

# CONSERVATION EASEMENTS

Prepared for the Colorado Cattlemen's  
Agricultural Land Trust

January 2007

By  
Lawrence R. Kueter, Esq.  
Isaacson, Rosenbaum, Woods & Levy, P.C.  
Suite 2200  
633 17th Street  
Denver, CO 80202  
303/2925656; Fax 303/2923152  
e-mail: *lkueter@irwl.com*  
website: *www.irwl.com*

## **CONSERVATION EASEMENTS**

### **I. What is it?**

- A. A conservation easement is a legal document which contains permanent restrictions on the use or development of land which is recorded in the real estate records. A conservation easement limits further development of the land and binds future landowners. The conservation easement is typically granted to a land trust or governmental entity.
- B. Colorado law specifically permits the creation of a real property interest by a conservation easement. C.R.S. §38-30.5-101 et seq.
  - 1. This act provides that a conservation easement is a fully transferable interest in real property. Compare to easements in gross.
  - 2. It requires that the purpose of a conservation easement be for maintaining land in a natural scenic condition, for wildlife habitat, for agricultural or recreational use, or for conserving buildings of historic or architectural value.
  - 3. To qualify as a property interest under Colorado law, a conservation easement must be granted to either:
    - a. a governmental entity, or
    - b. a 501(c)(3) charitable organization under the Internal Revenue Code, which organization was created at least 2 years prior to the receipt of the easement.
  - 4. The easement is deemed perpetual unless otherwise stated.
  - 5. Conservation easements may be donated or sold.

### **II. What is not required?**

- A. Public access is generally not required.
- B. Land encumbered by a conservation easement can be sold, mortgaged, and passed on to future generations.

### **III. What are other requirements to qualify for federal tax benefits?**

- A. A "qualified conservation contribution" satisfies the Internal Revenue Code requirements. A "qualified conservation contribution" is a:
  - 1. "Qualified real property interest";

2. Donated to a "qualified conservation organization";
  3. For "conservation purposes";
- B. A "qualified real property interest" is an "easement or other interest in real property that under state law has attributes similar to an easement."
- C. A "qualified conservation organization" is either a:
1. A 501(c)(3) charitable organization, which must generally be in the conservation field, or
  2. A governmental entity.
- D. Conservation purposes. Under the Internal Revenue Code, the conservation easement must be granted exclusively for conservation purposes. Conservation purposes include the following:
1. The preservation of land for outdoor recreation for substantial and regular use of the public;
  2. The protection of the natural habitat of fish, wildlife or plants;
  3. The preservation of open space, including farmland and forestland, where such preservation is for the scenic enjoyment of the general public or is pursuant to a clearly delineated governmental conservation policy and will yield a significant public benefit;
  4. The preservation of historically important land or a certified historic structure.
- E. Mortgage lender must subordinate.
1. Subordination by lender does not mean that they will not be able to foreclose on their security.
  2. It does mean that in the event of a foreclosure, the conservation easement will remain in effect as a restriction on the property.
  3. Whether the lender realizes the amount on its security will depend upon the value of the property with the easement in place.

- F. No surface mining.
  - 1. The general rule is that no charitable deduction is allowed if the landowner does not own the minerals if at any time there may be a removal of minerals by any surface mining method (other than very limited mining).
  - 2. However, a landowner may obtain a charitable deduction if the probability of extraction or removal of the minerals by any surface mining method is so remote as to be negligible.
- G. An easement must be perpetual.
- H. Easement must be recorded.
- I. A baseline inventory must be done concurrently with the donation to satisfy the Internal Revenue Code requirement of "documentation sufficient to establish the condition of the property at the time of the gift." It must be accompanied by a statement signed by the donor and donee that it is an accurate representation of the property at the time of the grant of the easement.
- J. Inconsistent Uses. A deduction is not allowed if the easement would protect one conservation value but permit destruction of other significant conservation interests.
- K. The instrument of conveyance must contain certain provisions.
  - 1. The instrument of conveyance must prohibit a transfer unless it is to a qualified organization and unless the donee, as a condition of the transfer, requires the conservation purposes to be continued to be carried out.
  - 2. It must provide that donee must have a right to enter the property to determine compliance with the provisions of the conservation easement.
  - 3. The qualified organization must have the right to enforce the terms of the easement.
  - 4. The donation must give rise to an immediately vested property right.
  - 5. It must provide that in the event of an extinguishment of the easement, or any subsequent sale, exchange or involuntary conversion of the property, the donee organization must be entitled to a portion of the proceeds in a proportion based on the value of the easement to the value of the property as a whole as of the time of the gift.

