



Conservation Easement Overview



An Overview

Conservation easements are one of the most powerful, effective tools available for the permanent conservation of private lands in the United States.

The use of conservation easements has successfully protected millions of acres of wildlife habitat and open space, keeping land in private hands and generating significant public and individual benefits.

This monograph provides basic information about conservation easements and an understanding of what a conservation easement is and how it can be useful to landowners and taxpayers. Points covered include:

- The history, purpose and public benefits of conservation easements.
- The technical requirements that must be satisfied before a land owner will be entitled to a federal tax deduction for the contribution of a conservation easement.
- Valuation of conservation easements, which determines the amount of any deduction.
- Issues related to ownership of easement property through entities taxed as partnerships.

History, Purpose and Public Benefits of Conservation Easements

Congress determined years ago that it was in the country's best interest to preserve land of ecological or historic importance in a manner that protects or preserves conservation values identified by Congress as being important. To accomplish this goal, Congress provided substantial tax benefits for those who voluntarily restrict their property in a manner which preserves these conservation values on their property in perpetuity. These restrictions are commonly known as conservation easements. The income tax benefits provided by Congress for these restrictions are found in section 170(a) and (h) of the Internal Revenue Code. Estate tax benefits are found in sections 2031(c) and 2055(f) of the Code. Many states have also enacted tax benefits for donating landowners, usually in the form of a credit.

What is a Conservation Easement?

A conservation easement is a voluntary, legally binding agreement that limits certain types of uses or prevents development from taking place on a piece of property now and in the future, while protecting the property's ecological or open-space values.

Conservation easements offer great flexibility. An easement on property containing rare wildlife habitat might prohibit any development, for example, while an easement on a farm might allow continued farming and the addition of agricultural structures. An easement may apply to all or a portion of the property, and need not require public access.

In more specific terms, a conservation easement (also called a conservation restriction or restrictive covenant) is a legal conveyance between a landowner and a third party whose role is to monitor the easement and enforce it if necessary. This third party must be a governmental entity or, more commonly, a special kind of tax-exempt Section 501(c)(3) organization known as a "land trust." Land trusts are viewed by the conservation community and Congress as the "gate keepers" for conservation easements. Land trusts accept easements on property with appropriate conservation values, and they monitor and enforce the legal restrictions on the property permanently. The landowner will continue to own the land and may use the land for various purposes that do not impair the conservation values of the property. The landowner may also sell the land or pass it on to heirs. However, the conservation easement must give the land trust the right and power to permanently restrict the uses of the land to those uses allowed by the easement.

What is a Conservation Easement?

Conservation easements can contain a variety of restrictions and permissible uses. For example:

- An easement might apply to all or to only a portion of a landowner's property.
- It might allow recreational uses, such as hunting, fishing and water sports.
- It can, but need not (in most cases), allow public access to the eased property.
- Landowners sometimes reserve sites on the easement on which to build homes and other structures.

Conversely, conservation easements necessarily place limitations on some uses of the property. For example:

- A conservation easement typically prohibits any intense development of the property for residential or commercial uses.
- Particular conservation values associated with the property must be perpetually protected; for example, significant wildlife or plant habitat, streams and lakes, or in some cases a scenic vista.
- Lenders may be unwilling to loan funds secured by restricted property, and existing mortgages must be subordinated to the conservation easement.

Tax Benefits

Potential Tax Benefits for Donation of Conservation Easements

To encourage the permanent preservation of land with significant conservation values, Congress has provided substantial tax benefits to landowners donating qualifying conservation easements. The primary incentive to this conservation is an income tax deduction under Section 170(a) and (h) of the Internal Revenue Code. A landowner who donates a “qualified” conservation easement to a qualified governmental entity or land trust, and who satisfies the technical requirements of the regulations issued under section 170, is eligible for a federal income tax deduction equal to the value of the donated easement. However, the value of restrictions placed on real property is a difficult question. In practice, the value of a conservation easement donation is generally measured by the difference between the fair market value of the property before the easement takes effect and the fair market value after the easement takes effect.

