

Conservation Easements: Profitable for All Virginians



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Land conservation benefits landowners and everyone who enjoys Virginia's diverse landscape. Congress and the General Assembly have acted to preserve the commonwealth's natural beauty by creating incentives for land preservation. Landowners choosing conservation over development can substantially ease their income, estate, and property tax burdens and generate immediate cash for themselves through the sale of conservation tax credits.

Land Preservation Law

Virginia's land preservation law is rooted in the Open-Space Land Act,¹ the Virginia

Conservation Easement Act² and the Virginia Outdoors Foundation laws.³ The Open-Space Land Act grants public bodies the power to acquire an open-space easement—a nonpossessory interest in real property designated for the preservation of open-space land.⁴ The Virginia Conservation Easement Act grants certain private entities the power to acquire conservation easements. A conservation easement is an agreement between a landowner and the holder of the easement that places permanent limits on the future development of the property in order to protect and conserve the land. The key elements are a proper purpose and a permitted holder.

The Virginia Conservation Easement Act allows easements for any of the following purposes: “retaining or protecting natural or open-space values of real property, assuring its availability for agricultural, forestal, recreational, or open-space uses, protecting natural resources, maintaining or enhancing air or water quality, or preserving the historical, architectural or archaeological aspects of real property.”⁵ A landowner granting an easement gives up the right to use the land for certain purposes, such as residential development. The landowner retains the land's underlying fee simple title. The land can be used for any purpose that does not violate one of the prohibited uses. However,

it must also “conform to the comprehensive plan at the time the easement is granted for the area in which the real property is located” in order for the easement to be valid and enforceable.⁶

The easement’s holder must be a “charitable corporation, charitable association, or charitable trust that has been declared exempt from taxation pursuant to 26 U.S.C.A. § 501(c)(3).”⁷ In addition, the charitable entity must be organized for one of a few primary purposes that coincide with the conservation purposes behind the actual easement.⁸ A Public Recreational Facilities Authority that a locality creates under Va. Code Title 15.2, Chapter 56 may also hold conservation easements.

The Virginia Outdoors Foundation (VOF) is the recipient of most conservation easements. The VOF is a state agency established by the Virginia General Assembly in 1966 to hold easements in private trust.⁹ Its goal is to “promote the preservation of open-space lands and to encourage private gifts of money, securities, land or other property to preserve the natural, scenic, historic, scientific, open-space and recreational areas of the Commonwealth.”¹⁰ The VOF currently holds easements on more than 229,000 acres of land in seventy-seven local jurisdictions.¹¹ The VOF also administers the Open-Space Lands Preservation Trust Fund, which assists persons conveying conservation easements with the costs related to the conveyance, such as legal fees and appraisal costs.¹² Family farms with demonstrated financial need and cost-only reimbursement projects receive funding priority.¹³

An easement is perpetual unless otherwise specified land—it must be perpetual to achieve most tax benefits.¹⁴ The size of tracts subject to easements varies based on the holder’s willingness to accept the easement. The VOF typically accepts easements on tracts of fifty acres or more.

It sometimes accepts smaller tracts with special significance.

Requirements for Tax Benefits

To achieve the tax benefits that this article describes, a conservation easement must be a “qualified conservation contribution” under federal tax law.¹⁵ A qualified conservation contribution is a qualified conservation interest, given to a qualified organization and given exclusively for conservation purposes.¹⁶

Qualified conservation interests fall into three categories: fee simples—less certain mineral interests, remainders and perpetual easements.¹⁷ Most taxpayers use the perpetual easement category because that category allows them to retain and alienate the underlying fee interest, subject only to the easement.

Government entities and publicly supported charities are “qualified organizations.”¹⁸ The VOF and Local Public Recreational Facilities Authorities are examples of government entities.¹⁹ A private foundation is not a qualified organization unless a publicly supported charity controls it.²⁰

An easement’s purpose determines its required terms, especially whether the IRS will require public access to the land. The first recognized conservation purpose is “preservation of land areas for outdoor recreation by, or the education of, the general public.”²¹ This type of easement requires the land to be open for substantial and regular general public use.²² In contrast, no public access is required for “preservation of a significant relatively natural habitat in which a fish, wildlife, plant, or similar ecosystem normally lives.”²³

Open-space preservation is the most commonly used conservation purpose in rapidly developing areas. Farmland and

forested land qualify for open-space preservation.²⁴ The land must be marked for open space under a clearly defined government conservation policy or for the general public’s scenic enjoyment. Public access to the entire parcel is not required; the ability to view a significant portion of the parcel and appreciate its scenic beauty from a public thoroughfare is sufficient.²⁵

Historical preservation is a recognized conservation purpose. The land must have a certified historic structure or be located in a “historically important land area,” as determined using National Register of Historic Places criteria. Civil War battlefields often qualify under this conservation purpose. Visual public access (rather than physical) may be sufficient for historical preservation easements, but if the historic structure is hidden from view or cannot be appreciated from a distance, physical access may be required.²⁶

All four conservation purposes prohibit use that is inconsistent with the conservation purpose.²⁷ Although the tax-qualified easement need not restrict all activity on the land, it must be stringent enough to protect the conservation purpose for which the taxpayer created it. The exact scope of prohibited activity depends in each case on the terms and purpose of the easement and on the nature of the subject parcel.

