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CONSERVATION EASEMENT GRANTORS: DOING GOOD AND DOING WELL

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ABSTRACT

Beginning in 2000, Colorado legislation authorized tax credits and cash refunds of up to \$100,000 for grantors of conservation easements. Other benefits accruing to grantors are lower property tax rates, federal income tax credits and decreasing estate valuations subject to federal estate taxes. Private conservation easements preserve land for outdoor recreation, education, scenic views, open spaces, historic properties and protect relatively natural habitat. Because the development rights are permanently transferred, conservation easements provide permanent protection from development regardless of shifts in political winds.

I. ORGANIZATIONAL PREVIEW

The purpose of this article is to investigate the benefits of conservation easements in light of the recent enactment by the Colorado legislature of a \$100,000 tax credit refundable in cash to grantors of conservation easements. First, the article will define conservation easements. Second, it will review the Colorado tax benefits accruing to grantors. Third, it will review Federal Income tax benefits associated with granting a conservation easement. Fourth, will be a discussion of the estate tax benefits of granting a conservation easement in the context of the debate to terminate the unified federal estate and gift tax. Finally, there is a comparison of the long-term effects of using private conservation easements compared to public conservation efforts.

II. CONSERVATION EASEMENTS

Most grantors of conservation easements wish to protect the character of their land. This section will use a hypothetical to illustrate the criteria and procedure to establish a conservation easement. Nancy and Mac Steward owned a 100 acre parcel in the Animas Valley in southwest Colorado, eight miles north of the Durango city limits in La Plata County. There was a three bedroom ranch style home, a barn, and several outbuildings on the property. Nancy and Mac inherited the land in 1970 from Nancy's parents who bred Palomino horses since the 1890's. When the Stewards became owners of the property, it was appraised at \$600,000. The land was bordered on the east by U.S. Highway 550, known as the San Juan Skyway connecting Durango with Purgatory ski area, Silverton, then north to Ouray and Grand Junction. There was

about 20 acres of valley land, and the remainder of the parcel included a hillside, stream, waterfall and a small section of the meadow above the hillside. The Stewards had a household income of about \$46,000 per year.

Property values in the Animas Valley had skyrocketed since the Stewards became owners of the land. Several landowners had sold their land to developers. The developers were selling one-acre parcels for single family homes at an average of \$100,000 per acre in 2000. The Stewards had an appraisal done to qualify for a loan to send their twins to college. The property was appraised at 3.5 million dollars. The Stewards were typical of many families who chose to explore conservation easements. They were cash poor, but owned a valuable parcel in fee simple. Fee simple is a legal designation where the owners own the right to the surface land, the airspace, as well as the subsurface rights to mine or drill for resources. Most importantly, they were committed to seeing that their parcel was not carved up into a subdivision.

1. CRITERIA FOR CONSERVATION EASEMENTS

To accomplish their goal of preserving the character of their land, a conservation easement appeared to be a potential solution. To qualify to grant a conservation easement, grantors must comply with tax law rules and interpretations under I.R.C. Section 170(h). known as the "Conservation Purposes" Test. The land needs to satisfy at least one of the following purposes.

- The land is preserved to protect a scenic view for the general public.
- The land is preserved to protect open space pursuant to a "clearly delineated" governmental policy.
- The land is preserved to protect important, relatively natural habitat.
- The land is preserved for public education or outdoor recreation.
- The land is preserved to protect historic property.

The Stewards' parcel would probably best qualify because it provided a scenic view for the general public traveling by on a major artery called the San Juan Skyway. The designation of the highway as a scenic skyway, might also fulfill the test of protecting open space. However, further research would have to be conducted about whether the county or state had a "clearly delineated" governmental policy of promoting open space in the Animas Valley. The fact that other developers where permitted to build one acre subdivisions would be evidence that the county did not consider open space in the valley to be a "clearly delineated" government policy.

Equally viable, Nancy and Mac could argue that their conservation easement would preserve and protect important, relatively natural habitat. Because their property included a stream, waterfall, and undeveloped hillside, a strong argument could be made about the plant and animal life that would remain undisturbed under a conservation easement.

