Conservation easements, the IRS & charity

By **Robert W. Wood**

With increased media focus on global climate change, people are paying attention to the environment, and especially to its conservation and preservation. Charitable conservation easements can help the environment, and ease one's tax burden at the same time.

A conservation easement is a voluntary restriction placed on the use of land for a conservation purpose. Valid conservation purposes can include the protection of open space, of timberland, farm land, scenic views, wetlands, or other significant natural resource values. The easement need not restrict the sale of the property.

Conservation easements are generally not required to provide the public with a right of access or use of the land subject to the easement, unless the purpose of the easement is a public benefit that requires public access (i.e. preservation of the land for outdoor recreation or education of the general public). Generally, the easement (as well as the restrictions it imposes) is donated to a charitable organization or government agency. The easement's terms are ordinarily negotiated between the landowner and the charitable conservation organization or government agency. In negotiating the terms of the easement, the landowner should consider Internal Revenue Code ("Code") requirements.

What are the tax benefits of charitable conservation easement?

You can deduct from your taxes the value of the easement (typically, the value of the property before contribution of the easement, minus the value of the property after contribution of the easement).[1] The amount of the deduction is subject to annual limitations, but unused deductions can be carried over to future years.[2] The annual limitations have recently been changed,[3] though the changes are only effective for easements donated in 2006 and 2007. Thus, donors should be aware of both the old and new annual limitations.

What are the annual limitations (through 2005)?

Under the old annual limitations (for 2005 and earlier contributions), "long-term capital gain" property (i.e. a capital

asset held for more than one year) and "ordinary income property" (i.e. a capital asset held for less than one year) were treated differently. When a donor made a contribution of "long-term capital gain" property, the federal income tax deduction was limited to 30 percent of the donor's "contribution base."[4] The "contribution base" is defined as adjusted gross income computed without regard to any net operating loss carryback.[5]

When a donor made a contribution of "ordinary income property," the federal income tax deduction for that donation was limited to 50 percent of the donor's contribution base.[6] However, a deduction for ordinary income property could not exceed the donor's adjusted basis in the easement (not to be confused with the donor's adjusted basis in the entire property).[7] For a donation of long-term capital gain property, the donor, however, may elect to treat the donation as a contribution of ordinary income property, and thus be subject to the 50 percent contribution base limitation.[8] Any unused amount could be carried forward for five years after the year of contribution.[9]

What are the new annual limitations?

The new annual limitations, which only affect contributions during 2006 and 2007, treat "long-term capital gain" property and "ordinary income" property identically. The annual limitation for contributions of both types of property is 50 percent of the donor's contribution base.[10] Any unused portion may be carried forward for fifteen years.[11]

Are there other limitations?

Yes. Donors should also consider certain other limitations which can affect the amount of the deduction for a charitable conservation easement contribution.[12]

Aren't easements nondeductible as partial interests?

No. In general, charitable donations of "partial" interests of property are denied tax deductions.[13] Easements are partial interests in real property, so without an exception, the donation of an easement would not qualify for a charitable contribution deduction. Fortunately, there is an exception for "qualified conservation contributions."[14]

How is a "qualified conservation contribution" defined?

A qualified conservation contribution is:

- A contribution of a qualified real property interest,
- to a qualified organization,
- exclusively for conservation purposes.[15]

A failure to meet any of these requirements can result in denial of the income tax benefits. Plus, in some cases, you can incur gift tax. Furthermore, in making a qualified conservation contribution, the donor must have a "donative intent" (in other words, an intent to make a charitable contribution).[16] More about this intent below.

What is a "qualified real property interest"?

A "qualified real property interest" is defined as the donor's entire real property interest other than a "qualified mineral interest," a remainder interest in real property, or a perpetual restriction on the use which may be made of the real property (in other words, a perpetual easement[17] or other restrictive interest in real property).[18] This definition adds one more requirement for tax purposes: the easement must be granted in perpetuity to be considered a "qualified real property interest".

Who is an eligible donee?

An eligible donee must be a "qualified organization", having a commitment to protect the conservation purposes of the donation, and the resources to enforce the restrictions.[19] Qualified organizations include local, state, or federal governmental agencies, and public charities defined in Code Sec. 501(c)(3).

What is a commitment to protect the conservation purposes of a donation?

