



Strategies for Using Conservation Easements in Tax and Estate Planning

By David Braun

Conservation easements are extraordinary tax and estate planning tools for clients with recreational or agricultural land they wish to keep undeveloped over many years or generations. Easements result in major income and estate tax savings and sometimes property tax savings, thereby greatly increasing the affordability of undeveloped land. These savings improve flexibility and allow clients to respond to competing planning priorities. The financial implications of easements are complex, and clients committed to long-term ownership of recreational or agricultural land need help assessing this strategy.

Technically, a conservation easement is a legal agreement between a landowner and a qualified organization (usually a nonprofit conservation group or a government agency) that permanently limits the use and/or development of land to protect its natural habitat, open space, scenic, educational, recreational, historical, or cultural values. Code § 170(h). In the modern American context, almost any land that a client would want to retain undeveloped has enough of these values to interest some qualified organization. As an incentive to conserve these values,

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Congress and many states and local governments have recognized tax deductions and exclusions in exchange for these restrictions.

When the price of undeveloped land grows beyond its value as an agricultural investment, clients face a dilemma. Is the land a financial asset or is it an heirloom with emotional and spiritual value? This dilemma becomes a conflict when some family members view it one way and others the opposite. The land cannot be both a financial asset, to be sold for the highest price, and an emotional anchor for the family. Many families resort to Solomon-like compromises, such as selling off or developing pieces to satisfy some family members while preserving some of the land for others. This approach does not usually satisfy either group.

Conservation easements offer an opportunity to disentangle the two competing views. Easements formalize and make permanent the commitment to the land's recreational and agricultural values. They also generate tax savings that increase financial liquidity and allow the owners to invest in true financial assets. With the help of planning professionals and sufficient time, it is possible to replace or exceed the full value of the unrestricted land, without giving up the most cherished values in the land.

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Tax Savings

A landowner can generate tax savings by donating the easement to the qualified organization, creating charitable deductions from income tax (Code § 170(f)(3)(B)(iii)), and reducing the value of the taxable estate (Code § 2031(a)). The size of the deduction/reduction is equal to the value of the easement, which is equal to the amount that the appraised value of the land has been devalued by the restrictions imposed. Congress has provided for an additional exclusion of up to \$500,000 for an estate that has given a conservation easement. Code § 2031(c). The following states have approved state tax credits: Alabama, California, Colorado, Connecticut, Delaware, Maryland, North Carolina, South Carolina, and Virginia. Property tax savings can also be achieved through reduction of the taxable value. Altogether, this package of tax and planning tools can create extraordinary opportunities for clients who intend to keep land undeveloped for the long term and who have the income or wealth to use tax deductions and reductions.

Actual tax savings vary widely depending on the location and status of the land and the tax situation of the owners. Estate-planning clients, however, will often be eligible for major tax savings. The biggest factors are

- the extent the land value is inflated by development potential;
- the client's ability to use income tax deductions and estate tax protection; and
- the type and extent of limitations the client is willing to place on the land.

Donating "Development Value"

The value of open land located near cities is generally increased by its

potential to be subdivided and developed. Clients who view the land as long-term recreational or agricultural land are not using this "development value." A conservation easement allows a landowner to give away this unused value in exchange for tax savings. An easement on land within a city's development envelope can achieve deduction/reductions from 50% to 90% of the value of the land. Rural land typically can generate deduction/reductions from 30% to 60%. Other types of restrictions usually do not contribute as much to the value of an easement.

Other Restrictions on Use

Besides development limitations, there are many other optional restrictions that a landowner-client can place in a conservation easement. In aggregate, the restrictions may have a significant effect on the client's tax savings. They range from allowing public access to limits on the type and extent of agricultural, timbering, or hunting activities. These restrictions depend a great deal on the individual client's view of conservation and the qualified organization with whom he or she chooses to work. The full range of possible provisions is covered later in this article.

Ability to Use Deductions

This article will not cover all the issues that can affect a client's ability to use income tax deductions and estate tax protection. These will be familiar to most practitioners. In short, income tax savings from conservation easements flow from their status as charitable gifts and all the rules of charitable giving and itemized deductions apply.

Estate tax savings occur because the easement reduces the total value of an estate. The actual savings depend on the size of the estate and the value of

the easement. All normal rules of appraisal and valuation apply, with two additions. First, in the absence of sales of comparable easements, the easement value is equal to the appraisal of the land before it is restricted minus the appraisal after it is restricted. Treas. Reg. § 1.170A-14(h)(3)(I). Second, the amount of the special exclusion for estates involving conservation easements is capped at \$500,000 in 2002 and is calculated by a formula related to the value of the easement and its proportion to the value of the land. Code § 2031(c).