In addition to meeting the conservation purpose tests, the donation of the development rights must be perpetual. This means that the conservation easement given to a qualified conservation organization must be permanent. To be considered a qualified conservation organization the recipient organization must meet the criteria set forth in Internal Revenue Code 501(c)(3). These qualified conservation organizations are empowered to enforce restrictions against development of the land where they hold the conservation easements.

To exemplify, the Stewards chose a regional organization called the La Plata Open Space Conservancy as the recipient of their conservation easement donation. In the conservation easement, the Stewards maintained ownership of the land, and reserved the right to create one additional house lot as well as development for continued ranching and agricultural use. Prohibited uses would include commercial, industrial, or further residential development.

The easement protected the land from development permanently. The easement was filed at the county land records office. Thereafter, the easement ran with the land. All future owners, including heirs, purchasers, and lenders would be prohibited from developing the property. La Plata Open Space Conservancy was charged in the easement to monitor the property to verify that the conservation easement was enforced.

Preferred recipient organizations are local in nature because they need to visit and monitor the land annually. To find a regional or national organization to hold a conservation easement, the best resource is published by The Land Trust Alliance. They publish the Conservation Easement Handbook, Appraising Easements, Conservation Options- A Landowner's Guide and The Federal Tax Law of Conservation Easements. Their phone number is (202) 638-4725. Their mailing address is Land Trust Alliance, 1331 H Street, N.W. Suite 400, Washington, DC 20005.

Alternatively, if the parcel of land was a home for certain endangered species, a more appropriate conservation organization might be the Audubon Society or Ducks Unlimited. Still yet, for historic properties, one might use the National Trust for Historic preservation.

It is essential to choose an appropriate organization because it is charged with monitoring and enforcing the easement in perpetuity. In the event that a donee organization that holds conservation easements goes out of business, the state's attorney general office would be responsible for assigning the easement to another similar organization. Many donors choose to designate a successor donee in the event that the recipient fails to fulfill its duties. Most often the donee will require an endowment fund to accept the easement. This fund is invested to earn sufficient funds to cover the cost of monitoring and enforcing easements.

In short, by granting a conservation easement, the Stewards would be able to maintain the character of their land. In addition they would receive several tax benefits based on the value of the conservation easement.

III. STATE TAX BENEFITS

1. INCOME TAX BENEFITS

Pursuant to Colorado Revised Statute Section 39-22-522, the Stewards would be entitled to a tax credit equal to the fair market value of the donated portion of the easement capped at a maximum of \$100,000 per donation. To determine the fair market value of the development rights, the IRS requires form 8283 to be completed and documented by a competent appraiser. The appraiser's letter carries great weight with the IRS. "There seem to have been very few unreasonable attacks by the IRS on conservation easements in recent years" (Small, 1997a, p. 41). The calculation of the fair market value of the easement would be the price that developers would be willing to pay for the property minus the value of the property under the restrictions of the easement. For instance, the Stewards' parcel would be evaluated as a property with two dwellings plus the present value of the earnings from the horse breeding operations. In this scenario, under the qualified appraisal, the fair market value of the land was 3.5 million dollars. The value of the land subject to a conservation easement would be one million dollars. Thus, the value of the conservation easement was 2.5 million dollars if they made one donation.

Under CRS 39-22-522, each taxpayer is entitled to a \$100,000 tax credit per year for one conservation easement donation. The Stewards might consider granting separate conservation easements by subdividing their parcel to be able to grant annual conservation easements. Each year, each donor could receive one \$100,000 tax credit to take advantage of multiple conservation easement donations over time. There is one caution about trying to create easements on parcels that are less than 80 acres. Agricultural property owners lose favorable property tax treatment when making easements on parcels less than 80 acres in size unless a smaller parcel had no structural improvements. Thus, when dividing the property, one would want to

consider keeping the portion of the property with the improvements together in an 80 acre parcel. See the property tax benefits discussed in the next section for further detail.

Because the Stewards had a small annual income, Colorado Revised Statute Section 39-22-522 provides that they can carry forward the tax credit for 20 succeeding income tax years. Moreover, beginning in 2000, pursuant to House Bill 1348, the \$100,000 tax credit could be refunded to the Stewards in cash as long as the state of Colorado ran a surplus budget. Also, House Bill 1348 provided that the Stewards could designate other taxpayers to receive the tax credit. Each transferee would have to receive at least \$20,000 of the tax credit pursuant to the legislation. Equally important, the Stewards could claim a charitable income tax deduction for the remaining value of the conservation donation above the \$100,000 tax credit.

