.C. § 170(h)(4)(A). Since the donation would presumably not meet the conservation purposes detailed in Section 58.1-512 of the Code of Virginia, the answer is that the tax credit would not be available for such a donation. *See* Rulings of the Tax Commissioner, P.D. 05-122 (July 22, 2005) and P.D. 09-19 (February 4, 2009) (no credit is allowed for a donation that does not meet I.R.C. § 170(h)). A second, subtler, question is whether the tax credit is available for testamentary donations and post-mortem donations in any event. It is important to note that the Virginia Land Conservation Incentives Act of 1999 only mentions donations that meet the requirements of I.R.C. § 170(h) and does not mention I.R.C. § 2055(f). Section 64.2-108 of the Code of Virginia provides authority for the executor to make a post-mortem conservation easement but only to comply with I.R.C. § 2031(c), not to provide the estate a charitable estate tax deduction or Virginia land preservation tax credits. *But see* Ruling of the Tax Commissioner, P.D. 08-66 (May 19, 2008) (tax credit awarded to beneficiary on post-mortem donation by the executor). Although not directly addressed in the Ruling, the reasoning of Ruling of the Tax Commissioner, P.D. 09-19, (February 4, 2009) appears to answer this question in the affirmative—that the beneficiaries of an estate would be eligible for a tax credit if the donation by the estate meets the requirements of Section 170(h), even though technically the deduction is allowed under Section 2055(f).

18. *Transfer of Tax Credits.* Because many landowners are not able to realize the full value of the tax credit, the Virginia legislature amended the law in 2002 (House Bill 1322), to allow a taxpayer to transfer or sell the credit to any other Virginia taxpayer. This law allows for the transfer of Virginia income tax credits between the donor of a conservation easement and any other Virginia taxpayer. Va. Code Ann. § 58.1-512 and 58.1-513. Section 58.1-513(C)(1) of the Code of Virginia provides that any taxpayer holding a credit may transfer unused but otherwise allowable credit for use by another taxpayer on Virginia income tax returns.

a. *Taxpayer.* For purposes of Section 58.1-513(C) of the Code of Virginia, the term "taxpayer" means every person, corporation, partnership, organization, trust or estate subject to taxation under the laws of this Commonwealth, or under the ordinances, resolutions or orders of any county, city, town or other political subdivision of this Commonwealth. *See* Va. Code Ann. § 58.1-1. Any person, corporation, partnership, organization, trust or estate falling into these categories could hold and transfer a tax credit. For example, a nonprofit corporation subject to sales tax, but not income tax, may transfer its credit to a taxpayer subject to income tax. However, only those taxpayers subject to state income taxes, may benefit from actual use of the tax credit to offset a tax liability. *See* Virginia Attorney General's Opinion, P.D. 02-094 (November 19, 2002). *See also* Rulings of the Tax Commissioner, P.D. 05-125 (July 26, 2005) (non-profit is a taxpayer because it is subject to retail sales and use tax and employment tax) and P.D. 07-82 (May 25, 2007). (LLC disregarded for federal tax purposes remains a taxpayer as the LLC may still be subject to retail sales and use tax).

b. *Non-Residents.* A nonresident who is nevertheless subject to Virginia income tax is "another taxpayer" for purposes of Va. Code Ann. § 58.1-513(C). *See* Ruling of the Tax Commissioner, P.D. 05-136 (August 10, 2005).

c. *Notification.* Section § 58.1-513(C)(1) of the Code of Virginia further provides that a taxpayer who transfers any amount of credit shall file a notification of such transfer to the Department in accordance with procedures and forms prescribed by the Tax Commissioner. The transfer of the credit is recorded and sent to the Department of Taxation on Form LPC-2 (Notification of Transfer of Land Preservation Tax Credit).

III. Income Tax Implications on the Transfer of Virginia Land Preservation Tax Credits

A. Procedure of Transfer. The actual mechanics of the transfer of Virginia land preservation tax credits are quite simple. A buyer in need of tax credits will pay an amount to the seller that is bargained for through negotiation. Credits may be purchased and sold among friends and family members, or though brokers or syndicated sellers.

Practitioners should advise clients to seek the advice of legal counsel with regard to any legal documents that may be required to effectuate the transfer of the credit.

1. *Form LPC-2*. After the sale, Form LPC-2 should be filed with the Department of Taxation within 90 days of the transfer of the credit, and at least 90 days before the filing of the donor's annual tax return. *See* Instructions to Form LPC-2 (Notification of Transfer of Land Preservation Tax Credit). Upon receipt of the Form LPC-2, the Department will provide a letter to each transferee acknowledging the transfer. Multiple transfers for the same donation may be filed on one Form LPC-2. When there are more than 15 transferees, the Department requires that the transferee information be submitted electronically on a spreadsheet provided by the Department.

2. *Fee*. The Department charges a fee equal to 2% of value of the donation (5% of the value of the credit) for the transfer of a donor's tax credits. Va. Code Ann. § 58.1-513(C)(2). There is no cap on the transfer fee. Landowners should be wary of the transfer of tax credits from a pass-through entity or trust to the individual owners or beneficiaries as the subsequent sale of tax credits by those individuals may trigger additional fees. *See* Instructions to Form LPC-2 (Notification of Transfer of Land Preservation Tax Credit). If at all possible, sales of the tax credit should be made at the entity level, rather than the partner/member level.

3. *Transfer Agreements*. Best practices would dictate the use of a formal sales agreement and bill of sale or assignment to transfer the tax credits between unrelated parties. Such an agreement would contain appropriate representations and warranties of the seller, indemnification provisions of the parties, and the rights and duties of the parties in the event that the tax credits are adjusted by the Internal Revenue Service or the Department of Taxation.

B. Income Tax Considerations For the Seller. Complex income tax issues exist for the seller of tax credits, including the character of the gain on the sale of the tax credits.

1. *State Income Tax On Transfer*. The transfer of the credit does not result in a taxable gain for the landowner for Virginia income tax purposes. Va. Code Ann. § 58.1-513(E). This includes gains in a partnership as the result of a disguised sale. Rulings of the Tax Commissioner, P.D. 17-46 (April 3, 2017) and P.D. 13-225 (December 17, 2013). In addition, Section 58.1-513(D) of the Code of Virginia provides that Virginia taxable income is reduced by any federal taxable income recognized by a taxpayer on the application of a tax credit against a Virginia income tax liability. The treatment of the credit for state tax purposes—the fact that the amount of the credit is or is not included in the claimant's gross income for state tax purposes—does not change its federal tax treatment. *See* Chief Counsel Advisory 200451041 (December 17, 2004).

2. *Federal Income Tax on Transfer*. While the Service has indicated that the issuance of a transferable tax credit is not an income recognition event, the

transfer of the credit for consideration will result in gain to the seller for federal income tax purposes. I.R.C. § 1001.

3. *Character of the Gain.* In *Tempel v. Commissioner*, 136 T.C. No. 15 (2011) *aff'd*. 744 F.3d 648 (10th Cir. 2014), and *McNeil v. Commissioner*, T.C. Memo. 2011-109, the Tax Court held that Colorado state tax credits resulting from the donation of a conservation easement were capital assets for determining the character of gain from the sale of the tax credits. In Chief Counsel Advisory 201147024 (November 25, 2011), the Service accepted the holding in *Tempel* and *McNeil* and stated that "a nonrefundable state tax credit that does not fall within the statutory exclusions in §1221(a) is a capital asset for purposes of §1221."

a. *Holding Period.* Even if the tax credit is a capital asset, the character distinction may be meaningless if the nature of the gain is short-term under I.R.C. § 1222. In *Tempel* and *McNeil*, the Tax Court held that since tax credits resulting from the donation of a conservation easement were capital, the sale of such credits within one year of origination would result in short-tem capital gain. The Tax court refuted all arguments to the contrary asserted by the petitioners in these cases, and this position was affirmed on appeal. This is often the case as Virginia donors routinely sell their tax credits as soon as they are registered with the Department of Taxation.

b. *Basis.* Another issue for the seller of tax credits is the seller's basis in the tax credit. The conservative approach here is to treat the transaction as if the seller has no basis in the tax credit. *See Tempel v. Commissioner*, 136 T.C. No. 15 (2011) *aff'd*. 744 F.3d 648 (10th Cir. 2014), and *McNeil c. Commissioner*, T.C. Memo. 2011-109. *See also* Chief Counsel Advisory 200147024 (November 25, 2011), Chief Counsel Advisory 200704028 (January 26, 2007), Chief Counsel Advisory 200704030 (January 26, 2007); and Chief Counsel Advisory 201105010 (February 4, 2011). In these cases and rulings, the Tax Court and the Service hold that a taxpayer who sold state tax credits has a zero basis in the credits at the time of sale because the taxpayer has made no investment in the tax credits, and the tax credits are not a property right in land that would necessitate the allocation of basis from the donated easement. *See also* Chief Counsel Advisory 200211042 (February 5, 2002) (wherein the Service stated that a taxpayer had no "tax cost or other basis" in remediation tax credits). Similarly, in Chief Counsel Advisory 200451041 (December 17, 2004), involving a Wisconsin Dairy Tax Credit, the Service reasoned that "[b]ecause the dairy investment credit is treated as a reduction in state tax liability, not a recovery or reimbursement of the expenditures that qualify a taxpayer for the credit, the credit does not affect the basis, for federal tax purposes, of the assets with respect to which those expenditures are made." Similarly, if the Virginia land preservation tax credit is treated as a potential reduction in state tax liability and not a payment for the easement itself, no basis of the property rights conveyed in the easement should be allocated to the tax credits. *See* Chief County Advisory 201147024

(November 25, 2011) (footnote 4) and Chief Counsel Advisory 201105010 (February 4, 2011) (Proceeds from sale of credit cannot be treated as an amount realized from a disposition of the contributed property). *See also Tempel v. Commissioner*, 136 T.C. No. 15 (2011) *aff'd*. 744 F.3d 648 (10th Cir. 2014 (Donor has no property rights in the tax credit until the donation was complete and the credits never were, nor did they become, part of the donor's real property rights).

c. *Like-Kind Exchange.* There is no direct authority on whether the proceeds from the sale of the tax credit may be used to purchase like-kind property in an exchange that qualifies for non-recognition treatment under Section 1031 of the Internal Revenue Code. *Compare* PLR 200649028 (December 8, 2006) and PLR 200651018 (December 1, 2006) (both holding that the sale of land use credits through a qualified intermediary, and subsequent purchase of replacement property, will qualify as a like-kind exchange) with PLR 8141112 (July 20, 1981) (development rights are not property for purposes of Section 1031). *See also* PLR 9612009 (December 18, 1995) (holding that mitigation credits are like-kind property for purpose of Section 1031). If the tax credits are considered intangible personal property separate from the land, then the allowable types of replacement property would be extremely limited. Treas. Reg. § 1.1031(a)-2(c). *See also* Chief Counsel Advisory 200211042 (February 5, 2002) (discussing Missouri remediation credits as intangible rights).

C. Income Tax Considerations For The Buyer. As with the seller, the buyer also faces some complex income tax issues mostly related to the tax impact of the application of the credit to the buyer's Virginia taxable income and the corresponding federal income tax deduction for state income taxes paid.

1. *Year of Purchase.* Virginia income tax credits must be purchased in the year to which they relate—so they must be purchased before the end of the taxable year for which they will be claimed. *See* Rulings of the Tax Commissioner, P.D. 03-12 (February 27, 2003) and P.D. 03-13 (March 4, 2003). Practitioners should make certain that fiscal year filers purchase their tax credit prior to the expiration of the fiscal year. These rulings also clarify that a transferred credit may not be carried back to a prior taxable year. However, credits that are purchased by a buyer may be carried forward to a subsequent tax year.

2. *Registration of the Credit.* In the case of a husband and wife, the Department of Taxation will register the transferred credit in the name of the first tax identification number provided on Form LPC-2. In addition, where the transfer form indicates that the tax credit was transferred to only one spouse, the Department will not look to whether the tax credit constitutes marital property, subject to equitable distribution. Ruling of the Tax Commissioner, P.D. 10-66 (May 12, 2010). Accordingly, spouses should consider whether or not to purchase credits in separate transactions if there is any chance of marital discord. (See also next item below).