While a "commitment to protect the conservation purposes of the donation" is not defined in the Code, a public charity's commitment to protect the conservation purposes of the donation can generally be found in its articles of incorporation or by-laws.

What resources to enforce the restrictions are required?

Potential donors should examine whether charitable organizations they are considering have the resources to enforce the restrictions of the contemplated easement. The amount of resources an organization must spend to enforce the restrictions of the conservation easements is not defined in the Code. However, the Treasury Regulations make clear that organizations are not required to earmark funds specifically for enforcement of conservation easements.[20]

Nonetheless, the IRS keeps an eye on qualified organizations' efforts to monitor and enforce conservation easements. Exempt organizations are required to file a Form 990 annually with the IRS. The Form 990 requires organizations holding conservation easements to report the amount of staff hours and expenses spent in monitoring and enforcing easements for the preceding year. Thus, while the resources an organization must spend to monitor and enforce conservation easements is undefined, a qualified organization must document the time and money it spends each year on these tasks.

What constitutes a conservation purpose?

There are four broad categories of conservation purposes:

(i) The preservation of land areas for outdoor recreation by, or the education of, the general public;

(ii) The protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem;

(iii) The preservation of certain open space (including farmland and forest land); and

(iv) The preservation of an historically important land area or a certified historic structure.[21]

What is recreation or education of the general public?

If the conservation purpose of the easement is for outdoor recreation, or education of the general public, then the Treasury Regulations require that the recreation or education must be for the

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"substantial and regular use" of the general public.[22] Accordingly, the easement must provide access to the real property for the general public.

What constitutes preservation of a significant, relatively natural habitat for fish, wildlife or plants?

The Treasury Regulations take a liberal view of what constitutes a significant, relatively natural habitat for fish, wildlife, or plants. Examples provided by the Treasury Regulations include lakes formed by man-made dams, salt ponds, habitats for rare, endangered, or threatened species of animals, fish, or plants, and natural areas that represent high quality examples of a terrestrial community or aquatic community.[23]

Furthermore, the regulations explicitly state that the fact that the habitat or environment has been altered to some extent by human activity does not result in a deduction being denied so long as the fish, wildlife, or plants continue to exist there in a relatively natural state.[24] Note the word "relatively" here.
The United States Tax Court has also taken a liberal view. For example, in *Glass v. Commissioner,*[25] the taxpayers donated two individual conservation easements with the conservation purpose of protecting a significant, relatively natural habitat. The easements were relatively small: one covered an area 150 feet wide by 120 feet deep, and the other covered an area of 260 feet wide by 120 feet deep. The taxpayers also presented evidence that a bald eagle roost (a perch on which birds can temporarily rest or sleep) was located on the property, and that one type of endangered plant grew on the property. The Tax Court held that both conservation easements met the conservation purpose requirement.[26]

There is an important distinction between this conservation purpose and the conservation purpose of recreation or education of the general public. The Treasury Regulations state specifically that limitations on public access to property donated for the preservation of a significant, relatively natural habitat for fish, wildlife, or plants do not jeopardize the tax deduction.

Can preserving open space qualify?

Conservation easements to preserve "open space" qualify as having a conservation purpose if they meet one of the following criteria:

- The preservation is pursuant to a clearly delineated federal, state, or local governmental conservation policy, and will yield a significant public benefit; or
- The preservation is for the scenic enjoyment of the general public, and will yield a significant public benefit.[27]

What is a government conservation policy?

There is not much guidance about what constitutes a "clearly delineated government conservation policy." However, the Treasury Regulations make it clear that a "clearly delineated federal, state, or local governmental conservation policy" is something more than a "general declaration of conservation goals by a single official or legislative body."[28] The Treasury Regulations also state that where a governmental entity adopts a resolution specifically endorsing protection of a particular property as "worthy of protection for conservation purposes," a conservation easement granted for that property will be respected.[29]

What constitutes scenic enjoyment of the general public?

