



## FEATURE: PHILANTHROPY

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# Keeping It Green

Conservation easements in estate plans protect natural resources and may lessen tax burdens

**P**ublic debate about global warming has highlighted the effect of human beings' actions on the world's open spaces. Regardless of your position in the debate, preserving open space—particularly near urban areas facing intense development pressure—offers immeasurable public benefits in terms of maintaining scenic vistas, protecting wildlife habitats, providing natural water filtration, reducing flood impacts, offering recreational opportunities, counteracting the buildup of greenhouse gases and preserving a community's character against rapacious real estate development. Increasing numbers of landowners are considering ways to preserve their land as a legacy gift to future generations and their communities.

### Conservation Easement Basics

In its simplest form, an easement is a written agreement in which a landowner (known as the "grantor") gives another person the right to access and use of a piece of land for a specific purpose during a specific period of time. The person who receives the right of access and use is known as the "grantee" or (less formally) the "holder" of the easement. Municipalities hold permanent easements to construct and maintain roads. Utilities hold long-term easements to construct and maintain gas, electric and telecommunication lines. The rights and obligations contained in the easement document are said to "run with the land," meaning that they bind not just the current landowner and holder, but also future landowners and holders who later acquire or inherit the property. A conservation easement is a

special type of easement in which the grantor donates unused development rights in the property to a government agency or a tax-exempt organization, such as a land trust, whose mission is to ensure that the property is preserved to achieve specific conservation objectives.

Conservation objectives can include maintaining a property as open space, protecting a wildlife habitat or preserving the façade of an historic building. Because conservation easements are intended to limit or eliminate the future development potential of the property, landowners who donate them often do so for philanthropic or altruistic reasons.

**Example:** Blackacre is a 10-acre parcel with a house and barn located at the edge of a large urban area. Local zoning permits Blackacre to be subdivided and developed with single-family homes on one acre lots, and there are no impediments to development. The landowner, Adam, wishes to preserve the property's open space and pass the homestead to his children. Adam donates a conservation easement to a qualified land trust. Under the negotiated terms of the conservation easement, Adam retains the use of the home and the barn and is permitted to expand them within pre-defined boundaries specified in the easement agreement. Under the terms, the rights to redevelop the property for 10 new houses are extinguished, and the land trust acquires a permanent right to enforce against Adam or any subsequent owner who tries to construct in the open space.

### Donation During Life

With proper planning, the donation of a conservation easement is a charitable gift that may provide immediate tax benefits to the landowner and long-term estate tax benefits to his heirs. A landowner who donates a qualified conservation easement during life may claim an income tax deduction equal to the value of the conservation easement at the time of the donation, as



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determined by an appraiser. The amount of the deduction is usually limited to 30 percent of the landowner's adjusted gross income (AGI) in any one year and can be carried forward for up to five years.<sup>1</sup> As of this writing, Congress is considering legislation to extend temporary rules that expired on Dec. 31, 2014 to allow a deduction of 50 percent of the landowner's AGI in any one year and carry over any excess amount for up to 15 years. To claim the conservation easement deduction, the contribution must be of a qualified real property interest donated exclusively for conservation purposes to a government agency or to a qualified Internal Revenue Code Section 501(c)(3) land trust.<sup>2</sup> The law defines "qualified real property interest" as a restriction granted in perpetuity on the use of real property.<sup>3</sup>

When a landowner dies owning the land subject to a conservation easement, IRC Section 2031(c) provides a partial exclusion from estate tax for the reduced value of the land that's subject to the qualified conservation easement if the land was owned by the decedent for at least three years prior to death.<sup>4</sup> If the value of the easement is at least 30 percent of the value of the land without the easement, then the exclusion is equal to 40 percent of the value of the land without the easement, not to exceed \$500,000.<sup>5</sup> To the extent that the easement value is less than 30 percent of the value of the land without the easement, the exclusion percentage is reduced by 2 percent for each percentage point that the easement value falls below 30 percent. As a result, the exclusion percentage drops to 0 percent when the value of the easement is 10 percent or less of the land value.<sup>6</sup> The exclusion isn't allowed to the extent there's acquisition indebtedness on the property (such as a mortgage) at the time of the landowner's death.<sup>7</sup> If the debt is assumed by the qualified land trust, the landowner must reduce the fair market value (FMV) of the property by the amount of the debt.

