
CONSERVATION EASEMENTS IN THE WEST

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**Technical Service Report No. 15
The Rocky Mountain Land Use Institute**



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The Rocky Mountain Land Use Institute at the University of Denver College of Law engages in a variety of educational and research activities related to public interest aspects of land use and development. In addition to providing educational opportunities for students at the College of Law through internships and research projects, the Institute sponsors conferences, workshops and symposia for land use practitioners and citizen groups on specific land use topics. The Institute, working closely with both the public and private sectors, also undertakes and supports research and service projects on selected issues and topics related to land use and development in the Rocky Mountain region. The Institute operates in affiliation with both regional and national advisory boards, the members of which are among the leading practitioners and academics in the field. The Rocky Mountain Land Use Institute is supported by revenues generated by the Institute's own activities, sale of publications, grants and gifts.

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INTRODUCTION

Much of the West has seen an unprecedented economic boom. This economic boom has dramatically increased the value of many family farms and ranches. As the population of the West increases, many of these family farms and ranches, as well as other beautiful parts of the West, have fallen into the path of increasing development pressures. Those pressures include both the pressure of the growth of the urban areas of the West, as well as the growth in resort and recreation communities. In addition, places in the West like Aspen, Colorado, are a part of an international real estate market, compounding the national economic and development pressures on such places.

For landowners in the West, this is a particular problem for those who want to stay in business and preserve the agricultural land and open space on which their livelihood depends, and who want to hand down those properties to their children. The increasing value of these family farms and ranches has made this a very difficult proposition. Often farm and ranch land values have become so high that the children inheriting them have no way to pay the estate taxes due at the death of their parents, without selling all or a significant part of the family farm or ranch.

For other landowners in the West who do not make their livelihood from their properties, the preservation of those properties may still be an important legacy that they wish to pass down to future generations. These properties can vary from significant acreages to small tracts but often include the extraordinarily beautiful terrain of the West, with significant wildlife or open space values.

Local governmental officials are victims of these same development pressures. Those pressures affect the local quality of life in many areas of the West. The result of population increases and development pressures for the West's urban areas is that shrinking amounts of open space are available for their growing populations, many of whom have relocated to the West because of the quality of life. If farmers and ranchers have to sell their land for purposes of payment of estate taxes or if the owner of a pristine mountain parcel succumbs to the pressures of development, the open space which everybody desired, often including local and state governments, is lost forever.

Over the last decade, a more commonly used legal tool for dealing with the preservation of open space and the preservation of farms and ranches is the conservation easement. While it is not the only legal tool available for people who desire to protect their land, it is the most frequently used tool in conservation and land preservation transactions in the West. The purpose of this report is to provide a summary of the legal characteristics and uses of conservation easements and to describe the federal income and estate tax benefits that are available to landowners

who make a donation of a conservation easement.

I. WHAT IS A CONSERVATION EASEMENT?

A conservation easement is a legal document that contains permanent restrictions on the use or development of land and that is recorded in the real estate records. A conservation easement will typically limit further development of the property and bind future landowners. Because, as discussed below, a conservation easement is typically an "easement in gross", most states have statutory authorization that provides that the creation of a conservation easement is the creation of a real property interest.

An easement in gross is an easement that burdens a parcel of real property but where the benefits of the easement in gross do not run to the benefit of (are not "appurtenant" to) other real property. An example of an easement in gross that has received common law protection as an interest in real property is a utility easement. Such an easement burdens real property and runs to the benefit of the holder of the easement, typically a utility provider. Notwithstanding the status of utility easements, common law has generally frowned on easements in gross, and there are serious concerns about whether they are interests in real property and thus about their survivability and enforceability. Therefore, most states in the West have statutory authorization for the creation of a conservation easement to provide it with all the attributes and enforceability of any other real property interest.

II. STATE LAW AUTHORIZATION

Wyoming is the only state in the West which does not have a state law authorizing the creation of a real property interest by a conservation easement. As a result, the creation of a conservation easement in Wyoming also necessitates the conveyance of fee title to at least a small parcel of property, to which the benefits of the conservation easement must run. Therefore, when an organization in Wyoming acquires an easement on a parcel of land it also acquires fee title to the small parcel, usually one acre, adjacent to the land over which it holds the easement, resulting in the creation of an appurtenant easement.