3. *Application of Annual Limitation.* Purchasers of tax credits are subject to the same $50,000 ($20,000 for 2017) yearly limitation that applies to the seller. Virginia Attorney General's Opinion, P.D. 02-094 (November 19, 2002). *See also* Ruling of the Tax Commissioner, P.D. 04-119 (September 15, 2004).

a. *Husband and Wife.* A husband and wife may be treated as separate purchasers, each being subject to the $50,000 limitation ($20,000 for 2017). Accordingly, a husband and wife could purchase up to $100,000 ($40,000 for 2017) of tax credits to offset their Virginia joint tax liability. Ruling of the Tax Commissioner, P.D. 05-136 (August 10, 2005). Note, however, that the ruling raises two concerns. First, a husband and wife should purchase tax credits in separate transactions and ideally with separate property funds. *See* Ruling of the Tax Commissioner, P.D. 07-131 (August 17, 2007) (holding that if one member of a consolidated group purchases the credit, it may not be claimed by other members of the group and also states that Ruling 05-136 "was based on the fact that both spouses had purchased separate credits."). Second, it is uncertain whether a non-resident spouse with no Virginia income will be considered a Virginia taxpayer for purposes of the application of the credit. *See* Ruling of the Tax Commissioner, P.D. 05-136 (August 10, 2005) ("limitations are imposed on a per-taxpayer basis and not a per-return basis"). *But see* Rulings of the Tax Commissioner, P.D. 07-131 (August 17, 2007) and P.D. 08-159 (August 28, 2008) discussed below.

b. *Consolidated Group*. Members of a consolidated group filing a consolidated return may each purchase credit and claim such credit on the return. *See* Ruling of the Tax Commissioner, P.D. 07-131 (August 17, 2007). However, each group member must separately purchase the tax credit. In addition, on the consolidated return, the credit of each member of the group may be applied against the joint tax liability regardless of each member's contribution to the joint tax liability. This is because each member of the group is jointly and severally liable for the tax liability of the entire group. Ruling of the Tax Commissioner, P.D. 08-159 (August 28, 2008). Note, that this reasoning would also presumably apply to a husband and wife on a joint return, but not on separate returns. Ruling of the Tax Commissioner, P.D. 10-66 (May 12, 2010).

4 *Excess Credit Purchased by the Buyer.* A buyer may carry any unused credit forward in the same manner as the seller. Va. Code Ann. § 58.1-512(D)(5)(b). *See also* Ruling of the Tax Commissioner, P.D. 04-119 (September 15, 2004); and Virginia Attorney General's Opinion, P.D. 02-094 (November 19, 2002). Also, the buyer may sell any unused tax credit to another Virginia taxpayer in a subsequent sale transaction. Ruling of the Tax Commissioner, P.D. 03-12 (February 27, 2003).

5. *State Income Tax Consequences to the Buyer.* As with the seller, there is no gain or loss to the buyer of a tax credit for Virginia income tax purposes. Va. Code Ann. § 58.1-513(E).

6. *Federal Income Tax Consequences to the Buyer.* For the buyer, state income taxes paid with the use of a tax credit remain deductible under I.R.C. § 164 for federal income tax purposes, subject to the limitations imposed on such deductions at the federal level. PLR 200126005 (June 29, 2001).

a. *Timing of Deduction*. While it is clear that the buyer of the tax credits is entitled to a state income tax deduction on their federal income tax return, the timing of the deduction is an issue. Two general approaches emerge, the first being that the deduction is proper in the year the credit is applied on the state return, and the second being that the deduction is proper in the year of purchase of the tax credit.

i. *When Applied*. The Service has ruled that the buyer will receive the full benefit of the credit applied as a state income tax deduction on his or her federal income tax return as a state tax deduction for federal income tax purposes, in the year the credit is applied (as compared to when purchased). Chief Counsel Advisory 200238041 (July 24, 2002), Chief Counsel Advisory 200704028 (January 26, 2007), and Chief Counsel Advisory 200704030 (January 26, 2007) (indicating that the state tax payment occurs not when historic rehabilitation credits are purchased, but when they are applied). This is consistent with the Service's theory that the tax credit is property being applied to pay the tax when due.

ii. *Year of Payment.* Some practitioners argue that a cash basis taxpayer should get the benefit of the deduction in the year they purchased the credit, rather then the following year when the credit is actually applied. There is support for this position in Rulings of the Tax Commissioner, P.D. 03-12 (February 27, 2003) and P.D. 03-13 (March 4, 2003). Both of these Rulings provide that a taxpayer must purchase tax credits in the same taxable year for which the credit will be claimed. In the Rulings, the Tax Commissioner stated "tax credits and payments are typically allowed as a credit against the tax liability in the taxable year they are earned or paid. It is clear that any credit transferred during a taxable year may be claimed as a credit on the tax return of the transferee in the taxable year that the transfer of the credit occurs." Under this approach, because a credit is treated as a payment of tax for purposes of Virginia law, the payment of the state tax liability occurs in the taxable year the credit is transferred. *See Mitchell v. Commissioner*, T.C. Memo. 1983-155 ("A taxpayer on the cash basis may deduct state and local income taxes only during the year in which such taxes are paid to the taxing authority.") and Rev. Rul. 71-190, 1971-1 C.B. 70 (advance tax payments of state income taxes made pursuant to specific provisions of state law authorizing such payments, constituted deductible items). *See also Glassell v. Commissioner*, 12 T.C. 232 (1949) (checks written

12/29 accepted as payment for that taxable year by state, were deductible in that year).

iii. *Contrary Positions.* Nevertheless, the Service takes a contrary position. PLR 200126005 (June 29, 2001) (with regard to Colorado easement tax credits the IRS stated: "[w]e think that the purchase of a credit, in itself, does not serve to extinguish the transferee's existing state tax liability."). *See also* PLR 200348002 (August 28, 2003) (payment of cash for rehabilitation tax credit is not a payment of tax or payment in lieu of tax for purposes of I.R.C. § 164) and PLR 200445046 (October 29, 2004) (regarding Massachusetts historic rehabilitation and low-income housing credits). The theory here is that the payment of the purchase price to the seller is not a payment of a tax to a state agency. *Cf.* Rev. Rul. 81-192, 1981-2 C.B. 50 (a payment of tax is a payment to a government of "an enforced contribution, exacted pursuant to legislative authority in the exercise of the taxing power, and imposed and collected for the purpose of raising revenue to be used for public or governmental purposes and not as a payment for some privilege granted or service rendered.") *See also* Rev. Rul. 61-152, 1961-2 C. B. 42. The Service's analysis is arguably incorrect. It is true that the mere payment of cash to the seller of the tax credits by the buyer is not the payment of tax to the state. However, where the state applies the credit as a payment of tax in the year of transfer, this is the tax period for which the payment occurs for purposes of the federal income tax deduction. Stated differently, the deduction does not accrue at the time of sale, or at the time of application of the credit on the state return, but rather at the time and period for which the Tax Commissioner determines the payment was made. Practitioners who are purchasing credits for clients who have substantial income in one year and typically lower income in other years should plan carefully here.

b. *Gain on Application*. When the buyer applies the tax credit on the state return to satisfy the buyer's state income tax liability, an issue arises as to whether the buyer has a gain on the application of the credit to satisfy the liability based on the difference between the purchase price and the face amount of the credit. There are three possible approaches here.

i. *Full Gain on Spread.* In Chief Counsel Advisory 200238041 (July 24, 2002), the Service indicated that the buyer should include the difference between the "face amount" of the credit claimed and the purchase price (cost basis) as a gain on his or her federal income tax return. In that ruling, the Service reasoned that "the taxpayer would be treated as having first disposed of the credit, with the 'face amount' of the credit as an amount realized, and then paid the proceeds to the state, resulting in a deduction for the full face amount under

I.R.C. § 164." Later, in Chief Counsel Advisory 200704028 (January 26, 2007), and Chief Counsel Advisory 200704030 (January 26, 2007) the Service indicated that the use of the credit would be a realization event under Section 1001 of the Internal Revenue Code and cited Rev. Rul. 86-117, 1986-2 C. B. 157 as support for the position. In these rulings, the Service analogized the use of the credit to the payment of state taxes with property in lieu of cash. In PLR 200951024 (September 10, 2009), the Service stated that the "[t]axpayer's basis in the purchased state tax credit will be the cost of the credit. In the year or years taxpayer applies the credit to satisfy the taxpayer's state tax liability, taxpayer will realize gain or loss equal to the difference, if any, between the basis of the credit and the amount of liability satisfied by the application of the credit." *See also* Chief Counsel Advisory 201147024 (November 25, 2011). None of the above-cited rulings answered the question as to the character of the gain, but presumably the buyer would use the credit within a year of the purchase.

ii. *Partial Gain and Partial Discharge of Indebtedness*. These later rulings listed in item i. above cite to Rev. Rul. 86-117, 1986-2 C. B. 157 in support of the proposition that the spread between the amount of tax liability satisfied and the purchase price for the credit will be the amount realized upon application of the tax credit to satisfy the state income tax liability. However, a careful reading of the ruling provides that where the fair market value of the property used to satisfy the tax liability is less than the undisputed tax liability, the fair market value is the amount realized, and the spread is income from the discharge of indebtedness. This could affect the character of any gain realized on the spread between the purchase price of the credit and the amount of state income tax liability satisfied.

iii. *Federal Deduction Equals Purchase Price.* A third approach is to limit the state income tax deduction to the cost basis in the credit. Since the buyer has recently purchased the credit, there should be no gain on application of the tax credit as the fair market value of the credit equals the basis of the recently purchased credit. *Cf.* I.R.C. §1012. Service position is that the use of the tax credit is treated as a transfer of property to the state. *Cf*. Rev. Rul. 86-117, 1986-2 C. B. 157. Accordingly, the amount of the state tax payment should be based on the fair market value of the property transferred to the state, which in the case of a recently purchased credit, would be the purchase price. The use, by the Service, of the face amount of the tax credit as the amount realized may be incorrect, as: (1) the face amount of the tax credit does not reflect the fair market value of the property used to satisfy the liability; and (2) the reduction in state income tax liability on account of the use of the tax credit is not an accession to wealth. Under this approach, the taxpayer would merely deduct the amount that they paid for the tax credits on Schedule A, ignoring any possible discharge of indebtedness. *Cf.* Rev. Rul. 79-315, 1972-2 C.B. 27 (Holding (3) Iowa tax rebate used to reduce income tax was not income), *Tempel v. Commissioner*, 136 T.C. No. 15 (2011) ("a reduction in a tax liability is not an accession to wealth. Consequently, a taxpayer who has more section 164 deductions has not received any income."), and *Snyder v. United States*, 894 F.2d 1337 (6th Cir. 1990) (reduction in state taxes is not "income" from the state). *See also Maines v. Commissioner*, 144 T.C. No. 8 (March 11, 2015) (analyzing New York investment credits) and *Rivera v. Commissioner*, T.C. Memo. 2015-35. Of course, these cases and rulings apply to the original issuance and use of the credit by the initial holder, and not a subsequent transferee. It is also important to note that even if there is gain recognition at the federal level, the buyer would be able to further reduce their Virginia taxable income due to the inclusion. Va. Code Ann. § 58.1-513(E).

D. Audit Issues. The audit and adjustment of the donation of a conservation easement by the Internal Revenue Service or the Department of Taxation create complex issues, particularly where the donor has sold Virginia land preservation tax credits to other Virginia taxpayers.

1. *Burden of Proof, Department Not Bound.* The Department may disregard any appraisal it deems incorrect, and the taxpayer bears the burden of proof regarding the fair market value and conservation value of the donated easement. *See* Va. Code Ann. §§ 58.1-512(B) and 58.1-512(E). The Department is not bound by the initial issuance of the credit by the Department. *See* Va. Code Ann. § 58.1-512(D)(6). Purchasers of tax credits are not entitled to rely on the initial issuance letter provided by the Department and such letter does not constitute written advice from the Department. Ruling of the Tax Commissioner, P.D. 14-93 (June 19, 2014).

2. *Department Not Bound by DCR Review.* The verification of conservation value by DCR does not prohibit the Department from auditing any tax credit, or assessing any tax related to the tax credit. *See* Va. Code Ann. § 58.1-512(D)(6).