Other potential tax benefits to donors of qualifying conservation easements include an estate tax deduction for donations made at the time of death (section 2055(f)) and an estate tax exclusion for eased property included in a decedent’s estate (section 2031(c)).

Tax Benefits

Technical Requirements for Income Tax Benefits

To qualify for the income tax deduction under Section 170, a conservation easement must meet several requirements:

1. The easement must be perpetual.

In order to be eligible for an income tax deduction, the donation must be perpetual. This means that the conservation restrictions will be recorded and will forever prohibit the uses of the property described in the easement. The perpetuity requirement manifests itself in various ways, and the scope of this requirement is only partly explained in the regulations. The scope of the perpetuity requirement is a common source of controversy and litigation in the courts.

It is clear that Congress intended that conservation easements perpetually encumber the land on which the easement is granted. For this reason, any outstanding mortgages, liens, encumbrances or other rights of third parties must be subordinated to the rights of the land trust to enforce the conservation easement restrictions. The subordination must be obtained and be effective before the easement is granted. Also, if the eased property were to be condemned, the land trust must receive a proportionate share of the proceeds from condemnation. There are unsettled questions about the impact on perpetuity of such things as amendment or modification of an easement.

2. The easement must be held by a qualified governmental or non-profit organization.

A conservation easement must be donated to a qualified governmental entity or to a qualified tax-exempt organization. Tax-exempt donee organizations are generally referred to as “land trusts,” and they must be a tax-exempt entity that is qualified to receive tax-deductible contributions. It was the intent of Congress to have land trusts function as the regulators of conservation easements. A land trust will monitor conservation easement property periodically to assure that the property is in compliance with the terms of the conservation easement and that the conservation values of the property are being preserved. If a land owner violates the terms of a conservation easement, the land trust must be willing and able to take appropriate enforcement actions that are available under the law.

Tax Benefits

3. The easement must serve a valid “conservation purpose,” meaning the property must have a significant ecological, scenic, historic, scientific, recreational, or open space value.

Congress has specified certain types of property that it wishes to be preserved, and these qualities are enumerated in the Internal Revenue Code and are further defined in the Treasury Regulations. The four conservation values that Congress has allowed as a basis for a deduction are:

- preservation of land areas for outdoor recreation by, or education of, the general public;
- protection of a significant, relatively natural habitat of fish, wildlife, or plants, or similar ecosystem;
- preservation of open space, including farmland and forest land, for the scenic enjoyment of the general public, or preservation of open space pursuant to a clearly defined governmental conservation policy, provided such preservation will yield a significant public benefit; and
- preservation of an historically important land area or certified historic structure.

The conservation easement must secure one, but only one, of these four types of preservation values. If land is suitable for such a purpose, the donor and the land trust must agree on, and implement, a set of restrictions which will preserve the identified characteristics of the property in perpetuity. These restrictions become the core of the conservation easement document, together with specified uses reserved to the landowner.

4. The easement donation must be substantiated and reported in specific ways.

An appraisal of the value of the donated conservation easement must be obtained within a certain time period and must be performed by a qualified appraiser whose work satisfies standards set out in the Treasury Regulations, as discussed more fully below. The landowner must obtain a written acknowledgment from the land trust prior to filing his tax return that confirms the donation and that makes certain certifications required by the Regulations. A document called the baseline documentation must be obtained which details the condition of the property and the conservation values associated with it. The fundamental documentation of the conservation easement must be carefully drawn, and the execution and recording of the documents must be done in the proper time and manner. In addition, the donor’s tax return must include a form that is signed by the appraiser and by the land trust and that sets out certain information about the donation and the donated property.

The Income Tax Deduction

The execution of a conservation easement which complies with these rules is considered by the Federal government to be a charitable contribution.

