The Rocky Mountain Land Use Institute

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Recent Developments in Land Conservation

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RECENT DEVELOPMENTS IN LAND CONSERVATION

I. PENSION PROTECTION ACT OF 2006

Expansion of Federal Conservation Easement Tax Incentives

A. Overview

1. On August 17, 2006, the President signed the Pension Protection Act of 2006 (the "Pension Act"). The Pension Act significantly increases the ability of individuals and corporations, particularly farmers and ranchers, to use federal income tax deductions from the donation of conservation easements that are considered qualified conservation contributions under the Internal Revenue Code (the "Code").

B. Federal Income Tax Benefits Prior to the Pension Act

1. Prior to passage of the Pension Act, the income tax deductions available for qualified conservation contributions were generally limited to no more than 30% of the taxpayer's adjusted gross income ("AGI").

2. Previously, individual taxpayers were allowed to carry forward the value of any qualified conservation contributions that exceeded the 30% of AGI limitation for up to 5 years.

3. Prior to the Pension Act, corporations faced a limitation of up to 10% of their taxable income for qualified conservation contributions.

C. The Pension Act's Expansion of Federal Income Tax Benefits

1. The Pension Act raises the amount of a conservation easement's fair market value an individual taxpayer may claim as an income tax deduction to 50% of AGI.

2. 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.

3. 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:

a. 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 a narrow definition set forth in the Code.

b. The conservation easement must cover property that is used, or is available for use, for agricultural or livestock production.

c. The conservation easement must contain a restriction that the property will remain available for agricultural or livestock production.

4. 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 agricultural conservation easement. In order to qualify, the stock of a farming or ranching corporation cannot be readily tradable on a securities market. This change offers a major opportunity for private farming and ranching corporations to take advantage of tax incentives that were previously severely restricted for them.

D. Effective Date and Duration

1. The increased Pension Act tax incentives currently 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, on January 1, 2008, the income tax rules for conservation easements will revert to their status before the Pension Act's passage.

2. On January 31, 2007, Senator Max Baucus (D-MT) introduced Senate Bill 469, which would make the Pension Act’s expanded tax incentives for conservation easements permanent.

E. Changes to Appraisal Rules

1. The Pension Act permanently tightens the oversight standards governing appraisers and lowers the threshold for imposition of accuracy-related penalties upon taxpayers by the IRS for all charitable gifts. The key changes are as follows:

a. The thresholds for imposing accuracy-related penalties on taxpayers were lowered. The threshold for “substantial” valuation misstatements has been lowered, from a claimed value of 200% of the amount determined to be the correct value, to 150%. The threshold for “gross” valuation misstatements has been lowered from 400% to 200%.

b. The thresholds for accuracy-related penalties for substantial and gross estate or gift tax valuation misstatements were also lowered.

c. The appraiser penalties were increased for appraisals used to support a tax position if the appraisal results in a substantial or gross valuation misstatement. The Pension Act also makes it easier for the IRS to initiate disciplinary proceedings against appraisers.

d. The Pension Act tightens the definition of "qualified appraiser" under the Internal Revenue Code. The act also references this more restrictive definition in its modified definition of "qualified appraisal."

e. The Pension Act now defines a “qualified appraisal” as an appraisal completed pursuant to the regulations of the Secretary of the

Treasury *and* conducted by "a qualified appraiser in accordance with generally accepted appraising standards" and subject to other guidelines of the Secretary.

f. The Pension Act defines a "qualified appraiser" under Internal Revenue Code §§ 170(f)(11)(ii) and (iii) as an individual who:

i. Has earned an appraisal designation from a recognized professional appraisal organization or has otherwise met minimum education and experience requirements;

ii. Regularly performs appraisals and receives compensation;

iii. Meets other requirements as may be prescribed by the Secretary;

iv. Demonstrates verifiable education and experience in valuing the type of property subject to the appraisal; and

v. Is not an individual who has been prohibited from practicing before the Internal Revenue Service during the previous three years.

F. Changes to Historic District and Structures Requirements

1. The Pension Act contains several changes to the Code's treatment of historic districts and historic structures to address Congress' concerns about questionable façade and other historic preservation easements. These changes do not have any expiration date. Below are brief descriptions of the key provisions:

a. The Pension Act changes the definition of "certified historic structure" to now exclude structures or land areas in certified historic districts, so that the definition of "certified historic structures" in a registered historic district includes only "buildings." This does not affect the IRC §170(h) reference to preservation of an "historically important land area."

b. A qualified conservation contribution deduction for a façade easement protecting the exterior of a building will only be allowed if the easement protects the entire exterior of the building, including the space above the building, and the building's front, rear and sides.

c. An easement protecting a building in a registered historic district must prohibit any changes to the building's exterior that are inconsistent with the building's historical character.

d. Donors of historical preservation easements must enter into written agreements certifying that the easement-holding organization is a "qualified organization" under the Internal Revenue Code, and they must submit a qualified appraisal, photographs of the protected building, and a list of the restrictions of the development of the building.