Tax Benefits Planning

Conservation easements are one of the most underutilized tax benefits. They can reduce an individual’s income and estate taxes at the federal, state and local levels. One immediate tax benefit of a qualified conservation interest is an income tax deduction for the year in which it is created in the amount of the easement’s value. The deduction is generally limited to 30% of the taxpayer’s adjusted gross income in any one tax year.²⁸ Unused charitable deductions carry forward for up to five years.

Next, land subject to a qualified conservation easement is automatically entitled to special use valuation for local real property taxes.²⁹ Localities assess the property's fair market value at its conservation purpose use, not its normal fair market value. This approach reduces a property's assessed tax value and, thus, the real property taxes.

Conservation easements can also achieve valuable estate tax savings on a property that the taxpayer owned for three years prior to death.³⁰ Easements reduce the land's fair market value, thereby reducing the value of the landowner's gross estate. Moreover, executors or heirs can place the easement on the property after the owner's death, generating a charitable deduction for the estate in the amount of the easement's fair market value.³¹ Finally, regardless of when the decedent or her estate created the conservation easement, and in addition to the other estate tax benefits, the estate receives an additional exclusion from the gross estate in an amount up to 40 percent of the value of the underlying land interest that the taxpayer retained, not to exceed \$500,000.³² This exclusion has the same effect as an increase in the exemption equivalent, sheltering additional assets from estate taxation. If the property is debt-financed, the exclusion is only available to the extent there is equity in it.³³ The combined impact of the estate tax benefits can save substantial federal taxes. Because the Virginia estate tax is based on the value of the estate for federal estate tax purposes, these planning techniques result in reduced Virginia estate taxes as well.

State income tax benefits are also significant for federally qualified conservation easements. Virginia provides a tax credit (not a deduction) of 50 percent of the easement's fair market value. A taxpayer can claim no more than \$100,000 in credit in any one tax year, but can carry unused credit forward for up to five additional tax years, for a total "shelf life" of six years.³⁴

To claim the credit, the taxpayer must complete Virginia tax Form LPC at least thirty days before filing his annual return.

Taxpayers may also transfer their tax credits for hard cash. People creating conservation easements are often "land rich/cash poor"—much of their wealth is tied up in real estate holdings. With lower annual income and taxes, they typically have little use for large tax credits. These taxpayers can now sell their tax credit to a corporate or high-income taxpayer who has more tax liability to offset, frequently through a broker who matches buyers and sellers. In this way, creating a conservation easement generates immediate cash for landowners without giving up ownership of their land.

Tax credits can carry over to subsequent tax years, up to the fifth tax year after the credit was created, and can be transferred again.³⁵ However, taxpayers cannot carry back the credit to prior tax years.³⁶ Tax credit recipients must themselves be taxpayers: "Any taxpayer holding a credit may transfer unused but otherwise allowable credit for use by another taxpayer on Virginia income tax returns."³⁷ The attorney general has allowed income tax-free nonprofit corporations to hold and transfer tax credits as long as they pay some type of tax, such as sales tax.³⁸

A tax credit's transfer is not a taxable event in Virginia. The credit's seller realizes no Virginia income on the proceeds, and the buyer realizes neither ordinary income nor capital gain when using the credit to pay taxes in an amount greater than the cost of the credit.³⁹ Federal tax consequences exist, but their scope is unclear. Cash received by the tax credits' seller may be a capital gain on the easement's transfer, although the IRS has not yet taken a position on this issue.⁴⁰ The receipt of tax credits on an easement's creation may also affect the donor's ability to take a charitable deduction because getting a *quid pro quo* reduces or eliminates the deduction.⁴¹

Other questions concern the federal tax treatment of a tax credit transferee. The IRS has stated that transferees using tax credits may still deduct from federal adjusted gross income the full amount of state tax paid with the credits, not just the amount paid for the credit.⁴² A transferee should arguably recognize ten dollars in capital gains income when it uses a tax credit that costs ninety dollars to satisfy one hundred dollars in tax liability, and characterization of the gain as short- or long-term should depend on the length of time the transferee held the credit. The IRS has not taken a position on the treatment of gain from a tax credit's redemption, but it appears that the deduction already approved by the Service of the full amount of the state tax would offset any such gain.⁴³

Valuing Easements

Valuation lies at the heart of creating a viable conservation easement. Federal regulations suggest valuing an easement by looking at market sales of similar easements.⁴⁴ However, the limited market for conservation easements prevents taxpayers from readily ascertaining a proposed easement's value by comparing other sales. Accordingly, the second valuation method suggested by the regulations—the "before-and-after" approach—is more commonly used.