A brief summary of the law of conservation easements in some of the other states in the West follows:

A. **Colorado.** Colorado enacted its Conservation Easement Act¹ in 1976

¹Colo. Rev. Stat. §38-30.5-101 (1997).

as a result of constituent and legislative pressure to preserve the State's agricultural heritage in the face of rapid growth within the state. Colorado's legislation contains the following requirements for creating, terminating, and enforcing conservation easements:

- Colorado requires that a conservation easement grantee be a government entity or a charitable organization exempt under §501(c)(3) of the Internal Revenue Code²;
- Colorado requires that before becoming eligible to accept conservation easements, any non-governmental entity be in existence for two years;
- Because the Colorado Statute does not articulate any third party enforcement rights, it is unknown whether a third party could enforce a conservation easement; however, when the holder of an easement is not capable of enforcing an easement, a co-holder may take on the enforcement responsibilities of the primary holder;
- A conservation easement in gross is perpetual unless provided to the contrary in the easement;
- Colorado property tax law protects agricultural land and open space by allowing agricultural land protected by a conservation easement to be taxed as agricultural even if after imposition of the easement, the land is no longer used for agricultural purposes. If a violation of the easement occurs, the Colorado Department of Revenue retroactively assesses the land at its fair market value and collects back-taxes from the landowner,³ and
- By voter initiative, the Colorado Constitution was amended to allow conservation and preservation to become a priority through Article 27⁴, which allows the dedication of state lottery funds to be dedicated to the Great Outdoors Colorado Trust Fund for the purpose of preserving and enhancing the wildlife, parks, rivers, trails, and open spaces of

²Id.

³Colo. Rev. Stat. §39-1-102(1.6) (a)(iii) and §39-1-103.

⁴Colo. Const. Of 1876, art. XXVII (1992).

Colorado.

- B. **New Mexico.** New Mexico adopted its Land Use Easement Act⁵ in 1991 as a response to increased development pressures and citizen support for open space. The State's general easement language establishes the following rules for creation, conveyance, and enforcement of conservation easements:
- In lieu of mirroring the criteria set forth by the federal income tax code for those entities that may hold conservation easements, the New Mexico Statute allows any non-profit corporation, association, or trust that has a purpose or authority allowing it to retain or to protect open space or natural resources to hold conservation easements; however, only easements donated to qualified organizations under the federal tax code⁶ yield federal tax benefits;
 - The New Mexico Statute does not expressly provide for the protection of air and water quality through its definition of a "land use easement";
 - New Mexico requires that a conservation easement document specifically identify a term for the duration of the easement;
 - Although silent on the issue in its statute, land trusts in New Mexico typically provide for assignment of a conservation easement should a land trust become unable to perform its obligations under that easement;
 - The State of New Mexico is not permitted to acquire or to terminate a conservation easement through eminent domain, although the statute is silent as to whether the State can condemn eased land;
 - In a feature that may prevent a landowner from deducting the donation of a conservation easement, the New Mexico Statute states that it shall not deny the right of a surface owner to consent to surface mining or interfere with extraction of minerals; and

⁵N.M. Stat. Ann. §47-12-1 to 6 (1991).

⁶I.R.C. §§170(h)(1)(3), 170 (b)(1)(A)(v)-(vi) (1997).

- New Mexico also has preferential property tax legislation allowing land that has been taxed at the lower agricultural or forest rate for at least one of the three last tax years to qualify for that assessment.⁷
- C. **Utah.** Utah's Land Conservation Easement Act⁸, adopted in 1985, lays out the requirements for acquiring, creating, and conveying conservation easements as follows:
- Like New Mexico, the Utah legislation expressly prohibits the government's ability to acquire a conservation easement or terminate its existence through the use of eminent domain;
 - The Utah Statute requires that a conservation easement recipient advise the easement grantor on the types of conservation easement available and their legal aspects, and recommend that the grantor seek advice of legal counsel prior to granting the easement;
 - Under the Utah Statute, the holder, or a third party assignee, of a conservation easement may enter the property at any time to enforce the easement through injunction or may obtain monetary compensation;
 - The Utah Statute clearly defines what must be included in the conservation easement document itself, as well as guidance for establishing easements;
 - Like New Mexico, Utah leaves open the duration of easements, instead of requiring them to be perpetual; and
 - Two laws relating to the preservation of undeveloped land also support conservation in Utah: the Agricultural Preservation Area law and the Farmland Assessment Act.⁹

⁷N.M. Stat. Ann. §7-36-20 (1978) (1995 rpl).

⁸Ut. Code Ann. §§57-18-6(1), (2).

⁹Ut. Code Ann. §17-41-101; §59-2-502 (1953) (1996 rpl).