As a result of legislation signed by President George W. Bush on August 17, 2006 (the Pension Protection Act of 2006), conservation easement donors in 2006 and 2007 were able to deduct the value of their easement donation in an amount up to 50% of their adjusted gross income (AGI) per year.

Further, landowners with 50% or more of their income from agriculture were able to deduct the donation in an amount up to 100% of their AGI. Any amount of the donation remaining after the first year could be carried forward for 15 additional years (allowing a maximum of 16 years within which the deduction could be utilized), or until the amount of the deduction has been fully used, whichever comes first. With the passage of the Farm Bill in the summer of 2008 these expanded federal income tax incentives were extended to apply to all conservation easements donated in 2008 and 2009.

This provision was extended additional times and most recently was extended to donations made through 2014. While the enhanced deduction limitation expired at the end of 2014, it is anticipated that the enhanced incentive will be addressed again and may be further extended if not made permanent. These limitations are complex and specific to each taxpayer, so anyone considering a conservation easement donation should consult with a tax advisor prior to pursuing the conservation easement donation.

In the absence of an extension of the enhanced limits of the Pension Protection Act, the standard limitations on charitable contribution deductions will become applicable to conservation easement donations. In general, these standard limitations would allow current deduction of donations up to 30% of AGI (vs. 50% under current law), and carryovers of unused deductions would expire after 5 years (vs. 15 years under current law).

Valuing a Conservation Easement

The amount of the charitable deduction available for a donation of property is the fair market value of the property donated.

In the case of a conservation easement, however, the donation involves a landowner placing restrictions on land he will still own after the donation. The land trust receives the right to enforce the restrictions. The value of these rights and restrictions would be difficult to appraise under normal appraisal methods. In some cases, there are actual sales and purchases of conservation easements that can be compared to the donated easement. In these cases, a standard appraisal method can be employed based upon the comparable sales. However, in most cases, such “comparable sales” of easements either do not exist or they are insufficient to perform a valid appraisal.

When there is no substantial record of marketplace sales of comparable easement rights, the Treasury Regulations provide that the fair market value of the conservation easement is deemed to be the difference between the fair market value of the property the easement encumbers immediately before granting the easement (the “Before Value”) and the fair market value of the encumbered property after granting the easement (the “After Value”). Under Section 1.170A-14(h)(3)(ii), this “before-and-after” valuation must take into account the “highest and best” use of the property in question, based upon an objective assessment of how immediate or remote the likelihood is that such property, absent the restriction, would in fact be put to that use – for example as with a residential development. The analysis must also realistically take into account the impact of zoning laws, conservation or historic preservation laws, and other issues related to feasibility of the property’s potential highest and best use. The following example illustrates a before-and-after valuation scenario.

Valuing a Conservation Easement

Mr. Jones owns 100 acres of ecologically important, undeveloped land. It is feasible and reasonably probable that Mr. Jones could develop the land into a residential community, and, if so, with the fair market value of the land at its highest and best use being \$10 million. However, Mr. Jones wants to donate to Land Trust a conservation easement over the land, which will eliminate in perpetuity his right to develop the land. A qualified appraiser determines that the value of the land after the restrictions are in place (thus eliminating any development potential) is only \$1 million. Assuming Mr. Jones meets all of the technical requirements applicable to conservation easement donations, Mr. Jones will be entitled to a \$9 million deduction.

If the amount claimed or reported as a charitable contribution deduction exceeds \$5,000, the deduction must be substantiated by a “qualified appraisal” performed by a “qualified appraiser” under Section 1.170A-13(c) of the Regulations. This is often a complicated and relatively expensive process which requires an appraiser with special skills and experience. As a result of this complexity and of the inherent subjectivity of property appraisal, tax controversies involving conservation easements must often sort out valuation concerns and issues.