**Example:** Blackacre is valued at \$10 million and has been owned by Adam without any mortgage since Year 1. In Year 15, Adam donated a conservation easement on Blackacre to a holder land trust that identified seven acres of Blackacre that it would use for the preservation of open space and natural wildlife habitat. The easement was a qualified conservation easement

and reduced the value of the land to \$7 million. Adam died in Year 17 when the land was still worth \$7 million. Adam was entitled to a \$3 million income tax deduction in Year 15. Blackacre is valued at \$7 million in Adam's estate, and the estate is eligible for the IRC Section 2031(c) exclusion of \$500,000. If Adam's executors elect to claim the exclusion, \$6.5 million will be subject to tax in Adam's estate.

If Adam were part owner of Blackacre, his estate may nevertheless be eligible to claim benefits under Sec-

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tion 2031(c). The IRC provides a look-through rule that confers the benefits of that provision to a decedent who, at the time of death, owned at least 30 percent of the interests in a partnership, corporation or trust that owned the land subject to the conservation easement.<sup>8</sup>

#### Donation On Death

When a qualified conservation easement is donated by will rather than during the landowner's life, the IRC still provides the exclusion limited to \$500,000 described above. The estate is also entitled to a charitable deduction in an amount equal to the appraised value of the conservation easement.<sup>9</sup> The disadvantage of waiting to make a donation on death is that the landowner will forego any income tax benefits produced by a charitable tax deduction during his life.

**Example:** If Adam is the sole owner of Blackacre and decides to donate a qualified conservation easement by will rather than during his life, the full \$10 million value of Blackacre will be includable in Adam's estate, the



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conservation easement becomes effective on Adam's death and the Tax Code permits his estate to take a \$3 million charitable deduction for the value of the easement.<sup>10</sup> In addition, Adam's estate is eligible for a \$500,000 exclusion, as described above.

### State Tax Incentives

Several states offer tax credits against a landowner's state income tax liability based on the value of the conservation easement contribution. Among these states, there's considerable variation in the percentage of conservation easement value that's creditable, the maximum credit amount, whether the credit can be carried over to future

Each state has its own laws governing the validity of easements and the authority of an estate's executor to convey property interests.

years or sold and whether the tax credit program is adequately funded by the state's legislature. Most states still don't offer tax credits for conservation easements.

Among the most generous state tax credit programs are: Colorado, which offers a tax credit of 50 percent of the FMV of the conservation easement, up to a maximum credit of \$375,000;<sup>11</sup> North Carolina, which offers a tax credit of 25 percent of the conservation easement value, up to a maximum credit of \$250,000 for individuals, with a 5-year carryover period;<sup>12</sup> and New Mexico, which offers a maximum tax credit of 50 percent of the easement value up to \$250,000 for individuals, with a 20-year carryover.<sup>13</sup> In addition, California offers an income tax credit of 55 percent of the FMV of the donated property and currently has an 8-year carryover.<sup>14</sup> New York offers owners of land under a conservation easement a refundable income tax credit of 25 percent against their school district, county and town property taxes paid during the year. The maximum credit available is \$5,000. If the landowner's tax credit exceeds the

amount he owes in state income taxes, the landowner receives payment for the difference.<sup>15</sup>

### Local Property Taxes

Donation of a conservation easement can marginally reduce the local property taxes assessed on a donated parcel, but only in those jurisdictions where the highest and best use of the land is a factor in establishing land value. In practice, tax assessors haven't fully recognized the reduced development potential resulting from condemnation easements, even when it can be considered.

### Key Requirements

Key requirements needed to establish a qualified conservation easement in an estate plan include:

**Achieve at least one of the conservation purposes recognized in the IRC.** To be eligible for a federal income tax deduction and exclusion from the donor's taxable estate, a qualified conservation easement needs to exclusively provide for at least one of the following purposes:

- preservation of land areas for outdoor recreation by, or for the education of, the general public;
- protection of a relatively natural habitat of fish, wildlife, plants or similar ecosystems; or
- preservation of open space (including farmland or forest land), when such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated federal, state or local government conservation policy.