- D. **Montana.** Montana's Conservation Easement Act,¹⁰ provides the requirements for its state's conservation easements much like a zoning ordinance, with much more specificity than the statutes of other states. Montana's legislation contains the following requirements for acquiring, conveying, and creating conservation easements:
- Montana permits conservation easements to be granted either in perpetuity or for a term of years, with no term less than fifteen years, and the opportunity to renew an easement with a fixed term for a term of fifteen years or more upon the expiration of the prior term;
 - No reassessment for property tax purposes of land subject to an easement granted for a term of years is made upon the expiration of the easement if it is renewed within fifteen days of its expiration;
 - Easements in Montana may prohibit or limit the following defined uses of or on the land: structures, landfill, vegetation, gravel, surface use, acts detrimental to conservation, subdivision of land, or other acts or uses detrimental to the retention of land or water;
 - Unlike most other states, Montana requires that all conservation easements be subject to review by local planning authorities in order to minimize conflict with local comprehensive planning. The local planning authority then has the power to comment in an advisory capacity on the relationship of the proposed conveyance to comprehensive planning for the area; and
 - In Montana, land subject to a conservation easement may not be assessed at a value of less than its actual assessed value in the calendar year of 1973.
- E. **Nevada.** Nevada's Easements for Conservation statute,¹¹ added to the Nevada Revised Statutes in 1983 tracks the federal law and provides for the following requirements for conveying, creating, and acquiring conservation easements:

¹⁰Mt. Code Ann. §76-6-201 *et seq.* (1969).

¹¹Nev. Rev. Stat. 111.390 (1983).

- Nevada's Statute provides for the right of enforcement by a third person who is not a holder of the easement but is qualified to be one;
- The legislation provides for conservation easements that are unlimited in duration, unless otherwise provided; and
- The general purpose behind Nevada's legislation was to make uniform the law of those states that enact the Uniform Conservation Act.

III. WHAT ARE THE REQUIREMENTS OF A CONSERVATION EASEMENT?

When the "requirements" of a conservation easement are discussed, it typically is shorthand for "what are the requirements of a conservation easement necessary to satisfy the Internal Revenue Code in order to qualify for the federal income and estate tax deductions", and it presumes that the conservation easement was created in compliance with state law. The first requirement of a conservation easement always must be that it is created in conformance with state law.

In the technical language of the Internal Revenue Code, a conservation easement satisfies the Internal Revenue Code requirements when it is a "qualified conservation contribution". A qualified conservation contribution is the donation of a "qualified real property interest" made to a "qualified conservation organization" for "conservation purposes".¹²

- A. **Qualified Real Property Interest**. A "qualified real property interest is an "easement or other interest in real property that under state law has attributes similar to an easement". This means that the easement must be created in compliance with state law.
- B. **"Qualified Conservation Organization"**. Under the Internal Revenue Code, a qualified conservation organization is either: (1) a 501(c)(3) charitable organization, which must be organized primarily for conservation purposes, with the commitment and resources necessary to protect the conservation purposes of the donation, typically a land trust, or (2) a governmental entity.

¹²I.R.C. §170(h)(1) (1997).

C. **"Conservation Purposes"**. The conservation easement must be granted exclusively for conservation purposes. Conservation purposes can include the following:

- (1) The preservation of land for outdoor recreation for substantial and regular use of the public. Outdoor recreation purposes could include a trail, a lake or reservoir, or property for winter sports activities.
- (2) The protection of the natural habitat of fish, wildlife, or plants. Examples of this could include the protection of a rare plant species, the protection of riparian area along a stream, the protection of a wildlife migration corridor, or the protection of a bird rookery.
- (3) The preservation of open space, including farm land and forest land, 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. To find a clearly delineated governmental policy to rely on, one can look to the provisions of state law and its policies for the protection of open space and agricultural lands, to the comprehensive plan for open space of a particular county, or to the county master plan policies that recite the benefits of the preservation of the agricultural economic base of the county. Such a policy need not be property specific.
- (4) The preservation of historically important land or a certified historic structure. A property can be preserved for both historical and open space purposes.

It is prudent to identify as many of a property's conservation values as possible. It is not uncommon to find that a property has numerous examples of the conservation values dealing with wildlife habitat, agricultural values, and open space values. Those represent combinations of the conservation purposes described in subparagraphs (2) and (3) above. More unusual are conservation easements which are for the purposes of public outdoor recreation or historic purposes. One of the benefits from identification of all of the

conservation purposes that can be identified is that the conservation easement is more likely to survive challenge. The Internal Revenue Service Treasury Regulations recognize that a change in conditions can make it impossible or impractical for the continued use of the property for conservation purposes, resulting in the possible extinguishment of the conservation easement by judicial proceeding.¹³ If a conservation easement is granted for the sole conservation purpose of protecting one small remaining stand of a rare plant species, and disease or other natural act eliminates the species, arguably the conservation easement can no longer satisfy its conservation purposes, and a court may extinguish such an easement. (Which is why the Treasury Regulations require all conservation easements to provide that the proceeds from a subsequent sale be used in accordance with the Treasury Regulations for conservation purposes.) Contrast that to a conservation easement that protects a property for its rare plant species but also has conservation values for its open space values and its wildlife habitat. In that instance, the untimely elimination of the plant species may not jeopardize the conservation easement because other conservation purposes hopefully would still exist.