Other Tax Benefits of Conservation Easements

There are other benefits beyond the federal income tax deduction that are available for conservation easement donations. Two of the more important benefits are discussed below.

Reducing Estate Taxes

A conservation easement can facilitate passing undeveloped land on to the next generation. By removing the land's development potential, the easement typically lowers the property's fair market value, which in turn lowers the potential estate tax. Whether the easement is donated during life or by will, it may make a critical difference to the heirs' ability to keep the land intact. The existence of a conservation easement will reduce any estate tax liability, making a sale of the property to raise tax funds less likely. In addition, the absence of development potential may make it more likely that the property will stay in the family, and in its current use, for future generations.

Another incentive for conservation easement donations is an estate tax exclusion of up to 40% of the restricted value (the "after value") of land protected by a conservation easement. That exclusion is capped at \$500,000 and is further reduced in cases where the easement reduces a property's value by less than 30%.

Other Tax Benefits of Conservation Easements

State Tax Benefits

In 1983, North Carolina became the first state to establish a state income tax program which provides donors of qualified conservation easements with credits that can be used to pay state income tax. In 1999, four state legislatures enacted state tax credit programs (Virginia, Delaware, Colorado, and Connecticut). South Carolina and California followed in 2000. Several other states, including Georgia, have followed since.

For landowners with little income subject to state taxation, a tax credit can be of little benefit. In response to this problem, Colorado in 2000 made their state tax credit transferable — that is, the donor/landowner can sell her/his credit to other parties; the buyers can then use the purchased tax credit to pay their Colorado income tax. Virginia followed by enacting transferability in 2002. Other states, including Georgia, have followed since. However, the amount of credit an easement can generate is often capped, and other restrictions limit the scope of the state tax credit programs in various ways.

In the states where the credit for conservation land donations is transferable, free markets for such credits have formed. Brokers assist landowners with excess credits to identify buyers. The brokers often handle payments and paperwork to protect the principals and to ensure that transfers are fully reported to the state tax authorities.

Conservation Easements & Real Estate Partnerships

The use of partnership structures can allow, under the right circumstances, the maximum use of tax benefits attributable to a conservation easement donation. This results in allowing preservation of land that might not otherwise be protected.

Many landowners are not able to take advantage of a deduction for a conservation easement on their property because they lack sufficient income. However, there are high-income taxpayers willing to invest in land owning entities if they can receive the benefit of a conservation easement deduction. This matching of interests allows preservation of the land on terms satisfactory to all and increases the amount of land preserved by fully utilizing the tax incentives of section 170(h).

For example, this may occur if, after the investment is made by the high-income taxpayer, the entity chooses to donate a conservation easement on the property and forego other options available to it. The charitable deduction resulting from the conservation easement would then be allocated to the current owners of the land owning entity, which would include the high-income investor. Thus, the tax incentive for conservation easements found in Section 170(h) will achieve its purpose by encouraging the donation of a conservation easement on property and by protecting the conservation values Congress wants to preserve in perpetuity for future generations.

Conservation Easements & Real Estate Partnerships

These transactions can be complex, but they are designed to allow the tax incentives of Section 170(h) to be used as Congress originally intended. Below is an example of how this works.

Assume that Mr. Jones (from the example above) owns the property with his son, Casey, in a partnership, and assume that Mr. Jones and Casey each have an annual adjusted gross income of only \$50,000. If Mr. Jones and Casey were to donate a conservation easement over their property, they would likely be unable to fully utilize the \$9 million deduction attributable to an easement donation because of the deduction limitations discussed above (Mr. Jones and Casey would each be limited to deducting \$25,000 of the \$9 million deduction in the year of donation, and roughly the same amount for each carryover year afterward). However, if Mr. Jones and Casey admitted other high-income investors into their partnership by selling them LLC interests, and the partnership subsequently elected to donate an easement over the property, the investors would be able to share in the deduction. Thus, the partnership structure, and the admission of additional partners, can enable the tax benefits attributable to a conservation easement donation to be fully utilized.