II. COLORADO HOUSE BILL 06-1354

Expansion of Colorado’s Conservation Easement Tax Credit

A. Colorado’s Conservation Tax Credit *Before* HB 06-1354

1. Colorado’s highly successful conservation easement tax credit program has been in place for more than six years. Under Colorado law (C.R.S. § 39-22-522), there is a Colorado income tax credit for a donated conservation easement of up to $260,000 in 2006 (see below for increased credit amount beginning 2007) with a 20 year carry forward.

2. For conservation easements donated after January 1, 2003 and through December 31, 2006, the income tax credit limit is $100,000 plus 40% of the amount over $100,000 not to exceed $260,000. The practical effect was to cap

the value of tax deductible conservation easement donations at $500,000 ($100,000 plus 40% of $400,000 = $260,000).

3. The Colorado income tax credit can be transferred by the donor of a conservation easement, a transferor, by gift or sale to a third party, a transferee, who can then claim the credit. There is no limit to the number of credits from multiple conservation easement transactions that a transferee can claim. However, the entire credit of a transferor must be claimed or refunded (in a surplus year) before the transferor may claim a new credit for an additional conservation easement donation. For example, assume a transferor donates a conservation easement in 2006, which is eligible for the entire $260,000 Colorado income tax credit. The transferor sells the credit to a transferee who claims $100,000 of the credit in 2006 and $160,000 of the credit in 2007. The transferor must wait until 2008 before donating any additional conservation easement or such a donation will not be eligible for a Colorado income tax credit.

4. Even though the conservation tax credit has incentivized the protection of significant land areas in Colorado, the limitations on the value of potential tax credits tended to encourage protection of parcels through multiple smaller "phased" transactions, which led to higher transaction costs and smaller land areas being protected.

B. HB 06-1354's Expansion of the Conservation Tax Credit

1. Replaces the old "two-tiered structure" for determining the amount of a donor's conservation easement tax credit. The new single-rate structure allows a conservation easement donor to claim up to 50% of the fair market value of the conservation easement as a tax credit. The bill increases the maximum amount of the donation to $750,000, which results in a maximum income tax credit of $375,000.

2. Applies to conservation easement donations made beginning January 1, 2007.

3. The credit allowed to donors who own property as joint tenants or tenants in common will be allocated to the donors in proportion to their ownership percentage, and the total aggregate amount of the credit claimed by all donors of one conservation easement may not exceed $375,000.

4. The increased amount of potential tax credits encourages the protection of larger, more valuable parcels of land than the former tax credit structure.

III. *GLASS v. COMMISSIONER OF INTERNAL REVENUE*

2006 Tax Opinion from the 6th Circuit – No. 06-1398 (December 21, 2006)

A. Background

1. Charles and Susan Glass owned ten acres on the shore of Lake Michigan in the northern part of the lower peninsula of Michigan. The property runs approximately 1055 feet back from the shore and is approximately 460 feet wide. The eastern 155 feet include a level beach and a steep bluff. The western 900 feet is a flat area above the bluff that contains a small house, guest cottage and garage. In 1990, the taxpayers contributed a conservation easement to the Little Traverse Conservancy ("LTC") over the western 250 feet of the property, reserving the right to construct a garage/work space/studio of up to 3200 square feet.

2. In 1992, the taxpayers contributed a conservation easement running 120 feet from the shoreline to the west on the northernmost 150 feet of the shoreline.

3. In 1993, the taxpayers contributed a conservation easement to LTC over the southern 260 feet of shoreline, 120 feet deep. The 1992 and 1993 easements permitted expansion or replacement of the house and guest house, to construct a second foot path to the beach, to construct minor structures, and to selectively cut trees and shrubs. The middle 50 feet of the beach was not included within any of

the easements, nor was the eastern 685 feet of the flat area above the beach. The taxpayers claimed values of $99,000 and $241,800 for the 1992 and 1993 easements, respectively.

4. The IRS issued taxpayers a notice of deficiency claiming that the taxpayers were not entitled to charitable deductions for the 1992 and 1993 easements (the statute of limitations expired for the 1990 easement). The taxpayers appealed, and a trial was held in the Untied States Tax Court in 2004. The Tax Court issued its decision in May 2005, (over 12 years after the 1992 easement). The Tax Court decided that the 1992 and 1993 easements were qualified conservation contributions, donated exclusively for the conservation purpose of protecting a relatively natural habitat of wildlife and plants. The Court took note that a threatened plant, Lake Huron Tansy, grew on the property. The Court also noted the presence of another threatened plant, Pitcher's Thistle, as well as piping plovers and bald eagles in the vicinity of the property. Because the Court held that the easements qualify as protecting relatively natural habitat, the Court did not consider the taxpayers' assertion that the easements also qualified for preserving open space. The IRS appealed.