Whether or not an easement is for the "scenic enjoyment of the general public" is determined by a facts and circumstances test. Factors such as topography, geology, biology, cultural, and economic conditions are relevant.[30] In addition, the Treasury Regulations list eight other factors to be considered:

- The compatibility of the land use with other land in the vicinity.
- The degree of contrast and variety provided by the visual scene.
- The openness of the land.
- Relief from urban closeness.
- The harmonious variety of shapes and textures.
- The degree to which the land use maintains the scale and character of the urban landscape to preserve open space, visual enjoyment, and sunlight for the surrounding area.
- The consistency of the proposed scenic view with a methodical state scenic identification program, such as a state landscape inventory; and
- The consistency of the proposed scenic view with a regional or local landscape inventory made pursuant to a sufficiently rigorous review process, especially if the donation is endorsed by an appropriate state or local governmental agency.[31]

Of course, to qualify as scenic enjoyment, the easement must grant visual access to the general public over a significant portion of the property.[32] In some ways, this is intuitive: there cannot be a scenic view if no one can see it.

What is a significant public benefit?

The Treasury Regulations list 11 different criteria for evaluating whether the open space conservation easement yields a significant public benefit. They are:

- The uniqueness of the property to the area.
- The consistency of the proposed open space use with public programs (whether, federal, state, or local) for conservation in the region.
- The intensity of land development in the vicinity of the property.
- The consistency of the proposed open space use with existing private conservation programs in the area.
- The likelihood that development of the property would lead to or contribute to degradation of the scenic, natural, or historic character of the area.
- The opportunity for the general public to use the property or enjoy its scenic values.
- The importance of the property in preserving the local or regional landscape or resource that attracts tourism or commerce to the area.
- The likelihood that the donee will acquire equally desirable and valuable substitute property or property rights.
- The cost to the donee of enforcing the conservation easement.
- The population density in the area of the property.
- The consistency of the proposed open space with a legislatively mandated program identifying particular parcels of land for future protection.[33]

Some landowners may want the current tax deduction for the easement, but to retain a right to develop the property in the future. The Treasury Regulations do not allow this. An easement for the preservation of open space cannot permit "a degree of intrusion or future development that would interfere with the essential scenic quality of the land or with the governmental conservation policy" which the easement allegedly promotes.[34]

What is preserving a historic land area or structure?

The preservation of an historic land area or structure is another valid conservation purpose. Historic land areas are defined as any that meet the National Register Criteria for Evaluation in 36 CFR 60.4 (Pub.L. 89-665, 80 Stat. 915), any land area within a registered historic district, and any land area adjacent to a property listed in the National Register of Historic Places where the physical or environmental features of the land area contribute to the historic or cultural integrity of the property.[35] A historic structure is defined as any building, structure, or land area listed in the National Register, or any building located in a registered historic district, and certified by the Secretary of the Interior as being of historic significance to the district.[36]

Claiming a tax deduction for a conservation easement to preserve a historic structure became more difficult in 2006 with the passage of the Pension Protection Act. Congress added such requirements as requiring the easement to include a restriction which preserves the entire exterior of the building, requiring the easement to prohibit any change in the exterior of the building which is inconsistent with the historic character of such exterior, and requiring a written agreement between the donor and donee where the donee certifies that it is an eligible donee.[37]

The donor must also include with his tax return for the year of the donation, a qualified appraisal, photographs of the exterior of the building, and a description of all the restrictions on the development of the building.[38] Also, Congress requires the donor to make a $500 payment with the filing of any tax return claiming a deduction in excess of $10,000 for conservation easements contributed to protect historically significant structures.[39]

Are certain transfers restricted?

Yes. The Treasury Regulations restrict the transfer of easements to certain organizations. For example, the easement not only has to initially be conveyed to a qualified organization, but it must prohibit the easement's transfer to any organization that is not "an eligible donee."[40] An eligible donee is defined as an organization that must be a qualified organization, have a commitment to protect the conservation purposes of the donation, and have the resources to enforce the restrictions.[41]

Furthermore, a conservation easement must include provisions prohibiting the donee from subsequently transferring the easement unless, as a condition of the subsequent transfer, the donee requires "that the conservation purposes which the contribution was originally intended to advance continue to be carried out."[42]

The Treasury Regulations add one more requirement based on the cy pres doctrine.[43] If there is an unexpected change in the conditions surrounding the property subject to the easement which makes impossible or impractical the continued use of the property for conservation purposes, any proceeds resulting from the sale or exchange of the property must be used in a manner consistent with the conservation purposes of the original contribution.[44]

Are there other requirements?

Yes. The Treasury Regulations list several other requirements for a charitable conservation easement deduction. For example, existing mortgages on the property must be subordinated to the easement.[45] In addition, uses of the property which are inconsistent with any conservation purpose (whether or not the purpose is specifically identified by the easement) must be prohibited.[46]

Furthermore, the easement may not allow the donor to retain surface mining rights or any other mineral extraction rights in the property.[47] There are also substantiation requirements and reporting requirements.[48]

Are there any basis implications of a donation?