Conclusion

Risks

Despite Congress's clear intent to promote easement transactions, the IRS has been active in attempting to weed out what they perceive as "bad" easements.

Unfortunately, these efforts by the IRS to locate and disallow bad easements has resulted in many good easements being examined with deductions often being disallowed due to a technical problem, inaccurate paperwork, or simple disagreement over valuation issues. The risk of audit is the primary risk in taking one of these approaches. The courts have often drawn hard lines on certain technical issues, so it is more important than ever to make sure easement transactions are carefully scrutinized by competent and experienced tax counsel – and that all of the many procedural and technical requirements are satisfied.

Conclusion

Conservation easements can provide land owners and potential real estate investors with significant tax and non-tax benefits.

Congress has repeatedly expressed its desire for the preservation of private property for public benefit by enacting Section 170(h) of the Code and by repeatedly expanding or extending the tax benefits available for conservation easement donations. By participating in either a conservation easement or a conservation partnership, land owners can enjoy the economic benefits afforded under the U.S. tax code while facilitating the preservation of environmentally sensitive lands for current and future generations.



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Published Treatise & Social Media

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Articles

Co-author, *Circuit Courts Speak on Conservation Easements, But is the IRS Listening?*, **Taxation of Exempts**, January 2013

Proving the Value of a Charitable Donation May Be the Least of Your Problems, **Journal of Taxation**, August 2011

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Simmons—Substantial Compliance Revisited, **Tax Notes**, Jan 2010

A Guide to Donating Conservation Easements Substantiating Their Value, Valuation Strategies, May/June 2010 Edition

Reasonable Compensation and the Built-in Gains Tax, presented at the **68th New York University Institute on Federal Taxation**, 2010

Real Estate Dealer vs. Investor: Maximizing Capital Gains, presented at the **67th New York University Institute on Federal Taxation**, 2009

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Operating as an S Corporation Through a State Law Limited Liability Company, presented at the **66th New York University on Federal Taxation**, 2008

The Uncertainty of Basis Increases in Connection with Back-to-Back Loans to S Corporations, **Business Entities**, January/February 2007

Back to Back Loans, presented at the **65th New York University Institute on Federal Taxation**, 2006

Redemptions & Purchases of S Corporation Stock, presented at the **64th New York University Institute on Federal Taxation**, 2005

Avoiding Unreasonable Compensation Attacks on Professional Service and Other Closely Held Corporations, published in **BNA's Executive Compensation Library**, 2004

Reasonable Compensation Issues for Closely-Held and Service Companies, presented at the **61st New York University Institute on Federal Taxation**, 2003

Shareholder Agreements for Closely Held Corporations, 15 **Business Entities** 20, 2003

Drafting Shareholder Agreements for Closely-Held C and S Corporations, presented at the **60th New York University Institute on Federal Taxation**, 2002

What RRA '93 Giveth and Taketh Away: Investment Incentives and Revenue Raisers, 5 **Journal of S Corporation Taxation** 339, 1994

Will the Real One-Class-of-Stock Rule Please Stand Up? 2 **Journal of S Corporation Taxation** 25, 1991

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ABA Tax Section Programs and Committee Meetings; NYU Institute on Federal Taxation; Southern Federal Tax Institute; American College of Trust & Estate Counsel; American Institute on Federal Taxation; Great Lakes Federal Tax Institute; Heart of America Tax Conference; University of Texas Taxation Conference; UNC Tax Conference; University of Alabama Federal Tax Clinic; Birmingham Tax Forum; Chattanooga Tax Practitioners

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Conservation Easements

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Published Works & Presentations

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Conservation Easement Confusion in the Tax Court and the Fifth Circuit, **Taxation of Exempts**, September 2013

Circuit Courts Speak on Conservation Easements, But is the IRS Listening?, **Taxation of Exempts**, January 2013

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