3. *Rejection of Appraisals.* Any appraisal that, upon audit by the Department, is determined to be false or fraudulent, may be disregarded by the Department in determining the fair market value of the property and the amount of tax credit. *See* Va. Code Ann. §§ 58.1-512(B). In the event that any appraiser falsely or fraudulently overstates the value of the contributed property in an appraisal, the Department may disallow further appraisals signed by the appraiser and may take other disciplinary action. *See* Va. Code Ann. § 58.1-512(B). However, the Department has ruled that the mere adjustment of an appraisal on audit is not the same as the disregard of an appraisal under the false or fraudulent standard. Ruling of the Tax Commissioner, P.D. 14-7 (January 21, 2014). In various Rulings of the Tax Commissioner, P.D. 11-154 and 11-155 (August 30, 2011) P.D. 14-7 (January 21, 2014, P.D. 14-61, (April 30, 2014) and P.D. 15-234, (December 22, 2015), the

Department rejected appraisals submitted by easement donors for a variety of reasons, including that the reports: (1) failed to use comparable sales and used a discounted cash flow approach, (2) failed to provide supporting documentation for development costs, (3) failed to take into account available water and sewer, as well as soil quality, (4) failed to take into account floodplain and zoning restrictions; and (5) failed to provide justification for the substantial increase in the value of the property for the period between purchase and the easement. *See SWF Real Estate, LLC v. Commissioner,* T.C. Memo. 2015-63, for a recent case where the Service's appraisal was rejected by the Tax Court in favor of the donor's appraiser, and the appraiser is one used frequently in the past by the Virginia Department of Taxation in conservation easement state audits.

4. *Adjustment at the Federal Level*. If the Internal Revenue Service adjusts the charitable deduction at the federal level, the Department will make a corresponding adjustment to the Virginia charitable deduction and to the land preservation tax credit. In Ruling of the Tax Commissioner, P.D. 05-122 (July 22, 2005), the Department stated that "should the IRS review a land conservation easement and disallow the associated charitable deduction . . . the Department is required . . . to make a corresponding adjustment to Virginia taxable income and also disallow the Virginia Credit." In an earlier ruling, superseded by P.D. 05-122, the Department stated that: ". . . if the Internal Revenue Service disallows a charitable deduction . . . , the statute requires the Department to similarly disallow Virginia Land Preservation Tax Credits. The statute provides no authority for the Department to allow an exception." *See* Ruling of the Tax Commissioner, P.D. 05-76 (May 19, 2005).

5. *Adjustment at the State Level*. Any adjustment by the Department of Taxation would reduce the Virginia charitable deduction and the amount of the Virginia land preservation tax credit. In Ruling of the Tax Commissioner, P.D. 03-77, (October 31, 2003), the Department stated:

> Because the transferees would be subject to the credit amount and carryforward limitations as provided under *Va. Code* § 58.1-512(B)(1), the Attorney General has ruled that the limitations applicable to taxpayers by *Va. Code* § 58.1-512(B)(1) also apply to transferees of the Credit. See Opinion of the Attorney General 02-094 (11/19/02). The Credit claimed by a transferee of the Credit could be affected by any adjustment by the Department to the Credit earned by a transferring taxpayer. Accordingly, if the Department adjusts the Credit claimed by a taxpayer within the statute of limitations, such adjustment would flow through to any transferee of the Credit.

In Ruling of the Tax Commissioner, P.D. 12-190 (November 26, 2012), the Department rejected a claim by the purchaser of tax credits, which were later adjusted. The purchaser contended that the purchaser should not be subject to later assessment for the adjusted tax credits because they were purchased in "good faith." In Ruling of the Tax Commissioner, P.D. 13-29, (March 11, 2013), the Department again rejected a "good faith" claim by a purchaser of tax credits, and also rejected claims that the seller and the tax matters representative should be held liable for the assessment, and not the purchaser. The Department also rejected the purchaser's claim that interest should not apply to the assessment. The Department has also ruled that purchasers of tax credits are not entitled to rely on the initial issuance letter provided by the Department and such letter does not constitute written advice from the Department. Ruling of the Tax Commissioner, P.D. 14-93 (June 19, 2014).

6. *Tax Matters Representative for Pass-Through Entities*. Section 58.1-513(F) of the Code of Virginia provides that a pass-through entity may appoint a tax matters representative, who shall be a general partner, member/manager or shareholder, and register that representative with the Commissioner. The Commissioner is entitled to deal with the tax matters representative as representative of the taxpayers to whom credits have been allocated or transferred by the entity. In the event a pass-through entity allocates or transfers tax credits to its partners, members or shareholders and the allocated or transferred credits are disallowed, the Commissioner shall first make written demand for payment of any additional tax, together with interest and penalties, from the tax matters representative. In the event the tax matters representative does not satisfy such payment demand, the Commissioner may collect against the individual taxpayers.

7. *Period of Limitations for Assessment*. In Rulings of the Tax Commissioner, P.D. 11-154 and 11-155 (August 30, 2011), the Department held that, under the authority granted in Section 58.1-1822 of the Code of Virginia, the Department will make assessments after an appeal only if the statute of limitations for making an assessment has not otherwise expired. Purchasers of tax credits, later adjusted, may file protective claims for refund based on the outcome of an appeal prosecuted by the seller of the adjusted tax credits. *See* Rulings of the Tax Commissioner, P.D. 14-76 and P.D. 14-78 (May 30, 2014), P.D. 14-125 (July 28, 2014), and P.D. 14-170 (September 12, 2014). The filing of Form LPC-2 by the seller of tax credits is not considered a return for purposes of assessment by the Department within the applicable statute of limitations. Ruling of the Tax Commissioner, P.D. 14-93 (June 19, 2014). The Department may adjust the amount of Tax Credit carried forward by the donor or a buyer in any open year during the carryforward period. Ruling of the Tax Commissioner, P.D. 15-79 (April 22, 2014). Based on this ruling, and stated differently, there is truly no "audit proof" unclaimed Tax Credit in the Commonwealth based on the expiration of the period of limitations as a defense.

8. *Confidentiality of Tax Information*. Section 58.1-3(F) of the Code of Virginia provides that any information submitted to any government official pursuant to Section 58.1-512 of the Code of Virginia shall be treated as confidential tax information. This provision was enacted to impose the same confidentially requirements on the Department of Conservation and Recreation as are imposed on the Department regarding taxpayer information.

9. *IRS Audit Techniques Guide*. The Service has issued an Audit Techniques Guide for the examination of charitable deductions claimed as the result of the donation of a conservation easement. The guide may be found at http://www.irs.gov/pub/irs-utl/conservation_easement.pdf. Among the numerous issues discussed, the guide identifies the following specific issues: (a) noncompliance with substantial requirements, (b) inadequate documents or lack of conservation purpose, (c) lack of perpetuity evidenced by deeds allowing for abandonment or termination of easement, (d) reserved property rights inconsistent with the claimed conservation purpose, (e) failure to comply with subordination rules, (f) failure to provide the donee organization with a right to proceeds in the event of termination, (g) use of improper appraisal methodologies and overvalued conservation easements, and (h) failure to report income from the sale of state tax credits.

IV. Gift Tax Considerations with the Donation of Conservation Easements

A. Charitable Gift Tax Deduction Issues. Most literature on the tax considerations regarding conservation easements focuses on the availability of the charitable income tax deduction for individual landowners rather then gift and estate tax charitable deductions. Nevertheless, there exists important gift and estate tax considerations and planning opportunities for practitioners.

1. *Charitable Gift Tax Deductions.* Section 2522(d) of the Internal Revenue Code allows a deduction for qualified contributions of conservation easements. The deduction is allowed regardless of whether the easement meets the conservation purposes test of I.R.C. § 170(h)(4)(A). The Committee Reports provide as follows:

> The committee is concerned that applying the same conservation purpose standards for income, estate, and gift tax deductions may cause undesirable results in certain cases. For example, under present law, if a conservation contribution is made and it later is established that the conservation purpose requirement for the contribution to be deductible is not satisfied, the donor loses his or her income tax deduction, and also may be subject to gift or estate tax. This is true notwithstanding the fact that a charitable organization owns the property interest and the donor may not have other property or funds with which to pay the gift or estate tax.

Pub. Law 99-514, TRA 86 (October 22, 1986).

This reasoning also applies in the context of the federal estate tax deduction under Section 2055(f) of the Internal Revenue Code. It is important to note, however, that since the donation would not qualify for all of the requirements of Section 170(h), no Virginia land preservation tax credit would be allowed. *See* Va. Code Ann. § 58.1-512(C)(2) ("qualified donations . . . include the conveyance of . . . a less-than-fee interest in real property, . . . provided that such less-than-fee interest qualifies as a charitable deduction under §170(h) . . .").

2. *No Gift Tax Return*. There is no requirement to report the gift on a federal gift tax return to claim the charitable gift tax deduction. *See* I.R.C. § 6019(3)(B).

B. Gift Tax Benefits of Conservation Easements. The diminution in value as a result of the grant of the easement will reduce the value of the property for purposes of the gift tax, including the annual exclusion from the gift tax. *See* I.R.C. § 2512. This may allow greater potential gifting leverage when the reduction in value attributable to the easement is combined with appropriate valuation discounts. *Cf. Estate of Hoover v. Commissioner*, 69 F.3d 1044 (10th Cir. 1995) (minority discounts allowed in calculation of Section 2032A valuation). *See also* PLR 200448006 (November 26, 2004) (confirming such treatment for applying the 2032A special use valuation rules).

1. *Chapter 14*. Chapter 14 was added to the Internal Revenue Code to provide special valuation rules for certain transfers of property. I.R.C. §§ 2701-2703 *et. seq*. As a general rule, restrictions on property in terms of use, economic benefit and transferability are ignored for valuation purposes unless such restrictions comply with Chapter 14. Conservation easements are generally not subject to the special valuation rules in Chapter 14. *See* I.R.C. § 2703 and Treas. Reg. § 25.2703-1(a)(4). Note, however, that if the donation does not meet the requirements of Sections 2522(d) or 2055 of the Internal Revenue Code, the Chapter 14 special valuation rules will apply to the donation. *See* Treas. Reg. § 25.2703-1(a)(4). In such a situation, it may be difficult for a conservation easement to meet the "bona fide business arrangement," "testamentary device" and "comparability" tests of Section 2703. This could create potentially adverse estate tax consequences where the value of the real estate at the death of the donor would be valued without regard to the restrictions in the easement. *Cf. Holman v. Commissioner,* 130 T.C. No. 12 (May 27, 2008) (section 2703 of the Internal Revenue Code applies to disregard restrictions in a family limited partnership).

2. *Use of Easements with Other Estate Planning Techniques*. The reduction in value on account of the donation of the easement may be used in conjunction with a variety of other estate planning techniques where a further reduction in the value of an asset will leverage the benefits of the technique. Examples include: Qualified Personal Residence Trusts, Family Limited Partnerships, Self-Canceling Installment Notes (SCINs) and Private Annuities, and Sales to Intentionally Defective Trusts.

3. *Donations by Qualified Personal Residence Trusts*. Qualified Personal Residence Trusts (QPRTs) are also grantor trusts. I.R.C. § 677(a)(1); Treas. Reg. § 1.677(a)-1(g). Since a QPRT is a grantor trust, a QPRT should be able to donate a qualified conservation easement and obtain the charitable income tax and gift tax deductions assuming the rules of Section 2702 of the Internal Revenue Code are otherwise met. *Cf.* PLR 199916030 (January 22, 1999) (leasing of portion of property to unrelated third party did not prevent qualification as a QPRT provided remainder of property was donor's primary residence). Numerous rulings also hold that easements donated prior to the formation of the QPRT are acceptable. *See* PLR

200617035 (April 26, 2006) (two parcels of real estate subject to qualified conservation easement and containing vacation residence, pavilion, and access road); PLR 200241039 (July 10, 2002) (vacation property with a residence, guest house, barn, boathouse, two sheds, and dock, together with adjacent acreage, all of which were subject to a conservation easement, qualified as a personal residence for this purpose); PLR 200751022 (December 21, 2007) (house and rented caretaker cottage); PLR 200109017 (November 27, 2001) (vacation home, a detached garage with an apartment above the garage, a one-bedroom cabin with a loft, a tennis court and a Jacuzzi with an outdoor shower was all a residence); and PLR 200039031 (June 30, 2000). It is important to note that Section 2702 of the Internal Revenue Code requires that the land surrounding the residence conveyed to the QPRT must not be in excess of what is reasonably appropriate for residential purposes. *See* Treas. Reg. § 20.2702-5(b)(2)(ii) and PLR 200729004 (April 5, 2007) (property surrounding personal residence was "not in excess" where it was comparable in size to that of residential properties surrounding the parcel in question).

a. *Planning Opportunity.* The better planning opportunity is to place the easement on the property prior to contribution to the QPRT, then donate the property to the QPRT for excellent gift tax leverage. A husband and wife could also divide ownership of the property and transfer their respective interests to two separate QPRTS for additional leverage through fractional interest discounts. *See* PLR 200039031 (June 30, 2000) (transfer of personal residence subject to conservation easement into two QPRTs) and PLR 9714025 (January 6, 1997) (transfer of personal residence 50% into two QPRTs). Note that practitioners should take the necessary steps to avoid the "reciprocal trust doctrine" when using such a technique. *See generally Estate of Grace v. United States,* 395 U.S. 316 (1969) and *Estate of Levy v. Commissioner*, T.C. Memo. 1983-453.