B. IRS Argument on Appeal

1. On appeal to the Sixth Circuit Court of Appeals, the IRS argued four main points to support its contention that the Tax Court incorrectly ruled in favor of the taxpayers:

a. The Tax Court erred in concluding that preservation of *any* natural habitat is significant.

i. According to the IRS, the Tax Court misinterpreted the Treas. Reg. § 1.170A-14(d)(3)(i), which requires the easement protect a "significant" habitat. The IRS believed that the court incorrectly interpreted the regulation to mean that protection of *any* relatively natural habitat is itself a significant conservation purpose.

ii. The IRS believed that not every natural habitat is significant and that the court's interpretation disregards legislative history allowing deductions only for "the preservation of unique or otherwise significant land areas."

b. The Tax Court erred by focusing its attention on the endangered flora and fauna that exist in the *general area* of taxpayers' property instead of considering whether the flora and fauna can actually be found on the easement property and whether the property is a habitat where a threatened plant or animal "normally lives."

i. The IRS argued that Treasury Reg. §1.170A-14(d)(3)(i) requires that an easement must protect property that is actually home to endangered flora and fauna.

ii. The IRS argued that even if the threatened species did live within the easement areas, the Tax Court erred by finding that the easements could protect their habitat.

iii. The IRS argued that the easements are quite small and that the taxpayers retained development rights on their adjoining property outside the easement area. Also, within the easement area, the taxpayers retained the right to cut trees and move shrubs and other vegetation in order to provide views of the lake. Due to the development rights retained by the taxpayers, the flora and fauna within the easement area are not properly protected.

iv. The IRS asserted "the easement must protect property that actually is the home to endangered species of flora and fauna" and that the "taxpayers have not met their burden of showing that threatened species normally live in the encumbered areas."

c. The Tax Court erred in its interpretation of Internal Revenue Code §170(h) that requires easements be "exclusively for conservation purposes." According to the IRS, if the taxpayer retains the ability to develop the easement property the exclusivity requirement is not met.

i. The IRS argued that an easement cannot be exclusively for conservation purposes "unless it excludes inconsistent purposes." Here, the easements allowed the taxpayers to disturb the easement areas by constructing structures, cutting trees, and removing vegetation for safety and to view the lake. In addition, the IRS argued that the taxpayers retained unlimited development rights on taxpayers adjoining property outside of the easement areas. Due to the rights retained by the taxpayers both inside and outside of the easement areas, the IRS argued that the easements themselves were not exclusively for conservation purposes.

d. The court improperly applied the requirement that the conservation purpose be "protected in perpetuity." According to the IRS, the court focused on whether the Land Trust would hold the donation in perpetuity, not whether the easements themselves were protected in perpetuity.

i. The IRS argued that because of the development rights retained by the taxpayers outside of the easement areas and the increased traffic that would result from development, the easement holder does not have the power to prevent uses that are inconsistent with easement.

C. The Sixth Circuit Upholds Conservation Easement & Deduction

1. With regard to "significant relatively natural habitat," the Sixth Circuit affirmed the Tax Court's construction of Internal Revenue Code § 170(h)(4)(a)(ii) and Treasury Regulation §§ 1.170A-14(d)(3)(i) and (ii) as expressly recognizing that habitats for rare, endangered or threatened plant or animal species are "significant" relatively natural habitat.

2. The court further rejected the Commissioner's argument that the subject property must actually contain the rare, endangered or threatened species, rather than serve as habitat where such species normally live or may be found, in order for the conservation easement to satisfy the conservation purposes test.

3. The court also examined the conservation easement's terms on their face and determined that the conservation easement did in fact protect the conservation purposes.

    a. Because the conservation easement's terms prohibited the taxpayer from exercising development or any kind of reserved rights in a manner that would be inconsistent with protection of the stated conservation values, the court explicitly rejected the IRS's contention that the reservation of development or other rights violated the Revenue Code's requirement that the conservation easement be entered into "exclusively" for conservation purposes.

4. The Sixth Circuit also rejected the IRS's claim that the taxpayer's reservation of development rights precluded the conservation easement or the grantee from protection the property's conservation values "in perpetuity." The court recognized the conservation easement's permitted and prohibited use of the property as "carefully limited" and not impairing the significant conservation interests they were designed to protect.

5. The Sixth Circuit issued its decision in just four weeks.

IV. *TURNER v. COMMISSIONER OF INTERNAL REVENUE*

2006 U.S. Tax Court Opinion – 126 T.C. 16 (May 16, 2006)

A. The Tax Court affirmed the IRS's determination that Turner was not entitled to a charitable contribution deduction because the conservation easement did not satisfy the Revenue Code's conservation purposes test.

B. The property consisted of 29.3 acres, approximately 15 of which were located in a floodplain and therefore not available for development. The remaining 14.3 acres were zoned to allow residential development of 30 residences. The conservation easement over all 29.3 acres restricted residential development to 30 residences. The owner claimed a right to construct up to 62 residences, even though it had only obtained approval to construct 30 residences. Turner claimed that the conservation purposes protected by the conservation easement consisted of an open space component resulting from the reduced density of 30 units instead of 60 units, as well as historical significance, due to the property's proximity to Mount Vernon, home of President George Washington. The Court rejected this position and found that the conservation easement did not protect conservation values as required by the Internal Revenue Code.

C. The Court also upheld the IRS's imposition of 20% accuracy-related penalty. The Court found that the appraisal supporting the deduction was based on erroneous assumptions about the property's development potential, and that Turner was negligent in allowing the appraisal to stand as support for the valuation claimed for his deduction.

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