In a "before-and-after" valuation, the easement's value is the difference between the value of the property with and without the easement.⁴⁵ The appraiser must consider both the likelihood that the property would be developed absent the easement and any historic or zoning regulations already preventing the property from realizing its highest and best use.⁴⁶ For example, a parcel in Northern Virginia without a conservation easement might be worth ten thousand dollars but only one thousand dollars with the easement, yielding an easement value of nine thousand dollars. The same parcel in a rural county

might be worth one thousand dollars easement free and nine hundred dollars with an easement identical to the Northern Virginia one, yielding only a one hundred dollars value, because it is unlikely that someone would develop the rural property even without the easement.

Special rules apply when a conservation easement increases the value of the donor's contiguous property. The donor must subtract any increase in the value of contiguous property that he owns from the value of the granted easements.⁴⁷ If the benefit to the donor is greater than the value of the easement itself, no deduction is permitted. The easement's valuation may also affect the donor's basis in his retained property. A donor must reduce the basis in his property by the same ratio that the value of the easement bears to the value of the property without the easement.⁴⁸

Valuation is the most litigated issue in conservation easements. Familiarity with the area's commercial real estate market is essential to developing a realistic assessment of an easement's value. Cases are fact-intensive and often turn on the experts' credibility. To cite just one, in *Schwab v. Commissioner*,⁴⁹ the Tax Court rejected the opinion of the IRS's expert that an easement had no value and ruled for the taxpayers, commenting that the expert had never appraised a conservation easement before. The taxpayers' experts had experience appraising development rights and one had actually hunted on the property. A credible expert has experience in the field, preferably in the same geographic region, and makes a thorough analysis of the "before-and-after" market values of the property that is consistent from his initial report to his final trial testimony.⁵⁰

Valuation issues can return to haunt the easement donor, as well as those who purchase credits from the donor, years later. The value of state tax credits is directly proportional to the value of the conserva-



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tion easement allowed under I.R.C. § 170(h).⁵¹ The Virginia tax commissioner recently ruled, as expected, that the tax return of any taxpayer who used a credit based on a valuation found to be erroneous by the IRS may be reopened, subject to the statute of limitations, and a deficiency assessed for claiming an excessive credit.⁵²

Conclusion

One final word of advice: it is always possible that the IRS or the Virginia Department of Taxation will disallow easements or credits based on improperly drafted documents failing to satisfy federal tax rules. To avoid this outcome, taxpayers and practitioners should consult attorneys experienced with tax law, conservation easements, and the interplay between the two. However, the extra effort reaps win-win rewards. Donating a properly structured conservation easement not only produces economic and tax benefits for the

landowner but also broader benefits for all Virginians by preserving the farmlands, open spaces, and scenic beauty that make our commonwealth a natural wonder. ♪

Endnotes:

- ¹ *Va. Code Ann.* §§ 10.1-1700 to 10.1-1705 (Lexis 1998 & Supp. 2003).
- ² *Va. Code Ann.* §§ 10.1-1009 to 10.1-1026 (Lexis 1998 & Supp. 2003).
- ³ *Va. Code Ann.* §§ 10.1-1800 to 10.1-1803 (Lexis 1998 & Supp. 2003).
- ⁴ §§ 10.1-1700 to 10.1-1701. The Open-Space Land Act is not the subject of this article.
- ⁵ § 10.1-1009. The statute more specifically defines a conservation easement as "a nonpossessory interest of a holder in real property, whether easement appurtenant or in gross, acquired through gift, purchase, devise, or bequest imposing limitations or affirmative obligations," for a purpose including those set forth above.
- ⁶ § 10.1-1010(E).
- ⁷ *Id.* In addition, the holder must either have had a principal office in Virginia for five years or be a national organization for at least five years with an office in Virginia and be registered and in good standing in Virginia. *See* § 10.1-1010(C).
- ⁸ *See* § 10.1-1010(C).
- ⁹ *Va. Code Ann.* § 10.1-1800 (Lexis Supp. 2003).
- ¹⁰ *Id.*
- ¹¹ Virginia Outdoors Foundation, Overview, at www.virginiaoutdoorsfoundation.org/VOF/overview.htm (last updated Sept. 2003).

