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Income Taxes

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Conservation Easements Revisited

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In the early 1990s, the political firestorm surrounding the Environmental Protection Agency's threatened listing of 33 central Texas counties as critical habitat for the endangered Golden-Cheeked Warbler caused landowners to view conservation easements with suspicion.

The easements were espoused by environmental advocates, but landowners saw them as an attempt to impose land-use controls that they had effectively opposed in that controversial confrontation.

Many Texas landowners investigated the benefits of conservation easements and saw little or no prospect of financial gain. Their income levels failed to generate the primary financial return for contributions, which was supposed to be a significant deduction in federal income taxes.

Those less-than-impressive tax "advantages" were revised and augmented in the farm bill passed last spring, however. Some landowners may now find it tempting to donate a conservation easement to dramatically reduce income taxes.

A conservation easement consists of a legal agreement between a landowner and a land trust or government agency. It limits land uses to protect the land's conservation values.

Originally, conservation easements protected productive agricultural land from spreading development near burgeoning

urban areas. Financial pressures on landowners near cities on the eastern seaboard made it difficult to maintain agricultural operations. Those owners saw property-related costs rising rapidly because of urbanization. With a conservation easement, however, farmers and ranchers could reap part of the financial benefit of development by donating an easement and receiving a charitable income tax deduction while continuing to use the land as farms or ranches.

The tax benefit amounts to a charitable deduction equal to the value of the rights transferred by the easement. For example, a rancher foregoing development could continue reasonable ranching activities but would be prohibited from building a subdivision. The value of the contribution would be the value of surrendered development rights, which would be determined by first conducting a property appraisal based on current market values before imposing the easement.

Presumably, those values reflect the contribution of potential developments. The appraiser would then estimate the land value without development rights. The difference between those amounts is the easement's value as a charitable deduction.

For example, suppose a ranch was valued at \$3 million before an easement was granted and only \$1 million after. A