2. PROPERTY TAX BENEFITS

Another appealing aspect of granting a conservation easement is that if the Stewards chose to discontinue their horse breeding operations, their property would still receive favorable agricultural property tax classification. Beginning in 1996, House Bill 1268 was enacted into law to ensure that property owners who donated conservation easements would be protected from increased property taxes if they chose to retire, or cease agricultural operations based on changes in market or other conditions. This preferred property tax only applies to agricultural acreage exceeding 80 acres. Smaller agricultural parcels with no structural improvements can also receive this benefit.

Similarly, if the Stewards chose to move off of the property, they would not be subjected to Colorado's 29% tax rate for vacant property that is double the rate for occupied residential property. Moreover, their vacant property would not be re-appraised at its "Highest and Best" use for tax purposes as is the case for most vacant property in Colorado.

Colorado's public policy concerning open space appears contradictory at first glance. However, after further scrutiny, it sets forth a sophisticated incentive system to maintain open space without subsidizing development speculators. The extremely high property tax rates for vacant property represents a public policy to deter speculators in bare ground from tying up open spaces for subsequent development purposes. Meanwhile, owner occupants are taxed at lower rates to avoid forcing occupants off of their property because they can't afford the property taxes in a rising real estate market. Further, the legislation promoting open space conservation via reduced property tax rates represents recognition of the value of permanent preservation of scenic views, historic properties, relatively natural habitats, and areas for public education and outdoor recreation.

3. FEDERAL TAX BENEFITS

For the purposes of Federal Income Taxes, the Stewards would be entitled to a charitable deduction for the value of the conservation easement valued at 2.5 million dollars. However, this deduction is limited to 30% of the donors' adjusted gross income. In this case, the Stewards would be limited to a deduction of about \$15,000 per year because of their income was only about \$46,000. They would be permitted to carry forward the deduction for five years. Hence, if they donated the easement on the entire 100-acres in one year, their deductions would be limited to \$75,000 (\$15,000 x 5).

In order to maximize the federal income tax deductions, it would be advisable to consider subdividing the property and donating successive conservation easements. Once the five-year period expired, they could make a second donation and start the five year period again thereby taking advantage of another \$75,000 deduction over five years. Estate Tax Benefits

One of the largest financial benefits that would accrue to the Stewards from their donation of the conservation easement would be that the value of their estate would be decreased to one million from 3.5 million. Pursuant to the Unified Federal Estate and Gift Tax provisions, each owner would be entitled to an exemption of \$675,000 as of the year 2000. Thus, by donating a conservation easement, no estate tax would be owed as long as the Stewards took advantage of their estate tax exemptions. Estate tax savings are significant because on average the federal estate tax rate is 50 percent. In many cases, this forces heirs to sell property to pay the estate taxes.

In the Stewards' case, by donating a conservation easement, they would be able to reduce their estate to one million dollars thereby avoiding all liability for estate taxes. From the Stewards' children's perspective, the children might feel that they were being deprived of two million dollars worth of property. The most common device to replace the perceived loss is life insurance. Many families purchase a second-to-die policy for two million dollars to replace the value of the donated development rights. It is essential for the heirs to own the insurance policy so that the proceeds of the policy is not counted in the parents' estate and subject to Federal Estate Taxes.

In order to purchase the life insurance, the Stewards' could make gifts of \$10,000 per donor to each child per year. These annual \$10,000 gifts would not be subject to tax under the Unified Federal Estate and Gift Tax provisions. The Stewards could fund these gifts with monies refunded to easement donors under Colorado House Bill 1348.

It is worth a comment that there have been numerous attempts by Congress to abolish the Unified Federal Estate and Gift Tax. These efforts have been unsuccessful in the

past, and are reported to be unsuccessful in the foreseeable future (Roser, 2000). On August 31, 2000, President Clinton vetoed the most recent legislation aimed at repealing the Unified Federal Estate and Gift Tax.

Congress has been successful in increasing decedents' exemption from \$600,000 in 1999 to over one million dollars by 2006. This increase in the exemption was designed to keep the real value of the exemption in step with the rate of inflation. In sum, because Federal Estate Taxes are likely to be in effect for the foreseeable future, donors of conservation easements will continue to avoid estate taxes by granting conservation easements that reduce the value of their estates subject to federal estate taxes.