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- 12 § 10.1-1801.1.
- 13 *See Overview, supra note 11.*
- 14 § 10.1-1010(C).
- 15 I.R.C. § 170(h)(2)(C) (CCH 2003); *Va. Code Ann.* § 58.1-512(B) (Lexis 2000).
- 16 § 170(h)(1).
- 17 § 170(h)(2).
- 18 § 170(h)(3) (2000).
- 19 *Va. Code Ann.* §§ 10.1-1800 (Lexis Supp. 2003), 15.2-5604 (Lexis 2003).
- 20 § 170(h)(3).
- 21 I.R.C. § 170(h)(4)(A)(i) (CCH 2003).
- 22 Treas. Reg. § 1.170A-14(d)(2)(ii) (2003).
- 23 § 1.170A-14(d)(3).
- 24 § 1.170A-14(d)(4).
- 25 § 1.170A-14(d)(5).
- 26 § 1.170A-14(d)(5)(iv) (2003).
- 27 Treas. Reg. § 1.170A-14(e)(2) (2003).
- 28 I.R.C. § 170(b)(1)(C)(i) (CCH 2003). However, if the donor elects to limit his deduction to his basis in the property, the donor's deduction limit will be 50 percent of the donor's AGI. § 170(b)(1)(c)(iii).
- 29 *Va. Code Ann.* § 10.1-1011(C) (Lexis 1998).

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- 30 I.R.C. § 2031(c)(8)(A)(i)(CCH 2003).
- 31 § 2055(f).
- 32 § 2031(c). The 40 percent exclusion is reduced by 2 percent for each percentage point by which the easement's value is less than 30% of the property's total value without regard to development restrictions. *Id.*
- 33 § 2031(c)(4)(B) (2000).
- 34 *Va. Code Ann.* § § 58.1-512(B)(1) (Lexis 2000); 2002 Va. Op. Atty. Gen. 85 (No. 02-94).
- 35 Ruling of the Virginia Tax Commissioner 03-13 (Mar. 4, 2003).
- 36 2002 Va. Op. Atty. Gen. 85 (No. 02-94) (credits good for "five consecutive years following the taxable year in which the credit originated" (emphasis supplied)).
- 37 § 58.1-513(C) (emphasis supplied).
- 38 2002 Va. Op. Atty. Gen. 85 (No. 02-94) ("A nonprofit corporation subject to sales tax, but not income tax, may transfer its credit to a taxpayer subject to income tax."). Accordingly, entities paying no taxes appear to be prohibited from transferring tax credits.
- 39 § 58.1-513(E).
- 40 Gen. Couns. Mem. 200238041 (July 24, 2002).
- 41 I.R.C. § 170 (CCH 2003).
- 42 Priv. Ltr. Rul. 200348002 (Aug. 28, 2003); Gen. Couns. Mem. 20012600 (June 29, 2001).
- 43 Gen. Couns. Mem. 200238041 (July 24, 2002); Gen. Couns. Mem. 20012600 (June 29, 2001).
- 44 Treas. Reg. § 1.170A-14(b)(3)(i) (allowing valuations based on "substantial records of sales of easements similar to the donated easement").
- 45 *Id.*
- 46 § 1.170A-14(b)(3)(ii).
- 47 § 1.170A-14(h)(3)(i).
- 48 § 1.170A-14(h)(3)(iii). For example, a taxpayer with a basis of ten dollars in a property worth one hundred dollars and who grants a conservation easement worth sixty dollars must reduce her basis by sixty percent to four dollars.
- 49 67 T.C.M. (CCH) 3004 (1994).
- 50 *See also Johnston v. Commissioner*, 74 T.C.M. (CCH) 968 (1997) (Court accepts taxpayer expert's opinion when taxpayer expert has more experience in valuing conservation easements in same geographic region as subject property); *Schapiro v. Commissioner*, 61 T.C.M. (CCH) 2215 (1991) (Court rejects IRS expert's opinion, finding taxpayer expert's analysis more credible).
- 51 *Va. Code Ann.* § 58.1-512(A) (Lexis 2000). It appears, however, that the amount of the state credits is not limited by the 30 percent AGI limitation on itemized deductions contained in other federal tax law. Ruling of the Virginia Tax Commissioner 03-77 (Oct. 31, 2003).
- 52 Ruling of the Virginia Tax Commissioner 03-77 (Oct. 31, 2003). Transferees can avoid this problem by purchasing the credits through a broker that will stand behind its product by warranting the validity of the credits.