CONSERVATION EASEMENT OVERVIEW

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Conservation Easement Overview

History, Purpose and Public Benefits of Conservation Easements

Owners of real property in the United States have the right to use their property in many different ways and to use traditional real estate strategies to maintain or change the character and use of their land. Accordingly, landowners employing such traditional strategies can construct or replace existing buildings (for residential or industrial use) on their land, or may use land for agricultural purposes (to grow crops or forests, or to raise livestock). In the alternative, landowners may employ strategies to maintain property in its current condition, whether developed or not, and the owners may decide to give away, sell, lease and otherwise transfer their rights in such property to others.

Much is known and written about such traditional real estate strategies and this discussion will not expand on that body of knowledge. Instead, this composition explains how landowners can employ conservation strategies for real estate in ways that preserves significant open spaces, vistas, natural habitats, forest land and farm lands and historical structures for future generations. Such conservation strategies arose from Congress's recognition of the importance and benefit of such preservation activities, and Congress's determination that it was in the country's best interest to encourage landowners to preserve land of ecological or historic importance in a manner that protects or preserves the conservation values identified by Congress as being important.

To accomplish this goal, Congress provides substantial tax benefits for taxpayers who voluntarily restrict their property in a manner which preserves such conservation values on such 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 tax credit.

The concept is timely and important, and we have had numerous requests from landowners and others for information about conservation easements and how they can be used to accomplish various tax and real estate goals. These requests have prompted us to write this article which covers the basics of conservation easement planning. 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.

What is a Conservation Easement?

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 in perpetuity. 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.

Conservation easements offer great flexibility and can contain a variety of restrictions and of 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.

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- Landowners sometimes reserve sites on the easement on which to build homes and other structures.

On the other hand, 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.
- The Tax Court has recently explained that the conservation easement must permanently encumber the real property upon which it is granted, and cannot ever be "substituted" to different real property.

Potential Tax Benefits for Donation of Conservation Easements

To encourage the preservation (in perpetuity) 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. The IRS regulations require the taxpayer to first attempt to value the conservation easement by looking at sales of other "comparable" easements. In practice, however, such comparable easements rarely exist, so the value of a conservation easement donation generally is 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)).

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. What this means is 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. However, the courts have recently determined it is impermissible for a donor to retain the right to modify the boundary lines of an easement. Whether the nature and extent of the restrictions within the eased property (such as the location of reserved "development areas") can be moved, is subject to ongoing litigation.

(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.

(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 four types of property that it wishes to be preserved, and these types of property 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 a 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. The IRS is currently taking the position that a land owner cannot protect one type of conservation purpose, while allowing a use that would impair a separate conservation purpose. For this reason, all potential conservation purposes should be evaluated in light of the easement restrictions and uses reserved by the donor.

(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 the earlier of filing his tax return or the due date (including extensions) thereof, 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 (Form 8283) 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 IRS is carefully scrutinizing Forms 8283, and will deny a deduction if it determines a Form 8283 is incomplete.

The Income Tax Deduction

(1) Enhanced incentives for conservation easement donations available to individuals.

Under current law, individuals may deduct conservation easement donations up to 50% of the individual's contribution base and the unused portion the donation may be carried forward for up to 15 additional tax years. This enhanced incentive applies to deductions for conservation easement donations made directly by an individual taxpayer directly as well as those "passed through" from an entity such as a partnership or S-Corporation (as discussed in the following subsection, separate limitations apply to donations made by C-Corporations). Further, an individual that is a "qualified farmer or rancher" (defined as a taxpayer that earns 50% or more of its annual gross income from the trade or business of farming) may deduct a conservation easement donation of property used in, or made available for use in, the production of agriculture or livestock production ("agricultural property") up to 100% of the qualified farmer or rancher's contribution base provided that the easement includes a restriction that such agricultural property remain available for such production.

These enhanced incentives, signed into law by President George W. Bush as part of the Pension Protection Act of 2006, were enacted to encourage and reward conservation easement donations. Prior to the enactment of these incentives, conservation easement donations by individuals were subject to the general 30% contribution base limitation and the 5 year carryover period. While the enhanced incentives for conservation easement donations were originally scheduled to expire at the end of 2007, these incentives were subsequently (and, as necessary, retroactively) extended by Congress for each year between 2008 and 2014, thereby making this one of the most confusing areas of conservation easement law. Fortunately, the pro-easement incentives were finally (and retroactively for 2015) made permanent when President Barack Obama signed into law the Protecting Americans from Tax Hikes Act of 2015 (the "2015 PATH Act") on December 18, 2015. Accordingly, the 50% contribution base limitation and 15 year carryover period apply to conservation easement donations made in every tax year beginning on or after January 1, 2006. While some of the uncertainty surrounding this topic was eliminated when the enhanced incentives were made permanent in 2015, these limitations remain complex and particular to each taxpayer, so anyone considering a conservation easement donation should consult with a tax advisor prior to making the decision to pursue a conservation easement donation.

(2) Enhanced incentives for conservation easement donations by certain corporations.