IV. OTHER INTERNAL REVENUE CODE REQUIREMENTS

Several other requirements of the Internal Revenue Code must be met in addition to those discussed above in order to have a "qualified conservation contribution". Those are as follows:

- A. **Subordination of a mortgage or deed of trust.** If there is an existing mortgage or deed of trust on the property at the time of the donation of the conservation easement, that mortgage or deed of trust must be subordinated to the conservation easement.¹⁴ The effect of this subordination should be to prevent an act of foreclosure from terminating the conservation easement should the lender choose to foreclose on the real property.

¹³Treas.Reg. §1.170(A-14)(g)(6).

¹⁴Id. §1.170(A-14)(g)(2).

- B. **Surface mining is prohibited.** The general rule related to mining is that no charitable deduction is allowed if the landowner does not own the mineral rights underlying the property, and if there may be a removal of those minerals by any surface mining method. However, in recognition of the regularity with which mineral rights are severed from the surface interest in property, particularly in the West, a landowner may obtain a charitable deduction if the probability of extraction or the probability of the removal of the minerals by any surface mining method is so remote as to be negligible. This remoteness can be established by the preparation of a report by a qualified professional, typically a geologist, identifying which mineral interests have been severed, whether those minerals exist underlying the property, and the likelihood or probability of their removal or extraction. The prohibition against surface mining methods does not necessarily prohibit the removal of oil and gas from a property. If such oil and gas exploration is accomplished in a manner consistent with the conservation purposes identified for the property, the charitable deduction can still be allowed.¹⁵
- C. **The conservation easement must be perpetual.** This means that the conservation easement must be forever, and cannot be for a term of years.¹⁶ As noted in Section II, a conservation easement can be created for a term of years under most state authorizing legislation. However, the donation of such a conservation easement for a term of years would not generate a federal charitable income tax benefit.
- D. **Recording.** For a charitable deduction to be allowed, the conservation easement must be recorded so that any subsequent purchaser of the property is on notice of the restrictions contained in the conservation easement.¹⁷

V. WHAT ARE TYPICAL PROVISIONS OF A CONSERVATION EASEMENT?

¹⁵Id. §1.170(A-14)(g)(4).

¹⁶Id. §1.170(A-14)(b)(2)..

¹⁷Id. §1.170(A-14)(g)(1).

- A. **Access Issues.** A conservation easement typically does not require public access. The exception is if the conservation purpose for the conservation easement is for outdoor recreation for the substantial and regular use of the public, such as trail access granted by a landowner. A type of access to the property which will be required in any conservation easement is for the qualified conservation organization to have access to the property for the purpose of monitoring the conservation easement. A charitable organization or governmental entity performing the monitoring role will typically monitor a property for compliance with the restrictions of the conservation easement at least once or twice a year, and the conservation easement will have to allow for such access.
- B. **Commercial and Industrial Uses.** Commercial or industrial uses would be prohibited. This would not include the prohibition of agricultural uses or commercial recreation uses that are consistent with the conservation purposes of the property. Permissible commercial recreation would include uses such as hunting, fishing, and skiing. Other active commercial recreation uses such as amusement parks and ball fields, would not be permitted.
- C. **Additional Residential Dwellings.** A conservation easement will limit additional building on the property and typically prohibit all additional residential development with the exception of a small number of home sites for possible future use. The number of those home sites that could be reserved and their location would have to be determined on a case by case basis. Factors which would be considered are the total number of acres within the property being protected, the location of the reserved sites (whether they are clustered on one portion of the property or scattered over large parts of the property), the number of existing residences already on the property, and the proposed location of the reserved home sites. Unfortunately, no hard and fast rule exists, such as not more than one reserved home site per 160 acres. Several factors will typically limit the number of additional home sites reserved. Those are as follows:
- (1) Increasing the number of home sites reserved increases the value of the property as encumbered by the conservation easement and therefore reduces the amount of the charitable

deduction.

- (2) The negotiation of the conservation easement with the land trust or governmental entity is an arms length transaction, and they can, and will, refuse to accept donations of conservation easements if they believe the number of home sites reserved compromises the conservation values.
- (3) The donor of a conservation easement and his or her professional advisors will need to be sure that the donation complies with the requirement that the conservation easement must be primarily for conservation purposes or the federal estate and income tax benefits could be jeopardized.