6. The donor must agree to notify the qualified organization, in writing, before exercising any right under the conservation easement that may impair the conservation interest.

**IV. What are typical restrictions in a conservation easement?**

- A. No subdivision or limited subdivision.
- B. Limited additional building. A landowner may reserve several homesites for present and future use.
- C. No commercial or industrial uses other than cottage industry.
- D. No surface mining.
- E. No clear cutting.
- F. Water rights.
- G. Siting of additional buildings.
- H. Management plans.

**V. How is a conservation easement valued?**

- A. A taxpayer who claims a value in excess of \$5,000 for a charitable gift must have done a qualified appraisal to substantiate the value of the gift.
- B. The appraisal will value the property before a conservation easement is placed on the property and after the property is encumbered by the conservation easement. The value of the conservation easement is the difference between the "before" and the "after" values of the property.
- C. Possible to do a present value analysis of the development rights, taking into account absorption rates and development costs.
- D. The appraisal must be a "qualified appraisal" done by a "qualified appraiser."
- E. If the conservation easement does not cover all of the property owned by the donor or related parties, then any enhancement to the value of the property is offset against the value of the conservation easement.
- F. The appraisal is the document most likely to be reviewed by the I.R.S.

- G. The Pension Protection Act enacted changes regarding appraisers and appraisals. Prior to the Pension Protection Act of 2006, Internal Revenue Code §170(f)(11)(E) defined a "qualified appraisal" as an appraisal done pursuant to the regulations or other guidelines of the Secretary of the Treasury. The Pension Act revised this section to provide that a "qualified appraisal" is an appraisal that is done pursuant to the regulations of the Secretary of the Treasury and is conducted by "a qualified appraiser in accordance with generally accepted appraising standards" and subject to other guidance of the Secretary.
1. A "qualified appraiser" under Internal Revenue Code §170(f)(11)(ii) and (iii) is an individual who:
    - a. Has earned an appraisal designation from a recognized professional appraisal organization or has otherwise met minimum education requirements.
    - b. Regularly performs appraisals and receives compensation.
    - c. Meets other requirements as may be prescribed by the Secretary.
    - d. Demonstrates verifiable education and experience in valuing the type of property subject to the appraisal.
    - e. Is not an individual who has been prohibited from practicing before the Internal Revenue Service during the prior three years.
  2. A "qualified appraisal" as defined in Treasury Regulation §1.170A-13(c)(3) is an appraisal which:
    - a. Must be made not earlier than 60 days prior to the date of contribution.
    - b. Include certain information which is described below.
    - c. Be prepared, signed and dated by a "qualified appraiser".
    - d. Not involve a prohibited appraisal fee, such as a fee based on the percentage of the valuation.
  3. Prior to the Pension Act, the law imposed accuracy related penalties of 20% for an underpayment of tax resulting from a "substantial" valuation misstatement and 40% for a "gross" valuation misstatement. The definition of a "substantial" valuation misstatement was that the value was at least 200% or more of the amount determined to be the correct value. A "gross" valuation misstatement meant a value claim that was 400% or more of the amount determined to be the correct value.

The Pension Act lowers the threshold for these accuracy related penalties. A "substantial" valuation misstatement now is 150% or more of the amount determined to be the correct value and a "gross" valuation misstatement is where the value claimed is 200% or more of the amount determined to be correct. The code also eliminates the reasonable cause exception in the case of any "gross" valuation misstatement.

The procedural requirements for the Secretary of the Treasury to impose civil penalties or disciplinary action against the appraiser have also been streamlined.

## **VI. What are the tax benefits for individuals?**

### **A. Federal Tax Benefits**

1. Income Tax Deduction. If a conservation easement satisfies the Internal Revenue Code requirements, then the grantor may receive a charitable income tax deduction (not a tax credit) for the difference in value of the property before the easement was granted compared to the value of the property after the granting of the conservation easement. The general rules regarding the use of this charitable income tax deduction are as follows:
  - a. May be used against ordinary income as well as capital gains.
  - b. Limited to basis until the property is owned for one year.
  - c. Limited to 30 % of adjusted gross income.
  - d. May be used in the year of the donation and each of the following five years.
  - e. Gift of cash or if donation is limited to basis - limit raised to 50 % of adjusted gross income.
  - f. C Corporation - deduction limited to 10% of corporation's contribution base (taxable income with certain adjustments).
  - g. S Corporation - deduction passes through to shareholders but limited to their basis in their stock.
  - h. Partnerships, limited liability companies - deduction passes through to owners without the basis limitation.