The estate tax savings accrue whether the easement was created in the client's lifetime or by action of a trustee empowered by the client's will. Code § 2055(f). Conservation easements can be used with other estate planning tools, such as family limited partnerships, to compound the deductions/reductions. The benefits of converting a "frozen asset" to cash liquidity can be multiplied by using tools like an irrevocable life insurance trust (ILIT).

When and How to Recommend a Conservation Easement

Clients with land that they intend to leave undeveloped should be made aware of conservation easements and be helped to evaluate the potential benefits. The land may be recreational property purchased by clients interested in hunting or as a country home. Or the property may be inherited land that has been in the family for generations. The land does not have to be spectacular or unique, nor does the client have to be an active conservationist. The land can be actively used for ranching or agricultural production. Moreover, the client does not need an independent commitment to leave the land undeveloped forever. That is why there are incentives.

Even when the commitment to keeping the land undeveloped is as little as ten years, it is worth evaluating the financial benefits of an easement, because the tax incentives can be great enough to make the client consider a permanent commitment. For example, a client who intends to

keep land during his lifetime or until his children grow up, then treat it like any other investment, may find that the easement with its current tax incentives gives a better financial result than selling or developing the land later.

The result depends on the time value of money, and that can only be evaluated in the context of each individual situation. Clients who hold land undeveloped for a decade or more may lose a financial opportunity if they are not helped to evaluate the financial benefits of a conservation easement. The loss of opportunity is compounded for clients who are motivated by their desire to preserve the land. They lose a financial reward for doing what they were already emotionally inclined to do anyway.

Recapturing Stranded Capital

In many parts of the country, the price of undeveloped land has grown beyond its value as an agricultural investment. Most of this value represents the development potential of the land. Someone who is committed not to subdivide or develop has an asset that they are not using, and therefore a large amount of capital that is poorly invested. Most recreational and agricultural landowners think that this is simply the price one pays for owning land. But the income tax savings from conservation easements make it possible for landowners to regain some of the unused capital and continue to use that part of the land that really interests them.

A landowner may be able to recapture 10% to 30% of the value of the land through income tax savings alone, without giving up any of the intended uses. The money saved can be invested in higher-return investments, which even if conservative and taxable can eventually replace the value given away. And, of course, the landowner still owns the restricted land, which continues to appreciate and can be sold if the need arises. In many parts of the country, the market for restricted land is at least as strong as the market for other recreational or agricultural land.

In families without sufficient liquid assets, the conservation easement can save the heirs from selling all or part of the land in order to pay taxes.

If clients plan to leave the land to their heirs, the tax incentives are even more valuable. The income tax savings can be used to fund an irrevocable life insurance trust. The life insurance policy can be structured to immediately replace the value given away, or more, with nontaxable death benefits payable to the heirs. Estate tax savings can dwarf the income tax savings, preserving much of the estate that would have been paid to the government. In families without sufficient liquid assets, the conservation easement can save the heirs from selling all or part of the land in order to pay taxes.

Conservation easements must be presented to clients in the context of these financial concepts, unless they are motivated only by conservation and are simply looking for a means of preserving the land. Otherwise, they will tend to see an easement as unduly giving away value and imposing restrictions on future owners of the land. Once they understand the financial benefits for themselves, their heirs, and other future owners of the land, they may find themselves willing and excited about extending their commitment to leave the land undeveloped.

Client Profiles

The most likely profiles of clients who will be able to use the benefits of conservation easements are

- successful, urban owners of rural land,
- cash-poor, land-rich families in agriculture, and
- well-to-do families with “heritage” land.

These clients will either be highly motivated to keep the land undeveloped or they will be able to take advantage of the tax deduction/reductions that incentivize even

moderate interest in long-term conservation.

Best Case Scenario

The best case scenario for conservation easements will involve most if not all the following elements:

- undeveloped land near an urban area that has high development value,
- a wealthy landowner with sufficient income to use deductions over six years,
- a landowner highly motivated to preserve the land, and
- land with unique natural or historical attributes that provides strong public benefit.

Introducing Clients to Conservation Easements

The recommended steps for introducing conservation easements to clients include:

- Have a face-to-face meeting at which easements and their financial implications can be explained and questions thoroughly answered.
- Ask for permission to develop a “rough estimate” of the client’s potential tax savings, assuming simple restrictions on future development and subdivision.
- Consult on an hourly basis with an MAI-certified appraiser, experienced with conservation easements, to estimate the value of an easement on the client’s land.
- Consult with the client’s accountants or financial advisors to estimate the size of charitable deductions the client would be able to use.
- Present the rough estimate of the client’s tax savings along with other estate planning tools that can multiply the benefits, such

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as ILITs or family limited partnerships.