- D. **Location of Reserved Home Sites.** For any additional home sites which are reserved, the easement should provide for a location for such additional buildings. The location should be fixed well enough to eliminate the possibility of dispute in future years as to its permitted location. This might mean the location of a specific building envelope of several acres, or it might mean the identification of a larger portion of the property within which a several-acre building envelope could later be precisely located.
- E. **Subdivision.** Most easements prohibit further subdivision of the property, or permit only limited subdivision to enable any permitted additional home sites to be separately sold. The division of a large parcel by subdivision, where that property has had development prohibited by a conservation easement, is an invitation to disaster. The result of such subdivision could be multiple owners of a property on which those owners could not put any improvements or structures, resulting in a constant headache for the land trust or any governmental entity charged with enforcing the conservation easement.
- F. **Timber and Minerals.** The conservation easement will prohibit surface mining and clear-cutting of timber. Some commercial cutting of timber is permitted if it is done in conjunction with a forest management plan, for watershed management purposes, or for non-commercial uses of the property, such as fencing and firewood.

VI. WATER RIGHTS

Whether contemplating conservation or development, water is a significant, but limited, resource in the West. Even then, not every situation that involves a conservation easement will concern itself with water rights. The conservation easement that protects a scenic ridgeline probably is not concerned with whether the water rights are encumbered by the conservation easement. But it is not hard to think of situations where water is a central issue to the conservation values:

- The conservation easement that is protecting prime, irrigated, agricultural lands.
- The conservation easement that is protecting a significant riparian area.
- The conservation easement that is protecting an endangered plant species that survives on spring-fed water.
- The conservation easement that limits surface development in order to protect significant ground water aquifers (as is used in Bexar County, Texas, for the San Antonio water system).

In all of these circumstances, identifying the water rights and restricting their separation from the property needs to be specifically addressed in the conservation easement. Hand-in-hand with that is the necessity of understanding the vagaries (which there are likely to be) of the water law of the state within which the property is located.

Just because water flows over or is stored on a piece of property does not necessarily mean that the property or conservation easement holder holds any rights in that water. Most of the eastern United States operates under the riparian system, under which a property owner has certain rights in the water which flows over or along the property. With the exception of coastal areas of California, Oregon and Washington, however, few riparian rights to water exist in the West. The states of the Rocky Mountain West operate primarily on variations of the prior appropriation system.

The basic tenet of prior appropriation is "first in time, first in right." This generally means that whoever first diverts water and puts it to a beneficial use has the right to use the water. These water rights are generally considered property rights that can be transferred independent of the property on which they are used.

As a result, part of the process for creating a conservation easement should include a consideration of use and ownership of any water resources on the property.

The discussion that follows identifies some of the water rights issues which could arise in the creation of a conservation easement. It is important to note that while there are some underlying principles common to water law in the Rocky Mountain states, each state has its own rules and procedures. A water attorney in the jurisdiction in question should be consulted prior to entering into a transaction involving water rights.

A. Beneficial Use.

Due to the relative scarcity of water in the West, the prior appropriation system places high emphasis on preventing the waste of water. Therefore, water must be put to a beneficial use. Historically, leaving water in its channel for environmental purposes was not considered a beneficial use of the water. While western states are giving more consideration to the idea of using water for the protection of conservation values such as wildlife habitat, such uses are often still given less emphasis than the traditional beneficial uses of water, such as agricultural or manufacturing. A common approach, which is used in Colorado, is to allow for the appropriation of instream flows for environmental protection, but to restrict the dedication of such flows to state agencies. In such jurisdictions, if an instream flow right cannot be obtained, it may be necessary to find a way to reconcile the continued use of water with the conservation objectives of an easement.

In contrast, Oregon law allows the owner of a water right to donate, sell, or lease water rights for instream use. These instream water rights retain their priority in the prior appropriation system over more recent water rights. Such laws have led to the creation of water trusts, which work to protect water resources in a manner similar to the land trust's protection of land.

B. Abandonment.

As part of the emphasis of putting water to beneficial use, water rights which are not used may be abandoned. In Colorado, for example, the intent to abandon must be found before a water right is abandoned; however, a ten year period of nonuse creates a legal presumption of such intent. As a result, if water rights historically have been put to a use which is prohibited by a conservation easement, those water rights could end up being abandoned if not put to an alternate use.

C. Encumbering Water Rights.

As property rights, water rights can sometimes be subject to encumbrances in the same manner as land. That being said, the authors are unaware of any attempts to place a conservation easement only on a water right itself. Land conservation professionals, as well as water lawyers, should be consulted before attempting to encumber solely a water right through a conservation easement. Even if such an easement is permissible, any attempts to place an easement on a water right must consider the beneficial use and abandonment provisions described above. For example, in Colorado, a conservation easement on a water right that prohibited the use of the water would probably lead to the abandonment of the water right.