**Example:** June owns Wonderview Ranch, a beautiful mountain ranch. If June sold the Ranch it would produce a long term capital gain. June places a conservation easement on the Ranch in 2005. The Ranch's fair market value (FMV) before the easement is \$3,000,000 and the value of the property after the easement is \$1,500,000. June has reduced the value of the Ranch by 50% and made a \$1,500,000 charitable contribution. June has an adjusted gross income (AGI) of \$60,000. June would be allowed to take a charitable deduction up to 30% of her AGI or [ $\$60,000 \times 30\% = \$18,000$ ] in the year she makes the charitable contribution. She could carry forward the remaining \$1,482,000 of deduction and apply it against income for the next five years subject to the 30% limitation. If June's income remains at the same level, she would not be able to use the entire deduction.

2. Pension Protection Act of 2006. On August 17, 2006, the President signed the Pension Protection Act of 2006 (the "Pension Act") that revised the rules for how the charitable donation of a conservation easement may be used against federal income. The Pension Act is currently only applicable for conservation easement donations made on or after January 1, 2006 and on or before December 31, 2007. There are no regulations to interpret the Pension Act, and there are not likely to be unless the incentives are extended past 2007. Therefore, we have only the law to guide us, and no clear interpretation of some of the provisions.

- a. Rules Prior to Adoption of the Pension Act:

- i. The charitable deduction was generally limited to 30% of an individual's adjusted gross income ("AGI").
- ii. Any unused portion of an easement deduction could be carried forward for five years after the year of the donation (six years total), or until the amount of the deduction is used up, whichever came first.

- b. Rules under Pension Act during 2006 and 2007

- i. The Pension Act raises the amount of a conservation easement's fair market value an individual taxpayer may claim as an income tax deduction in any year to 50% of AGI.
- ii. Previously, individual taxpayers were allowed to carry forward the value of any qualified conservation contributions that exceeded 30% of the AGI limitation for up to five years. The Pension Act allows individuals to



carry forward the value of a qualified conservation contribution in excess of the new 50% of AGI limitation for up to 15 years.

- iii. Qualified farmers or ranchers may deduct the conservation easement value up to 100% of their AGI, with the same 15 year carryforward period, for donations of conservation easements that satisfy the following requirements (referred to hereafter as the "agricultural requirements of the Pension Act"):
  - A qualified farmer or rancher is a taxpayer who earns more than 50% of his or her gross income from the business of farming in the taxable year in which the conservation contribution is made. The definition of "farming" is the definition set forth in IRC §2032A(e)(5).
  - The conservation easement must cover property that is used, or is available for use, for agricultural or livestock production.
  - The conservation easement must contain a restriction that the property will remain available for agricultural or livestock production.
- iv. Income Tax Deductions for Farming and Ranching Corporations. Prior to the Pension Act, all corporations faced a limitation of up to 10% of their taxable income for qualified conservation contributions. For conservation easement donations in 2006 and 2007, the Pension Act allows corporations earning more than 50% of their income from the business of farming to deduct up to 100% of taxable income with a 15-year carryforward period for a qualified conservation easement that also satisfies the agricultural requirements of the Pension Act. In order to qualify, the stock of a farming or ranching corporation cannot be readily tradable on a securities market.
- v. Subchapter S Corporations. For corporations that elect Subchapter S treatment under the Internal Revenue Code, a charitable donation may not be limited to the basis in the stock of the corporation for donations made during 2006 or 2007.

- vi. **Effective Date.** The increased Pension Act tax incentives apply to qualified conservation easements donated from January 1, 2006, through December 31, 2007. Unless Congress votes to extend the Pension Act provisions before they expire, the income tax rules for conservation easements will revert to their status before the Pension Act's passage on January 1, 2008. The requirement that the conservation easement contain a restriction that the property will remain available for agricultural or livestock production only applies to conservation easement donations after the date of enactment of the Pension Act.
3. **Estate Taxes.** For estate tax purposes, the grant of the easement results in a lower value for the property and therefore a lower value of the estate for the federal estate tax, and may generate an additional exclusion from the valuation of an estate for property subject to a conservation easement.
- a. Lowers value of property to "after" value.
  - b. Removes a portion of the property's appreciation from estate.
  - c. **1997 Taxpayer Relief Act.** If the easement qualifies as a "qualified conservation easement" under the 1997 Taxpayers Relief Act, then forty percent (40%) of the value of the property remaining after the granting of an easement is excluded from the value of the estate, up to a maximum exclusion of \$400,000 in 2001 and increasing to \$500,000 in 2002.
- (1) Land subject to a "qualified conservation easement" means land that:
    - (a) Is located within the United States or any possession of the United States
    - (b) Where the conservation easement includes a prohibition on more than a *de minimus* use for commercial recreation activity, and
    - (c) Is owned by the decedent or a family member of the decedent for the three years prior to decedent's death.
  - (2) The exclusion does not apply to any retained development rights.