V. Estate Tax Considerations with the Donation of A Conservation Easement

There are generally three estate tax benefits available to donors of conservation easements. These are (A) a reduction in the value of the gross taxable estate; (B) a special exclusion from the estate tax that excludes up to $500,000 of the value of land in the estate subject to a qualified conservation contribution; and (C) an estate tax charitable deduction for testamentary and certain post-mortem easement donations.

A. Estate Tax Reduction. The reduction in value of the property due to the lifetime donation of a conservation easement will also result in a reduction in the landowner's gross taxable estate for federal estate tax purposes. Such a reduction in the gross taxable estate may result in lower federal and state estate taxes at the death of the landowner. Because the easement restrictions last in perpetuity, at the death of the landowner, the value of the property subject to the easement for purposes of computing the landowner's gross taxable estate will almost certainly be less than it would be if the property were not subject to the easement. *See* Treas. Reg. § 20.2031-1(b). *See also Estate of Einseildler v. Commissioner*, T.C. Memo. 1994-155 (regarding the effect of a set back easement on value of the property for purposes of computing the gross taxable estate).

Section 2033 of the Internal Revenue Code provides that the value of the gross estate of a decedent shall include the value of all property to the extent of the interest therein of the decedent at the time of his or her death. The easement should also reduce the value of a direct skip included in the donor's gross estate for generation skipping transfer (GST) tax purposes. *Cf.* I.R.C. § 2624(b).

B. Section 2031(c) Exclusion. In addition to the reduction in the value of the gross estate, a special exclusion from federal estate taxes excludes up to 40% of the value of the land (limited in total to $500,000) from estate taxation. I.R.C. § 2031(c). It is important to note that the Section 2031(c) exclusion is available at death for easement donations made during a person's lifetime and donations made by the executor after a person's death. It is also important to note that Section 2031(c) excludes 40% of the value of the land *in addition to* the reduction in the gross estate for the value of the donated easement.

1. *Determination of Exclusion Amount*. Section 2031(c) of the Internal Revenue Code provides that there shall be excluded from the gross estate the lesser of (a) the "applicable percentage" of the value of land subject to a qualified conservation easement, reduced by the amount of any deduction under section 2055(f) with respect to such land, or (b) the "exclusion limitation."

a. *Nature of the Exclusion*. There is a fundamental question as to whether Section 2031(c) provides for an asset based exclusion, that excludes a portion of a specific asset from the estate—or is a dollar based exclusion that merely excludes a portion of the total value of the estate determined under Section 2031(a). A hybrid approach is also theoretically possible. *See generally*, Stephens, Maxfield, Lind, Calfee & Smith, FEDERAL ESTATE AND GIFT TAXATION (WG&L, 8th Ed. 2009) at 4.02[7]. There is no legislative history or rulings from the Internal Revenue Service on this issue. However, because of the complex definition of a qualified conservation easement created by Congress, the better approach is to treat the exclusion as an asset based exclusion with a cap. Nevertheless, this dichotomy can have a significant effect on calculations under Sections 2032A, 6166, and 303.

b. *Exclusion Limitation.* The maximum amount of value exclusion for an estate is $500,000. I.R.C. § 2031(c)(1).

c. *Applicable Percentage Defined.* I.R.C. § 2031(c)(2) defines the term "applicable percentage" as 40 percent reduced (but not below zero) by 2 percentage points for each percentage point (or fraction thereof) by which the value of the qualified conservation easement is less than 30 percent of the value of the land (determined without regard to the value of such easement and reduced by the value of any retained development rights). Accordingly, if the easement reduces the value of the land by 10% or less, no exclusion is available under Section 2031(c).

i. *Determination of Applicable Percentage Values.* The values taken into account in determining the applicable percentage are the values at the time of the contribution of the easement rather than the date of death values. I.R.C. § 2031(c)(2) ("values taken into account *under preceding sentence*") Emphasis added. *See also*, Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 107th Congress (JCS-1-03) (January 24, 2003) (stating that the "provision also clarifies that the date for determining easement compliance is the date on which the donation is made."). For a lifetime donation, this will require the donor to retain information regarding the easement values for proper administration of the estate.

ii. *Limited to Land Value and not Improvements*. The applicable percentage is calculated based on the value of the land and excludes the value of any improvements or any other rights, which may be included in the easement and the valuation thereof. *See* I.R.C. §2031(c)(1)(A) ("the applicable percentage of the *value of land* subject to a qualified conservation easement, reduced by the amount of any deduction under section 2055(f) with respect to *such land*") Emphasis added.

iii. *2055(f) Reduction.* The value of the land for purposes of the applicable percentage under Section 2031(c) is reduced by the amount of any charitable estate tax deduction taken under I.R.C. § 2055(f) for a post-mortem easement contribution. I.R.C. § 2031(c)(1)(A). This avoids a potential double benefit to the estate of both an exclusion based on the value of the land and the donated easement. Accordingly, the estate would have the benefit of a charitable deduction for the value of a post-mortem easement and an exclusion of 40% of the remaining value of the land. To apply the exclusion to the total value of the land without reduction for the value of the easement and then correspondingly reduce the gross estate by the Section 2055(f) deduction would not be appropriate and would result in a disparity in treatment for pre and post mortem easements. *See* Stephens, Maxfield, Lind, Calfee & Smith, FEDERAL ESTATE AND GIFT TAXATION (WG&L, 8th Ed. 2009) at 4.02[7][d][i] footnote 327.

iv. *Timing of Easement Donation*. If the easement is placed on the land before the decedent's death, the effect is that the value of the land for purposes on inclusion under Section 2031(a) is reduced by the value of the easement. *See* Stephens, Maxfield, Lind, Calfee & Smith, FEDERAL ESTATE AND GIFT TAXATION (WG&L, 8th Ed. 2009) at 4.02[7][d][i]. If the easement is placed on the property at or after the decedent's death, then the value of land included in the gross estate pursuant to Section 2031(a) is not reduced by the value of the easement. *Id.* Instead, the date of death value is determined under Section 2031(a) and is then is reduced by the Section 2055(f) deduction, which accounts for the reduction in value due to the easement. Thus, the possibility of an estate tax exclusion and estate tax deduction for the easement is foreclosed. *Id*. This also insures that the net value used to calculate the exclusion under Section 2031(c) is the same whether the easement is conveyed before the decedent's death or after the decedent's death. *Id.*

v. *Debt-financed Property*. The 2031(c) exclusion does not apply to the extent that the land is debt-financed property. I.R.C. § 2031(c)(4)(A). Debt-financed property is property subject to "acquisition indebtedness," which is further defined as the unpaid amount of debt to acquire the property, debt incurred after the acquisition the need for which was foreseeable at the time of acquisition, and any extension or refinancing of such indebtedness. I.R.C. § 2031(c)(4)(B). Note, however, that the debt would be a reduction in the value of the estate under I.R.C. § 2053(a)(4). This provision avoids a double benefit to the estate of the exclusion and the further reduction of the gross estate of any outstanding debt on the property.

vi. *Retained Development Rights*. Any retained development rights in the easement are not eligible for the exclusion and reduce the applicable percentage. I.R.C. §§ 2031(c)(2) and (c)(5). Development rights are defined as any right to use the land for commercial purposes, which rights are not subordinate to and directly supportive of the use of the land as a farm for farming purposes. I.R.C. § 2031(c)(5)(D). The terms "farm" and "farming purposes" are the same definitions found in I.R.C. §§ 2032A(e)(4) and 2032A(e)(5), although Section 2031(c)(5) does not specifically incorporate the definition of "farm" from Section 2032A. *See* above for definitions. Examples of such retained rights would be the right to sell additional parcels of land for development, or to build additional structures for rental. Retention of rights regarding agricultural activities and the right to build additional residences for personal use are not likely to be held as commercial uses. Section 2031(c) allows retained development rights to be terminated by execution of an agreement among those with an interest in the land (whether or not in possession), which permanently extinguishes some or all of the development rights retained by the donor. I.R.C. § 2031(c)(5)(B). Retained development rights may be extinguished through an agreement, followed by an amendment to the existing easement, or the grant of a new easement. An agreement to extinguish such rights must be executed on or before the due date for filing of the estate tax return and the agreement must be filed with the estate tax return. I.R.C. § 2031(c)(5)(B). The agreement must be implemented at the earlier of the date that is two years following the date of the decedent's death, or the date of the sale of the land subject to the easement. I.R.C. § 2031(c)(5)(C). Failure to implement the agreement will result in a recapture of the estate tax savings on account of the exclusion. I.R.C. § 2031(c)(5)(C)(ii). Once extinguished, the Section 2031(c) exclusion will apply as if the development rights had not been reserved in the original easement. I.R.C. § 2031(c)(5)(B). The ability to terminate retained development rights creates an important planning opportunity that allows the family to have a "second bite at the apple" with regard to estate planning with the easement. Nevertheless, because the agreement will require the consent of all of the beneficiaries, practitioners should consider whether or not to retain development rights in the original donation.

vii. *Provisions to Include in an Agreement to Extinguish.* An agreement to extinguish retained development rights must contain the following provisions:

a) A statement that the agreement is made under Section 2031(c)(5);
b) A list of all persons in being holding an interest in the land that is subject to the conservation easement, including name, address, tax identification number, relationship to the decedent, and a description of their interest;
c) A description of the real property shown on the estate tax return that is subject to the easement (identified by schedule and item number on the return);
d) A description of each retained development right that is to be extinguished;
e) A clear statement of consent, that is binding on all parties under applicable local law, that such parties will take whatever action is necessary to permanently extinguish the retained development rights listed in the agreement and to be personally liable for additional taxes under 2031(c)(5)(C) if the agreement is not implemented by the earlier of the date that is 2 years after the decedent's death or the date of the sale of the land subject to the easement;
f) A statement that in the event the agreement is not timely implemented, the parties will report the additional tax on whatever return is required by the IRS and will file the return and pay the additional tax; and
g) The execution by all of the parties to the agreement on or before the due date of the estate tax return (including extensions).

In addition, the agreement could ensure compliance with I.R.C. § 2031(c)(5)(d) by also extinguishing any right to use the land subject to the easement for commercial recreational purposes. It may also be desirable that the agreement include (i) a savings provision, (ii) any agreements between the parties as to the payment of costs associated with the amendment to the easement, (iii) any agreement between the parties as to the payment of any recapture taxes, and (iv) releases, hold harmless and indemnification provisions between the parties. For general guidance as to the provisions that should be included in an agreement to extinguish development rights see PLR 200014013 (December 22, 1999) and Form 706, Instructions to Schedule U.

2. *Determination of Value of Land Subject to Easement.* The value taken into account in determining value of the land for purposes of applying the exclusion at the death of the donor is determined as of the date of death, or on the alternate valuation date under I.R.C. § 2032. *See* I.R.C. § 2031(c)(1)(A). Section 2031(c)(1) of the Internal Revenue Code provides that there shall be excluded from the gross estate the applicable percentage of *the value of land* subject to the easement. Section 2031(a) of the Internal Revenue Code provides that the value of the gross estate of the decedent shall be determined by including *the value at the time of his death* of all property held by the decedent. *Cf. Flanders v. U.S*., 347 F. Supp 95 (D.C. N.C. Cal. 1972) (pre-2031(c) case, land subject to post-mortem conservation restriction valued as of date of death).

a. *Comparison to Applicable Percentage Values.* While the values in determining the applicable percentage are taken into account at the time of the easement donation (whether during the decedent's lifetime or post-mortem), the value of the land for purposes of applying the exclusion from the estate is determined at death or on the alternate valuation date. The applicable percentage rules were designed to add a qualitative measure to allow the exclusion to apply to certain easements, and were not designed to alter the long-standing rules on valuation dates for a decedent's estate. This is evident from the operation of the applicable percentage in Section 2031(c)(1) and from the creation of a new statutory definition of "qualified conservation easement" in Section 2031(c) rather than the use of the existing "qualified conservation contribution" definition found in Section 170(h).

b. *Calculation of Estate Tax Value of Partial Interest.* To calculate the estate tax value of a partial interest in the land subject to a qualified conservation easement, the presumed method is to calculate the value of the property, then apply any appropriate valuation discounts, and then apply the permitted Section 2031(c) exclusion to the discounted value. *Cf. Estate of Hoover v. Commissioner*, 69 F.3d 1044 (10^{th} Cir. 1995) (minority discounts allowed in calculation of fair market value for purposes of Section 2032A). The approach here is that you first determine the underlying value of the property for purposes of general Section 2031(a) inclusion, with appropriate discounts, and then apply the 2031(c) exclusion. *See also* PLR 200448006 (November 26, 2004). Where the partial interest in the land is owned through an entity, the valuation rules are not clear. The question is what is being valued in such a case—the interest in the entity, or the fractional interest in the land. Because