An income tax deduction can also be obtained for the preservation of a historically important land area or a "certified" historic structure. An estate tax exclusion can't be obtained for such purpose.<sup>16</sup>

**Extinguish specific rights to develop specific lands permanently.** The donation of development rights must be in perpetuity for the easement to qualify for estate and income tax deductions.<sup>17</sup> Courts have determined that lack of clarity in the description of the property or the development rights being conveyed defeats the perpetuity requirement and disqualifies the donation from estate and income tax benefits.<sup>18</sup> Mortgages also prevent the conservation easement from being perpetual due to



the potential that the easement could be foreclosed on and extinguished by the mortgage holder.<sup>19</sup> Thus, if there are mortgages or other security interests in the owner's property, Internal Revenue Service regulations require that they must be subordinated to the holder of the conservation easement before the easement is granted.<sup>20</sup> For estate tax purposes, the easement must "include a prohibition on more than a de minimis use for a commercial recreational activity."<sup>21</sup>

**Get an appraisal.** Before a landowner can donate a conservation easement, he must obtain an independent appraisal by a credentialed real estate appraiser to establish the FMV of the development rights at the time of the donation.<sup>22</sup> Because comparable sales of conservation easements are rare, the appraisal is almost always based on the difference in the FMV of the property immediately before and after the conservation easement is imposed.<sup>23</sup> Before accepting a donation, land trusts typically review the appraisal as a matter of best practice, but ultimately it's the landowner and the surveyor who will be on the hook if the IRS determines the easement is substantially overvalued.

**Donation must be accepted by a government conservation agency or qualified land trust.** A land trust must be operated as a non-profit Section 501(c)(3) organization for the donation of the easement to be eligible for tax benefits. The Washington, D.C.-based Land Trust Alliance represents more than 1,100 state and local land trusts and maintains a membership directory of land trusts around the country that are qualified to hold conservation easements.<sup>24</sup> Because the holder of the conservation easement must agree to accept responsibility to monitor and enforce the terms of the easement in perpetuity, the land trust will be actively involved in negotiating the easement terms and will ultimately decide whether the terms further its conservation mission.

**Adhere to the state's legal requirements for easements.** Each state has its own laws governing the validity of easements and the authority of an estate's executor to convey property interests. Every state in the United States permits conservation easements, but some state laws have quirks that may disqualify the donation for tax benefits under federal law.

## Balanced Negotiation

Every conservation easement is unique in view of the specific characteristics of the real property involved,

the conservation values being advanced and the real property laws of the state where the property is situated. All conservation easements require a balanced negotiation affording the landowner sufficient flexibility to use the property in the future, while requiring that the landowner relinquish meaningful rights to develop the property so as to achieve the stated conservation purpose of the donation. For these reasons, conservation easements draw on legal expertise in areas of environmental law, land use, real estate, trusts and estates and taxation. Competent legal advice and careful negotiations with the land trust are essential in achieving the landowner's conservation objectives while maximizing estate-planning benefits.

## Endnotes

1. See H. Rpt. 114-17 (House Committee on Ways and Means); Internal Revenue Code Section 170(b)(E).
2. IRC Section 170(h).
3. Section 170(h)(2)(C).
4. IRC Section 2031(c)(1) and (c)(8)(A)(ii).
5. Section 2031(c)(1).
6. See Section 2031(c)(2).
7. Section 2031(c)(4).
8. Sections 2031(c)(10) and 2057(e)(3).
9. Sections 2031(c)(9) and 2055(f).
10. IRC Sections 170(h) and 2055.
11. Colorado Revised Statutes 39-22-522.
12. North Carolina G.S. Section 105-151.12 and GS Section 105-130.34.
13. Rule 30.13.20 NMAC.
14. California Public Resources Code Section 37000, *et seq.*; see also California Revenue and Taxation Code 17053.30 and 23630.
15. N.Y. Tax Law Section 606(kk).
16. IRC Section 2031(c)(8)(B).
17. IRC Section 170(h)(2)(C) and (h)(5)(A).
18. "The placement of the article 'the' before 'real property' [in § 170(h)(2)(C)] makes clear that a perpetual use restriction must attach to a defined parcel of real property rather than simply *some* or *any* (or interchangeable parcels of) real property." *Belk v. Commissioner*, 2014 U.S.App.LEXIS 23680 (4th Cir., Dec. 16, 2014) (emphasis in original).
19. Treasury Regulations Section 1.170A-14(g); *Mitchell v. Comm'r*, 2015 U.S.App. LEXIS 116 (10th Cir., Jan. 6, 2015).
20. Treas. Regs. Section 1.170A-14(g).
21. IRC Section 2031(c)(8)(B).
22. Treas. Regs. Section 1.170A-14(i).
23. Treas. Regs. Section 1.170A-14(h)(3)(i).
24. The directory is accessible online at <http://findalandtrust.org/>.