- If the client is interested, explore desirable restrictions and compatible qualified organizations.

It is important to note that legal fees for tax advice on a conservation easement are deductible and that other costs may be added to the client's basis in the property.

Preparing for Drafting an Easement

After assessing the potential benefits and securing the client's interest, the attorney should engage the client, and possibly potential heirs, in a careful planning process to determine what restrictions on the land would be compatible with current and future use of the land.

Permissible Categories of Conservation Easements

First, the planning group should determine which of the four permissible categories of conservation will be the focus of the easement:

- protection of relatively natural habitat,
- open space and scenic enjoyment,
- outdoor recreation or education, or
- historical or archeological preservation.

Code § 170(h)(4).

At least one of these categories of conservation must be identified and supported by the terms of the easement. Each category has its own requirements. Most easements focus on the protection of habitat for fish and wildlife or on open space for scenic enjoyment. Many organizations actively seek to protect these conservation values, and these categories are easier to support than the other categories.

The preservation of open space, including farmland and forestland, can be accomplished by restricting intense development. Open space must be shown to provide scenic enjoyment for the general public, or it must be conserved for a clearly delineated government policy.

Outdoor recreation and education must be for the benefit of the general public. This greatly limits the use of this category, because few landowners want to open their property to the general public. Likewise, historical or archeological preservation requires some public access. But this access can be more limited; for example, an historical monument clearly visible from the roadside or during limited tour times can qualify.

Specific Terms to Consider

After determining the conservation category, the planning group is ready to explore specific terms. It must carefully think through the current and future uses of the property. It is usually helpful to work through the following list of possible uses and determine the extent and form of each activity to be allowed in the future:

- Subdivision and partition?
- Additional home and building sites?
- Agriculture and grazing?
- Oil and gas drilling?
- Timber management?
- Hunting and fishing?
- Other commercial activities?
- Road and trail building?
- Use of motorized vehicles?
- Habitat management and restoration?
- Exotic species management?
- Management of water features?
- Management of scenic and open space?
- Permitted outdoor recreation?

- Permitted outdoor education?
- Maintenance of historic features?
- Trash and dumping practices?
- Monitoring and access agreements?

Choosing a Qualified Organization

Having determined the client's intended use of the land and the compatibility of certain restrictions, it is time to discuss qualified organizations. Code § 170(h)(3). Some clients will already know a qualified organization to which they want to donate the easement. Others will be uncertain. Many types of qualified organizations exist, and each has its own mission and approach to conservation easements. It is extremely important to match the client and the land to the right organization.

The chosen organization will have its own goals and concerns in accepting a perpetual easement, because accepting the easement carries a permanent obligation to monitor and enforce the terms. After determining his or her own priorities, the client should expect to negotiate with the qualified organization. Drafting the easement should proceed only after negotiating final restrictions that are acceptable to both the client and the qualified organization.

Major Challenges for Legal Advisors

The legal issues raised by conservation easements are not particularly difficult, but they fall at the intersection of tax, real estate, environmental, and estate planning law. This can make easements challenging for most attorneys, who become specialists in only one or two of these areas. Still, nonlegal issues are the major challenge for most attorneys advising clients on conservation easements. These include (1) knowing the various qualified organizations and how to negotiate with them and (2) knowing other experienced professionals who can consult on technical issues.

Knowing and Working with Qualified Conservation Organizations

The most common organizations that routinely accept conservation ease-

ments are called land trusts. Over 1,200 land trusts currently work in the United States, some locally and some nationally.

Land trusts come in all shapes and sizes, and each has its own unique interests and mission. Land trusts tend to focus on preserving open space in a discrete geographic area or on preserving a particular biological or land feature. Examples of geographically focused land trusts would be those that work in a particular watershed, county, or bioregion. Examples of land trusts focused on a particular feature would be those that are interested in springs or archeological sites or bat conservation.

Some huge land trusts like The Nature Conservancy and the Audubon Society operate in every state and also on an international scale. They have professional staff and sophisticated resources to form active partnerships with landowners who contribute easements. Other land trusts are run entirely by volunteers and lack the resources of the larger organizations, though these smaller land trusts may be very sophisticated and capable.