Section 2031(c)(10) adopts a "look-through" rule and Section 2031(c)(1) provides that the exclusion applies to "*the value of the land*" it is arguable that only a fractional interest discount should apply here, if at all. *See* Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1997 (December 19, 1997) ("With respect to land held by a partnership, corporation, or trust, a look-through rule applies to the extent that the decedent owns (directly or indirectly) at least 30 percent of the entity involved."). This is also consistent with the operation of Section 2032A in that such a provision "should be construed to give [an estate] the same rights that it would have had if the farm had not been incorporated." *Estate of Maddox v. Commissioner,* 93.T.C. 228, 234 (1989). However, Section 2031(c)(10) provides that "*this section shall apply to an interest in*" such entity. So it is equally arguable that the interest in the entity is what is valued for purposes of the application of the exclusion. For a logical approach here *see* Henderson, *This Land Is Your Land, This Land Is (Still) My Land: Using Qualified Conservation Contributions to Preserve Cherished Family Properties,* 33 ACTEC Journal 71 (2007) wherein the author stated that "the estate tax value of the decedent's interest in the entity should likely be computed by first determining the value of a pro rata share of the entire net asset value of the entity, reducing that value by the permitted exclusion, and then applying the appropriate discounts for lack of control and marketability." This approach would apply the exclusion to the underlying property and then apply discounts to the non-excluded value of the decedent's interest in the entity. This method would be consistent with the look-through approach; however, it is arguably inconsistent with the approach in *Hoover* cited above.

c. *Alternate Valuation and Post-Mortem Easements.* Where the alternate valuation date under Section 2032 is elected, it was previously unclear as to the value to be taken into account with respect to a post-mortem easement. *See Flanders v. U.S*., 347 F. Supp 95 (D.C. N.C. Cal. 1972) (pre-2031(c) case, land subject to post-mortem conservation restriction valued as of date of death not at alternate valuation date) and Prop. Reg. § 20.2032-1(f) (2032 is available for reduction in value due to "market conditions" but not due to other "post-death events"). Under Treas. Reg. §20.2032-1(c)(4), if a post-death easement satisfies the provisions of Section 2031(c) of the Code, the easement is taken into account in determining both the fair market value of the property at the decedent's date of death, and the fair market value of the property on the 6-month date. If the post-death easement does not qualify for Section 2031(c), then the alternate valuation date for the property is the date the easement was granted and the value of the property included in the estate is the fair market value of the property immediately prior to the grant. *See* Treas. Reg. §20.2032-1(c)(4), example 13.

3. *Election*. The executor of the estate of the decedent must make an affirmative election to take advantage of the I.R.C. § 2031(c) exclusion on the date on

which the estate tax return is due, including extensions. I.R.C. § 2031(c)(6). The election is irrevocable and is made on Schedule U of Form 706.

4. *Qualified Conservation Easement*. The exclusion is available for "qualified conservation easements" rather than "qualified conservation contributions" as provided in I.R.C. §§ 170(h) and 2055(f). The easement must meet the requirements of I.R.C. §170(h) to be eligible for the exclusion. I.R.C. § 2031(c)(8)(B). In addition, a qualified conservation easement must comply with additional requirements that are not required to satisfy the definition of a qualified conservation contribution under I.R.C. § 170(h). First, the easement must burden land owned by the decedent or a member of his or her family for the three-year period prior to the decedent's death. Second, the donation of the easement must have been or be made by the decedent or a member of the decedent's family. Third, the easement must have a conservation purpose other than historic preservation. Fourth, the easement cannot allow commercial uses, other than *de minimis* commercial recreational use.

a. *Donation by Decedent of Member of Family.* The donation must be made by the decedent, a member of the decedent's family, the executor of the decedent's estate, or the trustee of a trust the corpus of which includes the land subject to the easement. I.R.C. § 2031(c)(8)(C). The term "member of the family" has the same meaning as provided in I.R.C. § 2032A(e)(2), and includes the ancestor or spouse of the individual; a lineal descendant of the individual, a lineal descendant of his or her spouse, or a lineal descendant of his or her parent; or the spouse of any lineal descendant described above.

b. *Donations by Corporate Fiduciaries*. While Section 2031(c)(8)(A)(ii) requires that the donation be "made by an individual", presumably a corporate trustee or executor could also make a donation. *See also* I.R.C. §2031(c)(8)(C) (defining an individual to include an executor or trustee).

c. *Ownership Rules.* In order to be eligible for the exclusion, the decedent or a member of his or her family must have owned the land subject to the easement at all times during the three-year period ending on the date of the decedent's death. I.R.C. § 2031(c)(8)(A)(iii).

d. *Land Held in Trust*. The exclusion should be available for land held in a trust created by the decedent during his or her lifetime, if the trust assets are included in the decedent's gross estate pursuant to Sections 2035, 2036, 2037 or 2038. *See* Stephens, Maxfield, Lind, Calfee & Smith, FEDERAL ESTATE AND GIFT TAXATION (WG&L, 8th Ed. 2009) at 4.02[7][b][ii], footnote 292.

e. *Historic Preservation.* Section 2031(c)(8)(B) provides that easements to protect historically important land areas or certified historic structures pursuant to I.R.C. § 170(h)(4)(A)(iv) are not eligible for the exclusion. However, if the easement meets any of the other conservation purposes under I.R.C. § 170(h)(4)(A), the easement would be eligible for the Section 2031(c) exclusion. This limitation is not particularly troublesome in Virginia since most easements qualify as open space easements under I.R.C. § 170(h)(4)(A)(iii).

f. *No Commercial Recreational Uses*. I.R.C. § 2031(c)(8)(B) provides an additional and troublesome requirement for a qualified conservation easement. This requirement is that the easement must include "a prohibition on more than a *de minimis* use for a commercial recreational activity." Commercial recreational activity is not defined in the statute. The legislative history provides "[d]e minimis commercial recreational activity that is consistent with the conservation purpose, such as the granting of hunting and fishing licenses, will not cause the property to fail to qualify for the exclusion. It is anticipated that the Secretary of the Treasury will provide guidance as to the definition of 'de minimis' activities." *See* Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1997 (JCS-23-97), December 17, 1997.

i. *Planning Note.* Because of the uncertainty with the definition of commercial recreational activity, practitioners should consider the inclusion of language in deed of easement prohibiting all commercial activity or all commercial recreational activity except *de minimis* activity. If the easement was already donated, consideration should be given to an amendment to the existing easement prior to the client's death. Lastly, the prohibition may be included in a post-mortem agreement followed by an amendment to the easement. *See* PLR 200014013 (December 22, 1999) (language precluding commercial uses included in agreement to extinguish retained development rights). While a post-mortem amendment is possible, under Virginia law, the amendment would require the consent of all of the beneficiaries of the estate. *See Id.*; *See also* Va. Code Ann. § 64.2-108.

5. *Family Succession Planning*. The exclusion is available for succeeding generations of the decedent so long as the property remains in the family through descent and distribution. This is because the exclusion applies to any estate holding the property subject to the easement, not the easement itself. *See* I.R.C. § 2031(c)(8)(A). The term "family" is the same definition as is contained in I.R.C. § 2032A.

6. *Post-Mortem Planning*. The Section 2031(c) exclusion is also available for easement donations made after the decedent's death by an executor or trustee. I.R.C. § 2031(c)(9). *See also* Va. Code Ann. § 64.2-108. The easement must be granted on or before the due date (including extensions) for the filing of the federal estate tax return. In addition, the post-mortem donation may entitle the estate to a deduction under Section 2055(f) of the Code. *See* PLR 200418005 (December 24, 2003) (post-mortem easement by trustee of revocable trust qualifies for 2055(f) deduction and 2031(c) exclusion).

a. *Planning Note*. If a qualified conservation easement is granted after the decedent's death, but before the filing of the estate tax return, and an income tax deduction for the donation of the easement is taken by beneficiaries, then the Section 2031(c) exclusion is not reduced by the Section 2055(f) deduction because no Section 2055(f) deduction was allowed to the estate. This will have the effect of increasing the exclusion to the estate, while allowing the beneficiaries a federal income tax deduction for the donation. *See* Stephens, Maxfield, Lind, Calfee & Smith, FEDERAL ESTATE AND GIFT TAXATION (WG&L, 8th Ed. 2009) at 4.02[7][d][i] footnote 326. Practitioners should carefully consider whether it is advisable for the estate to take the Section 2055(f) deduction or have the beneficiaries take the Section 170 charitable income tax deduction, with the potential for an increase in the Section 2031(c) exclusion. An example of such a situation would be where the Section 2031(c) exclusion and other deductions and exclusions (without the need of Section 2055(f)) are sufficient to reduce the estate tax liability of the estate to zero.

7. *Summary of Timing and Donation Rules*. Analyzing the permissible donor and timing rules together, qualified conservation easements may be granted before the decedent owns the property, during the decedent's lifetime, or after the decedent's death. *See* Stephens, Maxfield, Lind, Calfee & Smith, FEDERAL ESTATE AND GIFT TAXATION (WG&L, 8th Ed. 2009) at 4.02[7][b][ii].

a. *Previous Donations by a Family Member*. Qualified conservation easements may be donated by a family member (or a trustee or executor) prior to ownership of the property by the decedent (with a prior charitable income of estate tax deduction to the donating family member but not the decedent). Here the decedent, who was not the donor, obtains a reduction in the value of the property due to the easement, and the Section 2031(c) exclusion.

b. *Donations By the Decedent During Lifetime*. Qualified conservation easements may be donated by the decedent (or a trustee) and the decedent will receive a charitable income tax deduction during their lifetime, a reduction in the gross estate on account of the easement, and the Section 2031(c) exclusion.

c. *Donations By Executor*. Qualified conservation easements may be donated by the executor of the estate (or trustee) after the decedent's death but prior to the filing of the estate tax return. This will result in the exclusion under Section 2031(c) and a Section 2055(f) deduction to the estate.

d. *Donations by Beneficiary*. Qualified conservation easements may be created by a family member after the decedent's death and after the land has been distributed to the beneficiaries, but prior to the filing of the estate tax return. In such a situation, the Section 2031(c) exclusion would be available to the estate, and a charitable income tax deduction would be available to the beneficiaries. *See* Stephens, Maxfield, Lind, Calfee & Smith, FEDERAL ESTATE AND GIFT TAXATION (WG&L, 8th Ed. 2009) at 4.02[7][b][ii].

8. *Indirect Ownership*. In the event that the land subject to the easement is owned indirectly by a decedent, through a corporation, partnership, LLC or trust, the decedent's estate may still be eligible for the exclusion so long as the decedent owns at least a 30% interest in such entity. I.R.C. § 2031(c)(10). Note that the statutory language does not contain the words limited liability company, but this should not be an issue. *See generally* I.R.C. § 7701. Ownership is determined under the same rules as are found in I.R.C. § 2057(e)(3) regarding the qualified family-owned business interest rules. Assuming the 30% requirement is met, the value of the decedent's interest in the entity will be excluded pursuant to the rules of Section 2031(c). In such a situation, the amount excluded under Section 2031(c) will be reduced on a pro rata basis by the percentage of the entity not owned by the decedent.

a. *Donations by Entities.* This provision is difficult to reconcile with the requirement that the donation be made by the decedent or a member of the decedent's family as required by I.R.C. §§ 2031(c)(8)(A)(iii). If the donation of the easement is made by the decedent or a member of his or her family and then contributed to the entity, Section 2031(c)(10) would appear to apply. However, if the easement is placed on the property after the property is contributed to the entity, Section 2031(c) may not apply, as the easement would not constitute a donation by the decedent or his or her family. In addition, transfer of the property to a partnership, LLC or corporation could also create issues with the three-year rule. The legislative history indicates that Section 2031(c)(10) is indented as a "look-through" rule so this may not be a concern. *See* Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1997 (JCS-23-97), December 17, 1997. *See also* PLR 200014013 (December 22, 1999) (exclusion allowed on easement on property owned by corporation).

b. *Failed QPRT.* The Section 2031(c) exclusion may be available to shelter the inclusion of real property subject to an easement in a QPRT in the gross taxable estate, where the QPRT fails due to the untimely death of the donor. *Cf.* PLR 199912026 (December 23, 1998) (Section 121 exclusion applies to property owned in a QPRT).