IV. DISCUSSION OF PRIVATE CONSERVATION EASEMENTS IN COMPARISON TO PUBLIC CONSERVATION EFFORTS

1. SUPPLY-SIDED CONSERVATION

The central strength of conservation easements is that preservation efforts are driven by the providers' permanent desires to maintain open spaces, scenic views, relatively natural habitat, and historic property. The donors' permanent ban on the development of these parcels is legally enforceable and not subject to challenge. The donors' land use decisions are not subject to growing demand for higher density housing, commercial, or industrial use of the land. Once the development rights are legally transferred, there is little danger of the property being developed.

Second, private conservation is not subject to "Tragedy of the Commons" (Hardin, 1968). Because specific owners maintain the open space, the owner, and the conservation easement donee take responsibility for the resource. By contrast, when open space is preserved under the United States Forest Service (USFS), National Parks, State Parks, or the Bureau of Land Management (BLM) supervision, there is little incentive by the users to preserve the resource. Each user is motivated to maximize his/her own gain. There is no personal benefit in protecting the resource because other users of the common resource will maximize their own gain at the expense of others. The commons are subject to universal ruin.

From a philosophical perspective, private conservation can be grounded in ecocentrism (Wearing & Neil, 1999). This means that land use decisions may be based on the sustainability of the environment. Private conservation efforts do not have to be justified in terms of benefiting humans. They can be grounded in sustaining the balance between species, and life forms.

By contrast, decisions made by public agencies such as zoning boards, the USFS, or the BLM, are required to justify preservation efforts based on their benefits to man. This anthropocentric morality requires one to justify conservation efforts on maintaining genetic diversity for scientific use, or to provide recreational or aesthetic resources for the public benefit.

As a result of this anthropocentric perspective, public management of open spaces are always subject to political processes. By definition, public management of open spaces is demand driven. As the surrounding land changes in character, the decisions to maintain open spaces can be challenged based on the changing nature of public demand. Examples of this type of demand pressure can be found when private owners receive zoning changes permitting higher density development based on the changing character of surrounding properties.

Likewise, political pressures to allow multiple uses and higher density in BLM lands and U.S. Forests are affected by increasing demand combined with budget cuts. In the face of reduced budgets, public agencies are forced to make difficult decisions about which land they can afford to monitor. Public agencies seeking to preserve open spaces have become much more cost efficient by using public education in their efforts to recruit the public to self-monitor and preserve the character of open spaces. However, as carrying capacities are exceeded due to increased public demand, the open spaces suffer from decay, degradation, and over-use. To recapitulate, public management via zoning, public management, and education is subject to demand pressures.

V. CONCLUSION

Conservation easements represent an exciting area of private management of open spaces. It relies on appropriate donor motivation, as well as careful legal planning such as verification of the donors' title in fee simple, subordinating any outstanding mortgages to the conservation easement, and filing a carefully analyzed qualified appraisal for IRS approval.

From a personal perspective, constructive donations of conservation easements stem from consensus among the donors and the heirs apparent. Donors can make the conservation easement more palatable to heirs by purchasing life insurance on the donors' lives owned by the heirs to replace assets donated in the conservation easement. The premiums can often be funded from the tax savings generated by the Colorado state tax credit and cash refund legislation. Consensus building avoids enforcement litigation against subsequent owners of the parcel to be preserved. Consensus planning may be necessary, but it isn't sufficient. In the long run, one

needs a conservation organization that is adequately capitalized to monitor and enforce the conservation easement long after the donors are gone.

In sum, recent Colorado legislation promotes the establishment of conservation easement creation. This is an exciting intersection where property and tax law have established a framework for permanent, private open space preservation efforts. In Colorado, the legislature has created incentives for private landowners to preserve open spaces. The public sector has sacrificed potential tax revenues from likely development to promote private conservation.

Even though the Colorado legislature has enacted laws to promote private conservation efforts, this privatization scheme is dependent on the benevolent monarch concept. Unless landowners of open spaces are intrinsically dedicated to preserving the character of their land, a supply-sided conservation system cannot take root or grow in the shadow of the profits to be reaped from private land development.

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