Even the largest land trusts will have limits on the types of easements that they accept. For example, the National Trust for Historic Preservation considers only historic sites, and The Nature Conservancy works only with rare and endangered species and ecosystems. The Audubon Society is interested only in bird habitat, and Ducks Unlimited is interested only in waterfowl habitat.

Many other types of organizations are qualified to accept conservation easements. Any government organization is qualified, if it has a mandate to own and conserve land of the permissible categories. For example, any government entity with the authority to own and operate parks, historic sites, and recreation areas is qualified. A government agency with an environmental mandate would also be qualified, but many government agencies that are qualified do not have policies in place and will not readily accept easements.

Other nonprofit organizations can also be qualified to accept easements, if they have a sufficient "conservation purpose" in their mission. For example, education or recreation organizations may accept easements for those categories, if they have the preservation of land for those purposes as part of their mission. A university might hold an easement for land used in biological research, or a neighborhood association might hold an easement on a common area used for recreation.

Matching the Client with the Qualified Organization. Matching the client and the land to the best organization, keeping in mind long-term interests, is crucial. Matching the mission of the organization to the client's conservation purpose is the first step. The more subtle work comes in matching the style and personality of the parties. Some clients will feel most comfortable with organizations that have hunting as part of their mission. These clients are not likely to relate well to groups that have an environmental-activist personality. Others will want a combination of conservation and agriculture on their land and will need a group that supports multiple use. Luckily, there are organizations of all types, and more are created all the time.

Some clients will not find the perfect match. In those cases, it may be possible to recruit nonprofit organizations that could qualify or to start new organizations. Many nonprofit organizations could accept easements to further their mission but have not yet made that decision. For example, associations of cattle raisers in some states have begun to accept easements to promote the health of their industry, but in many states no organization is currently doing that. Depending on the organization, they may already be qualified, or they may need to amend their bylaws, or they may want to start a subsidiary organization.

Requirements of the Qualified Organization. Most qualified organizations are not passive recipients of easements. Experienced organizations have very specific conservation measures that

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they want to see in the easement. Most also have financial and procedural requirements. The most important of these will be a requirement for an endowment.

Organizations want endowment funds donated, at the time they accept an easement, to fund the perpetual monitoring and enforcement of the easement. A typical request for an endowment will be a few percentage points of the value of an easement. The group invests this money and uses the interest to fund the cost of regularly checking on compliance and of enforcement when needed.

These requests should be negotiated and not accepted without careful justification. The group should be able to document its actual costs and relate them to the size of the endowment for the client's particular easement. Easements on larger properties, for example, do not require proportionally more monitoring and enforcement, so

the same percentage as required for smaller properties is usually not justified.

Most groups also require that the initial status of the property be documented, so that future disputes do not develop over compliance with the easement. Documentation provides valuable protection for the client and future owners as well. The IRS also requires these baseline studies, and minimum standards are set by regulation. They include photographs and maps of the property as well as written descriptions of the conservation values. Larger organizations will have staff to perform this documentation. Others may ask the client to fund a consultant to do the work.

Knowing and Working with Other Consultants

Another major issue for attorneys assisting clients with conservation easements is the ready accessibility of other experienced professionals. The expense

of having these advisors is not large, but their input can be invaluable. In many states, the list of professionals with easement experience is exceedingly short, so time must be spent locating them or educating otherwise competent consultants.

A certified, third-party appraiser must value an easement to qualify it for federal tax incentives. Treas. Reg. § 1.170A-13(C)(3). Getting a reliable appraisal of the property that can stand up to IRS scrutiny is essential, because all IRS challenges of easements have been over valuation. Time spent locating an experienced appraiser will be well spent, because only he or she will have had reason to study and use the procedures.

Land planners can have a huge effect on the valuation of an easement in situations in which a development plan clarifies and helps quantify the highest and best use for a property. A land plan done with the wrong focus or in the wrong circumstances, however, can be a complete waste of time and money.

The client's accountant or financial advisor will be the best consultant on the tax issues that arise from the client's specific circumstances. In complex cases, however, it can be helpful to have an experienced CPA or tax lawyer available to consult on maximizing the use of the deductions.

Land surveyors are needed when only part of the property is placed under easement or when certain areas are going to be reserved. Experienced biologists or historians are needed when documenting the property baseline. Finally, specialists such as oil and gas engineers or timber managers are very helpful when drafting the specific terms of the easement.

Conclusion

This article provides a basic introduction to conservation easements and strategies for using them. For case studies and examples of successful use of easements, please feel free to contact the author at d_braun@mindspring.com. ■