Yes. The donor must reduce his adjusted basis in the property that is subject to the easement by the proportion of the easement's value over the fair market value of the property before the contribution of the easement.[49]

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NOTES

1. Code Sec. 170(a)(1).
2. See Code Sec. 170(b)(1).
3. Pension Protection Act of 2006
4. Treas. Reg. § 1.170A-8(d).
5. Treas. Reg. § 1.170A-8(e).
6. Treas. Reg. § 1.170A-8(b).
7. I.R.C. § 170(e)(1); Treas. Reg. § 1.170A-4(a)(1). This limitation remains unchanged by the Pension Protection Act of 2006.
8. Treas. Reg. § 1.170A-8(b).
9. Treas. Reg. § 170A-10(c)(1)(ii).
10. The new annual limitations are even better for "qualified" farmers or ranchers. Under Code Sec. 170(b)(1)(E)(iv), a "qualified farmer or rancher"can deduct up to 100 percent of the donor's contribution base.
11. Code Sec. 170(b)(1)(E)(ii).
12. See Code Sec. 170(b)(1)(A) (limiting the aggregate amount of all of the donor's charitable deductions for the year to 50 percent of the donor's contribution base). See also Code Sec. 68 (limiting itemized deductions, which include deductions for charitable conservation easements).
13. Code Sec. 170(f)(3)(A).
14. Code Sec. 170(f)(3)(B)(iii).
15. Code Sec. 170(h).
16. *United States v. American Bar Endowment*, 477 U.S. 105 (1986); *Hernandez v. Commissioner*, 490 U.S. 680, 690 (1989); Rev. Rul. 67-246.
17. Note that state laws govern the creation and enforcement of easements. Thus, the easement must also comply with all of the state statutory requirements in order to qualify as a "qualified real property interest."
18. Code Sec. 170(h)(2).
19. Treas. Reg. § 1.170A-14(c)(1).
20. Treas. Reg. § 1.170A-14(c)(1).
21. Treasury Reg. Sec. 1.170A-14(c)(2).
22. Treas. Reg. § 1.170A-14(d)(2)(i).
23. Treas. Reg. § 1.170A-14(d)(3)(i), (ii).
24. Treas. Reg. § 1.170A-14(d)(3)(i).
25. 124 T.C. No 16 (2006), aff'd, 471 F.3d 698 (6th Cir. 2006).
26. Id.
27. Treas. Reg. § 1.170A-14(d)(4)(i).
28. Treas. Reg. § 1.170A-14(d)(4)(iii)(A).
29. Treas. Reg. § 1.170A-14(d)(4)(iii)(A).
30. Treas. Reg. § 1.170A-14(d)(4)(ii)(A).
31. Treas. Reg. § 1.170A-14(d)(4)(ii)(A).
32. Treas. Reg. § 1.170A-14(d)(4)(ii)(B).
33. Treas. Reg. § 1.170A-14(d)(4)(iv)(A).
34. Treas. Reg. § 1.170A-14(d)(4)(v).
35. Treas. Reg. § 1.170A-14(d)(5)(ii)(A), (B), (C).
36. Code Sec. 170(h)(4)(B), (C).
37. Code Sec. 170(h)(4)(B)(i), (ii).
38. Code Sec. 170(h)(4)(B)(iii).
39. Code Sec. 170(h)(4)(B), (C).

40. Treas. Reg. § 1.170A-14(c)(2).
41. Treas. Reg. § 1.170A-14(c)(1).
42. Treas. Reg. § 1.170A-14(c)(2).
43. The cy pres doctrine, emanating from English and French law, holds that where the donor's original intent becomes illegal or impossible to perform, the court may amend a charitable trust to conform as closely as possible to the donor's original intent.
44. Treas. Reg. § 1.170A-14(c)(2).
45. Treas. Reg. § 1.170A-14(g)(2).
46. Treas. Reg. § 1.170A-14(e)(2).
47. Treas. Reg. § 1.170A-14(g)(4).
48. Treas. Reg. § 1.170A-13(c)(3). See also I.R.S. Form 8283.
49. Treas. Reg. § 1.170A-14(h)(3)(iii).