9. *Basis Issues.* The portion of the value of the land that is excluded from the decedent's estate retains a carryover basis under I.R.C. § 1014(a)(4). Accordingly, despite the fact that the property was acquired from a decedent, the basis of the excluded portion does not receive a step-up to fair market value at the decedent's death. The beneficiaries will continue to receive a basis step up for any improvements since only the value of the land is subject to the exclusion and the basis rule applies only to the extent of the exclusion. *See* I.R.C. §§ 2031(c)(10) and 1014(a)(4). There is no guidance on the actual calculation of the adjustment and commentators have arrived at different conclusions. Indeed, arguments may also be

made that basis calculations are different for pre and post death easements. *See* Stephens, Maxfield, Lind, Calfee & Smith, FEDERAL ESTATE AND GIFT TAXATION (WG&L, 8th Ed. 2009) at 4.02[7][e][iii]. Legislative or interpretive guidance is needed in this area.

10. *Coordination with Other Tax Provisions*. The exclusion may be used in addition to estate tax value reduction, the applicable exclusion from the estate tax, the special valuation rules under Section 2032A, the estate tax charitable deduction, and the income tax deduction (on lifetime donations).

a. *Relationship to Unified Credit*. The I.R.C. § 2031(c) exclusion is available to reduce the value of the estate in addition to the applicable exclusion amount (unified credit) from the estate tax provided in I.R.C. § 2010.

b. *Relationship to Gift Tax Exclusion.* The I.R.C. § 2031(c) exclusion does not provide any additional exclusion amount from the federal gift tax. *See* I.R.C. § 2031(a) and (c)(1). The exclusion is only available at the death of the donor, and is not available for lifetime transfers.

c. *Relationship with the GST Tax Exclusion*. The I.R.C. § 2031(c) exclusion is not available to reduce the amount of any direct skip transfer from a deceased donor or a taxable termination from a trust in computing GST taxes. *Compare* I.R.C. §§ 2623, 2031(c) and 2033. This is because I.R.C. § 2031(c) is an estate tax provision and the application of the exclusion will not preclude the imposition of the GST tax.

d. *Relationship to Marital Deduction*. The portion of the land excluded pursuant to I.R.C. § 2031(c) that passes to a surviving spouse will not be eligible for the marital deduction under I.R.C. § 2056 because that portion of the value of the land was not included in the gross estate of the decedent. *See* I.R.C. § 2056(a) and Treas. Reg. § 20.2056(a)-(2)(b)(1).

e. *Coordination with Sections 6166 and 303*. The exclusion of the value of land under Section 2031(c) should not preclude an election for deferral of federal estate taxes pursuant to Section 6166. *Cf.* S. Rep. No. 105033, 105th Cong., 1st Sess. 40 (1997) (providing that Section 2032A remains available for the excluded land). This same reasoning would also apply to Section 303.

f. *Income and Estate Tax Deductions.* Because of the differences in the requirements of I.R.C. § 2031(c) and I.R.C. § 170(h) regarding the types of contributions that are "qualified," an easement could conceivably qualify for Section 170(h) but not for Section 2031(c). This could be the case where the easement does not prevent commercial recreational uses, the easement is for historically important land, or the applicable percentage is zero. Nevertheless, the other estate and income tax benefits discussed herein are available whether or not I.R.C. § 2031(c) applies. In addition, in the event that the easement does not meet the conservation purposes test under any provision of I.R.C. § 170(h)(4)(A), the charitable gift tax and estate tax deductions will still be available. See discussion above.

g. *Coordination of 2055 and 2031(c) and 170(h).* Section 2031(c)(9) of the Internal Revenue Code provides that in a case in which the easement is granted after the decedent's death and on or before the due date (including extensions) for filing the estate tax return, the deduction under Section 2055(f) shall be allowed to the estate, but only if no charitable deduction is allowed to any person with respect to such easement. *See* PLR 200418005 (December 24, 2003). This provision enables the estate to claim a Section 2055(f) deduction without the direct grant of an easement in the will or trust of the decedent. The fact that other surviving tenants in common owning the property have claimed a charitable income tax deduction with respect to the easement will not bar the deduction under Section 2055(f) with respect to the estate of the deceased co-tenant. *See* PLR 200143011 (July 25, 2001). Accordingly, the estate may be entitled to both a Section 2031(c) exclusion and a Section 2055(f) deduction, but note that the Section 2055(f) deduction will reduce the amount of the Section 2031(c) exclusion. *Compare* I.R.C. § 2031(c)(1)(A) which generally excludes 40% of the *value of the land* subject to the easement with I.R.C. § 2055(f) which allows a deduction from the gross estate of the *value of the easement*.

i. *Planning Note*. Lifetime contributions of conservation easements offer several tax advantages over post-mortem easements. First, with a post-mortem easement the estate will not receive an income tax deduction for the grant of the easement. In contrast, a lifetime donor would have the benefit of a charitable income tax deduction during the donor's lifetime. Second, any estate tax deduction taken by the estate under Section 2055(f) will reduce the exclusion under Section 2031(c). There is no similar reduction in the applicable percentage under Section 2031(c) for a deduction taken during the decedent's lifetime under Section 170(h). Also, it is important to note that the estate will still have the benefit of the value reduction at death for a lifetime grant of the easement. Accordingly, it is almost certainly better to grant the easement during the decedent's lifetime due to the additional income tax savings to the donor. A possible exception for consideration is a terminally-ill client, where the marginalized value of the income tax deduction is limited due to the decreased life expectancy of the donor. This is because any carryforward income tax deduction would be lost at the decedent's death. *See Stussy v. Commissioner*, T.C. Memo. 1997-293. In addition, in the case of a terminally-ill client, Virginia income tax credits generated from the donation may be included in the client's gross estate. This is not the case with a post-mortem donation. *See* discussion below.

h. *Coordination with 2032A Special Valuation Rules*. Section 2032A of the Internal Revenue Code provides special valuation rules that allow certain real property used in farming to be valued for estate tax purposes with regard to its use as a farm and not the property's highest and best use.

The existence of a qualified conservation easement does not prevent such property from subsequently qualifying for special-use valuation treatment under Section 2032A. *See* Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1997 (JCS-23-97), December 17, 1997. Accordingly, an estate may claim the benefit of both the exclusion under Section 2031(c) and the special use valuation under Section 2032A. *See id. Also cf.* H.R. Conf. Rep. No. 220 (Statement of Managers), 105th Cong., 1st Sess. 396 (1997) (Section 2057 exclusion applies in addition to Section 2032A and Section 6166). In addition, Section 2032A valuation should be available for conservation easements that do not meet the requirements of Section 2031(c), but otherwise qualify under Section 170(h). *Cf.* I.R.C. § 2032A(c)(8).

i. *Order of Application of 2031(c) and 2032A.* Where Section 2032A special valuation is elected, an unanswered question exists as to in what order Sections 2031(c) or 2032A are applied to the estate assets. *See* Stephens, Maxfield, Lind, Calfee & Smith, FEDERAL ESTATE AND GIFT TAXATION (WG&L, 8th Ed. 2009) at 4.02[7][e][ii]. The better approach may be to apply the valuation provision first and then apply the exclusion provision second. *Id*. The statutes do not explicitly state the impact of Section 2032A on the requirements to qualify for the exclusion. Similarly, the impact of Section 2031(c) on qualification under Section 2032A is not specifically addressed. *Id.*

ii. *Section 2032A Recapture.* The grant of a qualified conservation easement on property subject to an election under Section 2032A will not trigger estate tax recapture. I.R.C. § 2032A(c)(8). Note that this rule applies to the donation of an easement, and may not apply to the sale of an easement such as through a purchase of development rights program. *See Gibbs v. Unites States*, 163 F.3d 242 (3d Cir. 1998) (stating in *dicta* that the enactment of Section 2032A(c)(8) would not have changed the result of the decision that a sale triggered recapture). *But see* I.R.C. § 2032A(c)(8) ("A qualified conservation contribution by gift *or otherwise,* shall not constitute a disposition."). In PLR 200840018 (October 3, 2008), the Service indicated that the phrase "or otherwise" does not necessarily include sales and exchanges for valuable consideration. *Compare* PLR 200608012 (February 24, 2006) (easement granted for water rights did not trigger recapture).

ii. *Discounts Under Section 2032A*. Note that minority interest and marketability discounts may not be used to reduce the special use value determined under Section 2032A. *See* I.R.C. § 2032A(g) and *Estate of Maddox v. Commissioner*, 93 T.C. 228 (1989). *See also* P.L.R. 9119008 January 31, 1991 (same result as *Maddox*). However, for purposes of imposing the maximum Section 2032A(a)(2) reduction in value, a minority discount is allowed in measuring the fair market value of an interest as compared to discounting the special use value. *See Estate of Hoover v. Commissioner*, 69 F.3d 1044 (10th Cir. 1995) and PLR 200448006 (November 26, 2004).

iii. *Planning Notes*. Planning to coordinate the benefits of Sections 2032A and 2031(c) is complex. Under Section 2032A, special use valuation only applies if the property constitutes at least 25% of the gross estate. I.R.C. § 2032A(b)(1). Placing an easement on the property may reduce the proportionate value of the property below the 25% requirement. Such a reduction in the value of the property may also cause a family owned farming business to lose the benefits of Section 6166 regarding the deferred payment of estate taxes. *See* I.R.C. § 6166(a). However, where the client has multiple parcels, some not connected with the farm or business, a lifetime or post-mortem conservation easement on these unrelated parcels may help an estate qualify for Sections 2032A and 6166. Practitioners should run careful calculations to compare the benefits of these provisions under multiple scenarios and applying Sections 2032A and 2031(c) in different orders.

11. *Lifetime Planning for Section 2031(c).* As is seen in the discussion above, Section 2031(c) creates the need for careful planning during the landowner's lifetime to ensure that the increased exclusion amount is available upon the landowner's death.

a. *Husband and Wife*. The exclusion is available to both the estates of a husband and a wife who have the required interest in the land subject to the easement. Accordingly, a couple may be able to exclude up to $1,000,000 from their combined taxable estates. However, careful planning is required here to enable the family to have the benefit of both exclusions. As is the case with bypass trust planning to maximize the use of the applicable exclusion amount, practitioners must pay careful attention to the manner in which the couple holds title to property subject to the easement as well as provisions in the couple's wills and/or trusts.

b. *Formula Clauses In Testamentary Documents*. Attention should focus on formula clauses in testamentary documents to make certain that on the death of the first spouse to die, the distribution of the property to the family does not otherwise waste the Section 2031(c) exclusion by having the property pass to a surviving spouse. This is accomplished through proper titling of the assets prior to death and careful review of fractional or pecuniary formulas in testamentary documents to ensure that the credit shelter trust is funded with both the applicable exclusion amount and the 2031(c) excluded assets. In addition, if "portability" of the first spouse to die's applicable exclusion amount remains the law, credit shelter or bypass trust planning will be required to maximize both of the couple's Section 2031(c) exclusions, unless Congress also makes the Section 2031(c) exclusion portable.

i. *Choice of Formula and Modification.* As with Sections 2032A and 2057, pecuniary formulas should work best with Section 2031(c) planning. However, practitioners should be wary that “true pecuniary” formulas may trigger a capital gain on the funding of the credit shelter trust because of the basis adjustment required under I.R.C. § 1014(a)(4) on account of the easement. *See* Rev. Proc. 64-19, 1964-1 C. B. 682. Assuming drafters are using “fractional share” formulas with generic language to account for changes in the applicable exclusion amount in recent years, such formulas should work as well, and without the capital gain issue presented with a pecuniary formula. Nevertheless, practitioners should devote the required attention on formula clauses for clients intent on taking advantage of Section 2031(c).

ii. *Other Options*. Maximization of the Section 2031(c) exclusion could also be handled post-mortem through a partial QTIP election of a marital trust—a so-called “Clayton QTIP Trust.” *See generally Clayton v. Commissioner*, 976 F. 2d 1486 (5th Cir. 1992). Also, in drafting clauses, it is important to remember that the portion of the land excluded pursuant to I.R.C. § 2031(c) will not be eligible for the marital deduction under I.R.C. § 2056 because that portion of the value of the land was not included in the gross estate of the decedent. *See* I.R.C. § 2056(a) and Treas. Reg. § 20.2056(a)-(2)(b)(1). If the marital share of the estate plan passes outright to the surviving spouse in lieu of a marital trust, and the credit shelter trust funding formula is not modified, the Section 2031(c) exclusion may be wasted. As a “last gasp,” many estate plans contain a provision that any disclaimer of property by the surviving spouse is added to the credit shelter trust. Such a provision could be used, but should not be relied on, to maximize the use of the exclusion by over funding the credit shelter trust. *See also* Treas. Reg. § 25.2518-2(c)(4)(i) (regarding the disclaimer of survivorship interests in jointly held property). However, the donation of a post-mortem easement following the disclaimer could raise issues regarding whether the disclaimer meets the technical requirements of I.R.C. § 2518.