D. Tax Implications of Encumbering Water Rights.

Water rights can often be very valuable assets in prior appropriation states and are assets that can be transferred in a manner similar to land. Therefore, if the use of water is restricted through a conservation easement, the owner should be entitled to a deduction for the diminution in value of the water right, provided that the requirements for a deductible easement are met. That being said, however, such a deduction may be more likely to be challenged if the Internal Revenue Service is unfamiliar with the intricacies of Western water law.

E. Transfer of Water Rights.

While water rights are separate from the underlying property, water rights may sometimes be transferred as an appurtenance to land. In Colorado, for example, if water rights have historically been used on a specific parcel that is transferred or encumbered and it appears that the intent of the grantor was to include the water in the transaction, the water can be transferred without specific mention in the transfer instrument. Ultimately, in any transaction, including conservation easements, involving property to which water rights may be appurtenant, any conveyance documents should *explicitly* state whether the water rights are intended to be included in the transaction.

F. Title to Water Rights.

Due to some of the above-listed issues, record title to water rights can sometimes be difficult to trace. As a result, many title insurance companies will not

insure title to water rights. If water rights are a significant aspect to a conservation easement transaction, it may be advisable to obtain a title opinion letter, wherein an attorney researches the title to the water and gives advice as to how safe and reliable the grantor's title is.

From a water law perspective, the first step in any conservation transaction is to determine whether there are water rights associated with the property, and whether those water rights are significant to the conservation values sought to be protected. Where water rights are an important consideration in a conservation transaction, land conservation professionals and water attorneys in the jurisdiction should be consulted prior to entering into the transaction.

VII. WHAT ARE THE TAX BENEFITS?

A. **Federal Tax Benefits.** If the donation of 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.

- (1) For income tax purposes, this difference in value is a charitable deduction that can be used in the year of donation and any unused portion for a period of up to five additional years for reducing the income tax of the grantor of the easement.
- (2) 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. It also may generate an additional exclusion from the valuation of an estate for property subject to a conservation easement.

B. **Federal Charitable Income Tax Deduction:**

- (1) The charitable deduction may be used against ordinary income as well as capital gains.
- (2) It is limited to an individual's basis until the property is owned for at least one year.

- (3) The charitable deduction is limited in any tax year to 30% of the adjusted gross income of the donor.
- (4) The deduction may be used in the year of the donation and in each of the following five years. Any charitable deduction not used at the end of those six years is lost.
- (5) If the donation is limited to the basis of the property, then the limit is raised to 50% of the taxpayer's adjusted gross income.

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. The Ranch's fair market value (FMV) before the easement is \$2,000,000 and the value of the property after the easement is \$1,200,000. June has reduced the value of the Ranch by 40% and made an \$800,000 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 [$\$60,000 \times 30\% = \$18,000$] in the year she makes the charitable contribution. She could carry forward the remaining \$782,000 of the 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.

C. Federal Estate Tax Benefits:

- (1) The grant of a conservation easement lowers the value of property to its value with the restrictions of the conservation easement (often referred to as its "after" value).
- (2) The result is that the value of the conservation easement is removed from the estate.
- (3) 1997 Taxpayer Relief Act. If the easement qualifies under certain provisions of the 1997 Taxpayers Act, then up to 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 \$300,000 in the year 2000 and increasing by \$100,000 each year until reaching a maximum

exclusion of \$500,000 in 2002.

Example: Same facts as above except June dies after placing the easement on the Ranch. The FMV of the Ranch before the conservation easement is \$2,000,000 and FMV after the easement is \$1,200,000. The estate tax due on the Ranch without the easement is approximately \$560,000. The estate tax due on the Ranch with the easement is approximately \$200,000. The conservation easement saves June's family over \$350,000 in estate taxes. If the easement qualifies under certain provisions of the 1997 Taxpayers Relief Act, then in 2000 an additional \$300,000 may be excluded from the value of the estate, saving additional estate taxes.

D. **1997 Taxpayer Relief Act.** In 1997, President Bill Clinton signed into law the Taxpayer Relief Act of 1997. The Act created additional estate tax incentives for the donation of conservation easements. A portion of the value of land subject to a "qualified conservation easement" is excluded from estate tax.

- (1) A "qualified conservation easement" is one that
 - a. is located within 25 miles of a metropolitan area (as defined by the U.S. Department of Commerce), national park or wilderness area, or within 10 miles of an urban national forest,
 - b. that includes a prohibition on more than a *de minimis* use for commercial recreation activity, and
 - c. must be on land owned by the decedent or a family member for the three years prior to the death of the decedent.
- (2) The amount of the exclusion is limited to the lesser of 40% of the value of the land subject to the qualified conservation easement or \$100,000 in 1998, increasing each year to a maximum of \$500,000 in the year 2002.
- (3) The exclusion does not apply to any retained development

rights.