**Example:** Same facts as above except June dies in 2002, after placing the easement on the Ranch. (The FMV of the Ranch before the easement is \$3,000,000. The estate tax due on the Ranch without the easement is approximately \$780,000. This number is found by subtracting the \$1,000,000 exemption and applying the applicable tax on the remaining \$2,000,000). Remember from the previous example that the FMV after the easement is \$1,500,000. The estate tax on the ranch with the easement is approximately \$155,000. The easement saves June's family over \$600,000 in estate taxes. If the easement qualifies as a "qualified conservation easement" under the 1997 Taxpayers Relief Act, an additional \$500,000 of value (the lesser of \$500,000 or 40% of \$1,500,000) may be excluded from estate tax calculation. So with the \$1,000,000 exemption and the \$500,000 exclusion, with the easement, the estate tax on this property is eliminated.

B. Colorado Tax Benefits.

1. Property tax benefits in Colorado. The value of property should be split between the value of the conservation easement and the value of the lands subject to the easement.
2. Benefits of House Bill 95-1268.
3. Colorado Income Tax Benefits. In 1999, the Colorado Legislature passed House Bill 99-1155 for a tax credit against Colorado income tax for the donation of a conservation easement. In 2000, House Bill 1348 permitted a transfer or refund of the credit, and House Bill 1090, passed in 2001, increased the amount of the credit, beginning in 2003. In 2006, House Bill 1354 again increased the amount of the credit, beginning in 2007. Key elements of the legislation are:
  - a. Limited to first \$100,000 for donation of conservation easements prior to January 1, 2003.
  - b. No double counting, cannot take a deduction and credit for same \$100,000.
  - c. Twenty years to use.
  - d. For conservation easements donated after January 1, 2003 and up until and through December 31, 2006, 40% of the amount over \$100,000 may also be claimed as a credit, with the maximum total credit not to exceed \$260,000. The practical effect of this requires a \$500,000 donation in order to take full advantage of the \$260,000 tax credit. [ $\$100,000 + (40\% \text{ of } \$400,000)$ ].

- e. For conservation easements donated after January 1, 2007, 50% of the conservation easement's fair market value may be claimed as a credit, with the maximum total credit increasing to \$375,000. The practical effect of this new maximum credit requires a \$750,000 donation in order to take full advantage of the \$375,000 tax credit. [ $\$375,000 = 50\%$  of  $\$750,000$ ].
- f. For conservation easements donated from January 1, 2000, to December 31, 2002, the income tax credits claimed by joint tenants, tenants in common, partnerships, or corporations shall be allocated to the entity's owners or members in proportion to their distributive shares of income or ownership interest in the entity, and the total aggregate of the credits shall not exceed \$100,000. For conservation easements donated from January 1, 2003, to December 31, 2006, this total aggregate of the credits claimed shall not exceed \$260,000, and for conservation easements donated on or after January 1, 2007, this total aggregate of the credits claimed shall not exceed \$375,000.
- g. Appraisal summary required to be filed.
- h. Can claim a credit for only one donation per income tax year.
- i. May transfer credit to third party. For easements donated prior to January 1, 2003, the minimum amount of the transfer is \$20,000. After January 1, 2003, there is no minimum amount.
- j. Can claim a refund from the State in years which state revenues exceed the limitation on state fiscal year spending under the Tabor Agreement. If a refund is claimed, the total of the credit used to offset taxes and the refund cannot exceed \$20,000. This total increases to \$50,000 for conservation easements donated after January 1, 2003.
- k. Third party transferee cannot claim a refund.

**Example:** Back to June and the Wonderview Ranch. In addition to the federal income tax deduction and estate tax benefits, June can also qualify for the Colorado income tax credit. She has the option of selling all or part of the tax credit. If the easement is donated after January 1, 2003, but prior to January 1, 2007, June receives a tax credit of \$260,000. If the easement is donated after January 1, 2007, June receives a tax credit of \$375,000.