iii. *GST Planning.* Also note that GST planning will be more complex as Section 2031(c) is not available as an exclusion to the GST tax. In drafting wills and trusts, practitioners will need to allow for exempt and non-exempt shares of the credit shelter trust to handle both the GST portion attributable to the applicable exclusion amount and a non-GST portion attributable to the Section 2031(c) exclusion. This would be in addition to any “Reverse QTIP Trust” planning for maximization of the GST exclusion where a client has less of his or her applicable exclusion amount available at death either due to changes in the law or lifetime taxable gifts. It is certain that drafting estate plans where Section 2031(c), Section 2032A and the GST tax are considerations will be challenging for practitioners.

c. *Lifetime Gifting versus 2031(c).* A critically important planning consideration is coordination of a lifetime gifting program with the I.R.C. § 2031(c) exclusion. As noted above, the I.R.C. § 2031(c) exclusion results in a reduction of the estate tax and does not provide any additional exclusion from the federal gift tax. For this reason, practitioners should be careful with lifetime gifting programs to family members of property subject to a conservation easement as such gifts could cause a loss of the I.R.C. § 2031(c) exclusion as well as other adverse income tax consequences. First, gifting property subject to an easement during the decedent's lifetime (which would have otherwise been excluded under Section 2031(c)) may result in the taxation of other non-excluded assets that could have been removed from the gross estate through the gifting program. Second, removal of the property from the gross estate may result in the loss of the basis step-up at death on the gifted property. Practitioners should carefully calculate the loss of step-up in basis (with the I.R.C. § 1014(a)(4) basis offset above) in calculating the benefits of lifetime gifting versus including the property in the gross estate to be sheltered by the exclusion. It is important to remember that the loss of basis step up though a gift is potentially a substantial portion of the fair market value of the entire property, while the loss of basis step up due to the exclusion is only attributable to the excluded portion (the lesser of 40% or $500,000).

d. *Apportionment of Estate Taxes at Death.* Practitioners should also carefully consider the effect of tax apportionment clauses in wills and trusts with respect to the Section 2031(c) exclusion both in terms of which shares should receive the benefit of the tax savings of the exclusion as well as the burden of any potential recapture taxes. *See* Va. Code Ann. §§ 64.2-540 and 64.2-541; *See also* Section 7 of the Revised Uniform Estate Tax Apportionment Act (2003). Presumably, the tax savings should be apportioned to the property subject to the easement, but this could create issues in more complex disposition schemes.

e. *Section 2031(c) for Developers and Conservation Buyers*. For dealers and conservation buyers, Section 2031(c) is a less attractive planning opportunity because of the three-year rule found in I.R.C. § 2031(c)(8)(A)(ii), the debt-financed property rule found in I.R.C. § 2031(c)(4), and perhaps the commercial recreational activity prohibition found in I.R.C. § 2031(c)(8)(B).

f. *Planning Note*. It is of critical importance for the practitioner and the client to understand that the tax consequences and legal rules regarding lifetime donations of conservation easements are much more certain than the tax consequences and legal rules surrounding post-mortem donations. Accordingly, Section 2031(c) planning should occur during the client's lifetime and practitioners should not rely on the post-mortem period for such planning.

C. Charitable Estate Tax Deduction. The availability of the charitable estate tax deductions for a testamentary or a post-mortem easement donation depends greatly on provisions contained in the testamentary documents and on what authority the executor or trustee donates the easement.

1. *Testamentary Donations*. Section 2055(a) provides the value of the taxable estate is reduced by the amount of any transfers to charity. Section 2055(f) provides that a deduction is allowed under section 2055(a) for the transfer of a qualified real property interest, which meets the requirements of section 170(h) (without regard to the conservation purposes requirement of 170(h)(4)(A)). Accordingly, where a decedent donates an easement at death through a will or testamentary trust, the estate is entitled to a charitable estate tax deduction.

2. *Post-Mortem Donations under 2031(c)(9).* Section 2031(c)(9) provides that the charitable estate tax deduction under Section 2055(f) shall be allowed to the estate for post-mortem easement donations (unless some other person claimed the charitable deduction). *Compare* I.R.C. § 2031(c)(9) and Treas. Reg. § 20.2055-2(b)(2), Example (2).

3. *Other Post-Mortem Donations By Executor or Trustee.* The estate will not be entitled to a post-mortem charitable estate tax deduction for the donation of an easement by an executor or trustee where such easement is not donated for purposes of Section 2031(c) and the donation is not provided for in the will or trust. If the will or trust does not provide for the specific grant of the easement, the estate tax charitable deduction is not available. *See Estate of Lockett v. Commissioner*, T.C. Memo. 1998-50. (estate not entitled to estate tax deduction for gift of land, because gift was not authorized in the will and trust) and *Estate of Marine v. Commissioner*, 97 T.C. 368 (1991) *aff'd.* 990 F.2d 136 (4th Cir. 1993) (estate not entitled to charitable contributions because amount of bequests could not be ascertained at time of death). The mere authority in the testamentary document to make a donation is not sufficient to support a charitable deduction to the estate. *See Taylor v. Commissioner*, 40 B. T. A. 375 (1939). As discussed above, an income tax deduction is also not available. *Crestar Bank v. Commissioner*, 47 F. Supp. 2d 670 (E.D. Va. 1999). As discussed immediately below, Section 64.2-108 of the Code of Virginia only allows easement donations for purposes of taking advantage of I.R.C. § 2031(c). *See* Va. Code Ann. § 58.1-512(C)(2). If Section 2031(c) and 2055(f) are not available, the beneficiaries should consider a post-administration easement in order to take advantage of the charitable income tax deduction.

4. *State Authority to Grant Post-Mortem Easement.* In the absence of an actual grant of an easement in the will or trust of the decedent or specific direction to the executor or trustee, Section 64.2-108 of the Code of Virginia grants personal representatives and trustees the power to donate a conservation easement on any real property of their decedents and settlors in order to take advantage of the benefit of the estate tax exclusion under Section 2031(c) of the Internal Revenue Code. Section 64.2-108 further requires that the fiduciary have the written consent of all of the heirs, beneficiaries and devisees whose interests may be affected thereby. It is

interesting to compare the consent requirement of Section 64.2-108 with I.R.C. §§ 2031(c)(2) and (6), which requires only the executor to make the election. Further, Section 64.2-108 of the Code of Virginia allows only easement donations for purposes of taking advantage of I.R.C. § 2031(c). Therefore, it may be important to provide additional fiduciary powers and disposition provisions for the executor or trustee regarding the donation of the easement to allow inter vivos or post-mortem easement donations that may or may not comply with I.R.C. § 2031(c). Also note that Section 64.2-108 was amended in S.B. 907 (March 27, 2009) to clarify that the power granted to the executor or trustee included the power to grant open-space easements.

D. Other Considerations of Post-Mortem Easements. In addition to the benefits of I.R.C. § 2031(c), easements granted at death and post-mortem conservation easements create multiple planning opportunities for the decedent, the estate and the beneficiaries. As stated above, the estate or the beneficiaries may want to donate a post-mortem easement irrespective of qualification for the Section 2031(c) exclusion. Such a case would exist where the easement would not meet the more technical requirements of Section 2031(c) but would provide the estate or the beneficiaries with other significant benefits. Such benefits include: (1) estate tax reduction; (2) a charitable estate tax deduction; (3) liquidity planning through the sale of land preservation tax credits; (4) potential income tax deductions for the beneficiaries (for donations by the beneficiaries after administration of the estate); and (5) attainting family land succession goals through the easement.

1. *Post-Administration Easements*. An estate situation may simply be too complex to allow for a post-mortem donation or amendment to the easement. Nevertheless, the beneficiaries should consider a new donation or an amendment to an existing easement after the administration of the estate to generate the other income tax benefits available to donors. *See Strasburg v. Commissioner*, T.C. Memo. 2000-94 (concerning valuation of an amended easement). This would be helpful to the ultimate beneficiaries of the property where the Section 2031(c) exclusion and 2055(f) deduction are not available or unwanted.

2. *Tax Credits*. It is critical in planning for a post-mortem donation to be aware that, absent planning to the contrary, the Commonwealth will issue any tax credits generated as a result of the donation directly to the beneficiaries of the estate. *See* Ruling of the Commissioner, P.D. 08-66 (May 19, 2008), and discussion below. This creates another planning opportunity (particularly for a terminally-ill client or a wealthy client) as the tax credits (or the proceeds from the sale of those credits) will not be included in the taxable estate of the deceased client.

VI. Estate and Gift Tax Considerations with Virginia Land Preservation Tax Credits

A. Gift Tax Considerations On Transfer of the Tax Credit. The transfer of tax credits to another person for less than adequate consideration would be considered a transfer of property by gift or by bargain sale. *Tempel v. Commissioner*, 136 T.C. No. 15 (2011) *aff'd*. 744 F.3d 648 (10th Cir. 2014) (transferrable tax credits are capital assets); *Cf.* Chief Counsel Advisory 200238041 (July 24, 2002) (tax credit may be construed as a property right) and I.R.C. §§ 2501 and 2512. *See also* PLR 9612009 (December 18, 1995) (holding that mitigation credits are like-kind property for purpose of Section 1031). Section 25.2511-1(c) of the Treasury Regulations defines the term "gift" broadly as "any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed."

1. *Interest in Property*. A transferable Virginia state income tax credit is properly treated as property for federal gift tax purposes because it has an exchangeable value. The Congressional Committee Reports accompanying the 1932 Act made it clear that an expansive definition of the term "gift" was intended when the gift tax was initially enacted. The Reports provide that the term "property" is used in the "broadest and most comprehensive sense" to reach "every species of right or interest protected by law and having an exchangeable value" and that the term "transfer … by gift" encompasses all transactions (except those specifically excepted) by which "property or a property right is donatively passed to or conferred upon another, regardless of the means or the device employed in its accomplishment." H. Rep. No. 708, 72d Cong., 1st Sess. 27 (1932); S. Rep. No. 665, 72d Cong., 1st Sess. (1932), 1939-1 C.B. (Part 2) 476, 524. Another alternative approach would be to treat the gratuitous transfer of the tax credit as a payment of donee's taxes by a gift of the donor. In addition to the taxable gift issue, there are also concerns here with the assignment of income doctrine particularly if excess credit is being gifted that may be later sold by the donee. *See Helvering v. Horst,* 311 U.S. 112 (1946) and *Rohmer v. Commissioner*, 21 T.C. 1099 (1954).

2. *Annual Exclusion*. If a gift of tax credit is made, a question arises as to whether the gift is a "present interest in property" for purposes of the annual exclusion. The annual exclusion provided in Section 2503(b) of the Internal Revenue Code does not apply to future interests in property. Section 25.2503-3 of the Treasury Regulations states that the term "future interest" includes reversions, remainders, and all other interests in property that are limited to commence in use, possession, or enjoyment at some future date or time. The question arises that since the donee may be unable to use the tax credit immediately, does the tax credit represent a future interest? In *Fondren v. Commissioner*, 324 U.S. 18 (1945), the Supreme Court stated:

> "[I]t is not enough to bring the [annual] exclusion into force that the donee has vested rights. In addition he must have the right presently to use, possess or enjoy the property. These terms are not words of art … but connote the right to a *substantial present economic benefit*. The question is of time, not when title vests, but when enjoyment begins. Whatever puts the barrier of a substantial period between the will of the beneficiary or donee now to enjoy what has been given him and that enjoyment makes the gift one of a future interest …"
>
> Emphasis added.
>
> *Fondren*, 324 U.S. at 20.

Because the tax credit would be immediately marketable by the donee, the transfer should qualify for the annual gift tax exclusion. *Cf.* TAM 9346003 (August 9, 1993) (gift of stock was a present interest because donee could sell the stock). Reliance solely on the use of the tax credit to offset the donee's state income tax liability as a "substantial present economic benefit" would be troublesome. *See Jardell Est. v. Commissioner.*, 24 T.C. 652 (1955) (gift of royalty interest commencing three months after date of gift was a future interest); *Braddock v. United States*, 369 F. Supp 925 (DC FL 1973) (gift of real estate with lease that expired in three months was a gift of a future interest); and *Fisher v. United States*, Docket No. 1:08-cv-00908 (SD Ind. March 11. 2010) (gifts of partnership interests subject to restrictions were gifts of future interests).