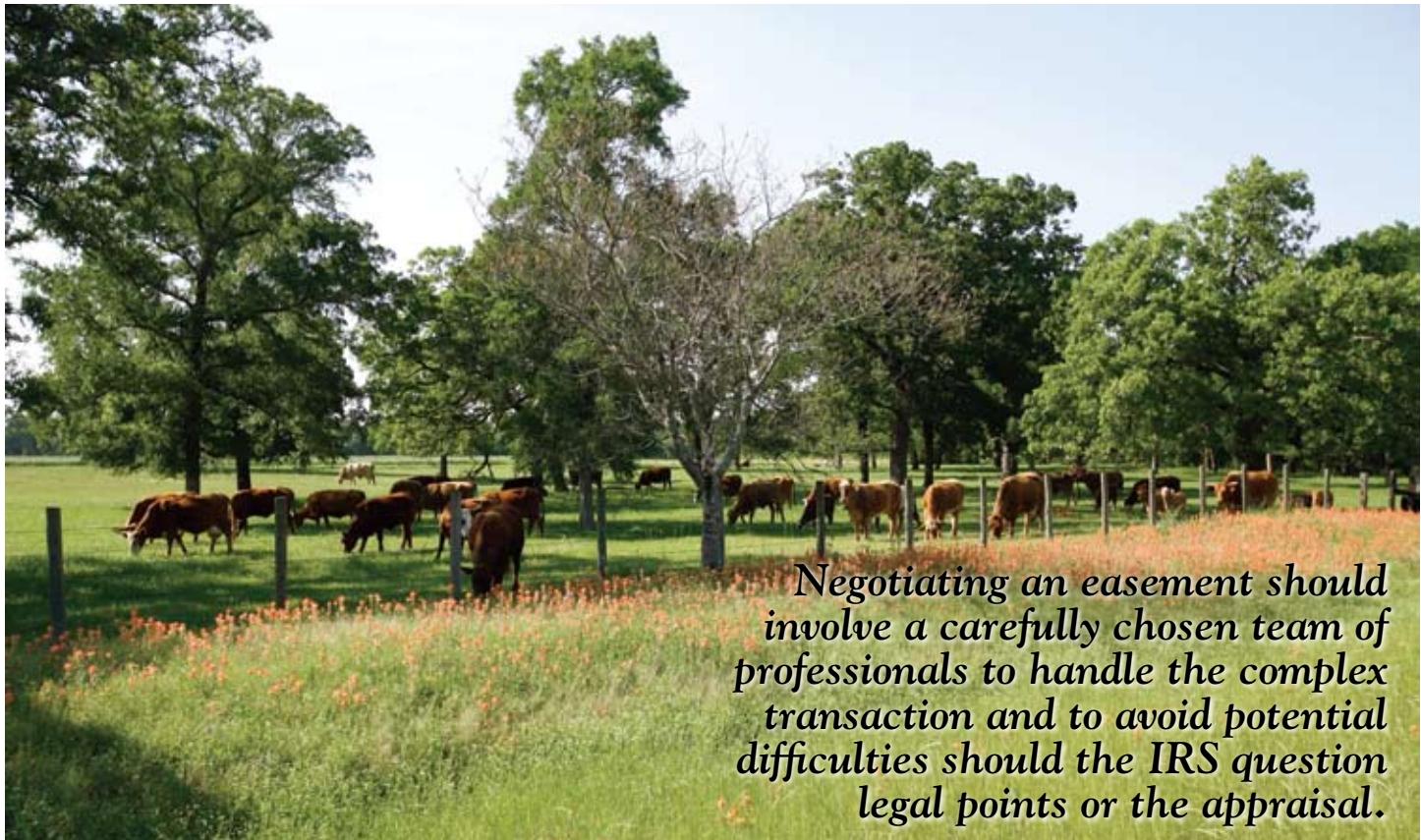


THROUGH CONSERVATION EASEMENTS, landowners may be able to reap tax benefits by continuing to farm or ranch their properties rather than developing them for other uses. Changes in the laws governing these tax benefits have loosened some of the restrictions that made the easements unprofitable when they first became available.

\$2 million charitable deduction would be available. Obviously, the owner would need a substantial taxable income to realize the value of that deduction. Previous IRS provisions limited annual deductions to 30 percent of adjusted gross income in any single year.

Followers of any remaining deduction had to be taken in the succeeding five years, creating a six-year window to capture the entire deduction. Any outstanding deduction remaining after the sixth year would be lost. As a result, farmers and ranchers with modest incomes would likely realize only a fraction of sizable deductions.

However, the Pension Protection Act of 2006 expanded the potential tax-saving benefits to landowners with modest incomes. Under its provisions, annually allowed deductions increased to 50 percent of adjusted gross income each year. Deductions of the balance of the contribution could be rolled



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over for 15 years, giving the landowner longer to recover the entire amount.

Qualifying farmers and ranchers fared even better. They could deduct up to 100 percent of their adjusted gross income in any single year, wiping out their entire federal income tax liability. Unfortunately, these benefits applied only to donations made from Jan. 1, 2006, through Dec. 31, 2007. Understandably, 2007 was an active year for donations of conservation easements.

As the expiration date approached, proponents of conservation easements lobbied to have them made permanent. Those efforts resulted in Section 170(b)(1)(a) of the five-year farm bill passed in May 2008, which reestablished these tax benefits for 2008 and 2009. The more liberal deduction rules now extend retroactively from Jan. 1, 2008, through Dec. 31, 2009.

Landowners should investigate the legal and financial implications of conservation easements thoroughly before proceeding. Negotiating an easement should involve a carefully chosen team of professionals to handle the complex transaction and to avoid potential difficulties should the IRS question legal points or the appraisal.

Lawyers can advise on negotiating the agreement and can draft the legal documents. Accountants can explain the tax implications of the charitable deduction. An appraiser can estimate the value of the easement to document the amount of the deduction.

The IRS has begun to question the accuracy of some appraisals used to justify sizable charitable deductions taken for donated conservation easements. To realize a large deduction, the conservation easement must restrict potentially valuable uses.

For example, a scenic ranch near a metropolitan area would have value enhancements because of its potential as a residential

subdivision. Foregoing that use represents a financial sacrifice for the owner. In this case, the charitable deduction would likely be substantial. A similar ranch several hundred miles distant from an urban area would not have the same development potential, however, and thus the resulting charitable deduction would be much less.

Owners should hire an appraiser who will carefully estimate before and after values should the IRS require justification of deductions. Some landowners in Colorado face potentially sizable liabilities from disallowed deductions. Some liabilities plus penalties may even exceed the value of these owners' lands. To protect themselves, owners should insist that appraisal work comply with the Uniform Standards of Professional Appraisal Practice to ensure a valid appraisal.

Finally, granting a conservation easement in perpetuity is an irreversible step. Owners should consider all of the implications for current and future generations before taking this step. For more information on conservation easements see "Land Locked: Controversial Conservation Easements Last Forever," <http://recenter.tamu.edu/pdf/1545.pdf>, and the presentation at <http://recenter.tamu.edu/speeches/CG022208LandInstitute.pdf>. ■

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THE TAKEAWAY

Texas landowners have historically been skeptical of conservation easement tax benefits, but the Pension Protection Act of 2006 and the farm bill passed in 2008 significantly improved those benefits. Landowners may want to take another look at the tax deductions offered by conservation easements.



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