- E. Tax Benefits for Partnerships and Limited Liability Companies.** For purposes of general partnerships, limited partnerships, and limited liability companies, these entities are what are characterized as "pass-through" entities under the Internal Revenue Code. This means that the entity itself does not pay any tax on its income or claim any charitable deductions. Instead, all income and charitable deductions flow through to the individual partners or members of the entity. Any charitable deduction for a conservation easement, therefore, is taken at the individual taxpayer level.
- F. Tax Benefits for Corporations.** A "C corporation" is limited in its charitable deductions to 10% of the corporation's taxable income. An "S corporation" passes the deduction through to its shareholders, but their deduction is limited to their basis in their stock. For estate tax purposes, the donation of a conservation easement by either an S corporation or a C corporation may have the effect of reducing the value of the assets of that corporation, which may have the effect of reducing the value of the stock owned by its shareholders. A reduction in stock value may then have an effect on the reduction of value of that individual's estate.
- G. State Income Tax Benefits.** Where a state levies an income tax, and that state income tax is calculated from an income level based on federal adjusted gross income, the effect on state income tax of the donation of a conservation easement will be to also reduce the income of the taxpayer at the state level, thus generating a lower income tax to be paid at the state level. Colorado is currently the only state in the West where an additional tax credit is provided at the state level for the donation of conservation easements. In 1999, the Colorado Legislature passed a bill that provides for a tax credit against Colorado income tax for the donation of a conservation easement.¹⁸ That tax credit is limited to the first \$100,000 of the donation, requires the filing of an appraisal with the tax return and provides the taxpayer with 20 years to use the tax credit. A taxpayer can claim a credit per income

¹⁸Colo. Rev. Stat. §39-22-522 (1999).

tax year for only one donation.

VIII. HOW IS A CONSERVATION EASEMENT VALUED?

- A. **Before and After Values.** The typical valuation procedure for a conservation easement is to do the "before and after" valuation. In this method, the property is valued at its market value before the conservation easement is placed on the property. A second valuation of the property will be done, which will be an appraisal of the value of the property after it is encumbered by the conservation easement. The difference between the "before" value and the "after" value is the value of the conservation easement, and the value of the charitable donation if the conservation easement is a donation.
- B. **Qualified Appraisal by a Qualified Appraiser.** This appraisal must be a "qualified appraisal" done by a "qualified appraiser". Under the Treasury Regulations,¹⁹ a "qualified appraisal" is one (i) done not earlier than 60 days prior to the date of donation of the easement, nor later than the date of the return on which deduction is first claimed, (ii) which is prepared by a qualified appraiser, and (iii) which includes the information required under the Treasury Regulations. A "qualified appraiser" is an uninterested party in the transaction who holds himself out to the public as an appraiser and who is qualified to make an appraisal as to the type of property interest being valued.
- C. **Qualities of an Appraiser.** Appraising the value of unencumbered property is not very difficult for most real property appraisers. However, the task of appraising the value of a property after it is encumbered by a conservation easement is a difficult task. A key element in the conservation easement transaction is finding an appraiser who has the skill and experience to be able to appraise the value of restricted properties.
- D. **Present Value Analysis.** It is also possible to do an appraisal based on a present value analysis of the development rights being restricted. Such a present value analysis would have to take into account the

¹⁹Treas.Reg. §1.170(A-13)(c).

value of the development rights being donated, the absorption rate before the development of those rights, and the cost of development for the same.

- E. **Enhancement Rule.** In those instances where the conservation easement does not cover all of the property owned by the donor of the conservation easement or related parties, the enhancement rule applies. This rule requires that the portion of the property not encumbered by the conservation easement be valued as of the date of the imposition of the conservation easement on the remainder of the property and be valued again after the conservation easement has been put in place. In theory, property that is contiguous to perpetually protected open space is likely to have a higher value than if it is contiguous to land that retains all of its development rights. This "enhancement" to the value of the unencumbered property has to be offset against the value of the donation of the conservation easement when determining the charitable deduction.²⁰

IX. OTHER FEDERAL TAX ISSUES

- A. **Baseline Inventory.** If any rights are reserved that could have a detrimental effect on the conservation values of the property, the Internal Revenue Code requires that "documentation sufficient to establish the condition of the property at the time of the gift" must be done.²¹ This is typically referred to as a baseline inventory. It typically will include photos of the property, a verbal description of the physical and ecological characteristics of the property, a description of any improvements, and an inventory of the plat and animal species.
- B. **Dealer Issues.** Different tax rules apply to the grantor of a conservation easement if he or she is a "dealer" under the Internal Revenue Code. A developer usually is a dealer. A dealer is limited to a charitable tax deduction equal to his or her "basis" (or cost) of the donated property. This is particularly a problem where the property is

²⁰Id. §1.170(A-14)(h)(3).