3. *Unintended Gifts.* Allocation of tax credits resulting from the donation of an easement among tenants in common, partners and LLC members, and estate or trust beneficiaries that are disproportionate to the ownership percentages of the partners or beneficiaries, would give rise to potential taxable gifts. *Cf. Shepherd v. Commissioner*, 115 T.C. 376 (2000) (opinion contains a good discussion of indirect gifts through business entities). *See also* Treas. Reg. §§ 1.704-1(b)(1)(iv) and 1.704-1(b)(5), Example (14)(iv) (alerting of potential disguised gifts among partners who fail to properly maintain capital accounts) and Rev. Rul. 69-486, 1969-2 C. B. 159 (disproportionate distributions from trust treated as exchange).

4. *Basis*. Assuming that the donor of the tax credit was the donor of the easement generating the tax credit, the donee would have no basis in the gifted tax credit. I.R.C. § 1015. If the donor had purchased the credit, the donee's basis would be the transferred cost basis from the donor. I.R.C. § 1015.

5. *Valuation.* The appropriate measure of the value of the credit is presumably the current sales price for the credit (under the willing buyer/willing seller standard) rather than the face amount of the tax credit. *See* Treas. Reg. § 25.2512-1 and Rev. Rul. 59-60, 1959-1 C.B. 23. The fact that the donee and the donor are related should not be relevant for valuation purposes. *Cf.* Rev. Rul. 93-12, 1993-1 C.B. 202 (no attribution rules for gifts of stock to family members). However, sales of tax credit between unrelated individuals contain representations, warranties, and indemnification provisions in the contract of sale that will not be present in a gratuitous transfer. Accordingly, it could be argued that the gift tax value is less than the current sales price for the tax credit. *Cf. Estate of Newhouse v. Commissioner*, 94 T.C. 193 (1990) (costs of potential litigation related to closely-held stock a factor in valuation for estate tax purposes).

6. *Gain on Use of Credit By Donee.* Since the donee of the credit would have no basis in the credit, the donee would recognize income on the use of the credit on the donee's personal income tax return, but would also have a corresponding income tax deduction. *See* Chief Counsel Advisory 200238041 (July 24, 2002), Chief Counsel Advisory 200704028 (January 26, 2007), and Chief Counsel Advisory 200704030 (January 26, 2007). However, there will be no Virginia income tax

consequences to the donee on the application of the credit. Va. Code Ann. § 58.1-513(E).

7. *Planning Notes.* For the reasons outlined above, it is arguable that gifts of tax credit should be avoided for a variety of reasons. First, such gifts may not qualify for the annual exclusion. Second, valuation issues exist regarding the gift tax value of the tax credit. Third, the donee will receive a carry over basis (zero) in the credit and will have gain on application of the credit to satisfy the donee's state income tax liability.

B. Estate Considerations with the Tax Credit. The Department of Taxation has issued two rulings regarding estate considerations with the Virginia land preservation tax credit. Both of these rulings raise significant issues for practitioners and create other unresolved issues not addressed in the rulings.

1. *Death of Seller.* If the donor dies before using or transferring the tax credit, any remaining tax credit after the year of death is extinguished. Rulings of the Tax Commissioner, P.D. 05-170 (December 5, 2005) and P.D. 11-20 (February 18, 2011). These Rulings opined that extinguishment of the credits was necessary because Section 58.1-513(C) of the Code of Virginia requires lifetime acts of the credit holder in order to transfer the tax credit. This was the case despite the fact that one of the decedents was survived by his spouse. The requirement for lifetime acts is not readily apparent from a review of the statute. This raises the question of whether the tax credit is a property right or a tax attribute. While the Service leans toward property right treatment with regard to the transfer of the tax credit, the Department apparently views the tax credit as a transferable state income tax attribute. *Compare* Chief Counsel Advisory 200238041 (July 24, 2002) and Ruling of the Tax Commissioner, P.D. 04-119 (September 15, 2004); and Virginia Attorney General's Opinion, P.D. 02-094 (November 19, 2002). *See also* PLR 9612009 (December 18, 1995) (holding that mitigation credits are like-kind property for purpose of Section 1031).

2. *Death of Buyer.* The same reasoning found in the rulings above would also apply to a purchaser with excess tax credit—that Section 58.1-513 of the Code of Virginia requires "lifetime acts on the part of the taxpayer who desires to transfer the credit." Although the Tax Commissioner has not ruled on this issue, a finding that purchased credits expire at the purchaser's death would also be supported by the various rulings that indicate that the credit attributes of the original owner carry over to any subsequent transferee. *See* Ruling of the Tax Commissioner, P.D. 04-119 (September 15, 2004); and Virginia Attorney General's Opinion, P.D. 02-094 (November 19, 2002). However, since the decedent-purchaser would be able to use any tax credit on the final state income tax return, this risk is limited for the purchaser.

3. *Federal Estate Tax Inclusion.* Because of Rulings P.D. 05-170 (December 5, 2005) and P.D. 11-20 (February 18, 2011), the value of any extinguished carryforward tax credit should not be included in the gross taxable

estate of the decedent. *Cf. Estate of Moss v. Commissioner*, 74 T.C. 1239 (1980) *acq.* 1981-1 C.B. 2 (promissory note that cancelled at death not included in estate); *Williams v. United States*, 41 F.2d 895 (Ct. Cl. 1930) (life estate that ended at death not included in estate). *See also Morgan v. Commissioner*, 309 U.S. 78 (1940) (state law determines what property rights exist, federal law determines whether they are taxed). However, the amount of the tax credit that is available for use on the decedent's final Virginia state income tax return could arguably be includible in the decedent's gross estate. *Cf. Estate of Miller. v. Commissioner*, 58 T.C. 699 (1972), *acq.,* 1973-2 C.B. 3. (tax refunds due a decedent but not yet received as of the date of death are includible in the gross estate). *See also* Treas. Reg. § 20.2053-6(f) and I.R.C. §§ 691(b) and (c). Further, if the donor transfers the tax credit to an entity controlled by the donor prior to death, the value of any interest in such entity would be included in the decedent's gross estate under I.R.C. § 2033.

4. *Transfer to a Controlled Entity*. The issues presented in Rulings P.D. 05-170 and P.D. 11-20 may be avoided through a transfer of the tax credit to another taxable entity controlled by the landowner—one that will survive the death of the landowner. *See* Virginia Attorney General's Opinion, P.D. 02-094 (November 19, 2002). *See also* Rulings of the Tax Commissioner, P.D. 05-125 (July 26, 2005) (non-profit is a taxpayer for state tax credit purposes because it is subject to retail sales and use tax and employment tax) and P.D. 07-82 (May 25, 2007) (LLC disregarded for federal tax purposes may still be subject to retail sales and use tax and is a taxpayer for state tax credit purposes).

a. *Disregarded Entities.* Transfer of the tax credit to a revocable trust or single-member limited liability company owned by the landowner may or may not be effective as those entities are generally disregarded for federal income tax purposes as separate taxpayers. However, support for the effectiveness of a transfer of tax credit to a disregarded entity may be found in Ruling of the Tax Commissioner, P.D. 07-82 (May 25, 2007). In that ruling, the Tax Commissioner ruled that, despite fact that a partnership is disregarded for federal tax purposes, the partnership is still regarded as a valid entity for state tax purposes for transfer of the Virginia historic rehabilitation tax credit. This follows the broad interpretation of the word "taxpayer" adopted in the Attorney General's Opinion and in later rulings by the Tax Commissioner. *See* Virginia Attorney General's Opinion, P.D. 02-094 (November 19, 2002) and Rulings of the Tax Commissioner, P.D. 05-125 (July 26, 2005) and P.D. 07-82 (May 25, 2007). More specifically, the Tax Commissioner stated as follows: "for example, a single-member limited liability company may be disregarded for federal income tax purposes and its income attributed to the member, but transactions between the LLC and its member would still be subject to the retail sales and use tax. See Public Document 98-157 (10/20/98)." However, the ruling cited by the Tax Commissioner concerns retail sales and use taxes and cited as support yet another ruling—Public Document 97-343 (August 28, 1997). In the citation, the Tax Commissioner stated as follows:

> "Public Document 97-343 (August 28, 1997), concerns a taxpayer forming a single member LLC which elects not to be treated as a separate entity for federal income tax purposes under Treasury Regulations Sec. 301.7701-1 et seq. ("check the box" regulations). In that determination, the department reiterated its conformity to the Internal Revenue Code in computing Virginia taxable income. Accordingly, if a single member LLC or a QSSS is disregarded as a separate taxable entity for federal income tax purposes, it will be disregarded as a separate taxable entity for *Virginia income tax purposes*."

Emphasis added. This ruling would appear to support a contrary result in the case of the use of a single member LLC to hold Virginia tax credits.

b. *Planning Note.* Practitioners relying on disregarded entities to avoid loss of the credit upon the death of the donor should obtain a ruling from the Tax Commissioner. In the alternative, partnerships or multiple member LLCs with the spouse or family members should avoid the issue as such entities will not be disregarded entities. In addition, an election out of subchapter K may be available under I.R.C. § 761(a) to avoid the necessity of filing a federal partnership return. Note that the "qualified joint venture" election under I.R.C. § 761(f) is most likely not available as that provision requires the conduct of an active trade or business. A last alternative would be reliance on Rev. Proc. 84-35, 1984-1 C.B. 509, where the Service has stated that it will not impose a penalty under I.R.C. § 6698 for failure to file a partnership return where a partnership of individual partners otherwise report income, deductions etc. pro rata on their individual returns.

5. *Tax Credit on Post-Mortem Donations*. The Tax Commissioner has ruled that the beneficiaries, not the estate, will receive the Virginia income tax credits on a post-mortem donation. Ruling of the Tax Commissioner, P.D. 08-66 (May 19, 2008), involved a post-mortem conservation easement donated by the executor of an estate pursuant to the authority granted under Section 64.2-108 of the Code of Virginia. There was only one beneficiary of the estate who consented to the easement. The question in the ruling was whether the estate or the beneficiary received the Virginia income tax credits. The Tax Commissioner found that Section 58.1-512 of the Code of Virginia provides that the credits are to be granted to the "landowner." Virginia has an unusual rule that upon the death of a decedent holding real property in Virginia, title to real property vests at the moment of death in the beneficiaries named in the will, or if there is no will, in the beneficiaries under Virginia's intestate succession statute. Accordingly, while the executor may have had the power of sale, and the power to convey the easement, the beneficiary of the estate was considered the landowner for purposes of Section 58.1-512 of the Code of Virginia. The Tax Commissioner also cited as support TAM 8003013 (October 10, 1979) (holding that, because of Virginia law, the beneficiary was the proper party to

report the capital gain realized on the sale of real estate by the executor). There is a potential flaw in the reasoning of P.D. 08-66 and TAM 8003013. The Tax Commissioner reasoned in P.D. 08-66 that "the personal representative has no interest in land devised to others *unless he exercises his power to sell*. I construe the power granted by Va. Code § 64.2-108 to be analogous to a power to sell real estate." Emphasis added. The Tax Commissioner went on further to quote the following excerpt from the reasoning of TAM 8003013: "[i]f the administrator has only a naked power to sell, title vests in the heir, *subject to be divested by the execution of the power of administrator*." Emphasis added. Did not the executor divest the beneficiary of title (or at least a portion) by the grant of the easement? Also, the credits are granted based on the gratuitous transfer of a property right—the easement, and not on the residual parcel. Nevertheless, the answer is probably that the grant of the easement did not divest the beneficiary of title on the residue so that the beneficiary is still the landowner for purposes of Section 58.1-512 of the Code of Virginia.

a. *Planning Note.* Loss of the tax credit (or the sales proceeds thereof) may be detrimental to the estate as the funds generated by the easement will not be available to the trustee or executor to pay debts and expenses of the estate, or to satisfy specific bequests. If the donor intends that a post-mortem easement be granted in order to generate funds for the estate, the donor should direct that the easement be specifically donated in the will or trust. If the proceeds from the sale of tax credits are needed to pay debts of the estate, perhaps the executor could petition the court for power of sale over the real estate and divest the beneficiaries of title. *See* Va. Code Ann. §§ 64.2-106 and 64.2-532.

b. *Planning Note for Terminally Ill Clients.* In planning for a terminally ill client or a client with a shorter life expectancy, post-mortem donations may yield greater benefits than a lifetime donation. Since the donor may have little or no benefit from the charitable income tax deduction during lifetime, the Section 2055(f) deduction to the estate may offer more tax savings. In addition, the tax credit from a lifetime donation would be included in the gross estate of the donor (with proper planning). However, on a post-mortem donation the tax credits would not be included in the gross estate of the donor, offering additional estate tax leverage.