4. FYI Income 39 (Revised September 2001). This was issued by the Colorado Department of Revenue and clarifies the Colorado income tax credit for conservation easements in several ways.
  - a. The tax attributes of the credit are determined by the laws as they exist in the year the credit is created.
  - b. If one member of a pass-through entity claims a refund, the maximum amount of the credit used collectively by the pass-through entity is \$20,000 (increasing to \$50,000 if the donation is made after January 1, 2003).
  - c. A credit may be transferred only once.
  - d. Credits transferred after January 1, 2003 for donations made prior to that date are still subject to the minimum transfer amount of \$20,000.
  - e. Sets forth the information required in the written statement to be filed by the donor and transferee.
  - f. If a credit is later disallowed in an audit, the transferee is liable for the disallowed credit that was claimed.
  - g. A transferee must purchase the credit prior to the due date for filing the transferee's Colorado income tax return (not including extensions).
  - h. Additional credits may not be earned by a taxpayer or transferee during any year in which a prior credit is being carried forward.
5. The IRS has issued a Technical Assistance Memorandum which states that individual taxpayers who purchase a conservation easement credit as transferees, will not lose their federal deduction for state income taxes when they apply the credit to their Colorado income tax liability.

C. Current Federal Estate Tax Requirements.

1. Estate tax return and tax due nine months after death. The Economic Growth and Tax Relief Reconciliation Act of 2001 changes the estate tax system. It will gradually phase out and then repeal the estate tax in 2010. However, Congress must reenact the Act by 2010 for the repeal to continue. If not reenacted, the estate tax system reverts to the rates in effect before the Act was originally signed.

Calendar Year	Estate tax exemption amount	Highest estate tax rates
2002	\$1 million	50 %
2003	\$1 million	49 %
2004	\$1.5 million	48 %
2005	\$1.5 million	47 %
2006	\$2 million	46 %
2007	\$2 million	45 %
2008	\$2 million	45 %
2009	\$3.5 million	45 %
2010	Estate tax repealed	Estate tax repealed

**VIII. What are other issues related to conservation easements?**

- A. Dealer Issues. Different tax rules apply to the grantor of a conservation easement if they are a "dealer" under the Internal Revenue Code rules. A developer usually is a dealer. A dealer is limited to a tax deduction equal to her "basis" (or cost) of the donated property. This is particularly a problem where the property is owned by a dealer and the land has appreciated substantially in value.
- B. "Donative Intent". A conservation easement that is granted in return for something, i.e., where there is a "quid pro quo", does not satisfy the "donative intent" requirement and does not qualify for a charitable deduction. An example is a conservation easement granted by a landowner to a city in exchange for annexation or zoning of the property. A conservation easement granted to take advantage of a rural cluster zoning is probably another example.
- C. A gift of a conservation easement can be made by will. A gift made by will is considered effective as of the date of death and will reduce the estate taxes of the decedent.

1. The 1997 Taxpayer Relief Act and the 1998 technical corrections bill allow a post-mortem election of a qualified conservation easement by an executor.
  2. Senate Bill 99-101 grants authority to executors to make this election under Colorado law, subject to notice to interested parties.
- D. Conservation easements are interests in real property that can be used in tax-free like-kind exchanges.
  - E. Caution: For estate tax purposes, property is valued without regard to any restriction unless it satisfies the requirements for a charitable deduction or unless it is a bona fide business arrangement.
  - F. Another caution: a donated conservation easement which does not satisfy the requirements for a charitable deduction may be a taxable gift.
  - G. A conservation easement may be donated or sold.
  - H. A cash donation to the land trust as an endowment for monitoring and enforcement of the conservation easement is usually part of the transaction.

**IX. What is a "limited" or "protective" development?**

- A. A limited or protective development is one in which a limited number of lots are sold to generate revenues sufficient to allow for the preservation of the balance of the property. A conservation easement is used to preserve the balance of the property and may generate a charitable income tax deduction if properly structured. The lots may be clustered or otherwise sited in such a way as to protect the conservation values of the property.

**X. What are the steps to accomplish a conservation easement?**

- A. Identify values to be protected
- B. Identify your financial goals
- C. Create a land plan
- D. Locate a land trust
- E. Consult with your tax advisor
- F. Obtain a title report for your property (mortgage, covenants, minerals)

- G. Prepare the deed of conservation easement
- H. Obtain an appraisal of the conservation easement
- I. Obtain a baseline inventory of the property
- J. Sign and record the conservation easement