Under current law, C-Corporations may deduct conservation easement donations up to 10% of the C-Corporation's taxable income and the unused portion the donation may be carried forward for up to 5 additional tax years. However, like the incentives for individuals, some pro-easement incentives are available for conservation easement donations made by certain C-Corporations. First, much like the similar incentive for individuals, a non-publicly traded corporation that is a qualified farmer or rancher may deduct a conservation easement donation of agricultural property up to 100% of the corporation's taxable income, and any unused deduction may be carried over for up to 15 subsequent tax years, provided that the easement includes a restriction that such agricultural property remain available for such production. Like the pro-easement incentives for individuals, this provision was originally enacted by the Pension Protection Act of 2006 and was subsequently made permanent by the 2015 PATH Act. Accordingly, this incentive applies to tax years beginning on or after January 1, 2006.

In addition to making the incentive for corporate farmers and ranchers permanent, the 2015 PATH Act also added a new (and permanent) pro-easement incentive for certain Alaskan "Native Corporations" (generally defined as entities, whether for-profit or not, organized under the laws of the State of Alaska for the purpose of holding, managing, investing or distributing funds, land or other property and rights on behalf of Native Alaskans). Under this new incentive, a Native Corporation may deduct a conservation easement donation of property conveyed under the Alaska Native Claims Settlement Act up to 100% of the Native Corporation's taxable income, and any unused deduction may be carried over for up to 15 subsequent tax years. Unlike the other pro-easement incentives discussed above, this new incentive applies only to donations made in tax years beginning on or after January 1, 2016.

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. The analysis must also take into account realistically 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.

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 then the fair market value of the land at its highest and best use is $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 are often embroiled in valuation concerns and issues. Moreover, the 2006 Pension Protection Act and subsequent guidance have expanded on the requirement of a "qualified appraisal" and "qualified appraiser." The IRS is frequently raising issues about what these terms mean and require in light of the changes.

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. If "eased" property is included in a decedent's estate at the reduced value of the property post-easement, the estate's estate tax liability may be reduced, and the need to sell the eased property to raise funds to pay estate taxes may be eliminated. Accordingly, the absence of development potential may make it more likely that the property will stay in the family, and in its current use, for 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%.

- **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, although there have been subsequent restrictions on the availability and prerequisites to obtaining such state tax benefits.

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 and Real Estate Partnerships

A conservation easement can be a valuable alternative for deriving real property value. In certain instances, the tax benefits that may be realized from a conservation easement donation will make such a donation attractive when compared to alternative uses for a property. Partnership structures that allow investors to become members of a land-owning partnership that is considering the development or conservation of such land can allow, under the right circumstances, multiple landowners to benefit from the tax benefits resulting from a conservation easement donation if that approach is chosen. This may result in the permanent preservation of land that might not otherwise be protected due to the significant profit potential to be extracted from the highest and best use of the property for development purposes. Ultimately, the decision of whether to develop or conserve the property, or to commit the property to some other use, will be made by the landowner(s) or their designee, regardless of how the property is held or owned.

Thus, the tax incentive for conservation easements found in Section 170(h) will achieve its purpose, even in a partnership setting, 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. While some partnership ownership structures can be complex, it appears that they are ideally designed to allow the tax incentives of Section 170(h) to be used as Congress originally intended; that is to incentivize the permanent protection of valuable lands by private landowners.

An example of how this might work is provided below:

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 the LLC interests, and the partnership subsequently elected (among several alternative decision) to donate an easement over the property, the investors would be able to share in the deduction.

IRS Notice 2017-10 (later modified by Notice 2017-29)

In late December, 2016, the IRS published Notice 2017-10 (as later modified by Notice 2017-29) (the "Notice"), which designates donations of certain conservation easements (and substantially similar transactions) that arise out of certain syndication transactions as "reportable" or "listed" transactions. In simple terms, the Notice requires any individual (a "Participant") who participates in a so-called syndicated conservation easement (that generally took place since 2010) that produces a deduction greater than 250% of the Participant's investment amount in the transaction to file IRS Form 8886, Reportable Transaction Disclosure Statement, provided that the applicable statute of limitations remains open for the year in which the investment was made. Additionally, so-called Material Advisors in such transactions are required to file Form 8918, Material Advisor Disclosure Statement, with respect to such transactions. Additionally, the Notice requires Participants and Material Advisors to maintain certain records with respect to such transactions. These new filing requirements are intended to generate information the IRS may use to audit such syndicated conservation easement transactions. Clearly, however, the Notice does not change the law governing conservation easements and does not mean that a transaction that has been disclosed by Participants (using Form 8886) and Material Advisors (using Form 8918) will be denied. The focus of the Notice appears to be on the valuation claimed by taxpayers with respect to affected conservation easements. Unfortunately, penalties for failing to comply with Notice 2017-10 (as modified by Notice 2017-29) can be draconian, so compliance with the requirements of such Notice is advisable. Whether or when Notice 2017-10 (as modified) will be amended, revoked or rescinded is uncertain.

Conclusion

Conservation easements can provide land owners 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.

Despite Congress's clear intent to promote easement transactions, however, the IRS has been active trying to weed out what they perceive as "bad" easements. Unfortunately, these efforts by IRS to find and to disallow bad easements has resulted in many good easements being examined and often deductions being disallowed due to a technical problem, inaccurate paperwork or simple disagreement over value issues. The courts have often drawn hard lines on certain technical issues, so it is more important than ever to makes sure easement transactions are carefully scrutinized by competent and experienced tax counsel and that all of the many procedural and technical requirements are satisfied.

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