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FAMILY TAX PLANNING USING CONSERVATION AND HISTORIC EASEMENTS

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INTRODUCTION

Both Congress and the Colorado legislature have recently enacted significant changes regarding the tax incentives for conservation easement donations. Some of these changes are effective immediately and are currently set to expire at the end of 2007, providing an important but potentially limited opportunity for landowners. We also summarize an important federal tax court decision regarding conservation easements.

FEDERAL LEGISLATIVE CHANGES

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 the income tax deductions from the donation of conservation easements that are considered qualified conservation contributions under the Internal Revenue Code (the "Code").

We believe that the Pension Act's tax changes offer a major opportunity for individual and corporate landowners to realize unprecedented tax benefits and protect the conservation values on their land in perpetuity. Below is a summary of the Pension Act's highlights, as well as brief summaries of related Pension Act provisions that address appraisals of qualified conservation contributions and the Code's treatment of historic districts and structures. Finally, we offer some practical advice on how to best take advantage of the Pension Act's increased tax incentives.

Charitable Deductions for Qualified Conservation Contributions

- **Income Tax Deductions for Individuals.**
  - 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"). 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.

- 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. 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.

- 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 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.

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

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

- **Income Tax Deductions for Farming and Ranching Corporations.** Prior to the Pension Act, corporations faced a limitation of up to 10% of their taxable income for qualified conservation contributions. The Pension Act allows corporations earning more than 50% of 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.

- **Effective Date.** The increased Pension Act tax incentives 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. The requirement that the conservation easement contain a restriction that the property will remain available for agricultural or livestock production only applies to conservation easement donations after the date of enactment of the Pension Act.

- **Appraisal Rules.** 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:

  - 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%.

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

- 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.

- 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."

- **Historic Districts and Structures.** The Pension Act contains several changes to the Internal Revenue 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:

  - 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."

  - 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.

  - 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.

  - 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.

Tips to Capitalize on Pension Act Tax Incentives

1. **Spouses Should Consider Donating Property and Filing Taxes Jointly.** With the Pension Act's expansion of the carryforward period from 5 to 15 years, jointly titling property and paying income taxes would ensure that the tax deduction survives the death of either spouse, and thus preserve the maximum tax benefit for the duration of the carryforward period.

2. **Window for Corporate Farmers and Ranchers.** Corporations have historically been constrained to claim a deduction equal to no more than 10% of their taxable incomes.

The Pension Act offers a window for farming and ranching corporations to reap the same benefits as individual farmers and ranchers. From now until the end of 2007, corporate farmers and ranchers should evaluate whether to take advantage of this opportunity to offset up to 100% of their taxable incomes for up to 16 years (year of donation plus 15 carryforward years).

3. **Land Trusts Should Consider Amending Forms.** To qualify for the 100% deduction and the 15 year carryforward period, an agricultural conservation easement <u>must</u> contain a restriction that the property *will remain available for agricultural production*. Land trusts should therefore revise their form conservation easements to include this restriction.

COLORADO LEGISLATIVE CHANGES

The Colorado legislature approved, and Governor Owens signed, a major change affecting the tax credit for conservation easements during the 2006 legislative session.

<u>HOUSE BILL 06-1354</u>

Colorado's highly successful conservation easement tax credit program has been in place for more than six years. Even though the tax credit program has helped conserve hundreds of thousands of acres in Colorado, the state's conservation community identified some areas where the tax credit could be improved. The existing tax credit tended to encourage protection of parcels through several smaller "phased" transactions so landowners could maximize their tax benefits. This system required more time, effort and transaction costs to complete conservation projects, and often resulted in smaller areas being protected. HB 06-1354 increased the maximum tax credit conservation easement donors could claim per transaction, and simplified the method used to calculate the value of the allowable tax credit. The bill also addressed Colorado Department of Revenue concerns that property owners holding title as joint tenants or tenants in common were claiming tax credits in excess of the statutory limit on the amount of allowable deductions. On behalf of Colorado's conservation community, members of the Isaacson Rosenbaum P.C. conservation practice group participated in the drafting of the bill and in the legislative hearings.

The key provisions of the bill are as follows:

- Replaces the old "two-tiered structure" for determining the amount of a donor's conservation easement tax credit. The old structure limited the tax credit to $100,000 plus 40% of the conservation easement's value in excess of $100,000, up to a maximum total tax credit of $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).

- 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.

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

TAX COURT RULING ON CHALLENGE OF CONSERVATION PURPOSES

James D. Turner et al. v. Commissioner of Internal Revenue, 126 T.C. 16 (2006):

The United States Tax Court held that taxpayer James Turner was not entitled to an income tax deduction for a qualified conservation easement under IRC §170(h) because the conservation easement for which he claimed a deduction did not satisfy the conservation purposes test. The Court also upheld a twenty percent accuracy-related penalty imposed by the IRS upon Turner for his negligence in relying upon an appraisal containing erroneous assumptions to substantiate his claimed deduction.

Turner was an owner of a development company that acquired 29.3 acres of land in Fairfax County, Virginia, near Mount Vernon, the home of President George Washington. About one-half of the property was located within a floodplain, and was therefore not available for development. The remaining one half of the property, consisting of approximately 14.26 acres, was zoned to allow development of a maximum of 30 residences. Turner's company sought and received local government approval to subdivide the property into 30 lots and construct 30 residences on the new lots. In applying for county approval for the project, the company claimed that it could legally construct up to 62 residences on the property.

In exchange for the support of local government and nonprofit organizations for its proposed development, Turner's company donated a purported conservation easement over the property to Fairfax County. The conservation easement stated that the company could develop 62 lots on the property, but that it would voluntarily agree to limit development to 30 lots to better serve the property's historic and scenic nature. As grantee of the conservation easement, the County never reviewed or acknowledged the receipt of the conservation easement. Turner claimed a $342,781 charitable contribution deduction for his share of the company's contribution of the conservation easement.

The IRS determined that Turner was not entitled to the charitable contribution deduction, Turner appealed, and the Tax Court upheld the IRS determination. The Court held that the easement donation was not "exclusively for conservation purposes," as required by IRC §170(h), and rejected Turner's claims that the easement protected both open space values and an historically important land area. The Court found that the easement did not protect open space values because it contained no limitations on open space within the buildable area, on the size of the buildable residences, or on the property's impact on views from local historic sites. Likewise, the Court found that the easement did not satisfy the historic preservation requirement in IRC §170(h) since the property did not contain any historic structures, and was merely adjacent to historic sites without demonstrating any independent historical significance.

Finally, the Court upheld the IRS' imposition of a twenty percent accuracy-related penalty under Section 6662(a) of the Internal Revenue Code. The Court found that a casual review of the appraisal would have revealed that the appraisal was based on erroneous assumptions, particularly as to the taxpayer's ability to actually construct 62 residences. The Court found that Turner was negligent in allowing the appraisal to stand as support for the valuation claimed for his deduction, and therefore sustained the penalty.