²¹Id. §1.170(A-14)(g)(5).

owned by a dealer and the land has appreciated substantially in value.

- C. **"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 another example.
- D. **Donation by Will**. 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. The 1997 Taxpayer Relief Act and the Internal Revenue Service Reform Act of 1998 (which made technical corrections to the 1997 Act) allow a post-mortem (after-death) election of a qualified conservation easement by an executor.
- E. **Like-Kind Exchanges**. Conservation easements are interests in real property that can be used in tax-free, like-kind exchanges under the Internal Revenue Code.

X. SITUATIONS THAT ARE LIKELY TO GENERATE CONSERVATION EASEMENTS

- A. A ranching family, whose primary asset is the land, desires to pass the land on to the next generation for ranching. A conservation easement, along with other estate planning techniques, can enable the passing of the land to the next generation. Without such planning, and with a 55% federal estate tax rate, it might otherwise be necessary to sell the land, in whole or in part, to pay the estate taxes for the estate.
- B. A landowner who owns a very scenic parcel of property and has resided on the property for a substantial period of time would like to be sure that the property does not end up in condominiums or five-acre ranchettes. The landowner places a conservation easement on the property to be sure that the property is retained for scenic open space purposes for future generations.

- C. A landowner desires to generate some income from his or her property but also desires to protect the property from full development. He or she may consider developing a small portion of the property, and putting the remainder under a conservation easement. (A caution: If the same or related parties own land adjacent to property on which a conservation easement was placed and the creation of the easement enhances the value of the adjacent property, that enhancement in value is used to reduce the amount of the charitable deduction generated by the grant of the easement).
- D. Not all owners may be interested in the donation of a conservation easement. Like any other real property interest, a conservation easement can be sold. A local government may desire to purchase a conservation easement from a landowner. It is also possible to purchase such a conservation easement in a bargain sale, where the landowner is paid only a portion of the value of the conservation easement. The difference between the actual value of the conservation easement and the amount received may generate a charitable deduction for income tax purposes. Such bargain sales are being used in the purchase of conservation easements in Colorado by the State Board of the Great Outdoors Colorado Trust Fund in its attempt to preserve ranch land in critical areas.
- E. A real estate developer may have occasion to consider the use of a conservation easement. State laws do not require that the conservation easement be capable of generating a charitable deduction under the Internal Revenue Code, so valid property interests can be created without the intent to generate a charitable deduction. A developer may have occasion to grant a conservation easement as a condition of development. This may occur under several circumstances:
- (1) Either a local governmental entity or concerned neighbors require that a promised open space within a development not be only designated as such on the land use approvals, but that the promised open space be protected by a conservation easement. A land use designation alone may not give much comfort to the concerned neighbors or the local government (never trust an unrestricted piece of property);

- (2) A grant of a conservation easement could be a required condition of support by neighbors for a land use proposal or a condition of approval of a rezoning request;
- (3) The developer may be willing to protect some portion of a property as open space but is resistant to the notion of dedicating the fee title to the property to the local government and is resistant to the notion of public access over the proposed open space.

In all of these circumstances, a required conservation easement may be a legitimate element of the land use approval process. Because the conservation easement is granted as consideration for approval of the development (the *quid pro quo*), there is no charitable deduction.

XI. RESOURCES

Because state laws authorizing the creation of conservation easements typically require that either a governmental entity or a 501(c)(3) charitable organization be the holder of the easement, land trusts have taken a prominent role in the field of conservation easements. If a landowner does not wish to deal with a governmental entity, which is not a surprising concept in the West, then that landowner will have to find a land trust with which to work. Some land trusts are national in scope, some exist on a statewide or regional basis, and others are local in nature.

Searching for the right land trust is an entirely appropriate exercise for a landowner to find a land trust with which it has a level of comfort. In theory, the relationship between the landowner and the land trust could last at least a lifetime, should the landowner never convey away title to the property. Not only are there decisions to make about whether a local, statewide or larger land trust is appropriate, but there are also considerations of land trusts' differing missions. Some land trusts will protect any kind of property in the sphere of territory within which it operates. Other land trusts have a mission for the protection of wildlife habitat for a particular species. Some, like the Colorado Cattlemen's Agricultural Land Trust, have a mission for the protection of agricultural lands. Finding a match with the mission and focus of a land trust is an important step for the landowner.

XII. CONCLUSION

Conservation easements are finding a unique role in the West as a voluntary action taken by a landowner to limit future development of their property. Because of their voluntary nature, conservation easements are being embraced as a landowner-friendly conservation tool. Because they often provide perpetual protection from development, they are being embraced by environmental groups as an important tool in the preservation of open space in the West. As a result, the conservation easement is also providing a common ground for discussion, in what is otherwise an often fractious debate, of the future of the West's vast open spaces.

